Ashmore

# Emerging Markets and tapering

By Jan Dehn

**Federal Reserve Chairman Ben Bernanke's announcement that Quantitative Easing (QE) will be scaled back carries enormous symbolic significance.**

The commencement of tapering marks the first reduction in the pace of monetary easing in the United States since the crisis began in 08/09, but the market has been keen to extend the logic well into the realm of monetary tightening. The US treasury market now prices hikes by early 2015. The turning point thesis has even been extended beyond the US treasury market. Many now allege that the 'Great Rotation' is upon us, the US Dollar is going to soar, and Emerging Markets – their rise constituting the single most important change in the global economy over the past three decades – are predicted to decline.

But is this really a meaningful turning point, beyond its purely symbolic significance? Highly symbolic events make for excellent stories, and excellent stories can drive markets. A risk-averse and structurally impaired world navigating uncharted waters of abundant liquidity using untested policies is perhaps particularly inclined towards the melodramatic.

Indeed, it is not so long ago that another powerful idea seduced the market, namely the break-up of the Eurozone. Like the idea of the great rebalancing, the Eurozone idea was also seductive, highly tradable, grand in scope, and completely wrong. Europe went on to expand its membership rather than break up. Once-strongly voiced calls for imminent EUR-collapse are now barely heard in whispers.

We think that the notion that all the big trades of the past 30 years must now go into reverse is far too simplistic. It fails to distinguish between fundamental and technical market drivers as well as between cyclical and structural factors. In this piece we tackle head-on a few misperceptions, which have become more widespread following June's sell-off.

1. First, we believe the sell-off in June was technical, not fundamental.
2. Secondly, we believe Emerging Markets are far less vulnerable to tapering and rising rates than the HIDCs (Heavily Indebted Developed Countries).
3. Thirdly, we believe the so-called 'era of Emerging Markets', far from being over, is only in its infancy.
4. Finally, we think that Fed rate hikes are further into the future than the market thinks. But we also believe that inflation risks are higher than the market thinks. What this translates into is a view that the Dollar is not about to embark on a long-term bull trend, but rather that it is heading for a fall in the coming years as inflation re-emerges.

In short, we believe the case for investing in Emerging Markets remains very strong.

Many now allege that the 'Great Rotation' is upon us, the US Dollar is going to soar, and Emerging Markets – their rise constituting the single most important change in the global economy over the past three decades – are predicted to decline.

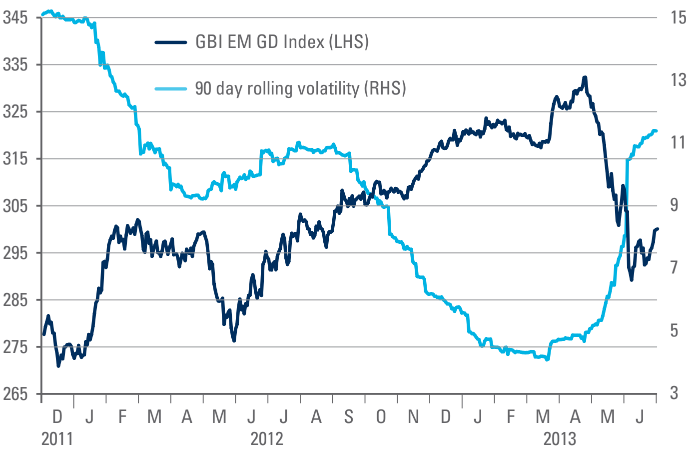
## Misperception number 1

### The Emerging Markets sell-off in June was fundamentally driven

Emerging Markets asset prices reacted far more strongly to the Fed's tapering announcement than appears to be justified by a 100bps of re-pricing of US treasury yields. The reason why the price action was so violent is that an unusually bad technical constellation had emerged in the market leading up to Bernanke's tapering announcement, particularly in local markets.

The weak technicals began with very strong inflows into Emerging Markets in Q1 2013 on the back of strong performance in 2012 and declining market volatility as European tail risk fears gradually dissipated. The flawed practice of measuring risk using volatility proved costly once again as many investors entered the market very late in the rally, which had its origins in the turmoil surrounding the Greek default in late 2011.

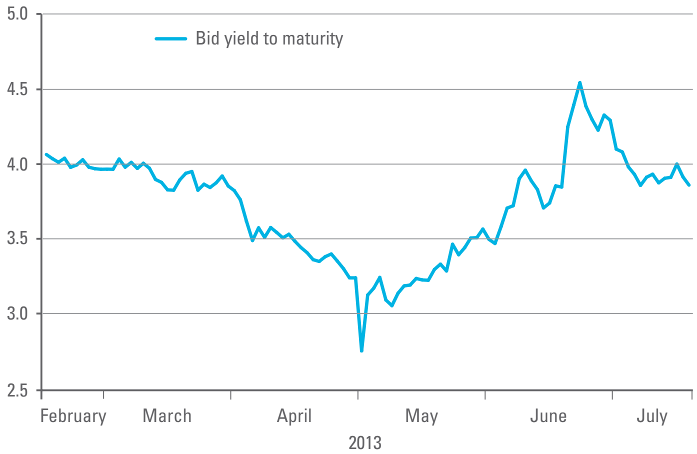
Fig 1: **Index levels are inversely correlated with volatility**




Source: Bloomberg, JP Morgan, Ashmore.

Next the market added leverage near the top of the market. In highly speculative bets, hedge funds and other leveraged investors added exposure on the view that Japanese institutional investors would significantly allocate to Emerging Markets fixed income in response to a rise in JGBs yields. Yields screamed lower in April, in some cases such as Poland, entirely unreasonably so.

Fig 2: **Poland: 10 year bond**




Source: Bloomberg.

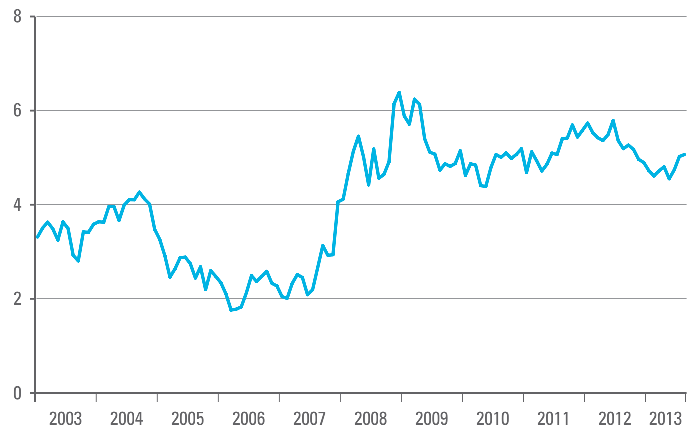
The straw that broke the camel's back was the Fed's tapering talk. Wall Street's market makers sharply reduced balance sheets for flow traders, the key liquidity providers for leveraged investors. As US treasury yields rose, the Japanese stock market turned, USDJPY declined, and the anticipated Japanese institutional flow into Emerging Market local bonds never materialised. Hedge funds found themselves trapped in leveraged long positions.

The resulting sell-off was material, largely indiscriminate, and essentially unrelated to Emerging Markets fundamentals. It serves as yet another reminder of the importance of not trading markets with highly pro-cyclical liquidity with excessive leverage. EM is still a very inefficient market, where prices can veer far from underlying fundamentals.

The other inefficiency on display during June was the market's tendency to treat all Emerging Markets as an amorphous mass of risk rather than a large investment universe with 65 countries and multiple asset classes. Idiosyncratic country-specific negative headlines in a small number of individual Emerging economies coincided with the technical sell-off. These headlines, which were unrelated to the developments in the US treasury market, included cyclical weakness in Asian exports, political noise in Brazil, Turkey, and Egypt, and stress in interbank market rates in China. The effect was an impression that the entire Emerging Markets universe was unravelling.

We strongly disagree and think the resulting sell-off has left Emerging Markets looking attractive. Positioning is now much cleaner. Local currency government bonds with an average investment grade rating are now trading more than 500bps over similar duration bonds in the US treasury market. This compares to less than 200bps before the crisis. Sovereign Dollar denominated bonds of investment grade quality are similarly trading at more than twice the spreads before the crisis. Equities, corporates, and currencies have produced similar opportunities plus a number of countries were left mispriced in absolute and relative terms.

Fig 3: **Spread between UST 5-year and GBI EM GD bond yields**



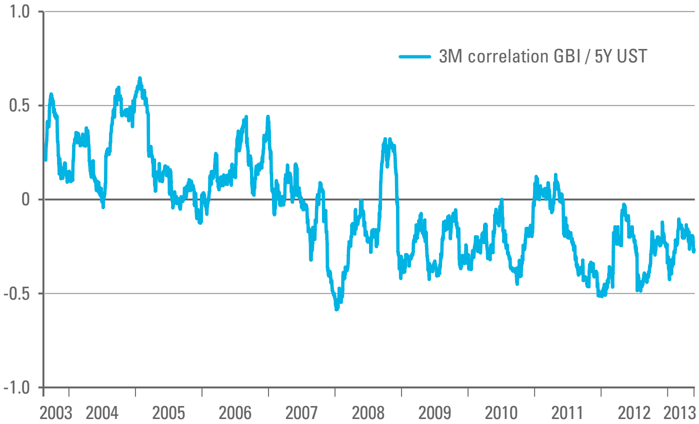

Source: Bloomberg.

## Misperception number 2

### Emerging Markets are more vulnerable to tapering and rising rates than the HIDCs

The recent re-pricing of the US treasury market did not create major difficulties in Emerging Markets. Obviously, countries in Emerging Markets are hugely diverse, not just in economic structures, but also in quality of governance and policy making. It is therefore no surprise that a smaller number of countries with weaker macroeconomic policies found it necessary to tighten monetary policy (Brazil, Turkey, Indonesia, and India). Even so, the vast majority of Emerging Markets countries saw no need to act. Some even lowered rates, others intervened to stabilise bond and FX markets with standard measures, or simply did nothing. None were even close to approaching crisis conditions. None turned to the IMF or other institutions for help.

Fig 4: **Three month rolling correlations between total returns in the GBI EM GD Index and 5 year US Treasuries has declined to zero over the past decade**



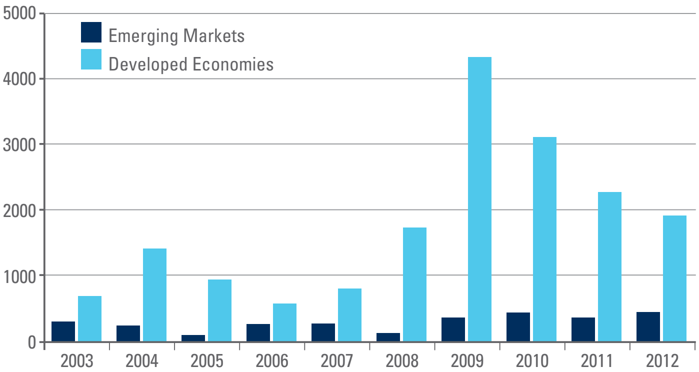

Source: Bloomberg, JP Morgan, Ashmore.

The other reason to be less concerned about rising US treasury yields is that 3-month rolling correlations between yields on Emerging Markets bonds and US treasury yields are insignificantly different from zero. Rather than making local markets less attractive, this feature makes local currency bonds more attractive for any diversified investor, who wishes to retain exposure to fixed income securities at a time of gradually rising US treasury yields.

The Fed is now committed to scaling back QE, so how will this impact Emerging Markets? In particular, will the diminishment of QE flows damage Emerging Markets? To answer this question we look at flows, leverage levels, and pricing. On all three metrics we conclude that the HIDCs are more at risk from tighter liquidity conditions than Emerging Markets.

Consider flows. The main worry here is that Emerging Markets have gorged themselves on easy money by issuing far too much debt. The chart below shows the absolute increase (in millions of US Dollars) of local currency denominated government debt in developed and Emerging Markets in the period prior to and during QE, which began in 2008. As the chart clearly shows, the increase of government issuance during the QE era has been vastly more pronounced in the HIDCs than in Emerging Markets, whose issuance has remained broadly flat.

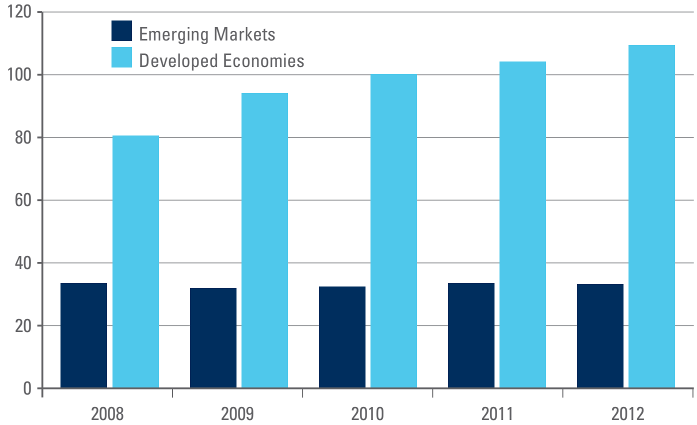
Fig 5: **Developed economies have increased issuance of Local Currency Debt sharply during the QE period compared to Emerging Markets**




Source: Bank of America, Merrill Lynch.

Moreover, Emerging Markets have grown faster than developed economies during the crisis period (about 15 times faster to be exact). This means that the amount of debt in their economies measured against the level of output has remained steady throughout the QE years. Indeed, Emerging Market fundamentals still look vastly stronger than fundamentals in the HIDCs. Emerging Markets control 80% of the world's FX reserves. Emerging Markets external debt to GDP including inter-company loans is 19% of GDP compared to 271% of GDP in the HIDCs. Asia has at least twice as many reserves as short-term external debt obligations.

Fig 6: **Public debt to GDP ratios have deteriorated sharply in developed markets, but remained stable in Emerging Markets**




Source: IMF.

Finally, it is clear that QE flows went to HIDCs rather than Emerging Markets, because the relative prices have moved sharply in favour of the former since the crisis. The table below summarises the level of spreads in the main fixed income markets today compared to pre-crisis levels. Without exception, all Emerging Markets themes trade cheaper today than they did pre-crisis, despite everything we have learned about the relative strength of Emerging Markets and the weaknesses which have been exposed in the HIDCs.

It is clear that Emerging Markets economies are already financing at much higher interest rates than HIDCs. This ultimately means that the very marginal increases in treasury yields, which are likely to occur over the next year or two will have much smaller percentage effects on borrowing costs in percentage terms in Emerging Markets than in the HIDCs.

| | Index Price or Bond Spread pre-08/09 | Current Index Price or Bond Spread |
|---|---|---|
| Sovereign external debt spreads | 169bps | 292bps |
| Corporate bond spreads | 147bps | 338bps |
| Local currency bond spread to UST | 174bps | 507bps |
| EM MSCI | 1241 | 951 |
| Frontier Markets MSCI | 1089 | 554 |

Source: Bloomberg.

## Misperception number 3

### The Emerging Markets era is over

The long-term case for investing in Emerging Markets is completely unaffected by June's price action. The case for Emerging Markets boils down to two fundamental dynamics.

First, Emerging Markets are going to continue to grow faster than developed economies for many decades to come on account of lower capital stocks. Buying Emerging Markets is to buy into a global convergence trade. The origin of this convergence trade is the end of the Cold War, which ushered in better economic policies across the developing world. The improvement in economic policies is now allowing Emerging Markets to realise the intrinsic growth potential they have by virtue of being less endowed with capital. This, the largest convergence process the world has ever seen, is still in its infancy. For example, China's income per capita is only one tenth of that of the United States. Many African countries have incomes per capital one hundred times lower than the United States.

Second, financial markets in Emerging Markets are going to become far too large to ignore. Institutional investors are massively under-invested. Moreover, the HIDC assets which dominate many institutional investors are unlikely to deliver the returns expected of them. We estimate that EM bond markets will reach USD30trn-45trn by the end of this decade, or 3-4.5 times larger than the size of the US treasury market.

The outlook for Emerging Markets is not without risk, of course. There is idiosyncratic country risk in Emerging Markets, so active management remains very important.

The outlook for Emerging Markets is not without risk of course. There is idiosyncratic country risk in Emerging Markets, so active management remains very important. The bigger challenge however, arrives with the return of inflation in the HIDCs.

Emerging Markets will then once again face material currency appreciation pressures due to a falling Dollar. This will require that Emerging Markets transition to more domestic demand led growth, which in turn will require more focus on supply side reforms, infrastructure investment, and developing domestic corporate bond markets. These are not easy adjustments to make. Some countries will fare better than others. Again, active management will be important.

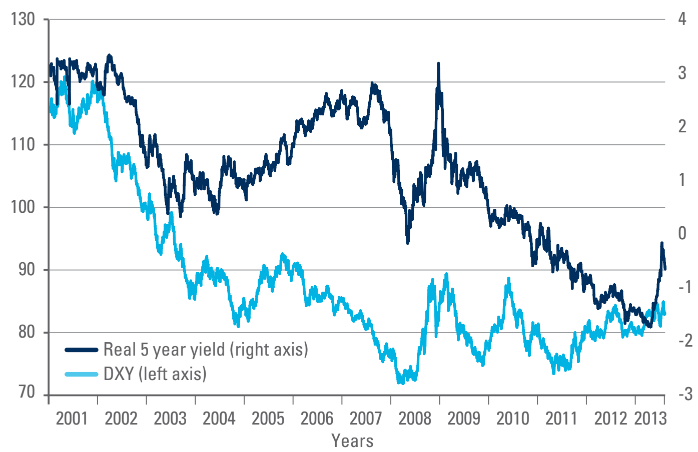
## Misperception number 4

### Rate hikes are around the corner

The global rate environment is going to be more volatile than in recent years. This is not just because the Fed is conditioning the pace of tapering on incoming data, which itself is highly volatile (the recent revisions to US GDP are an excellent case in point).

The recent anomalous strong dominance of trend over volatility in US real rates now looks well and truly done with, while currency volatility still remains within recently established ranges, probably due to the absence of inflation. This absence of inflation is however, temporary in our view, and currencies are likely also to become more volatile.

**Fig 7: Interest rate volatility has suddenly spiked after a period of pronounced trend with low volatility**



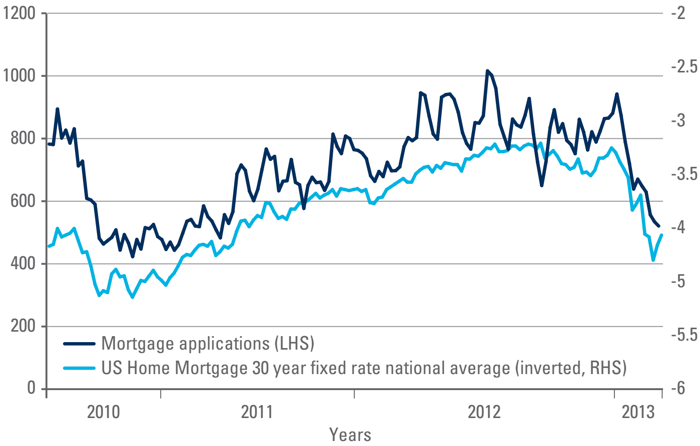

Source: Bloomberg.

A more volatile treasury market justifies shorter duration exposure, but it is not the same as directional shifts in the US yield curve. During June the US Treasury market not only priced in the end of QE, but also the start of rate hikes by Q1 2015, four hikes by July 2015, and a non-inflationary normalisation of monetary policy in the United States. We do not think this is how things will turn out.

First, too many hikes are priced in too early. Tapering is being scaled back because it's ineffective at the margin, not because the Fed wants to hike. The US economy is still not healthy enough to handle a rise in real rates. Unemployment is far above target amidst very low participation rates. Core PCE inflation is running at half of the Fed's target of 2% and US Q1 GDP growth was recently revised from 3.5% to 1.8%, while Q2 growth is now tracking less than 1%. Sequestration is weighing on the US economy and housing demand, the economy's sole engine of growth, is proving very sensitive to rising mortgage rates, judging by the recent fall in mortgage applications.

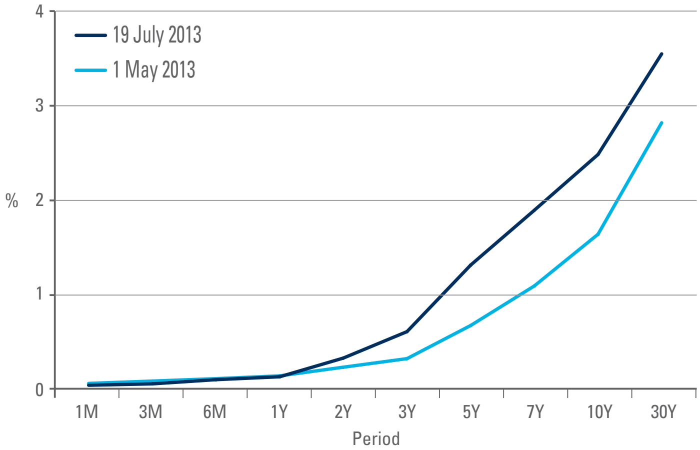
Ashmore

Fig 8: **US mortgage applications**




Source: Bloomberg.

Fig 9: **US yield curve shift**




Source: Bloomberg.

Second, the long-end of the curve is too flat, meaning that the market is too complacent about inflation in medium term. The belly sold off far more in percentage terms than the long-end, a term structure that is consistent with non-inflationary normalisation of monetary policy.

But we do not believe in a non-inflationary exit to the currency imbalances in the US economy. The reasoning starts with the premise that a sustainable US recovery requires a lower debt stock (currently total debt in the US economy is just under 400% of GDP). Deep fiscal reform looks unlikely in both the Obama administration and during the first term of a new administration, so inflation and Dollar weakness will become the preferred means of reducing the real debt stocks. This also has the distinct political advantage of sparing current voters from pain as the burden is passed to future generations via inflation and to foreigners via currency weakness.

An inflation episode could begin at the start of the second half of this decade as household deleveraging reaches completion. Among the HIDCs, the US recovers first because it recapitalised the banks early. The Fed's credibility obviously takes a hit – like it did under Chairmen Miller and Burns – but once the real debt stock has been inflated down to a more manageable size the Fed can easily restore its credibility by appointing a Volcker II to crush inflation. After this treatment the US economy will emerge super-competitive due to a weaker Dollar, economically stronger due to lower debt, and without inflation.

## Contact

**Head Office**

**Ashmore Investment Management Limited**
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

**Other locations**

**Beijing**
T: +86 10 5764 2601

**Bogota**
T: +57 1 347 0649

**Jakarta**
T: +6221 2953 9000

**Istanbul**
T: +90 212 349 40 00

**Moscow**
T: +74 9566 04258

**Mumbai**
T: +91 22 6608 0000

**New York**
T: +1 212 661 0061

**Sao Paulo**
T: +55 11 3556 8900

**Shanghai**
T: +86 21 3855 6766

**Singapore**
T: +65 6580 8288

**Tokyo**
T: +81 03 6860 3777

**Washington**
T: +1 703 243 8800

**Bloomberg Page**
Ashmore <GO>

**Fund Prices**
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper