



BNY MELLON
ASSET MANAGEMENT

Emerging market local currency debt - a look at Poland



Javier Murcio
Senior Sovereign
Analyst
Standish

Standish is based in Boston, with offices in Pittsburgh and San Francisco, USA. Standish is one of the world's largest dedicated fixed-income managers with capabilities in absolute return and hedge funds, high yield and emerging market debt and structured products.



Emerging market local currency-denominated debt is a relatively large and liquid asset class that represents some of the most creditworthy emerging market sovereigns. The asset class offers two distinct sources of return (currency and local bond yields) as well as providing the potential to generate equity-like returns without taking on direct equity risk.

We expect the sizeable economic growth differentials between emerging market countries and the developed world to continue serving as a magnet for capital flows into emerging markets. These capital inflows should augment appreciation pressures on many emerging market currencies, especially in the context of a global economic recovery.

In the following discussion, we examine the interaction between the US dollar and emerging market currencies and look at the prospects for the Polish zloty.

The greenback ache

Emerging market currencies tend to do well when the US dollar weakens against major currencies. The dollar weakness helps directly because the local currency-denominated emerging market debt indices have an exposure to central European countries whose currencies, such as the Polish zloty, trade primarily against the euro. In other words, if the zloty exchange rate remains unchanged against the euro,

and if the euro strengthens, then the zloty will usually strengthen against the US dollar. In addition, there is the indirect effect of dollar weakness on other currencies that trade primarily against the dollar such as the Brazilian real and the Malaysian ringgit. For example, while the Brazilian real trades mainly against the US dollar, its economy is much more diversified in terms of its export destinations, with Europe comparable to the US in value.

When the US dollar weakens against the euro, it allows the Brazilian real to strengthen incrementally against the dollar without sacrificing its competitiveness in trade-weighted terms. The corollary of this is that a rebounding dollar can hurt emerging market currencies and the extent of that damage depends on the conditions under which the rebound occurs. When the dollar strengthened against the euro, following the collapse of Lehman Brothers, it reflected the fact that US malaise had spread to Europe and as a result, would lead onto a global recession.

Polish affair with interest rates

Although better than its regional peers, Poland's economic data continue to point to relatively weak activity, suggesting that interest rates will remain on hold for the foreseeable future. Despite a slower rate of decline in industrial output, the year-on-

year contraction is not expected to turn positive until 2010. Sales remain weak, constrained by sluggish consumer spending, while industrial production growth is negative. The high unemployment rate of 11% is not expected to peak before next year. Consequently, the central bank revised its growth projections, with real GDP expected to grow between 1.1% and 1.5% in 2009 and between 0.8% and 2.8% in 2010.

As a result, the policy rate should stay at 3.5% through the second quarter of next year. However, there is a small probability that the central bank could consider yet another interest rate cut over the next two months due to the moderate growth projections for next year and the downside risk to inflation. Accordingly,

inflation is likely to remain within the +/- 2.5% inflation target this year and in 2010, although the central bank expects inflation to be even lower in 2010 (between 0.8% and 2.2%) than in 2009 (between 3.3-3.5%). The absence of excise and administered price increases partially explain the lower inflation and increase the chances of downwards inflation surprises in 2010. Economic sluggishness and low inflation are preventing any adverse impact on local interest rates.

Rosy outlook for the zloty

The reversal of risk appetite and concerns about Eastern Europe in general led to a rapid weakening of the zloty, which required significant defensive moves by the central bank, bringing foreign exchange reserves down to US\$56 billion in January

of this year. Replenishment of foreign exchange reserves has been taking place this year, but these remain about US\$10 billion below their peak seen in July last year.

The zloty has since recovered and traded within a narrow range of around 4.2 zlotys/euro over the last four months. Despite recent weakening to around 4.3, the recovery in exports, its fundamental strength compared to Eastern European peers and a resumption of capital flows suggest that the zloty could appreciate towards 4 zlotys/euro by the end of the year and reach 3.8 zlotys/euro within a year from now. The government's incentive to meet constitutional limits on external debt ratios also argues for a stronger currency in the longer run.

POLISH ZLOTY TO EURO EXCHANGE RATE



Source: Datastream as at 7 Dec 2009

www.bnymellonam.com

The statements and opinions expressed in this article are those of the author as of the date of the article, and do not necessarily represent the views of The Bank of New York Mellon Corporation, BNY Mellon Asset Management International or any of their respective affiliates. This article does not constitute investment advice, and should not be construed as an offer to sell or a solicitation to buy any security or make any offer where otherwise unlawful. BNY Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice based on information supplied. Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investments you may get back less than you originally invested. Portfolio holdings are subject to change at any time without notice, are for information purposes only and should not be construed as investment recommendations. This is not intended as investment advice but may be deemed a financial promotion under non-US jurisdictions. The information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors. This document should not be published in hard copy, electronic form, via web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited. In Australia, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. In Brazil, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. In Canada, interests in any investment vehicles may be offered and sold through BNY Mellon Asset Management Canada, Ltd., an Ontario registered Investment Counsel Portfolio Manager and a Limited Market Dealer. In Dubai, United Arab Emirates, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. In Germany, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between The Bank of New York Mellon Corporation and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. If this document is used or distributed in Hong Kong, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Unit 1501-1503, 15/F Vicwood Plaza, 199 Des Voeux Road, Central, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. In Japan, this document is issued by BNY Mellon Asset Management Japan Limited, Meiji Seimei Kan 6F, 2-1-1 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. In Singapore, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. This document is issued in the UK and in mainland Europe (excluding Germany), Taiwan and Korea by BNY Mellon Asset Management International Limited. BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. This document is issued in the United States by BNY Mellon Asset Management. BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by The Bank of New York Mellon Corporation. IC0078-07-12-09 (6M) 18157 12/09