Sunday, 5 May 2019

The FX Question: Reading the Tarot Cards

Late January, the Central Bank of Egypt's (CBE) Governor said that the FX market is expected to witness more volatility compared to the relatively stagnant rates that prevailed since mid-2017. This raises the ever-burning question: Where is the Egyptian pound (EGP) heading?

Answering this question has never been an easy task. We believe the EGP/USD rate is one of the most uncertain variables to forecast currently, especially that the purchasing power parity (PPP) hypothesis —we find—cannot solely lead the FX pattern. Rather, FX rates respond to interrelated factors, including fundamental long-term elements, market psychology, and even tactical measures. Besides, the EGP flotation does not have a long history that could provide a sufficient historical evidence or make the currency's pattern predictable. That is, trying to predict the behavior of the EGP could be as uncertain as playing or reading Tarot cards to foresee the future. Yet, we try to read different cards; to wit, we use different tools to assess what the currency will most probably look like in the short and medium terms.

Based on our analysis, we believe the EGP is slightly undervalued as we speak, but not very far from its so-called "fair value". We also believe there is no fundamental pressure that should cause sharp EGP depreciation in the near future, suggesting a favorable short-term outlook for the EGP.

In the longer term, we believe economic fundamentals, including a persistent trade deficit, overall current account dynamics, gradual monetary easing on the domestic front, and potentially less favorable global conditions in the future should all have a downward pressure on the EGP. Yet, we do not rule out any CBE intervention in case of sharp EGP depreciation at any point of time.

Below, we try to read some cards to puzzle out the EGP's future.

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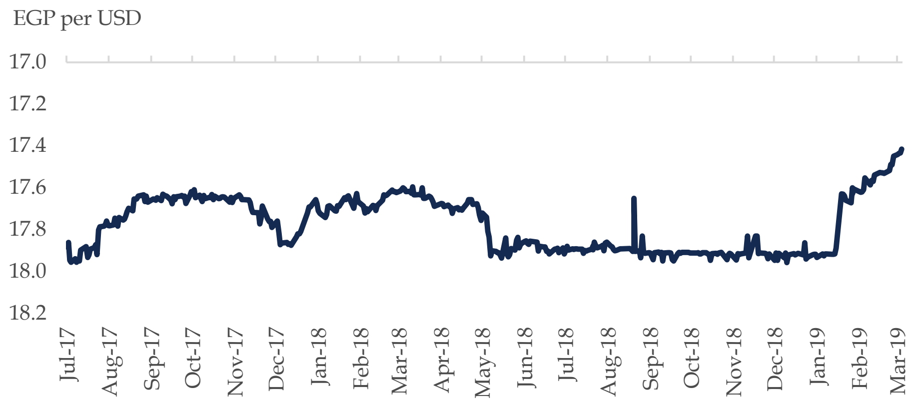
No intervention anymore?

After its flotation on 3 November 2016, the Egyptian pound saw some significant volatility in the couple of months right after the decision, approaching EGP20 per USD in December 2016 then falling rapidly to lower than EGP16 per USD in February 2017 before depreciating again to EGP18's in a fortnight. Ever since, the EGP stabilized at the high EGP17's per USD. Even during the hard times of the Emerging Markets' (EM) currencies in 2018, the EGP remained largely stable, depreciating only by around 1% throughout the year. This stability caused a perception in the market that the CBE may be propping up the EGP one way or another. Early 2019, the CBE's Governor announced there is more volatility on the way for the FX market. What is going on then?

- **Central banks' intervention is not necessarily a violation:** It is not a secret, nor is it taking place under the table, there is a room for the CBE to intervene given certain conditions. According to the IMF's exchange rate arrangements classification, foreign exchange market "*intervention may be either direct or indirect, and such intervention serves to moderate the rate of change and prevent undue fluctuations in the exchange rate, but policies targeting a specific level of the exchange rate are incompatible with floating.*" Monetary authorities of some countries classified by the IMF as having floating and—even—free-floating exchange regimes make some interventions to enhance stability and avoid volatility. For instance, Russia purchases foreign currency to eliminate volatility associated with energy prices. That is, even if the EGP stability were to be attributed to CBE interventions, it is not necessarily inconsistent with the IMF's Articles of Agreement VIII, General Obligations of Members.
- **Intervention may not necessarily be in the direction you think:** CBE intervention, if at all, does not necessarily have to support the EGP. Indeed, we believe the CBE has been intervening since mid-2017 to mid-2018, not to defend the EGP but to defend the EGP's competitiveness. This competitiveness is derived from being cheap enough and stable enough to spur foreign inflows. Besides, the aim of the intervention has been offsetting the hot money's unfavorable effect on the FX market. That is, we think foreign inflows to T-bills could have made the EGP stronger than the EGP17-18/USD range prevailing since Q2 2017, but this effect wore off through the accumulation of deposits that are not included in official reserve assets. This explains a great deal of the EGP stability throughout the EM turmoil. This was highly needed as the market was not developed enough to accommodate high volatility accompanied with hot inflows/outflows.
- **Less intervention going forward, more volatility on the way:** The CBE had announced back in December 2018 eliminating the repatriation mechanism – an intervention tool – to let all inflows/outflows take place solely through the interbank. Phasing out the repatriation mechanism was highly recommended by IMF staff to deepen the interbank market and enhance exchange rate flexibility.

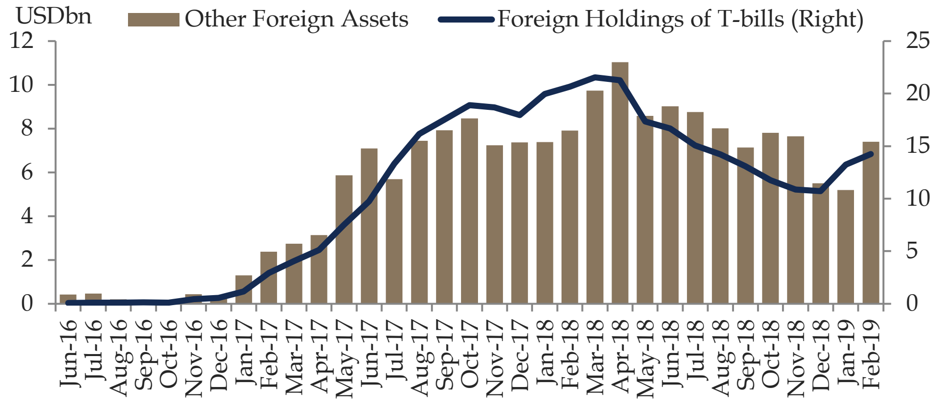
Therefore, in this report we try to analyze some forces that could affect the EGP profile, and different upward and downward pressures. Our main analysis includes: (1) REER, (2) interest rate parity, (3) external financing requirements, (4) global pressures, and (5) recalling the EGP flotation back in 2003.

EGP has gained 3.4% against the USD ytd



Source: Bloomberg.

CBE's off-balance foreign assets accumulated with increasing inflows to T-bills

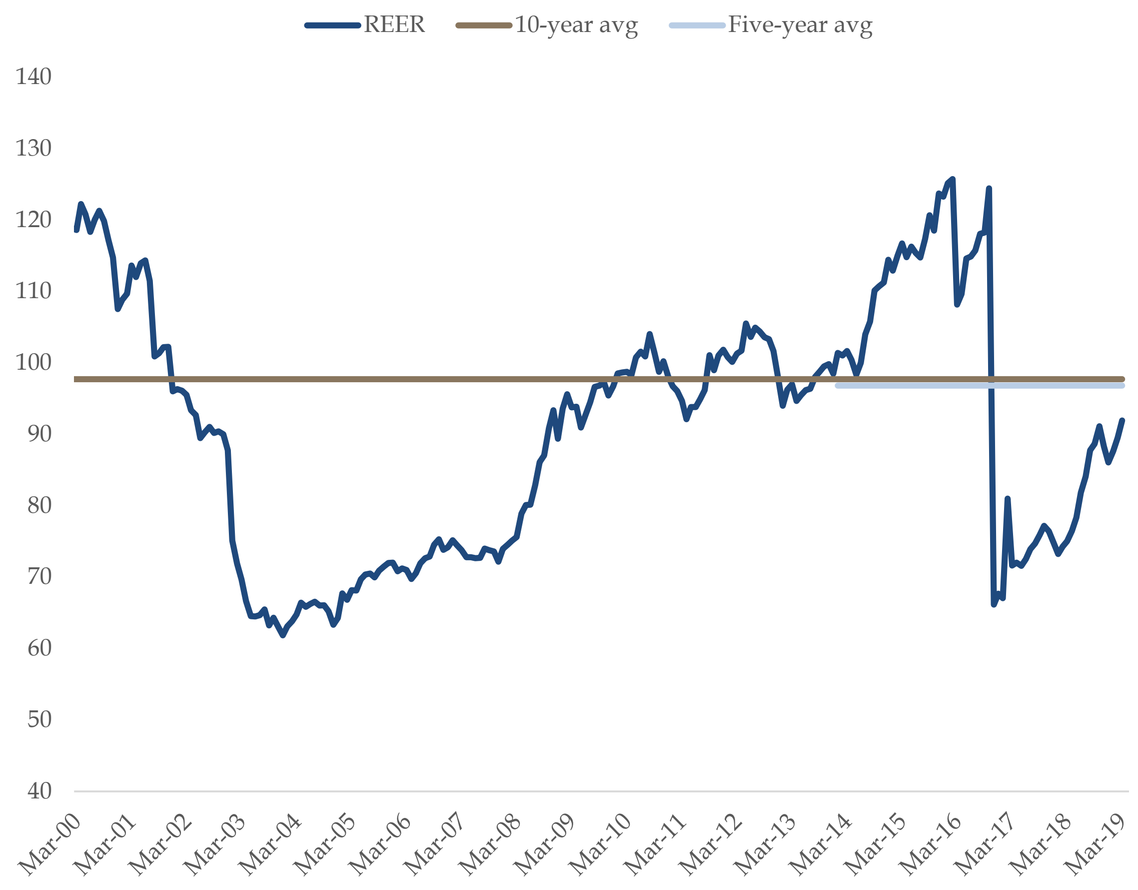


Source: CBE.

Card No. 1: Real Effective Exchange Rate (REER)

- **To begin with, REER is not a tool to precisely set a fair value for a currency:** Real effective exchange rate (REER) simply reflects long-term dynamics that impact the competitiveness of a currency, and to what extent the nominal FX rate responds to changes in a national currency's relative purchasing power – expressed in inflation differentials – compared to trading partners. When a currency's nominal FX rate does not adjust to inflation differentials between the nation and its trading partners, cumulative pressures on the currency start to evolve, pushing its currency to eventually appreciate/depreciate according to the situation. REER value tends to oscillate around long-term average which is affected by economic fundamentals, including inflation, nominal exchange rate, changes in trade pattern, and allocation of resources between tradable sectors and non-tradable sectors.
- **The EGP18 level recorded right after flotation was obviously an overshooting:** REER analysis suggests that the level the EGP/USD exchange rate reached right after the flotation was an overshooting beyond the EGP's fair value according to trade competitiveness (which factors in inflation differentials), as per the purchasing power of the EGP at that time (i.e. before the high inflation rates which escalated after November 2016).
- **EGP is still competitive, but not as strongly as it was before:** The EGP's REER is still below its 10-year average, suggesting that the EGP is still undervalued. However, the REER value is increasing – especially after the recent sudden EGP appreciation, and REER is approaching its long-term average. This indicates that the EGP's competitiveness is gradually weakening relative to trade partners.
- **So what does REER suggest?** Comparing the EGP's REER value by end of April 2019 with its 10-year average, we think – based on a REER analysis – that the EGP/USD rate stands at around EGP16.54.

JPMorgan's CPI-based REER suggests that the EGP is still cheap, posing no depreciation pressures in the short run, given trade and inflation dynamics. However, its competitiveness has been eroding due to cumulative high inflation rates.



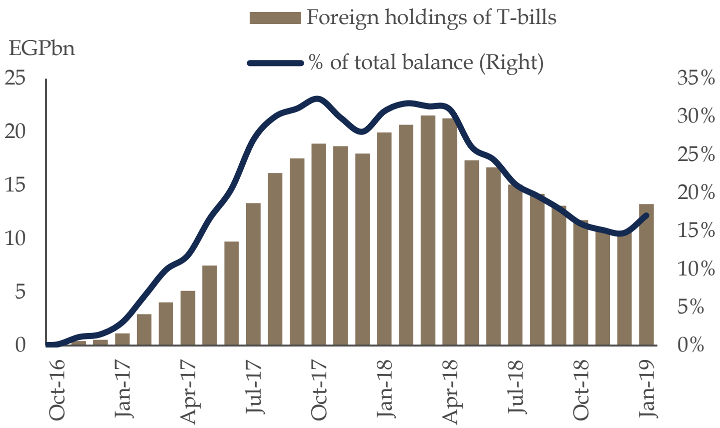
Source: Bloomberg.

Card No. 2: Interest Rate Parity Hypothesis

- **High foreign investors' appetite for domestic debt instruments …:** One of the biggest winners of the EGP flotation was the local debt market. Foreign inflows to Egyptian Treasuries skyrocketed from about USD0.4bn in November 2016 to a record USD21.5bn in March 2018 before a gradual outflow kicked off in the famous EMs apocalypse which caused an average of USD1.4bn of monthly outflows from T-bills. This tremendous inflow/outflow activity by foreign investors affected the banks' net foreign position. It reversed from a net liability position of USD6bn pre-flotation to a net asset position of USD4.6bn, before decreasing again to a net liability position of USD6bn in December 2018, followed by an uptick in January to a net liability position of only USD134mn.
- **… gives a hint about their perception of the EGP:** In our attempt to capture how foreign investors see the EGP through the interest rate parity hypothesis, we conducted an analysis comparing yields on US five-year Treasury note with those on Egypt's five-year bonds which were 100% covered by foreigners, as per the Minister of Finance's announcements. We calculate that investors have bet the EGP/USD rate will not go above EGP20 in a year's time (i.e. a foreign investor in Egypt's five-year T-bonds will be a net loser only if the local currency depreciates above EGP20 per USD in a year's time).
- **NDFs give another hint:** Non-deliverable forwards (NDFs), though not a very liquid market, reflects a highly similar pattern. They convey that investors see the EGP depreciating to as low as EGP18 per USD in a three-months' time and to approach EGP20 in a year.

We do not presume EGP18-20/USD is the fair value, and it does not have to materialize. However, it gives an indication of the maximum depreciation expected by investors and carry-traders.

Foreign holdings of T-bills picking up again

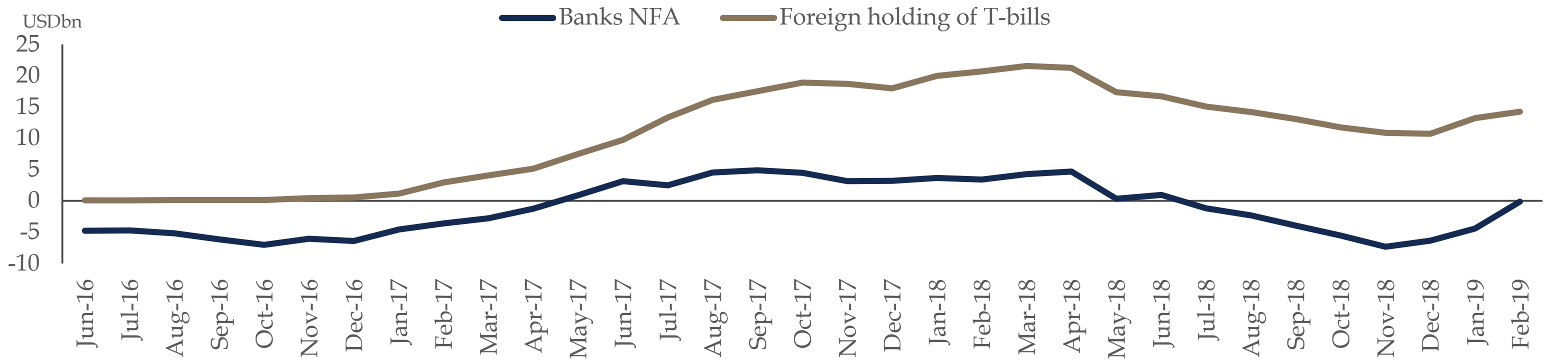


Source: CBE.

Three-month and 12-month Non-Deliverable Forward rates (EGP per USD)

Source: Bloomberg.

Net foreign assets of banks were impacted by the outflow from Egyptian T-bills



Source: CBE.

Card No. 3: External Financing Requirements

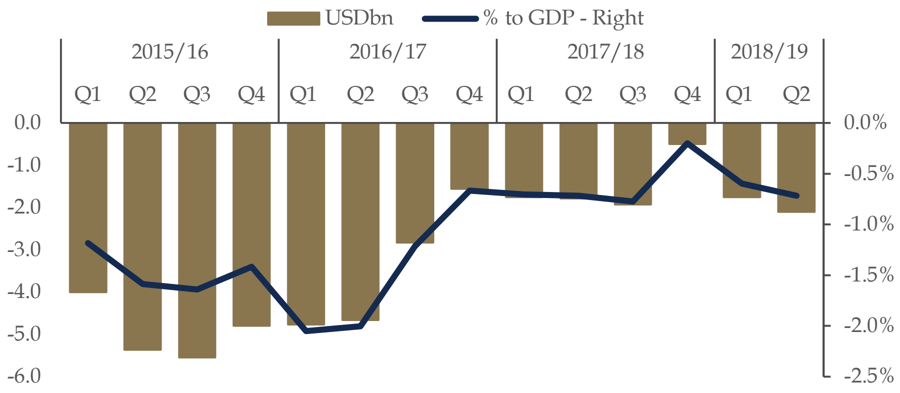
Other than REER and investors' perceptions, FX is also a matter of inflows and outflows which are based on various factors. "External Financing Requirements" simply measure the expected outflows of foreign currency: (1) current account deficit, (2) short-term debt, and (3) amortization of medium- and long-term (M&LT) debt. On the financing side, Egypt depends on (1) FDIs, (2) other net capital flows (including portfolio investments), (3) roll-over of short-term debt, and (4) net borrowing.

In the near term, we see no significant abnormal pressure on the foreign currency outflows that can trigger sharp depreciation in EGP, in view of the following:

- A current account deficit averaging around USD7bn and dwindling as a percentage of GDP.
- According to the CBE's figures as of 1 July 2018, Egypt had to repay about USD14.7bn in principal and interest for medium- and long-term debt during 2019, and around USD827mn in short-term debt. Of this debt, about USD6bn is owed to Saudi Arabia, around USD1bn to the UAE, and another USD1bn is owed to Kuwait. That is, a bulk of repayments has a high probability of roll-over. Indeed, Saudi Arabia has already rolled over USD6bn worth of deposits.
- Assuming an annual roll-over of around USD2bn of maturing debt, and consequently an increase in interest payments to an average of around USD1.5bn during FY2019/20.
- Based on the previous data and our calculations, we estimate the external financing requirements at around USD17bn in 2019. The sources of financing these requirements are FDIs, portfolio investment, a roll-over of a short-term debt, and – of course – medium- and long-term net borrowing.

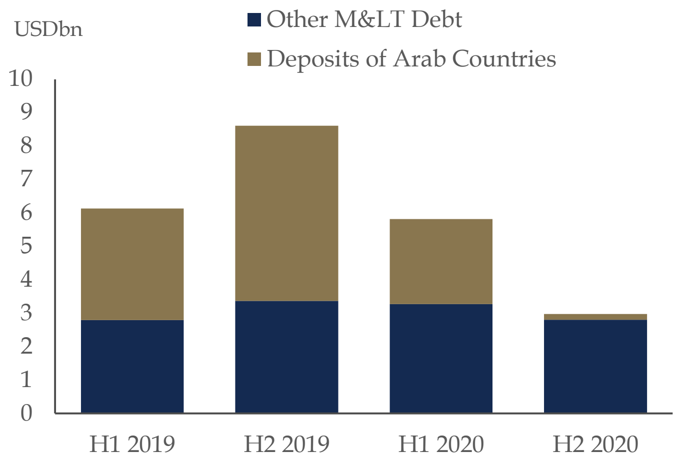
We do not think external requirements will place an abnormal pressure on the EGP in the near future. However, we highlight a downward risk on the EGP in case of sudden escalation in requirements or severe shortage in financing channels (e.g. draining FDIs, no roll-over of debt, or unattainable net borrowing from international markets).

Current account deficit (USDbn and % to GDP)



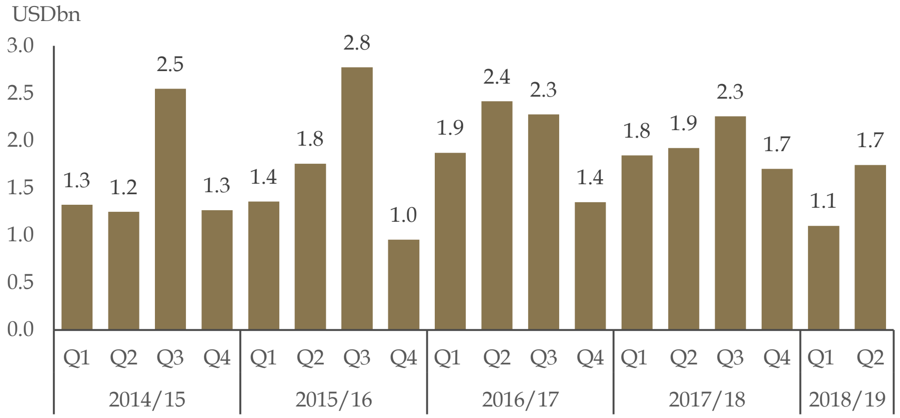
Source: CBE.

Expected M&LT debt schedule as of 30 June 2018 (FY2019/20)



Source: CBE.

Net foreign direct investments



Source: CBE.

Card No. 4: Global USD Pressures

- **It's not all about us:** Egypt's macroeconomics affect its currency, and so does the global direction of the US dollar. Excluding the period right after the EGP flotation, the EGP/USD rate has also been affected by the global dynamics of the USD. When we had a look at the DXY index (a measure of the USD against a basket of major currencies), we found that the correlation coefficient between the EGP/USD rate and DXY has been increasing gradually, exceeding 70% during the period from July 2017 to early February 2019.
- **No strong global pressure expected soon:** In our view, we do not expect a significant increase in global pressures that would drive the USD much higher. As we previously elaborated in our strategy report *"2019: A Year of Selectivity"*, the Fed is now more cautious of hurting the US economic growth, especially with uncertainties surrounding China's economy and Europe's Brexit scenarios. These two factors eroded the previous optimism from Trump's tax cuts and US growth expectations. Besides, current data of the US account deficit suggest no upward pressure on the greenback anytime soon.

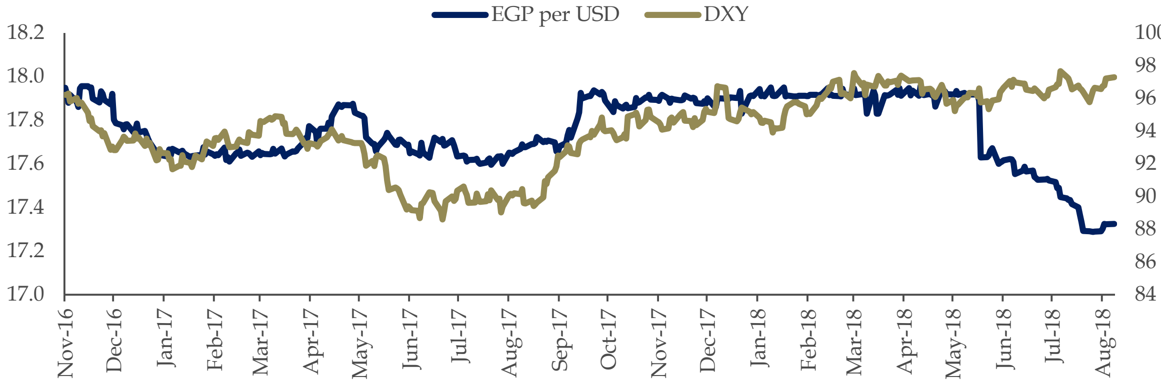
This stance will probably tap the breaks on the greenback worldwide, giving a breather to other currencies in turn—in our opinion.

Card No. 5: Do not forget the past. Learn from it.

- **Not the maiden voyage for our floated ship:** Early 2000's, the EGP had gone through another devaluation. A cumulative 27% devaluation had taken place in 2001 and 2002 before a floating regime was finally announced in January 2003. At the time, the exchange rate reached EGP5.34/USD, up from EGP3.4/USD three years before. The successive devaluations, among other reforms that took place at that time, helped improve the current account for six successive years before reverting back to the negative area in FY2008/09.
- **Current account … a déjà vu?** Looking at the current account response to the 2003 flotation, we saw an overall improvement, driven by tourism and transfers. However, trade balance improvement was temporary, as import payments resumed their aggressive growth shortly after flotation. We see today's current account performance is kind of a replica of its previous pattern. The described performance of the current account at that time is most likely to prevail in the medium term. That is, any improvement will be driven by growth in service balance and remittances from Egyptians working abroad.

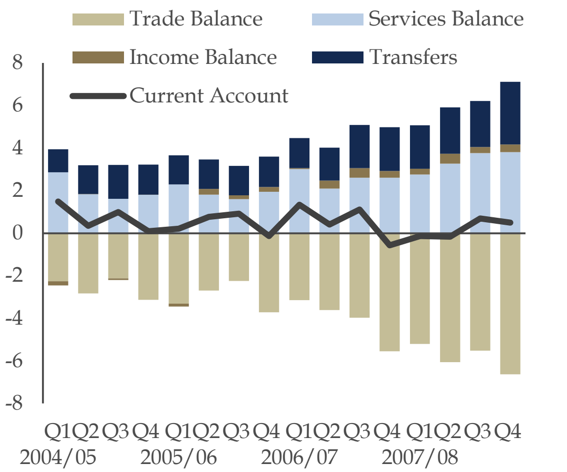
That said, we consider the persistent trade deficit as the main chronic disease in the balance of payments as a whole.

Until recently, the EGP was highly impacted by global pressures, which are not expected to tighten much anytime soon



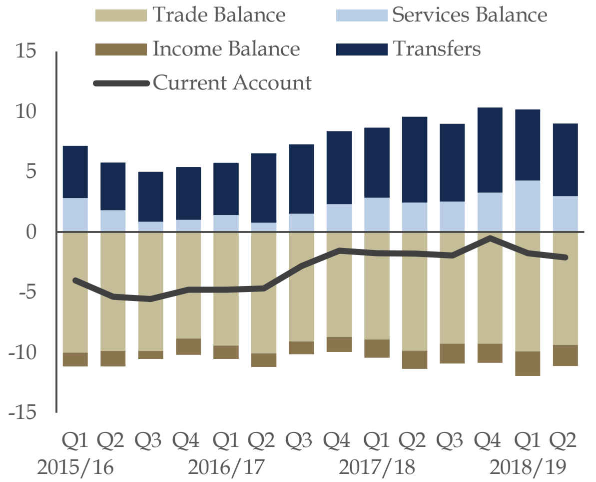
Source: Bloomberg.

CA improvements drivers post 2003 flotation



Source: CBE.

CA improvements drivers post 2016 flotation



Source: CBE.

Summing up our view in an FAQ format

1. Why did the EGP appreciate recently?

- The recent EGP appreciation might be justified by several factors topped by the hot money injected into banks after the CBE had terminated the repatriation mechanism in December 2018. Foreign investors' USD injections into the market found their way solely into the banking system. Central bank data reveal that some USD2.4bn was invested in Egypt's T-bills in January 2019, which was not absorbed by the CBE. This, in our view, has driven the EGP up.

2. Is such an appreciation sustainable?

- A sustainable appreciation in the currency is usually gradual and is mainly driven by a relatively long process of economic improvement. We believe the current "rapid" appreciation is driven by temporary reasons. In the short term, we see the EGP behavior most likely linked to foreign investments in Treasuries, which do not face significant threats given the current global scene.
- On the other hand, the tempo of the EGP strength might be tamed – or suspended – by a pick-up in imports in preparation for Ramadan and Eid seasons. This will be followed by lifting fuel subsidies, which will in turn push inflation upwards, adding to pressure on the EGP's REER, especially if accompanied with softer foreign inflows. That is, during the current year, there are some factors that may bring the USD back up again to the high EGP17's level.

3. Where is the EGP heading in the medium and long terms?

- Overall, a developing country that sustains a current account deficit most of the time – especially if it is widening, accompanied with high inflation relative to its trading partners, tends to witness currency depreciation over time. In Egypt, the effect of current account dynamics on the currency used to be "delayed". That is, depreciation pressures used to accumulate until a point comes when we have to face sharp depreciation.
- Looking at Egypt's current account performance, expected inflation path, and general macroeconomic outlook, we do not see sharp depreciation in the medium term. This is based on the following:
  1. The EGP is currently undervalued, based on the REER model.
  2. Egypt's external balances have significantly improved compared to the pre-flotation situation.
  3. The economy has not yet reached its potential in terms of tourism and exports. However, we highlight the chronic problem of growing non-oil imports, especially that a big bulk of the imports cannot be tamed without hurting production activities.
  4. Reserves are well-built, with no worrisome short-term liabilities.
  5. Egypt is expected to maintain a high appetite for debt instruments, securing decent inflows into the banking system (as long as the current global stance stays intact in the medium term).

After reading the cards: How do we see the future?

			FY2018/19	FY2019/20	FY2020/21	FY2021/22	FY2022/23
Depreciation Scenario	1. Rapidly increasing current account deficit in absolute terms and as percentage of GDP. 2. Humble FDIs, sluggish growth leads to lower international confidence. 3. Lower appetite for Egypt's Treasuries by foreign investors, leading to low portfolio inflows. 4. A slower-than-expected disinflation path . That is, higher inflation rates.	Average	17.77	18.04	18.55	19.07	19.48
Short-Term Correction Scenario	1. Strong portfolio investments that we believe will dominate in the short run. 2. Shrinking current account deficit. 3. Robust improvement in the banking sector's NFA position. 4. Normal growth in non-oil imports.	Average	17.77	17.03	17.52	18.00	18.39
Base Scenario	Gradual depreciation in the EGP value, justified by a persistent current account deficit and high inflation differential relative to trade partners: 1. Gradual increments in the absolute value of current account deficit, but stable as a percentage to GDP as growth in non-oil trade deficit is offset by better oil trade balance and higher tourism. 2. Almost stable net FDIs, hovering around USD7bn annually. 3. No major threats to portfolio investments. That is, no sustainable outflows that place a downward pressure on the financial account beyond one year. 4. Gradual normalization of interest rates by an average of 2% (rate cuts) annually, to reach an O/N lending rate of 10.75% by FY2021/22 end.	**Average**	**17.77**	**17.53**	**18.03**	**18.54**	**18.94**
		EOP	**17.20**	**17.87**	**18.20**	**18.87**	**19.00**

Source: SHUAA Securities Egypt.

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