Allianz Research | 25 July 2024

What to watch: Fed preview, EM currency outlook and Vietnam eyes the “market economy” prize

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In summary

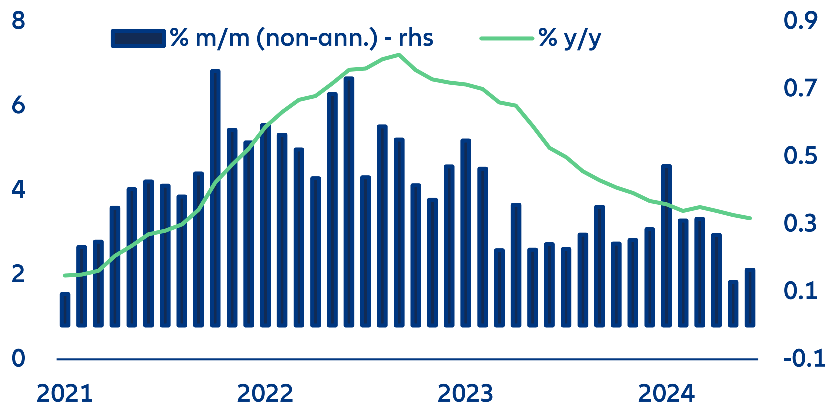
This week we look at three critical issues:

- **US Fed: Wake me up when September ends.** On 30 July, the Fed is likely to remain on hold once again. But recent data provide encouraging signs that inflation is finally cooling down: for instance, the three-month average annualized headline CPI came out at only +1.1% in July – its lowest level since before the inflation burst of 2021-2022. This should convince the Fed to deliver its first rate cut as soon as September (-25bps to 5.25%), especially since strong Q2 GDP and solid momentum continuing in the current quarter do not seem to be jeopardizing price stability. Moreover, liquidity should start to contract soon, easing concerns that inflation may be reignited. Nevertheless, we do expect the Fed to reaffirm a hawkish bias in coming weeks as tailwinds such as fiscal policy will start to fade. After September, we expect it will pause during the November meeting before easing again in December (-0.25bps to 5%).
- **Medium-term outlook broadly positive for EM currencies.** EM currencies have depreciated significantly on the back of the Fed’s delayed rate cuts and restricted investor appetite, exacerbated by regional and local factors such as the political calendar and fiscal concerns. Nevertheless, the medium-term outlook remains broadly positive, driven by solid economic growth and slowing inflation. Balance-of-payment (BoP) risks have moderated overall since the beginning of the year despite cyclical volatility in some markets. However, asynchronized monetary easing and external political factors remain significant risks for EM BoP stability, with Argentina, Egypt, Ghana, Nigeria, Tunisia and Türkiye still at risk of a crisis. The improved medium-term outlook and recent market moves present attractive entry points for EM financial assets, especially EM local currency bonds, keeping in mind the importance of local factors. We expect hard-currency sovereign spreads to reach 220bps by year-end, and local-currency yields reaching 6.3% and 6% by the end of 2024 and 2025, respectively.
- **Vietnam: Eyes on the "market economy" prize.** On 26 July, the US is likely to officially recognize Vietnam as a “market economy”, a long sought-after feather in the cap of Southeast Asia’s growing export powerhouse. This would allow Vietnamese exporters to use their own numbers during anti-dumping procedures, though the immediate direct impact is likely to be limited (lower tariff rates for goods equivalent to 0.7% of GDP). Vietnam is now the 23rd largest exporter in the world, and extending the trends observed since 2017 could bring it to the 10th position in 2034. The trade relationship with the US has been booming: The US now represents roughly 30% of Vietnam’s exports, up from less than 20% a decade ago, and Vietnam now represents nearly 4% of US imports, up from around 1% a decade ago. However, its rising dependence on imports from China and the risk of tougher trade policy following the US elections could still hold back Vietnam's long-term progress.

US Fed: Wake me up when September ends

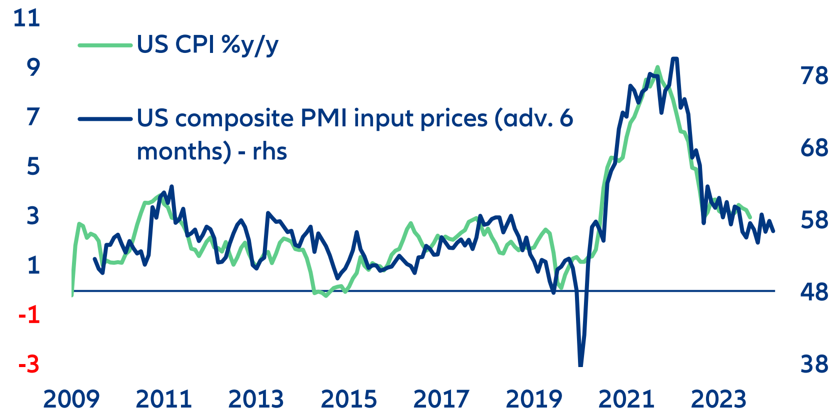
The Fed is likely to hold steady at its next meeting on 30 July but broadening disinflationary pressures should convince the committee to deliver the first rate cut in September. Since June, inflation data have been very encouraging. The three-month average annualized headline CPI came out at only +1.1% in July – its lowest level since before the inflation burst of 2021-2022. Moreover, the Federal Reserve of Cleveland's measure of trimmed mean CPI – which strips out the items from the CPI basket with the 16% highest and lowest price movements – returned to its pre-pandemic norm on a month-on-month basis in both May and June (Figure 1). Besides, softer inflation is also becoming more evident in services prices, which rose by only +0.2% m/m in May and +0.1% June. If this continues over the next few months, services CPI inflation on a year-on-year basis will come down rapidly to +3.4% in December, from +5.0% in June. Finally, the Q2-2024 GDP report showed that the GDP deflator slowed more than expected, to +2.3% y/y after +3.1% in Q1-2024. Nevertheless, this will not be enough to fully convince FOMC officials that the inflation tide has turned for good, so we do not expect a rate cut at the July meeting next week. But both July and August CPI and PCE data (the Fed's preferred measure of inflation) are likely to confirm the disinflation trend, supported by surveys such as the composite PMI input prices (Figure 2). CPI and PCE will be released in August and September, ahead of the 17-18 September meeting. Recent comments from FOMC officials acknowledging the progress on inflation further strengthen the case for a September cut[1].

Figure 1: Trimmed mean CPI inflation



Sources: LSEG Workspace, Allianz Research

Figure 2: CPI inflation & composite PMI input prices survey



Sources: LSEG Workspace, Allianz Research

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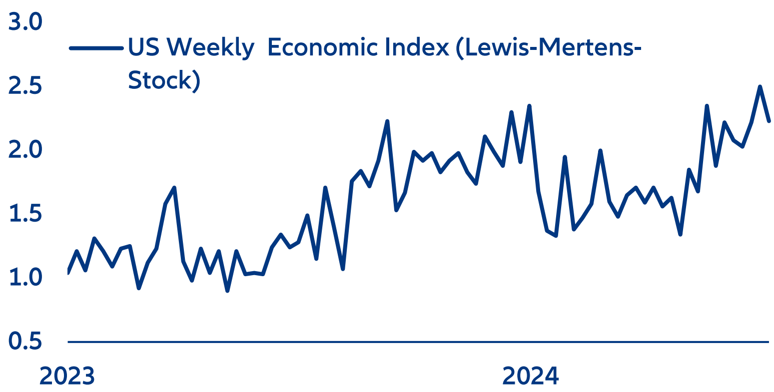
[1] *For example, NY Fed President John Williams noted that second quarter inflation data were "closer to a disinflationary trend that we're looking for". He added that "these are positive signs" although he would like to see more data to gain further confidence "that inflation is moving sustainably down to 2%".*

Nevertheless, strong GDP data in Q2 2024 (+2.8% quarterly annualized) and evidence of solid momentum in Q3 2024 will prompt the Fed to pause in November before easing again in December. Data released this week showed that the US economy remained on solid footing. Furthermore, the Weekly Economic Index of economic activity (a proxy for GDP at a higher frequency) available through the first two weeks of July points to economic momentum remaining strong, and even accelerating, at the beginning of the current quarter (Figure 3). We do not expect this will prevent the Fed from proceeding with a first rate cut in September (-25bp to 5.25%) as for now high growth does not seem to jeopardize price stability. What's more, as we highlighted in previous research[2], currently loose financial conditions, which are supporting aggregate demand and have been the number one factor keeping inflation too high in H1 2024, should start to tighten by early 2025. This is because quantitative tightening, i.e. the reduction of securities holdings on the Fed's balance sheet, should start to drain liquidity before long. Fiscal policy is also becoming less supportive. The Fed is mindful that there is a risk of a hard landing of the economy if it starts to ease policy too late as tailwinds are fading. At the same time, it also has to balance the risk of easing too early and re-igniting inflationary pressures. In this context, we expect the Fed to keep rates on hold at the November meeting, before delivering another 25bps rate cut in December (to 5%).

Figure 3: Weekly Economic Index (% year-on-year)



Sources: FRED database, Allianz Research

Medium-term outlook broadly positive for EM currencies

Emerging market (EM) currencies weaknesses resurfaced in H1 2024 on the back of the Fed's delayed rate cuts. The long-running uncertainty over the Fed's first rate cut has put EM currencies[3] under pressure, especially in Latin America, prompting several EM central banks to reverse course on their own monetary policy easing. Chile, Brazil and Peru started reducing policy rates as early as mid-2023 as domestic inflation returned towards targets, but their currencies have suffered significant depreciations of late amid narrowing interest rate differentials and a lower risk appetite from investors (Figure 4).

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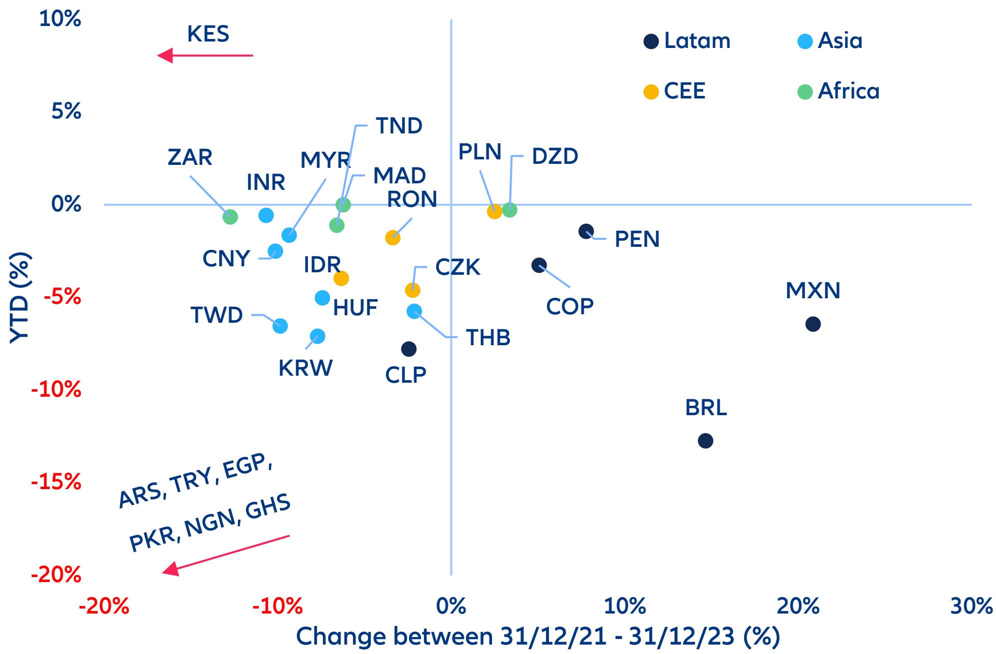
[2] *See What to watch I 14 June 2024 (allianz.com)*

[3] *See 2024_04_26_what_to_watch.pdf (allianz.com), p.4-5, for our analysis of EM currency weakness in April.*

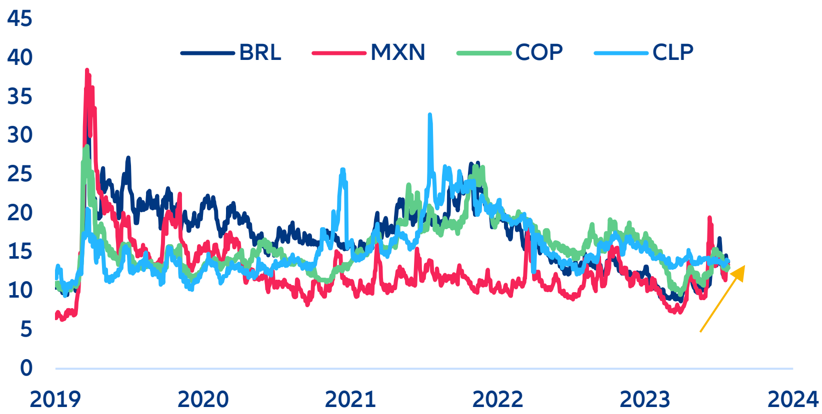
Figure 4: EM currency performance against USD



Sources: LSEG Datastream, Allianz Research.

For the hardest-hit LatAm currencies, country-specific factors including political uncertainty and fiscal concerns are also at play. In Brazil and Colombia, government overspending has raised concerns among investors about debt sustainability. Mexico faces potential negative impacts from its judicial reforms, which add to the uncertainty. In Peru, ongoing political turmoil is destabilizing investor confidence. Additionally, the region's sensitivity to the US and its exposure to commodity price fluctuations are exacerbating the situation. The implied volatility of high-yielding LatAm currencies has notably picked up after a relatively calm 2023 (Figure 5) despite the narrowing of rate differentials compared to the US, resulting in an unfavorable condition for carry traders. Consequently, the attractiveness of LatAm currencies as a favored long position for the carry trade over the past years has taken a U-turn as investors cut sizeable positions, an important driver for the depreciation.

Figure 5: Implied volatility of selected EM currencies



Sources: LSEG Datastream, Allianz Research.

Currency volatility is visible in other regions as well, from devaluations in Africa to the continued underperformance of major Asian currencies. The devaluations of two of the most important African currencies, the Egyptian pound and the Nigerian naira, in Q1 (which were the fourth and second of that kind for each country since 2022) raised alarms at a time when several African markets were returning to international bond markets. At the same time, Asian currencies have continued to underperform in 2024 as the financial pressures on the major currencies in the region (CNY, JPY) weighed on sentiment for a region that typically suffers more in these situations due to its lower yields. Eastern Europe, which had begun normalizing from high policy rates, also faced USD pressures. However, the ECB delivering its first rate cut provided some relief, even though it acted before the Fed, benefiting currencies more dependent on EUR rates. The Turkish Lira, one of the most idiosyncratic cases in the region, has continued to depreciate but reduced volatility and the central bank's return to orthodoxy have also led to an improvement in investor sentiment.[4]

However, looking ahead, the outlook for EM currencies remains broadly positive across regions. Domestic political developments in countries such as Brazil, India, Mexico and South Africa have contributed to higher volatility. However, economic growth remains solid and outpaces that of high-income economies. The impact on growth from the 2019-2022 polycrisis has largely subsided across the EM spectrum, despite the LatAm-5 and South Africa struggling to keep pace with other large EMs, with +2% and +1.4% GDP growth expected, respectively, for 2024. Inflation has mostly decelerated and the spread with high-income economies has narrowed. Interest rates are likely to stay on a downward trajectory, with Chile, Colombia, Czechia and Hungary still cutting rates in the last month. This goes hand-in-hand with an unwinding of current account imbalances (Hungary and Colombia) and improvements in the stock market and inflation (Chile and Czechia), alongside the positive trend of copper prices benefitting Andean countries.

The asynchronized monetary easing across emerging markets will still represent the most significant threat, with fiscal concerns adding pressures for further easing. In Latin America, for example, Mexico retains plenty of room to cut interest rates, but it is less so for Brazil. Real policy rates and inflation differentials vs the US in both Mexico and Brazil are comfortably positive compared to the 15-year average, implying that policy rate differentials may narrow further. While Mexico faces greater external risks in the run-up to the US presidential election, Brazil may suffer a more direct blow to its credit rating for domestic reasons. MXN20 per USD remains a kind of psychological threshold to distinguish between cyclical corrections and things getting nastier. As the Fed reduces interest rates, Mexico will most likely get back into the game. Brazil does not have the same room for maneuver, and any cuts this year could usher in more risks than benefits. At the same time, central banks must deal with additional political pressure to carry forward the monetary easing as fiscal concerns and higher cost of debt start to bite.

Secondly, external political risks in Q4 could cast a shadow over the positive macroeconomic developments. Certain EM currencies, such as the South African rand (ZAR) and the South Korean won (KRW), are particularly sensitive to trade tensions and global risk sentiment. At the same time, China's growth and market conditions also play a significant role and the transmission of Beijing's monetary policy to Taiwan, Thailand and Malaysia should also be considered. LatAm could face some external spillovers as well after the US elections, especially if the new administration implements significant policy changes. Additionally, CEE currencies could be sensitive to any perceived change in the trade relationship between the US and the Eurozone in the event of across-the-board tariffs, as well as additional concerns related to Russia and Ukraine.

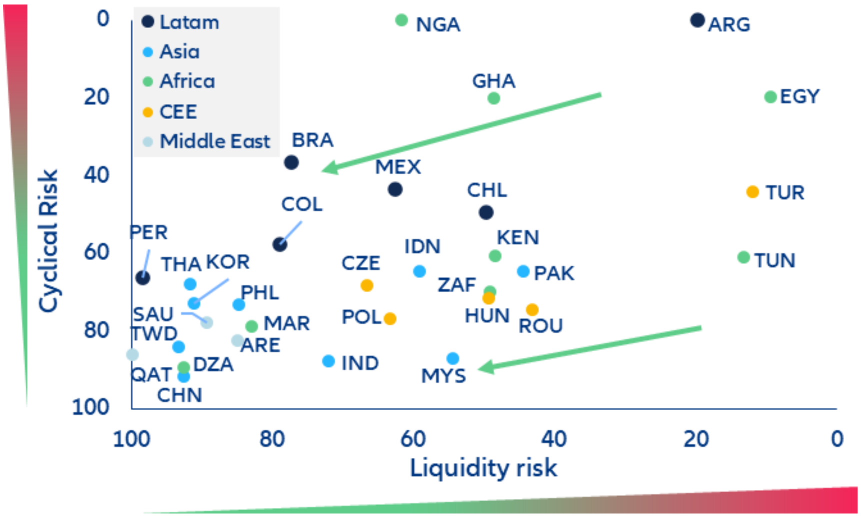
Balance-of-payment risks in major EMs have further moderated overall since the beginning of the year despite cyclical volatility in some markets. But Argentina, Egypt, Ghana, Nigeria, Tunisia and Türkiye remain vulnerable. Cyclical risk increased in Brazil, Mexico, Peru, Indonesia and Saudi Arabia, reflected in markedly weakened currencies and poor stock market performances. However, overall balance-of-payment (BoP) risk remained moderate in these markets (Figure 7). Cyclical risk also rose in Egypt and Ghana for the same reasons, here contributing to a further increase in BoP risk.[5] On the other hand, cyclical risk declined in Chile, South Africa, Kenya and Pakistan on the back of more stable currencies, lower inflation, higher real policy rates and/or improved stock markets, easing the earlier BoP pressures in these markets. In Kenya and Pakistan, this easing was also supported by a decrease in liquidity risk, mainly thanks to a moderation of credit growth. In Tunisia, however, reduced cyclical risk was outbalanced by increased liquidity risk due to surging credit growth. Moreover, cyclical risk

[4] *This has also been reflected in recent sovereign rating upgrades by S&P and Moody's as well as significant short-term capital inflows in recent months, thanks to high interest rates. These inflows, however, also leave the country vulnerable to sudden swings in investor sentiment.*

[5] *See What to watch 8 February 2024, p.2-4, for our analysis of BoP risks at the beginning of the year and the performance during 2023.*

improved in Algeria, China, Czechia, Malaysia and Thailand, all of which already faced moderate BoP risk previously. Meanwhile, liquidity risk and thus overall BoP risk improved in Hungary, thanks to a continued rebalancing of its earlier large current account deficit. Elsewhere, liquidity risk did not change markedly in the first half of 2024, confirming the substantial improvement over 2023 on the back of the unwinding of large current account deficits, rising FX reserves and slower credit growth. The rebalancing was supported by tighter monetary policies, which helped to lower inflation and currency volatility.

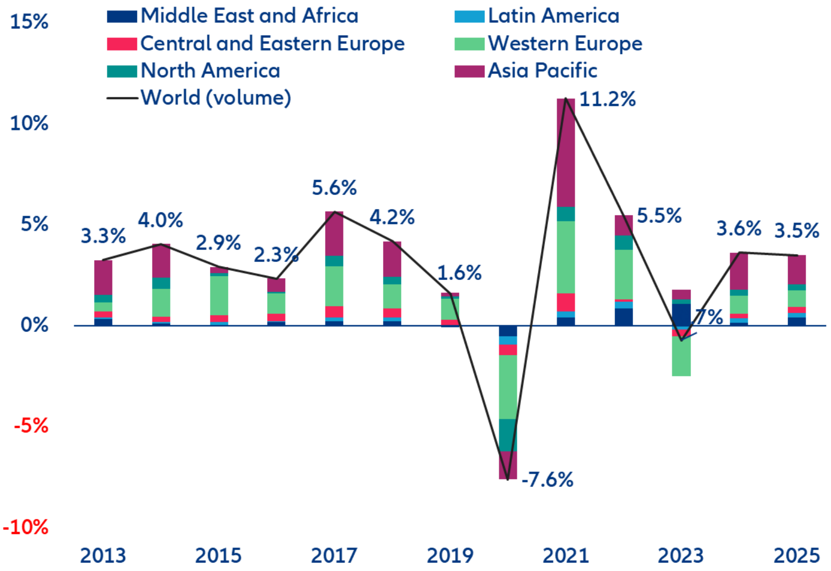
Figure 7: Balance-of-payments risks in major EMs (as of July 2024)



Sources: EIU, LSEG Datastream, Allianz Research. Note: Liquidity and cyclical risk scores include economic indicators (current account balance, FX reserves, external debt payments due) but also high-frequency market data (exchange rates, spreads) to identify both short-term and structural vulnerabilities. Each variable receives a 0-100 (0=worst) score that is later combined. Hence the upper right corner identifies the most vulnerable economies.

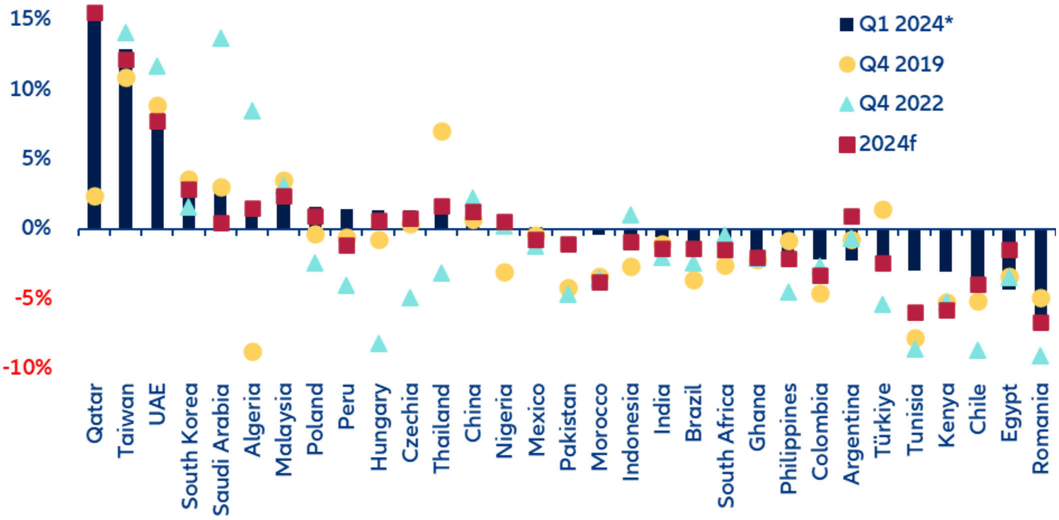
Going forward, we expect current account balances to remain in check in most major EMs in 2024-2025. We expect fiscal consolidation to accompany continued prudent monetary policy in keeping external vulnerabilities in check, notably in most of emerging Asia, Czechia, Hungary, Brazil, Chile and Peru. Moreover, we forecast global and regional export growth to return to or to remain in positive territory in all major EM regions in 2024-2025 (Figure 8). As a result, we expect annual current account deficits to remain under control, by and large, with only a few major EMs posting elevated shortfalls this year, notably Romania (-6.7% of GDP), Tunisia (-6%) and Kenya (-5.8%), see Figure 9.

Figure 8: Global and regional export growth (volume)



Sources: LSEG Datastream, Allianz Research

Figure 9: Current account balance of major emerging markets (% of GDP)



Sources: IMF, LSEG Datastream, Allianz Research

The improving medium-term outlook, combined with the recent market adjustment, presents a more attractive entry point for EM assets compared to the conditions seen late last year and early this year. With reduced currency pressures going forward and the recent spike in yields, EM bonds, particularly those in local currency, are well-positioned to benefit from the upcoming monetary normalization. While we remain cautious about existing threats, such as reduced tailwinds from US and China growth and the higher cost of existing debt, our outlook for EM fixed income remains constructive, keeping in mind the growing importance of local factors and selectivity as some important external factors such as Fed monetary policy normalize. We expect hard-currency sovereign spreads to reach 220bps by year-end, indicating a slight widening from current levels but following a downward trajectory into 2025. Yields for both hard- and local-currencies are projected to decline gradually, with local-currency yields reaching 6.3% and 6% by the end of 2024 and 2025, respectively.

Vietnam: eyes on the "market economy" prize

On 26 July, the US is likely to officially recognize Vietnam as a "market economy", a long sought-after feather in the cap of Southeast Asia's growing export powerhouse. The US considers Vietnam as one of 12 "non-market" economies, alongside Russia and China, on which it imposes higher anti-dumping duties due to the perception of higher state involvement in the economy[6]. Following President Biden's visit to Hanoi in September 2023, and the signature of a new comprehensive strategic partnership between the two countries, the US launched an investigation to reassess Vietnam's status based on six criteria: currency convertibility, free bargaining of wages, foreign investment, the government's ownership of means of production, allocation of resources and price setting, and other factors. Based on several indicators that measure these criteria, we find that there are sufficient grounds for the US to recognize Vietnam as a market economy, in line with the 72 countries that already do so, including the UK, Canada, Australia and Japan. However, beyond the economic rationale, this decision also has several (geo-) political considerations (such as the trade ties with China).

Table 1: US criteria for market economy status, measured with indices chosen by Allianz Research

	Index	Vietnam (latest)	China (latest)	India (latest)	Indonesia (latest)	Malaysia (latest)	Philippines (latest)
Currency convertibility	Chinn-Ito index[7]	0.42	0.16	0.16	0.42	0.42	0.45
Free bargaining of wages	Level of national compliance with labor rights[8]	9.1	8.9	4.8	2.8	5.6	4.8
Foreign investment	FDI Regulatory Restrictiveness Index[9]	0.13	0.214	0.207	0.347	0.257	0.374
Government's ownership of means of production	Share of sectors with companies that have the state as an important shareholder (%)	90	Data unavailable	95	85	Data unavailable	40
Allocation of resources and price setting	Allianz Trade Structural Business Environment rating[10]	4	4	4	4	3	4
Other factors	Signature of the Comprehensive Strategic Partnership between the US and Viet Nam in September 2023						

Sources: Chinn, Menzie D. and Hiro Ito (2006), ILO, OECD, World Bank, Allianz Research

[6] *The distinction originated following the end of the USSR and the subsequent membership of former communist countries in the World Trade Organization.*

[7] *The Chinn-Ito index measures a country's degree of capital account openness. It ranges between zero and one, one denoting a fully open capital account.*

[8] *The level of national compliance with labor rights indicator measures a country's level of compliance with fundamental rights at work, freedom of association and collective bargaining. It ranges between zero and ten, zero denoting the highest level of compliance.*

[9] *The index gauges the restrictiveness of a country's foreign direct investment rules. It ranges between zero and one, the lower the fewer restrictions.*

[10] *The Allianz Trade Structural Business Environment rating ranges from 1 to 6, the lower the better.*

Securing the status would imply lower tariff rates for exports amounting to just 0.7% of GDP, but more importantly it would provide a confidence and attractiveness boost to Vietnam. The non-market economy status allows the US to apply the surrogate country approach when determining the dumping margin, using the value of a third country, considered a market economy, to calculate production costs. However, if Vietnam is recognized as a market economy, Vietnamese exporters could use their own numbers during anti-dumping procedures. In effect, this would imply lower tariff rates for goods that are currently concerned with anti-dumping cases (see Table 2). For some of these goods, the US is an important market, although taken altogether they account for only 0.7% of Vietnam's GDP. As such, the direct immediate effect of obtaining market economy status is likely to be limited overall, but the decision would provide a boost of confidence and attractiveness for Vietnam's exporters.

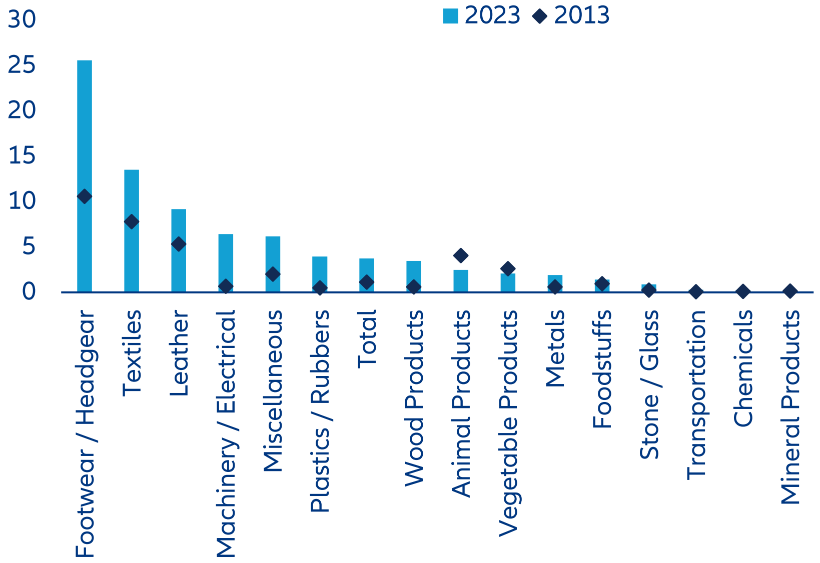
Table 2: Vietnam exports in anti-dumping cases with the US

	Vietnam exports to the US (2022, USD million)	as a share of Vietnam export in the sector	as a share of US imports in the sector	as a share of Vietnam GDP
Steel	1,179	25%	2.5%	0.29%
Rubber – Tires	1,147	53%	6.4%	0.28%
Sub-sectors in textiles	204	10%	4.2%	0.05%
Aluminum	131	41%	8.0%	0.03%
Crustaceans	35	12%	4.0%	0.01%
Frozen fish	34	7%	6.3%	0.01%

Note: we used HS codes 73 for steel, 4011 for rubber – tires, 54 and 56 for sub-sectors in textiles, 7604 for aluminum, 0306 for crustaceans and 0303 for frozen fish.
Sources: US Department of Commerce, ITC, Allianz Research

Vietnam has become one of the top export performers in the world in the past decades. Since its accession to the World Trade Organization in 2007, Vietnam has moved up from the world's 49th largest exporter to the 23rd in 2022. Within Asia-Pacific, Vietnam's exports are now similar in size to those of Taiwan. By extending the trends observed since 2017, Vietnam could become the 10th largest exporter in the world in 2034. Vietnam benefits from strong cost competitiveness, a large labor force and more than 15 bilateral or multilateral free trade agreements in effect (including with the EU). In particular, Vietnam has been able to benefit from the ongoing geopolitical developments, being an attractive alternative amidst US-China tensions and the trend towards supply-chain diversification. As a result, the US now represents roughly 30% of Vietnam's exports (or 27% of GDP), up from less than 20% (12% of GDP) a decade ago, and Vietnam now represents nearly 4% of US imports, up from around 1% a decade ago. More precisely, over the past decade, Vietnam's exporters have particularly gained market shares in the US in lower value-added sectors such as footwear / headgear, textiles and leather (Figure 10), but also in the machinery and electrical sectors more recently.

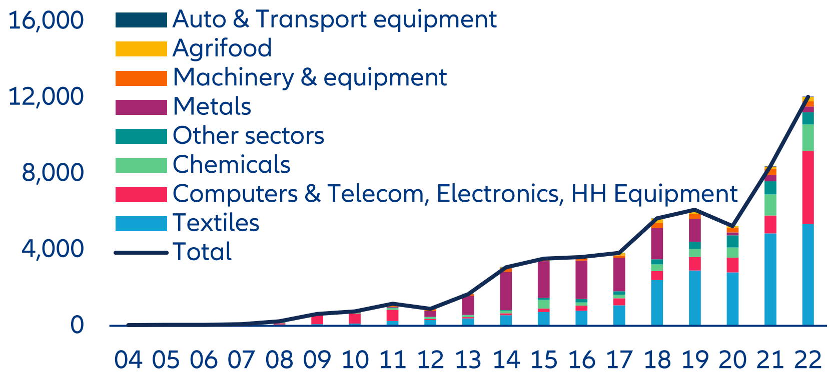
Figure 10: US imports from Vietnam by sector, as % of US imports in the sector



Sources: ITC, Allianz Research

At the same time, Vietnam's dependence on imports from China has been rising. China now represents around on third of Vietnam's imports, up from around a quarter a decade ago. In 2022 (latest data available), 10% of Vietnam's imports from China were critical dependencies[11] (up from 3% in 2012). 44% of these critical dependencies can be found in the textiles industry and 32% in computers & telecom, electronics and household equipment (Figure 11). This rising dependence could potentially pose a problem for the US-Vietnam trade relationship. Indeed, the US still treats China as a non-market economy. In this context, the US granting Vietnam market economy status could thus potentially lead to Chinese exporters transshipping their goods to Vietnam and then exporting them to the US, to avoid being targeted by higher US tariffs. This issue is already being monitored by the US authorities, and we could expect an increase in rule-of-origin disputes if Vietnam were to obtain market economy status.

Figure 11: Vietnam's critical dependencies on China (USD mn)



Sources: ITC, Allianz Research

Rising geopolitical tensions could slow Vietnam's long-term progress. Over the past decade, Vietnam has tried to maintain good relationships with all superpowers by signing strategic partnerships, including with the US and China in 2023 and with Russia in April 2024. But this balance could be hard to keep in the long run, considering increasing geopolitical tensions regionally and globally (South China Sea, US-China, US-Russia etc.). Furthermore, even if it is

[11] *Following the definition we have been using in our previous research, Globalization 2.0 and China: keeping the dragon awake.*

recognized as a market economy, the outcome of the US election in November 2024 could result in tenser trade relations. While the US only raising tariffs on China could potentially benefit Vietnam (through trade diversion and friendshoring, as seen after the first tariff hikes), Vietnam's rising trade surplus with the US could also make it a target. The electronic sector could be singled out, given its rising share in Vietnam exports and its potential link with Chinese transshipped goods. While the market economy status would prevent the use of the surrogate country approach during anti-dumping procedures, Vietnam could still be subject to the use of Section 301 of the US Trade Act, which would lead to trade sanctions. It was already used during Trump's first presidency, notably against China but also on two occasions against Vietnam.

These assessments are, as always, subject to the disclaimer provided below.