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MARKET COMMENTARY

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The looming Fed lift-off and interest rate volatility: considerations for fixed income and EM Debt

By Gustavo Medeiros

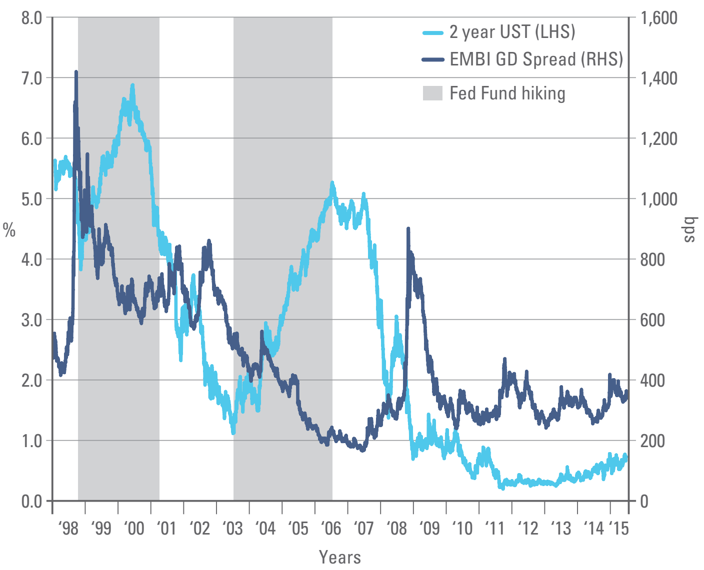
Leaving dovish/hawkish interpretations aside, the June Federal Open Market Committee (FOMC) had a clear message for investors: it is ready to start the process of interest rate normalisation as soon as the economy exhibits some signs of improvement from its first quarter lethargy. It may happen in September, December or even the beginning of 2016, but the 'sword of Damocles' will keep hanging over investors' heads for some time and uncertainties will linger on over what happens when the first rate hike comes.

Fear the VIX, not the Fed

However, we argue that investors should not fear the looming hiking cycle as any weakness in asset prices should be an opportunity to add to positions. This argument is based on empirical evidence that hiking rates is NOT the main event which derails Emerging Markets (EM) assets. Figure 1 demonstrates that EM credit spreads actually tighten during the period when the Fed is hiking interest rates. This has happened twice, first during the 1998-2000 hiking cycle and secondly during the 2004-2007 cycle. That makes intuitive sense. The lift-off is bound to coincide with a period when US growth is on a recovery path; lifting global growth prospects as the US economy starts hitting supply constraints and begins to import more of the goods and services it consumes.

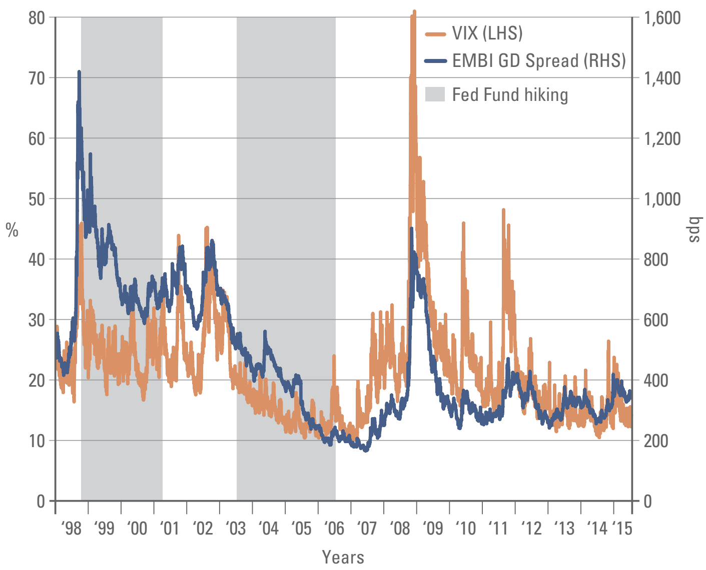
Investors should fear more, in our view, a sudden spike in global risk aversion, leading to a strong liquidity contraction, which would push credit spreads wider across the board. As evidenced by figure 2, that typically happens either just ahead of the Fed hikes – as the increased fear of rate hikes leads to liquidity contraction (Russia/LTCM in 1998) – or long after the hiking cycle is over, when the tightening of monetary policy feeds through the economy and the higher cost of funding eventually tips one or more sectors into liquidity problem (MBS/Banking crisis in the US in 2008).

Fig 1: **EMBI GD Spread vs. 2yr UST**



Source: JP Morgan, Bloomberg.

Fig 2: **EMBI GD Spread vs. VIX**



Source: JP Morgan, Bloomberg.

There is empirical evidence to suggest that hiking rates does NOT have a negative effect on EM assets. In fact, EM credit spreads have actually tightened during periods where the Fed has hiked interest rates

Continued overleaf

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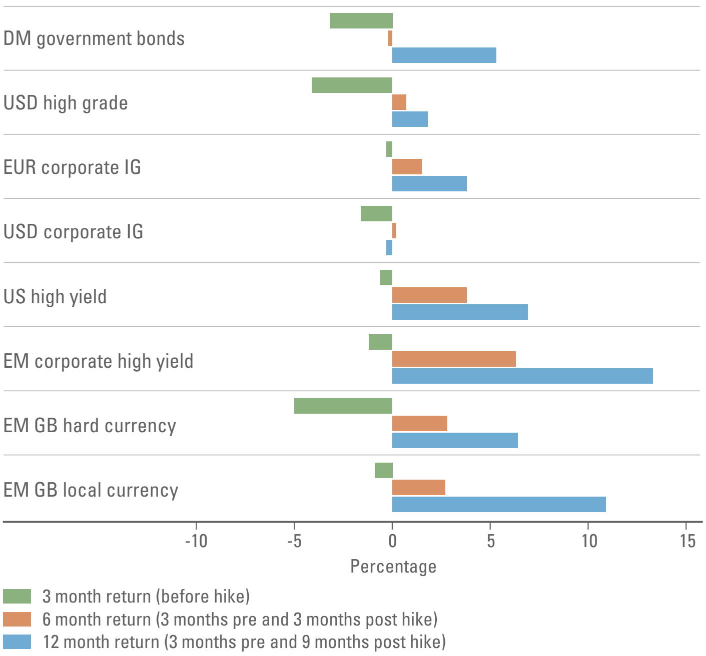
Thus, considering the current point in the cycle, we would consider any sell-off led by the 'fear of the Fed' as an opportunity to add. We currently favour EM High Yield (HY) credit, which trades at distressed levels in a number of countries that have better ability and willingness to pay than is currently priced in, allowing for attractive carry and gains from potential credit tightening as the undervaluation corrects. Coincidently, HY markets also did well during the latest 'telegraphed' hiking cycle starting in 2004. We think this time will not be different.

Fig 3: **Asset class behaviour around 2004 rate hike**



Source: UBS.

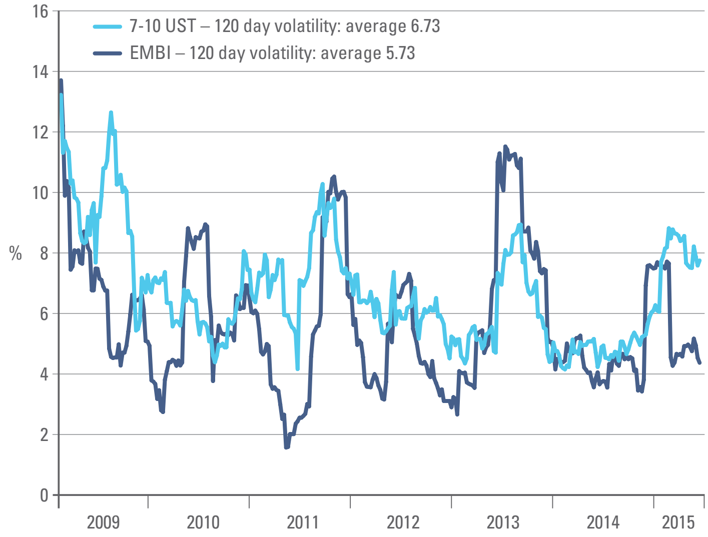
Considering the current point in the cycle, we view any sell-off led by the 'fear of the Fed' as an opportunity to add to EM exposure, particularly high yield credits

Volatility is seen in unexpected places

At the same time, we find it hard to justify allocations in 'core' developed market fixed income assets when assessed on current valuations together with liquidity and volatility considerations. Volatility has been increasing considerably, to levels much higher than EM USD assets (even with all the idiosyncratic events taking place in Ukraine, Russia and Argentina for example).

As a matter of fact, since February 2009, when the FOMC brought interest rates to the zero lower bound, the average of the 120 days volatility of weekly returns has been significantly lower for EM debt than a duration-matched US treasury index: volatility on the JPM EMBI GD index has averaged 5.73% vs. 6.73% for the Barclays 7-10yr US Treasury Index. Returns have also been consistently higher with the EMBI GD rising 10.47% annualised vs. 4.66% for the treasury index.[1]

Fig 4: **EM less volatile than US treasuries**

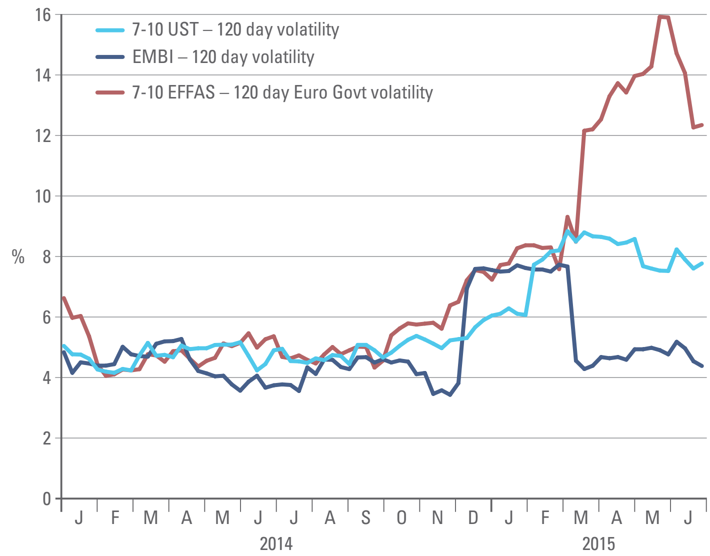


Source: Ashmore, JP Morgan, Barclays, Bloomberg.

The recent interest rate adjustment illustrates the defensive qualities of sovereign EM debt. The most vulnerable asset classes were those where valuations were the most stretched due to monetary policy distortions – European rates

The recent episode of interest rate adjustment serves as another illustration of the defensive qualities of an investment in sovereign EM debt. The most vulnerable asset classes were, in fact, exactly where valuations were the most stretched due to monetary policy distortions – European rates. US rates sold off in sympathy, even if US treasuries widened with a lower beta than German bunds. Again, the 120 day volatility analysis evidences that EM fixed income performed better as the 'fat' credit spreads cushioned part of the yield widening from US treasuries.

Fig 5: **Defensive qualities of EM debt**



Source: Ashmore, JP Morgan, Barclays, Bloomberg.

[1] Source: Ashmore, JP Morgan, Barclays, Bloomberg.

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Summary and conclusion:

- The Fed lift-off has been a major source of uncertainty in the markets. This has delayed important asset allocation decisions, particularly in EM fixed income assets, as the fear of an increase in volatility when the Fed raises rates dominates investment decisions. Once the hiking cycle starts, one of the main sources of uncertainty is removed which, we believe, will be a positive factor for EM asset flows.
- However, the data suggests the main risks in many portfolios will be in low yielding long duration assets in the developed world, as the numbers suggest that volatility and illiquidity is bound to be more pronounced there.
- Past hiking cycles coincided with tightening in EM credit spreads, which suggests short duration High Yield should out-perform again in this phase of the cycle.
- In particular, the current cycle is likely to be slow paced and shallow in the US at the same time that monetary policy will remain expansionist in Japan, EU and China. This should ensure that global liquidity will remain strong during the current hiking cycle, which will favour EM assets which currently trade at higher spreads than low yielding DM assets.

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