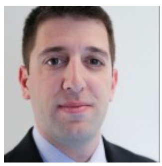

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Why Panic-Prone Emerging Markets Are Breaking Down In 2014

This is a guest post by Wolfgang Koester, chief executive and co-founder FiREapps, a provider of currency exposure management tools.

It wasn't too long ago that emerging markets were seen as the saviors of the global economy. In 2009, when advanced economies' gross domestic product (GDP) fell 3.43 percent, emerging market economies *grew* 3.1 percent. Capital poured in – from investors looking for the only place they could actually grow their money to multinational corporations investing directly in facilities and equipment.

But investors don't invest in emerging markets like they do in developed markets. Capital rushes in when the economy is hot; when the economy cools, investors dump their local currency holdings. That leaves piles of devalued local currency which the central bank is hard-pressed to prop up. (In developed markets like the U.S., United Kingdom, Japan, in contrast, investors are more willing to hold on to the currency.)

A cooling economy is exacerbated by the fact that worry breeds panic, and panic breeds crisis. In the midst of the Great Depression, President Franklin D. Roosevelt said, "We have nothing to fear but fear itself." Fear of weakening emerging market economies – and the panicked reactions that follow – is a bigger driver of currency depreciation than the weakness itself. It is irrational exuberance in reverse.

The single biggest selloff in emerging market currencies since '09

We've been seeing that phenomenon play out on the main stage for the past couple of weeks. The Argentine peso plummeted 15 percent in a single day (January 23rd); the "contagion" quickly spread to other emerging markets, including most prominently Turkey, South Africa, and Russia. It was what

Bloomberg has dubbed "the single biggest sell off in emerging market currencies since 2009."

- **Argentina** – In January, the Argentine peso fell 23percent. The most dramatic peso depreciation since the country's 2002 financial crisis was triggered by the central bank's decision to stop intervening in the markets to maintain the peso's value – intervention that was increasingly costly, draining the country's foreign currency reserves.
- **Turkey** – The Turkish lira fell 6 percent in January; at its low point, the lira was down 9 percent from January 1st. On January 28th, the Turkish central bank took action to brace the falling lira, raising its benchmark one-week lending rate for banks from 4.5 percent to 10 percent. The lira rallied, then gave up those gains, and then recovered slightly.
- **South Africa** – The South African rand fell 7.5 percent in January, its weakest level since 2008. The currency continued to fall even after the central bank raised its benchmark interest rate to 5.5 percent from 5.0 percent – the first rate increase in almost six years.
- **Russia** – In January, the Russian ruble fell 7 percent, hitting a five-year low. But unlike the central banks in Turkey and South Africa, which have raised interest rates in attempts to prop up their currencies, Russia's central bank has maintained a hands-off approach.

Even where central banks have taken action to stem the depreciation, “success is not guaranteed,” as The Economist put it. Theoretically, higher rates compensate investors for the additional risk they take on investing in weakening economies. The fact that these currencies continue to depreciate demonstrates that investors are unconvinced that the interest rate hikes are enough.

Furthermore, higher interest rates can be a double-edged sword, leading to further economic slow-down. The Wall Street Journal put it well: “Although higher rates are supposed to entice investors to continue investing in emerging-market currencies, analysts said the toll the higher interest rates may take on the economic growth of those nations may be too high.”

Benoit Anne, global head of emerging-market strategy at Société Générale, summed up the situation: “Global emerging markets are now trading in full-blown panic mode.”

What is causing the panic?

A confluence of factors is causing the emerging market panic. The first is the **pull-back of stimulus in the U.S.** Since September 2012, the Federal Reserve has pumped massive amounts of liquidity ($85 billion at its highest) every month into the global market in what has come to be known as “quantitative easing.” In December 2013, outgoing

Fed Chairman Ben Bernanke announced the beginning of tapering – a $10 billion reduction in monthly bond buying. On January 29th, the Fed announced that it would reduce its bond buying an additional $10 billion, to $65 billion a month.

Much of the capital that the Fed was infusing into the market through its bond buying flowed to emerging markets. With the Fed tapering off quantitative easing, that liquidity is drying up. In other words, no more easy money. And that means that growth in emerging markets will, in all likelihood, be both more expensive, and slower. Potentially, the slowdown could become a crisis. As Robert Kahn, a Senior Fellow at the Council on Foreign Relations (CFR) explains, "If you look at the long arc of past emerging market crises, a lot of them were triggered by a tightening of global monetary conditions."

CFR has a wonderfully illustrative graphic in their recent backgrounder, *Currency Crises in Emerging Markets*, which shows how the Fed's "taper talk" has affected emerging market currencies. In May 2013, when Bernanke, then Chairman of the Fed, told Congress that "[the Fed] could take a step down in the next two meetings," the currencies of Russia, Mexico, South Africa, Turkey, Brazil, India, and Indonesia fell between 3 and 15 percent against the U.S. dollar. When Bernanke announced on September 18th that the Fed would not be rolling back its bond buying, the currencies of those same countries rose between 1 and 3 percent.

The second factor causing emerging market panic is this: **at the same time that liquidity is drying up, the economies of many emerging markets are slowing.** Many analysts believe that the current sell-off was precipitated by a report showing a slowdown in China. Bloomberg explained in a recent article, "Developing-nation currencies sold off after a report from HSBC Holdings Plc and Markit Economics indicated yesterday that China's manufacturing may contract for the first time in six months, adding to concern that growth is losing momentum."

China is not only the world's largest emerging market economy, but it is also the chief buyer of exports from other emerging markets. A slowdown there spells bad economic news for many.

What it means for multinational companies

Both the tapering of stimulus in the U.S. and weakening of emerging market economies lead to currency volatility (clearly), which leads to panic, which leads to more volatility. What that means for U.S.-based multinationals is a stronger dollar, which means negative revenue impacts for the companies that don't manage currency exposure across all currency pairs. Just as yen devaluation did in 2013, emerging market currency volatility will generate ripple effects through 2014.

Wolfgang Koester is the CEO and co-founder of FiREapps (http://www.fireapps.com/)*, provider of foreign exchange exposure management solutions that aim to eliminate surprise currency impacts, reduce* *transaction costs and increase efficiency.*

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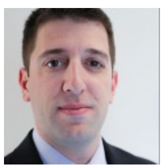

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Watch The Dollar In 2014, But Not Because Of Bitcoin

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This is a guest post by Wolfgang Koester, chief executive and co-founder FiREapps, a provider of currency exposure management tools.

Investors, boards, CFOs, and corporate treasurers take heed: in 2014, the U.S. dollar and its impacts will surprise those who are not prepared.

Not because 2014 will be the year a digital currency like Bitcoin kills the banknote (it won't be). And not because the Chinese yuan is taking over the world (it isn't).

The dollar is the currency to watch next year for a less exciting – though no less impactful – reason: the likelihood of it strengthening is much higher than weakening, and that appreciation will hurt multinationals that are not prepared. What makes the challenge greater is that the dollar won't strengthen equally across the board, but will against some currencies that mean quite a bit to corporations.

To understand why, let us take a lesson from recent history.

Lessons learned from impact of yen devaluation

Before he was elected prime minister in 2012, Shinzo Abe (http://www.forbes.com/profile/shinzo-abe/) promised to revitalize the long-stagnant Japanese economy, in part by "forcing" the Bank of Japan to weaken the value of the yen. Abe was election by a large margin and in December 2012 led the central bank to begin the competitive devaluation that is now regarded as the centerpiece of "Abenomics." By some measures, the policies are working: since Abe's election, the yen has fallen some 25% against the dollar and focused in around the 100 mark.

The yen's fall hit many U.S.-based multinationals hard; among currencies that companies cited as impactful, the yen was the most cited in the first and second quarters of 2013 and the second-most cited in the third quarter. The reason why is twofold:

1. A weaker yen makes the dollar relatively stronger, which makes U.S. exports less competitive than Japanese exports in global markets. Consider, for example, a car manufactured in Japan and a hypothetically identical car manufactured in the U.S. The Japanese car at the end of 2012 cost 1.75 million yen, or $22,000. The American car cost $22,000. At the end of 2013, the same 1.75 million yen Japanese car cost $17,500. In addition to making Japan's exports relatively less expensive, devaluation has been a boon to Japanese companies: for example, in the six months to September 2013, 96% of Toyota's operating profit increase was attributable to the yen's fall

(http://online.wsj.com/news/articles/SB10001424052702304448204579181413280473156?cb=logged0.7978499793487227).

2. A weak yen can also significantly impact multinational companies that do business in yen. Multinationals with revenue in Japan – companies like Varian Medical Systems (/companies/varian-medical-systems/) **VAR** +0.49% (/companies/varian-medical-systems/), NIKE (/companies/nike/) **NKE** -0.62% (/companies/nike/), Procter & Gamble (/companies/procter-gamble/) **PG** -0.07% (/companies/procter-gamble/) – get relatively fewer dollars for their yen as the currency depreciates. Indeed, U.S. companies in a range of industries have blamed the yen for eroding revenue. (Those with expenses in Japan, on the other hand, benefit, paying relatively fewer dollars for their yen as the currency depreciates.)

It took three quarters, but bottom line impact from the yen has been so significant, and so sustained, that it has forced companies to finally rethink their currency risk management programs. Investors have told CFOs – and CFOs their Treasurers — "We don't want to go through these kinds of losses again."

The U.S. dollar's impending rise

Not "going through these kinds of losses again" will require a change in the way multinationals approach currency risk management. If those companies that have realized nearly $12 billion in losses in 2013 keep doing what they have done, they will continue to see those kinds of impacts. Where will it come from in 2014? We will see currency volatility from a range of countries – some surprising, some not. But companies will also have to deal with currency movement right here at home: the appreciation of the U.S. dollar.

Why is the dollar likely to rise? Because:

1. With the appointment of Janet Yellen (http://www.forbes.com/profile/janet-yellen/) as the new head of the Federal Reserve, there are expectations of a bit more inflationary environment – the kind of environment that would result in rising interest rates and increased attractiveness of the dollar. Furthermore, the Fed is poised to roll back its bond buying as soon as the economy appears healthy enough to grow on its own. While the Fed kicked that can down the road this year, it can't do so forever, and most signs point to the economy being healthy enough sometime in 2014 (http://www.forbes.com/sites/afontevecchia/2013/12/02/the-fed-in-2014-janet-yellen-and-the-challenge-of-tapering-and-a-3-6b-balance-sheet/).

2. We are not likely to see a stronger euro. While it appears that Europe is emerging from its deep and long recession, the EU is not out of the woods yet; if the euro strengthens significantly, that could stymie the little momentum the economy has. So the European Central Bank will likely do everything it can to keep the euro down.

3. Weakness in the yen will continue. Prime Minister Shinzo Abe's depreciation of the yen to drive Japanese export competitiveness, in an attempt to kickstart the economy, has worked well in the year since it began. The Bank of Japan has articulated a goal of 2% inflation (http://www.bloomberg.com/news/2013-11-04/boj-struggles-to-convince-on-2-as-abenomics-shine-fades.html), well above the current levels below 1%.

Fundamentally, the factors behind a more expensive dollar are less critical to corporations than the impact of the move. Anything that results in dollar appreciation will impact U.S. multinationals, decreasing American export competitiveness and eroding U.S. dollar revenues.

So what is a corporate to do?

A few months ago I shared the screen on a news program with a financial markets commentator who said that companies simply cannot move very quickly or frequently to adjust to underlying exposures and mitigate risk. That was true at one time, but not anymore. Today, many corporations are able to achieve increasingly common benchmarks like limiting the balance sheet impact of currency fluctuations to less than 1 cent of earnings per share.

In 2014, management teams that do not take a more proactive approach to managing the risk of a rising dollar may find themselves explaining to shareholders why currency impacts landed on their bottom line.

Savvy investors and boards take heed: those kinds of impacts are less acceptable than they have ever been and – more importantly – are avoidable.

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