



James Syme

Senior Fund Manager



Paul Wimborne

Senior Fund Manager

Highlights

- We think that there are perhaps five important global macro indicators to monitor to assess risk and opportunity in the higher-risk, more capital-flow sensitive emerging markets.
- We believe that the conditions that have led to capital inflows, stronger currencies and good returns to equity investors are still in place.

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Emerging Markets Spotlight

Emerging markets and the Fed

If one wanted to paint a negative view of the emerging market asset classes (equities, bonds and currencies), there would be several pieces of evidence in macro conditions to point to. Traditionally, the northern hemisphere summer is seasonally difficult for risk assets; Covid-19 case numbers are again moving in the wrong direction in some countries; the surprisingly hawkish June commentary from the Federal Reserve has seen a rapid shift in a number of financial market indicators that are not supportive of risk assets.

Jim Bullard's comments that 'FOMC was surprised on the upside over the last few months... recent data is very good news... by the time you get to the end of 2022, you'd already have two years of two-and-a-half to 3% inflation. To me, that would meet our new framework where we said we're going to allow inflation to run above target for some time, and from there we could bring inflation down to 2% over the subsequent horizon' saw a sharp upward move in shorter-term US bond yields as the markets priced in tapering and a US rate hike in 2023.

There was an opinion piece in the Financial Times in June¹, by Duvvuri Subbarao, former Governor of the Reserve Bank of India, which we felt was an important indicator of the current environment for emerging markets (particularly the higher risk ones). The article is titled 'Emerging markets are right to worry about capital flows'.

In it, the author discusses the impact of foreign capital flows on India and the central bank's resultant policy dilemma. Because 'with extraordinarily loose money supply and low returns in the rich world, emerging markets inevitably become a destination of choice for investors looking for high yields... The RBI has been in the market almost continuously, buying dollars to prevent an unwarranted appreciation of the rupee. But buying dollars results in extra rupee liquidity which could go beyond the central bank's comfort level. The RBI could of course mop up the extra liquidity by selling bonds. But such a move would cause interest rates to spike, resulting in the economy being swamped with "carry trade" dollars looking to make money on the yield differentials.' Overall, his main concern is that, when inflows become outflows, India (and other, similar, emerging markets) will see a liquidity crunch and a hard-landing in the economy and financial markets.

We agree with the Mr. Subbarao's diagnosis of the mechanism, but not (yet) his concern. Generally, the conditions in emerging markets that typically mark the top of the capital-flow cycle have not yet occurred: sustained increases in credit and money supply, high capacity utilization, buoyant financial markets and, particularly, weak current account balances.

Five indicators to monitor risk and opportunity

We think that there are perhaps five important global macro indicators to monitor to assess risk and opportunity in the higher-risk, more capital-flow sensitive emerging markets.

Firstly, capital flows into the bond markets of emerging economies. One event that is in the mind of many investors is the 'Taper Tantrum' in the second quarter of 2013. When the Fed announced that it would, at some point in the future, reduce the volume of purchases of assets, it triggered a sharp rise in US yields and significant weakness in the currency and bond markets of many emerging countries as capital flowed out and back into US dollar assets. The fear is that the Fed's indication of future policy tightening will have a similar outcome.

We are much less concerned. In particular, positioning in EM fixed income markets is more benign, in our opinion. The years leading up to the Taper Tantrum has seen significant capital flows into the riskier emerging markets, and had driven down bond yields relative to US yields (this gap is the heart of the carry trade that attracts and keeps those flows into Emerging Markets).

We estimate that for the six main riskier emerging markets (Brazil, Mexico, South Africa, Turkey, India, Indonesia), net foreign capital flows into government bonds in the twelve months before the Taper Tantrum were over US\$100bn; right now that number is less than a third of that.

Similarly, the average ten-year local currency bond spread over US ten-year bonds was, we estimate, 1.5% below its long-term average, whereas now it is 1.0% above the long-term average. We would concede that US-denominated bonds look expensive relative to history, but these are now a small part of the funding mix for mainstream emerging markets.

Secondly, currencies in the riskier markets look reasonably valued – we have written at length this year about the large moves in terms of trade and current account balances in some of these markets (particularly Brazil, Mexico, India and South Africa) and how we see those underpinning currency valuations.

We think a lot of weak hands were flushed out of riskier emerging markets in the middle of 2020 and do not see the same positioning in equity or bond markets as we had back then (or, indeed in 2007/8, the previous period of excessive optimism towards the asset class).

Thirdly, a significant driver of inflationary concerns in the US are from commodity prices, and it remains our view that Chinese credit growth is contractionary at the margin, and that the Chinese economy is slowing. Chinese demand remains a major driver of global commodity prices, and we have seen some of the heat go out of some of the most dramatic commodity markets (for example, having peaked in May at US\$1,686 per lot, the Chicago lumber future contract finished June below US\$800).

Fourthly, the Fed's own long-term forecast for the peak US policy rate remains at only 2.5% (and, notably, is unchanged since before the pandemic). If the peak of the hiking cycle is only 225bp above current levels, it is likely to have far less of an impact than, say, the 375bp that was expected in 2013.

Finally, forecasts for both GDP growth and equity market earnings are still being revised up in our preferred emerging markets. This is not a universal phenomenon, but these improving expectations are a powerful support for markets, not only equities, but also currencies and bonds, as better conditions attract capital inflows.

Countries to avoid

Following on from that last point, we believe that investors should always be selective when investing in emerging markets. There are two types of countries that we think lack the economic fundamentals to be attractive at this time. The first are the South-East Asian economies where growth recoveries have been weak, and where the next move in policy rates is likely down, not up. Malaysia's commodity sectors have been more supportive of growth there (although we remain zero weight), but it is particularly Indonesia, Thailand and the Philippines where we see the lack of a compelling growth story.

The second country we choose to avoid on economic grounds is Turkey. Unorthodox fiscal and monetary policy means that Turkey has had a very significant credit boom in the last few years. With the current account deficit elevated, inflationary pressures mounting and a weakening currency, the pressure on the central bank to hike rates is a defensive one to prevent capital flight, rather than a reflection of strong growth.

Bob Farrell, the legendary head of research at Merrill Lynch, is famous for his '10 Market Rules to Remember'. Part of his fourth rule is that 'rapidly rising or falling markets usually go further than you think'. In our time in emerging markets, we have found that this is very much the case for the emerging market capital flow cycle. In good times, currencies appreciate far more, and interest rates and bond yields fall much further, than was predicted. Between 2003 and 2008, Brazilian policy interest rates fell from 14.25% to 11.25%, and at the same time, the Real strengthened from BRL 3.60 to the dollar to BRL 1.60.

We believe that the conditions that have led to capital inflows, stronger currencies and good returns to equity investors are still in place. We do not agree that a repeat of 2013 is likely to happen soon. We think that there is plenty of scope for a positive capital flow/growth cycle to continue in emerging markets. Markets usually go further than you think.

Sources:

1. <https://www.ft.com/content/30652b8d-8aff-444a-a703-fd8582058c69>.
Sources for all data: JOHCM/Bloomberg (unless otherwise stated).

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