EM and the Fed: Smaller pullbacks and greater recoveries

By Jan Dehn and Romain Bocket

Investors in Emerging Markets (EM) should no longer fear Fed events – instead they should actively add into any temporary market nervousness ahead of hikes, especially in local markets. As the Fed prepares to hike for a second time, it is noteworthy that EM pullbacks are becoming shallower, while recoveries after Fed events are getting stronger. We expect Fed tightening will now result in net positive returns for EM investors that buy ahead of events. The very gentle trajectory for Fed hikes is unlikely to hurt EM countries fundamentally, yet EM bond yields already hover close to levels last seen when the Fed had policy rates above 5%. This provides important protection.

There has also been a notable flip in correlations between performance in the short end of the US Treasury curve – reflecting market expectations of Fed action – and EM rates and FX markets. Specifically, EM local rates markets now react less and recover faster than US markets, while EM FX now has more gain than pain around Fed events, also thanks to shifting correlations. We demonstrate these important positive changes in correlations, which are also evident in EM's Dollar-denominated credit markets. Finally, we show that the real vulnerability lies in developed fixed income markets, where bonds are showing increasing sensitivity to Fed tightening.

EM's reaction to the first hike in December 2015 has been textbook – local currency and corporate High Yield (HY) bonds have outperformed, reflecting excessive risk aversion in these strategies ahead of the event. However, as the Fed now prepares for a possible second hike in June or July of this year investors are once again asking how EM can be expected to perform.

A second hike from the Fed would constitute the third effort at normalising monetary policy since the Developed Market Crisis (DMC) of 2008/2009, the first two efforts being 'tapering' in May 2013 and the Fed's first hike in December 2015.

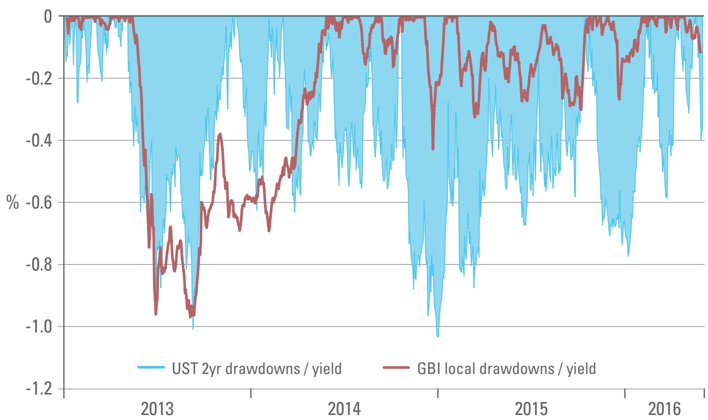
The purpose of this Emerging View is to answer this question and to offer recommendations for how to allocate to the asset class in response to Fed events.

Our main focus is EM local bond markets, because they are sensitive to both rates and FX, but we also examine the impact on Dollar-denominated EM fixed income assets classes as well as key bond markets in the developed world.

Smaller pullbacks, stronger recoveries in rates markets

Figure 1 illustrates the impact of Fed events on EM local bond market yields for the period spanning the Fed's two first normalisation events in May 2013 and December 2015 plus the current market nervousness ahead of a possible June or July Fed hike.[1] The red line shows drawdowns scaled by yield, that is, the vertical axis measures the number of years that would be needed for the yield to offset the impact of the drawdowns. For comparison, the chart also shows in blue the drawdowns in the US 2-year bond market, which reflects most closely expected Fed action.

Fig 1: **UST 2-year and GBI local market drawdowns, scaled by yield**



Source: Ashmore, Bloomberg, JP Morgan.

Two conclusions should be drawn with respect to the impact of Fed events on EM rates markets. First, the size of the pullbacks were roughly the same in EM local rates markets as in the US bond markets in response to the Taper Tantrum, but the size of the pullbacks have subsequently declined markedly in EM, while they have remained roughly the same in the US. Second, EM bond markets are now recovering much more quickly to Fed events than US bond markets. This can be seen from the time it takes for pullbacks to be reversed. In fact, drawdowns in the US bond market are arguably becoming more persistent when viewed across the period as a whole.

[1] Based on JP Morgan's GBI EM GD index.

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More gain than pain from more pain than gain

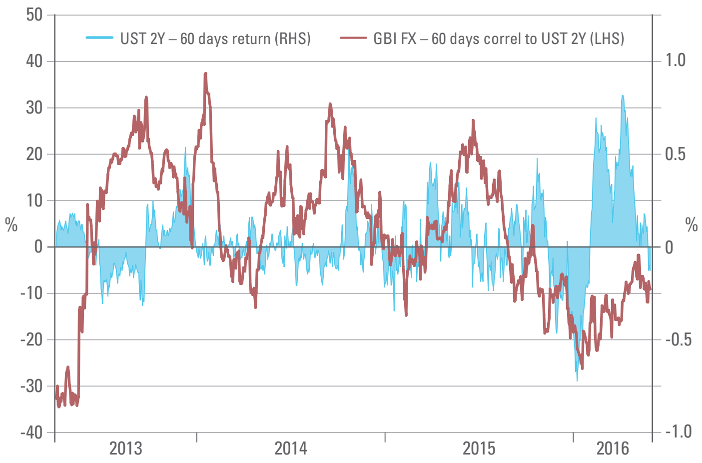
Total return depends on currency moves as well as rates moves. Figure 2 shows 60-day correlations between 2-year US Treasury bond returns and EM currencies.[2] The chart shows that there has been a significant change in this relationship. Consider, for example, the period from 2013 to September 2014. During this period, the correlation between EM FX and US 2-year bond market returns is strong and positive. This means that when US 2-year bond market returns decline, there are outsized losses in EM FX markets, while recoveries in EM currencies are weaker when Treasuries turn positive. In other words, EM currencies took more pain in Treasury sell-offs in this period than they gained during Treasury rallies.

EM FX's correlation with US 2-year bond returns now tends to increase when Treasuries rally and decline when Treasuries sell off. This means that EM FX gains more from rallies than it suffers from Treasury sell-offs

Since September 2014, however, this relationship has been turned on its head. EM FX's correlation with US 2-year bond returns now tends to increase when Treasuries rally (positive blue bars in the chart) and decline when Treasuries sell off (negative blue bars in the chart). This means that EM FX takes more gain from rallies than it takes pain from sell-offs in the Treasury market.

It is also clear that the size of correlations is in overall decline as reflected in the general downwards trajectory of the red line in figure 2.

Fig 2: **EM FX correlations with US Treasury returns and US Treasury returns**



Source: Ashmore, Bloomberg, JP Morgan.

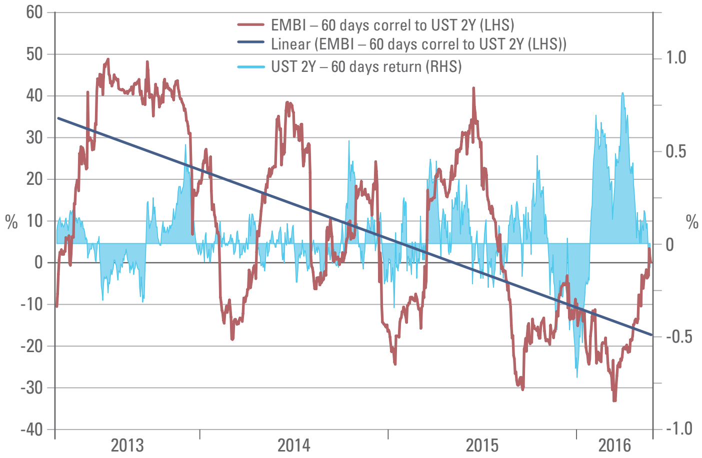
Fed hikes and the Dollar EM credit universe

It is perhaps a good indication of the indiscriminate nature of the selling of EM assets over the last few years that EM's Dollar-denominated fixed income markets display many of the same features as local markets.

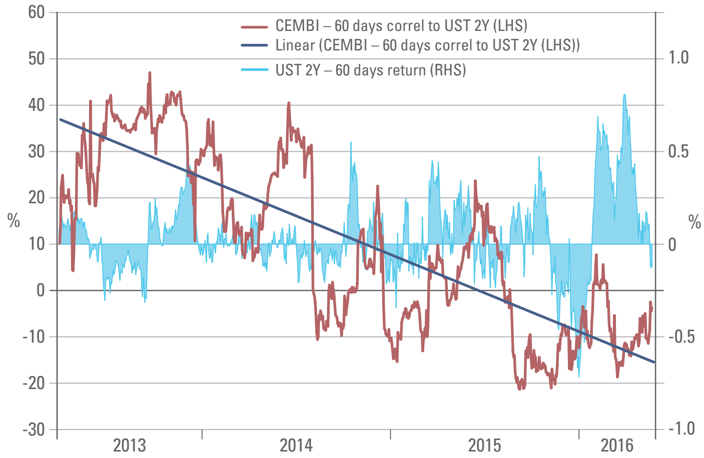
Figure 3 shows changes in correlations between 2-year US Treasury returns and returns on both EMBI sovereign Dollar-denominated bonds and CEMBI corporate Dollar-denominated bonds. Here too correlations have flipped completely, such that EM correlations with 2-year Treasuries now rise during Treasury bull markets and decline during Treasury bear markets.

Note also that correlations between Treasury returns and EM's Dollar-denominated credit markets have declined sharply since peaking in 2013. Incidentally, the same pattern is evident in the IG-only versions of the EMBI and CEMBI benchmark indices, albeit somewhat less pronounced due to the narrower spreads in the IG universe (see appendix 1).

Fig 3: **60 day correlations between 2-year US Treasury returns and EMBI and CEMBI returns, compared to 2-year US Treasury 60 days rolling returns**



Source: Ashmore, Bloomberg, JP Morgan.



Source: Ashmore, Bloomberg, JP Morgan.

[2] Based on the FX returns of JP Morgan's GBI EM GD index.

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Pity the others

The case for EM fixed income should always be couched within a discussion of the outlook for developed market fixed income – after all, developed market fixed income is the opportunity cost of investing in EM.

Quite aside from the basic valuation argument – the fact that EM fixed income pays high positive yields while developed market fixed income pays very low or even negative real yields – there is now also clear evidence that developed market bonds are becoming more risky than EM bonds.

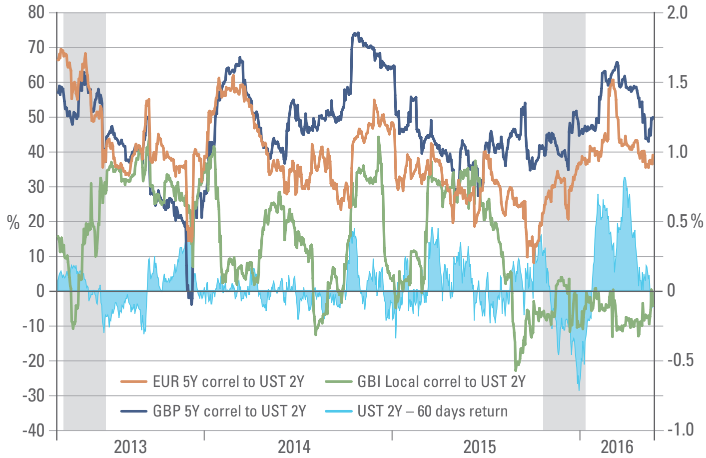
Figure 4 shows correlations between movements in the short end of the US curve – a proxy for Fed expectations – and returns in European and the UK bond markets. Just like in EM, correlations have flipped, albeit the other way around. European and British bond correlations with 2-year US Treasuries declined during in 2013, but by 2015 European and UK bond market correlations began to increase.

As an aside, the overall correlations between 2-year Treasury bonds and five-year bonds – in the US, Japan, Europe and in the UK – are all higher in absolute terms than correlations between 2-year Treasuries and EM bonds. Moreover, in the case of the US and Japanese five year bonds the correlations are actually rising over time (see appendix 2).

Developed market bonds tend to be highly correlated with each other, because the bonds tend to sit in the same portfolios. Hence, if US bond yields rise so will other developed market bonds as investors take profits in the better performing markets. Inflation is likely to arrive in the US before Europe and Japan, so it can be expected that central banks in the latter will have to expand bond purchase programs if only to keep real yields from rising in response to rising nominal yields in the US.

Correlations have also flipped in developed markets, but the other way around. Declining in 2013, correlations with 2-year US Treasuries has been on the rise since 2015

Fig 4: **60 days correlations between UST 2-year returns and 5-year bonds in Europe, Britain and EM local bond markets, compared to 2-year US Treasury 60 days rolling returns**



Source: Ashmore, Bloomberg, JP Morgan.

Conclusion

- EM bonds are becoming less sensitive to Fed events.
- Pullbacks ahead of events are smaller and recoveries are stronger.
- EM yields are higher and EM currencies have adjusted significantly, which now imparts upon EM countries greater resilience to Fed tightening.
- Bonds in developed markets have largely lost this protection. This has important implications for fixed income investors as the Fed continues on its path towards normalisation of interest rates.
- EM investors should no longer be afraid of such events. Instead, they should actively buy into the market in event of temporary weakness, because the odds strongly favour positive net returns around Fed events. The opposite is the case for developed market bonds.

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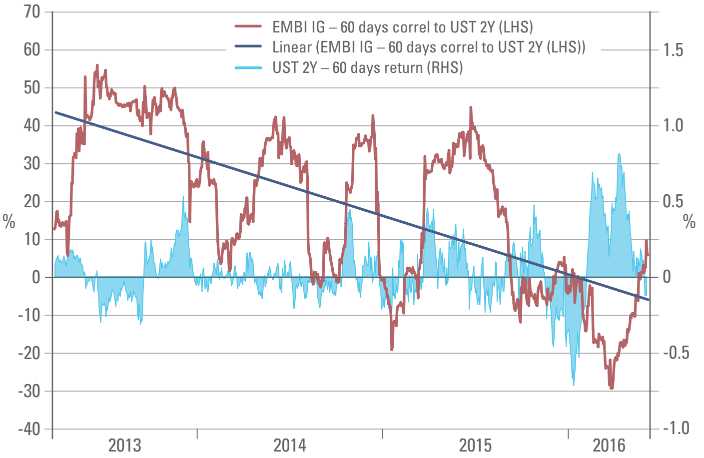
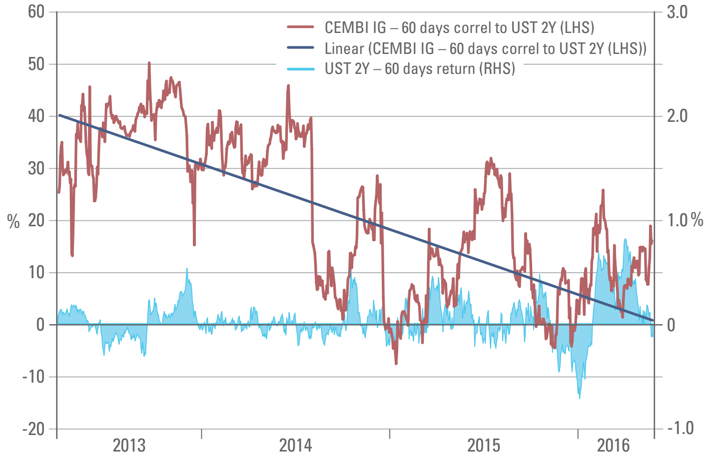
Ashmore

Appendix 1:

60 days correlations between returns in 2-year US Treasuries and IG version of EMBI and CEMBI, compared to 2-year US Treasury 60 days rolling returns



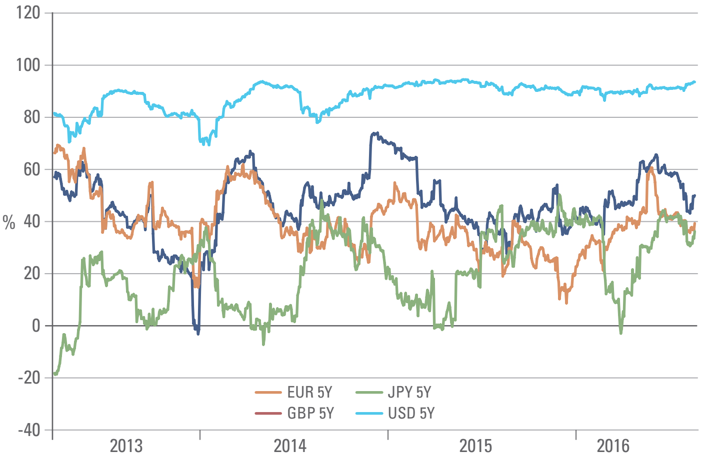
Source: Ashmore, Bloomberg, JP Morgan.



Source: Ashmore, Bloomberg, JP Morgan.

Appendix 2:

High and in some cases rising correlations between performance of 2-year US Treasury and performance of 5-year bonds in the US, Japan, UK, and Europe



Source: Ashmore, Bloomberg, JP Morgan.

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