EM unlikely to be at risk of another 'Taper Tantrum' episode

By Gustavo Medeiros

Fears of another 'Taper Tantrum' sell-off episode similar to 2013 due to the ongoing increase in US treasury yields are misplaced. Travel declined by three-quarters during the Chinese New Year in 2021, leading to higher consumption in big cities and faster reopening of manufacturing. Indonesia cut the policy rate by 25bps to 3.5%. South Korean exports rose strongly in the first 20-days of February. President Jair Bolsonaro fired the head of Petrobras in Brazil. In Ecuador, Guillermo Lasso will face Andrez Arauz in the presidential election run-off in April.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.5	–	0.09%
MSCI EM Small Cap	11.7	–	1.49%
MSCI Frontier	10.6	–	1.28%
MSCI Asia	15.9	–	0.22%
Shanghai Composite	12.5	–	5.72%
Hong Kong Hang Seng	9.6	–	2.51%
MSCI EMEA	10.1	–	-0.03%
MSCI Latam	11.4	–	-0.58%
GBI-EM-GD	4.50%	–	-1.35%
ELMI+	2.30%	–	-0.22%
EM FX spot	–	–	-0.41%
EMBI GD	4.88%	344 bps	-1.12%
EMBI GD IG	3.07%	157 bps	-1.18%
EMBI GD HY	7.21%	584 bps	-1.06%
CEMBI BD	4.17%	305 bps	-0.11%
CEMBI BD IG	2.94%	183 bps	-0.32%
CEMBI BD Non-IG	5.82%	470 bps	0.16%

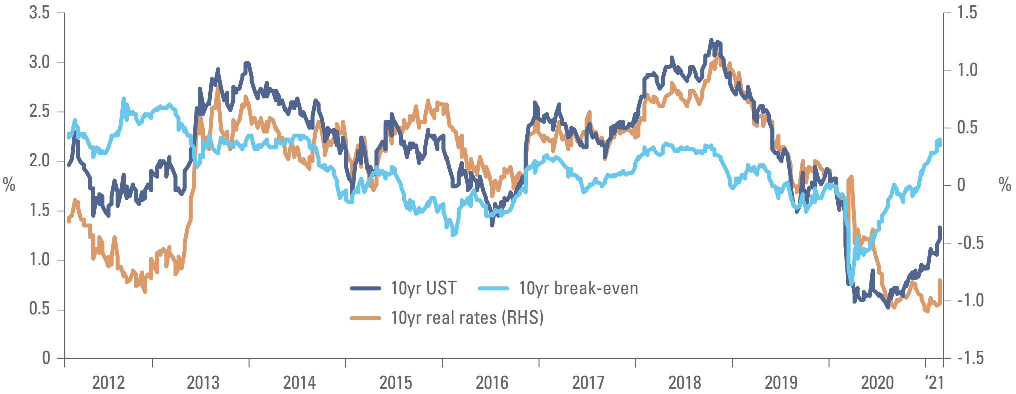
Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	19.8	–	-0.20%
1-3yr UST	0.11%	–	-0.02%
3-5yr UST	0.61%	–	-0.31%
7-10yr UST	1.39%	–	-1.39%
10yr+ UST	2.18%	–	-3.64%
10yr+ Germany	-0.31%	–	-2.15%
10yr+ Japan	0.00%	–	-0.47%
US HY	3.99%	319 bps	-0.05%
European HY	3.14%	369 bps	0.09%
Barclays Ag	1.01%	-38 bps	-0.63%
VIX Index*	22.05	–	0.80%
DXY Index*	90.33	–	-0.15%
EURUSD	1.2120	–	-0.07%
USDJPY	105.66	–	0.27%
CRY Index*	188.62	–	4.98%
Brent	63.7	–	0.70%
Gold spot	1791	–	-1.52%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

EM unlikely to be at risk of another 'Taper Tantrum' episode:

The interest rates on US treasury bonds have been on the rise since the end of July last year. Most of the increase in nominal yields can be attributed to a repricing of future inflation expectations. Figure 1 shows the yield on the 10-year US Treasury bond, which has increased from an all-time low of 0.53% on 31 July 2020 to 1.34% as of last Friday (+81bps). Over the same period, break-even inflation as priced by the 10-year inflation-linked US Treasury bond increased by 60bps from 1.55% to 2.16%, while real interest rates rose from -1.03% to -0.82%. The main difference in last week's price action is that real yields rose 20bps, leading to fears over a sharp further move higher, since real rates are still very low (close to the previous lows in December 2012 of -0.91%).

Fig 1: **10-year US interest rates: nominal, real rates and break-even inflation**



Source: Bloomberg, Ashmore. Data as at 19 February 2020.

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Emerging Markets

The increase in interest rates is leading to comparisons with the 2013 'Taper Tantrum', which had a severe negative impact on EM assets, including currencies, spreads and yields. Our view is that fears about a repeat of the 'Taper Tantrum' are misplaced for a number of reasons: (1) The Fed's reaction function is likely to be very different today compared to 2013. The Fed reiterated only last week via the January FOMC Minutes that it will be patient and keep policy at highly accommodative levels until the covid-19 crisis is in the rear mirror. However, even if the Fed were to make a repeat of its 2013 miscommunication, EM external accounts are in far better shape today with (2) EM current accounts in surplus in aggregate, and (3) EM currencies trading close to their all-time lows whereas in 2013 EM currencies were relatively expensive, while EM current accounts were in aggregate in a large deficit. Additionally, (4) commodity prices are moving higher as the global economy is rebounding from the covid-19 shock. Commodity prices only affect a few EM countries, but these economies tend to be very sensitive to commodity moves and higher prices will support their currencies. The following sections expand further on these points.

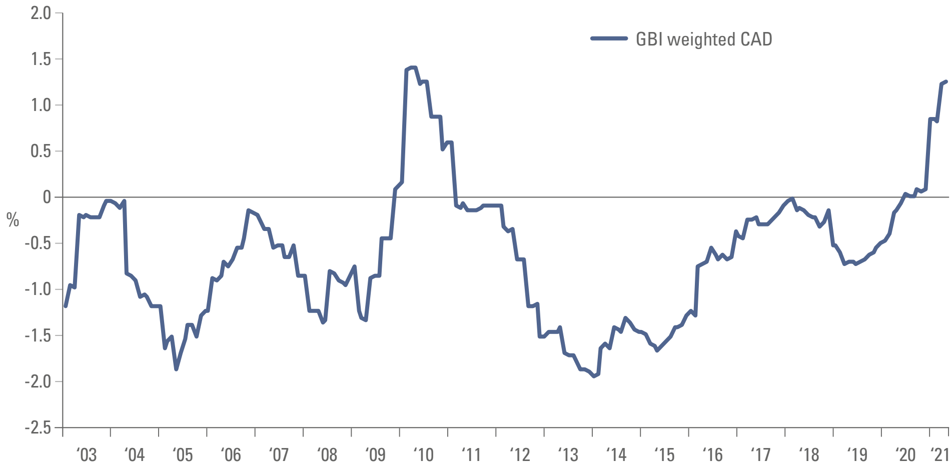
1. Fed's reaction function: 2013 versus today

In 22 May 2013, Fed Chairman Ben Bernanke said during a Congressional hearing that the Fed would consider reducing the pace of monthly bond purchases. The Fed had been discussing, in private, what would be the best way to communicate the tapering of government bond purchases since the beginning of 2013. Back then, the economy had been on a clear recovery path since 2009, and the unemployment rate had fallen from a high of 10.0% to 7.4% and was still showing signs of declining further. The impact on real interest rates following the announcement was much stronger than the Fed had envisaged, forcing the Fed to commit to larger bond purchases for longer in order to avoid an excessive tightening of financial conditions. Jerome Powell, the current chairman of the Fed advocated in favour of tapering back in 2013, but is likely to want to avoid repeating his past mistake. As the Chairman of the FOMC Powell has repeatedly said that the Fed wants to see the covid-19 crisis in the rear mirror before discussing any changes in policies. This suggests that a tapering announcement is highly unlikely before the summer, at the earliest. Moreover, when the Fed does decide to change its communication markets are unlikely to be caught by surprise since the Fed will allow the economy to recover fully before announcing any policy changes.

2. EM external accounts are in much better position today than in 2013

Back in 2013, the average EM country ran a current account deficit equivalent to 1.8% of GDP, which was close to the lowest levels since 2002. By contrast, today EM countries are running an average current account surplus to the tune of 1.3% of GDP, which is close to the strongest level in 20 years as shown in Figure 2. The size of the surplus means that higher external funding costs associated with rising US Treasury yields will impact EM countries far less. Moreover, EM countries are not as dependent on foreign capital to fund external deficits. In fact, a number of EM countries have recently had to intervene in FX markets to deal with an excess inflow of Dollars, including India, Thailand and Chile, whose central banks have been buying Dollars to avoid excessive appreciation of their currencies as well as taking advantage of favourable terms of trade to replenish FX reserves.

Fig 2: **EM current account (weighted by the GBI-EM GD)**



Source: Bloomberg, JP Morgan, Ashmore. Data as at December 2020.

3. EM currencies were expensive in 2013; they are cheap now

EM currencies measured by the GBI EM GD FX index were 39.9% weaker last Friday than in April 2013. The EM real effective exchange rate, which takes account of inflation differentials is 11.5% weaker over the same period as illustrated in Figure 3. This places EM currencies close to their cheapest levels in 20 years, giving EM economies a very important competitive edge by making these countries attractive destinations for investments as the global economy recovers. The recent price action in EM currencies is encouraging: 4.0% stronger today than in July 2020 and only 0.5% weaker in 2021 (until last Friday), in line with the broad USD index performance.

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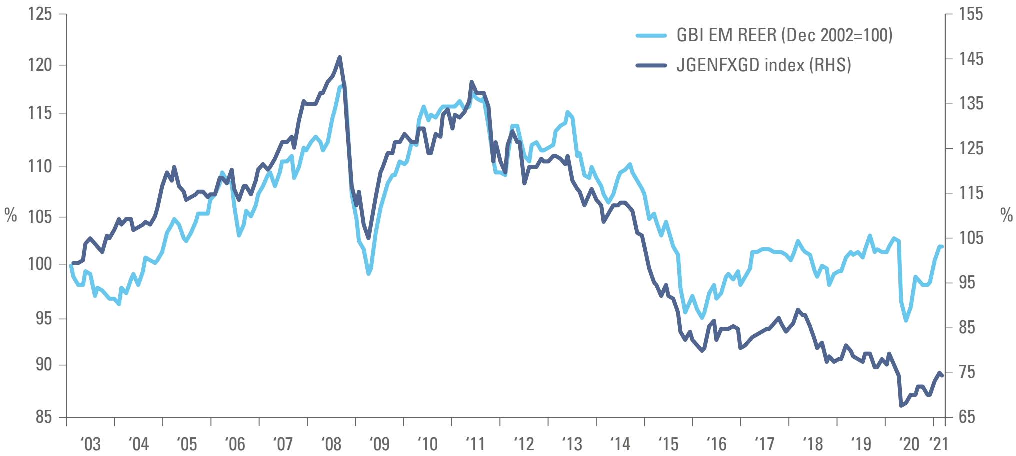
It is worth noting in passing that there is strong anecdotal evidence that investors have much lighter exposure to EM local markets today than in 2013. Prior to 2013, EM local markets had experienced large inflows thanks to the strong outperformance from 2009 to 2012. Since 2013, outflows from EM local markets have been very significant. While inflows to local markets, notably equities, picked up after April last year this merely reversed outflows seen in H1-2020. Importantly, positions among institutional investors are nowhere near where they were some ten years ago.

Fig 3: **EM currencies (weighted by GBI-EM GD) in nominal and real terms**



Source: Bloomberg, JP Morgan, Ashmore. Data as at 19 February 2020.

4. Commodity prices are rising, not falling

Figure 4 shows that commodity prices now exceed the levels prior to the covid-19 shock. The recovery in commodity prices can be traced to an increase in demand from China due to the economic recovery and lower supply due to reduced volumes of investment in various commodity sectors. While EM as a whole is no longer a commodity play,[1] a significant minority of EM, including some countries in Latin America, the Middle East plus South Africa and a handful of Asian countries benefit from higher commodity prices.

Fig 4: **The Refinitiv commodity price index**

Source: Bloomberg, JP Morgan, Ashmore. Data as at February 2021.

5. Forward-looking perspective

Over the next few months a number of factors are likely to keep US Treasury yields in a state of flux and a key focus in markets. Mobility is likely to improve, driven by declining numbers of coronavirus cases and hospitalisation rates as the weather improves in the Northern Hemisphere and vaccinations become more widespread. Furthermore, the US Congress is likely to pass a large fiscal stimulus at the same time that the global economy rebounds. Base effects from last year's depressed commodity prices are also likely to drive tradable goods prices inflation sharply higher. Lastly, the real yield in long dated US bonds remains at its lowest historical levels before 2020. It is therefore possible that US rates continue to rise through a combination of higher real interest rates and rising inflation expectations as inflation increase due to base effects. This scenario is constructive for global GDP growth and should favour high yield currencies and high yield bonds that have wider credit spreads that can serve as a cushion against higher US Treasury yields.

[2] See: *'EM is no longer a commodity play'*, The Emerging View, 16 February 2021.

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- China: The Chinese New Year holiday week from 11 to 17 of February saw much lower than normal domestic travelling due to the government's social distancing rules. The total number of passengers leaving big cities on the first day of the holidays was 76% lower than in the previous two years. The decline in travel has been offset by a boost to consumption in big cities, including cinema box office, which rose 35%, while broader retail was 5% higher than in 2019. More consumption has also helped the industrial sector to rebound more quickly than in previous years. In other news, rare earths are emerging as an area of rising contention between China and the US. China has considerable influence over rare earths (as well as advanced batteries), while US allies have a dominant role in semi-conductors. The two sides should be able to cooperate on these sensitive issues to their mutual gain, but whether China and the Biden Administration are able to take advantage will boil down to politics.[2]

- Indonesia: Bank Indonesia (BI) cut its policy rate by 25bps to 3.5%, in line with consensus expectations. The BI lowered its 2021 growth forecast to 4.3%-5.3% from 4.8%-5.8% and said it will keep supporting the government's fiscal policy objectives in 2021 via government bond purchases. BI has bought IDR 40.8tn so far in 2021 after purchasing IDR 473.4tn in 2020. The current account surplus narrowed to USD 800m in Q4 2020 from USD 1bn in the previous quarter, taking the full year current account deficit to 0.4% of GDP from 2.7% in 2019.

- South Korea: Exports registered strong growth in the first 20 days of February, rising at a yoy rate of 16.7%, or 29.2% yoy after adjusting for business days. South Korean exports is an important leading indicator for global trade growth. Imports jumped 24.1% on a yoy basis in January before adjusting for business day's variations. The yoy rate of producer price index (PPI) inflation declined to 0.1% in January from 0.2% in December, surprising consensus expectations to the downside.

- Brazil: President Jair Bolsonaro appointed General Joaquim Silva e Luna to the position of CEO of Petrobras, the national oil company. Former CEO Roberto Castelo Branco was dismissed for saying in public that a strike by truck drivers over diesel prices is not Petrobras' problem. His remark was unwise from a political perspective for two reasons. First, truck drivers are extremely powerful, since most goods are transported by road in Brazil. Second, diesel prices were hiked by 35% in 2021 on the back of rising crude oil prices. Petrobras' board of directors initially threatened to resign in sympathy with Castelo Branco, but have since indicated that it may work with the new president to defend Petrobras pricing policies implemented in 2018. Bolsonaro's intervention is a negative, which undermines investor confidence and the position of Finance Minister Paulo Guedes, who generally advocates for less state intervention in the economy and appointed Castelo Branco.

- Ecuador: The National Electoral Council declared that Andres Arauz will face Guillermo Lasso in the second round of the election, which will be held in April. The two candidates obtained 32.72% and 19.74% of the total votes, respectively.[3] Andres Arauz went to New York and Washington last week to meet with investors and the International Monetary Fund (IMF). Arauz also met with overseas Ecuadorians.

Snippets:

- Benin: Rating agency Fitch kept Benin's sovereign credit rating at 'B', but improved the outlook to positive from stable after the re-opening of the country's border with Nigeria.
- Colombia: President Ivan Duque said 5.7m vaccines will be available in early April and that one million people will be vaccinated by mid-March. The target is to inoculate 35m people (approximately 70% of the population) in 2021.
- Czech Republic: The Czech parliament approved an increase in the 2021 budget deficit to a record USD 23.4bn, or 8.5% of the GDP.[4]
- Egypt: The unemployment rate declined to 7.2% in Q4 2020 from 7.3% in Q3 2020.
- Iran: The International Energy Agency (IEA) was informed by Iran that the latter will put an end to sweeping inspection powers given to IEA under the 2015 Joint Comprehensive Plan of Action. Perhaps not coincidentally, the US government said last week it would be willing to meet with Iran.
- Kenya: The IMF reached staff-level agreement with Kenya. A USD 2.4bn loan will be disbursed over three years. The deal was expected to happen after the government unwound some tax exemptions and allowed the exchange rate to adjust.
- Kuwait: The Emir of Kuwait suspended parliament for a month in order to allow more time for the Prime Minister to form a new cabinet.
- Mexico: President Andres Manuel Lopez Obrador announced USD 3.6bn in tax cuts for PEMEX, the national oil company. This may be followed by further support, including assistance with debt payments.
- Nigeria: The yoy rate of consumer prices index (CPI) inflation rose to 16.5% in January from 15.8% yoy in December. This was higher than consensus expectations due to food price inflation.

[2] See: https://www.ft.com/content/d3ed83f4-19bc-4d16-b510-415749c032c1

[3] See: https://www.reuters.com/article/us-ecuador-election/ecuadors-lasso-advances-to-presidential-runoff-perez-disputes-results-idUSKBN2AL0HU

[4] See: https://www.reuters.com/article/czech-budget/update-1-czech-parliament-approves-raising-2021-state-budget-gap-to-23-bln-idUSL8N2KO7RC

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- **Pakistan:** The IMF reached agreement with Pakistan to resume the existing Extended Fund Facility (EFF) programme, which opens the way for a disbursement of USD 500m.[5]
- **Poland:** The yoy rate of CPI inflation rose to 2.7% in January from 2.4% yoy in December. Retail sales declined at a yoy rate of 6.0% in January compared to -0.8% yoy in December, while industrial production slowed to 0.9% yoy from 11.2% yoy over the same period.
- **Russia:** The Biden Administration is likely to try to avoid sanctions against Germany over the Nord Stream 2 pipeline, which is being built between Germany and Russia.[6]
- **Singapore:** The government's fiscal deficit target for 2021 was announced at 2.1% of GDP, which implies a very fast pace of adjustment following the fiscal deficit of 13.9% of GDP in 2020.
- **South Africa:** The yoy rate of CPI inflation rose 10bps to 3.2% in January, driven by higher fuel prices. Core CPI inflation was unchanged at 3.3% yoy.
- **Tanzania:** Tanzania and Burundi are raising USD 1.9bn in order to build a 190km railway link connecting nickel-rich Burundi with the port of Dar es Salaam in Tanzania.
- **Thailand:** The yoy rate of real GDP growth declined 4.2% in Q4 2020 after contracting 6.4% yoy in the previous quarter. This brings the full 2020 growth rate to -6.1% from 2.4% in 2019.
- **Turkey:** The Central Bank of Turkey left the policy rate unchanged at 17% in line with consensus expectations. Ratings agency Fitch affirmed Turkey's 'BB-' sovereign credit rating, while revising the outlook to stable from negative.
- **Zambia:** The Zambian central bank increased its policy rate to 8.5% from 8.0%. This is the first rate hike since November 2019 and followed CPI inflation of 21.5% in January 2021. The rate of CPI inflation was 12.5% in January 2020. Last week, the government said it will seek to control the prices of essential commodities to contain inflation. Such policies do not have an impressive record of success.[7]

Global backdrop

- **United States (US):** The severe spell of cold weather in the US has created shortages of both natural gas and refined petrol products in Texas, which is the biggest supplier of refined products to the rest of the US. The energy shortage is already showing up in broader supply chains, including exacerbating the scarcity of semi-conductor chips for the auto industry. These shortages may contribute to inflation which is already on track to rise due to base effects. The minutes of the January Federal Open Market Committee (FOMC) underlined that a substantial economic recovery has not yet been established and that it will still be some time before the recovery is guaranteed. The FOMC minutes also anticipated that any near-term rise in inflation is likely to be transitory. Interestingly, the Fed is also worried about certain financial stability risks as the committee highlighted the mismatch between buoyant markets and a weak economy.

In economic news, initial jobless claims rose to 861k in the week ending in 13 February from 848k in the previous week. Jobless claims are a very important and timely economic indicator, which has to be balanced against other lower frequency data, which was generally stronger. Retail sales rose 5.3% in January from -1.0% in December 2020, while the monthly rate of industrial production slowed to 0.9% from 1.3% over the same period. The yoy rate of producer prices index (PPI) inflation rose to 1.7% in January from 0.8% yoy in December, surprising consensus expectations for a lower 0.9% yoy price rise. Markit's composite purchasing managers index (PMI) rose to 58.8 in February from 58.7 in January thanks to the services element, which rose to 58.9 from 58.3. By contrast, manufacturing PMI declined to 58.5 from 59.2. Housing starts were lower than expected in January.

- **European Union (EU):** Euro area composite PMI rose 0.3 to 48.1 in February. Similar to the US, manufacturing PMI was stronger than services PMI due to the impact of coronavirus. Manufacturing PMI rose 2.9 to 57.7 while services PMI declined 0.7 to 44.7. The input price index rose 4.7 to 73.0, which is the highest level since 2011. Output prices rose 3.5 to 55.8. In Germany, the ZEW survey of economic growth expectation rose to 69.6 in February from 58.3 in January with automobile, steel, retail and service sectors posting the fastest increase over the last month.

- **United Kingdom:** Prime Minister Boris Johnson is due to release details of his plans to re-open the economy today. The British economy has been one of the worst impacted by the coronavirus, but GBP has outperformed other major currencies due to the country's successful vaccination campaign.

[5] See: https://www.imf.org/en/News/Articles/2021/02/16/pr2141-pakistan-statement-by-imf-staff-on-pending-reviews
[6] See: https://www.aljazeera.com/economy/2021/2/19/us-seen-leaving-germans-off-nord-stream-2-sanctions-list-report
[7] See: https://www.lusakatimes.com/2021/02/19/government-moves-in-to-control-the-prices-of-essential-commodities/

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	7.58%	10.79%	10.79%	32.80%	8.89%	17.16%
MSCI EM Small Cap	8.81%	8.90%	8.90%	32.85%	5.48%	12.25%
MSCI Frontier	2.88%	3.27%	3.27%	8.37%	0.05%	7.90%
MSCI Asia	7.90%	12.20%	12.20%	40.80%	11.90%	18.51%
Shanghai Composite	6.12%	6.42%	6.42%	27.15%	7.42%	7.65%
Hong Kong Hang Seng	8.01%	12.75%	12.75%	15.39%	2.74%	12.69%
MSCI EMEA	5.22%	6.40%	6.40%	3.36%	-2.44%	8.84%
MSCI Latam	5.23%	-1.84%	-1.84%	-11.01%	-5.32%	9.73%
GBI EM GD	-0.45%	-1.52%	-1.52%	2.38%	1.01%	6.06%
ELMI+	0.67%	0.09%	0.09%	3.49%	0.29%	3.85%
EM FX Spot	0.53%	-0.45%	-0.45%	-2.50%	-5.66%	-1.49%
EMBI GD	-0.89%	-1.97%	-1.97%	0.83%	5.08%	6.54%
EMBI GD IG	-1.51%	-2.73%	-2.73%	2.66%	7.33%	6.71%
EMBI GD HY	-0.18%	-1.09%	-1.09%	-1.61%	2.57%	6.30%
CEMBI BD	0.44%	0.37%	0.37%	5.15%	6.45%	7.17%
CEMBI BD IG	-0.20%	-0.34%	-0.34%	4.76%	6.69%	6.06%
CEMBI BD Non-IG	1.30%	1.33%	1.33%	5.56%	6.14%	8.96%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	5.29%	4.22%	4.22%	17.43%	14.77%	17.55%
1-3yr UST	-0.01%	0.02%	0.02%	2.70%	2.89%	1.76%
3-5yr UST	-0.35%	-0.46%	-0.46%	4.46%	4.54%	2.48%
7-10yr UST	-1.73%	-2.80%	-2.80%	3.94%	6.53%	2.98%
10yr+ UST	-5.42%	-8.83%	-8.83%	0.35%	8.87%	4.17%
10yr+ Germany	-4.38%	-5.61%	-5.61%	-1.66%	6.97%	3.13%
10yr+ Japan	-0.65%	-1.21%	-1.21%	-3.69%	1.09%	1.51%
US HY	0.96%	1.29%	1.30%	7.17%	6.84%	9.55%
European HY	0.98%	1.52%	1.52%	2.55%	3.48%	5.52%
Barclays Ag	-1.07%	-1.94%	-1.94%	6.84%	3.90%	3.70%
VIX Index*	-33.36%	-3.08%	-3.08%	29.10%	17.79%	13.78%
DXY Index*	-0.28%	0.43%	0.43%	-9.00%	0.66%	-7.24%
CRY Index*	8.28%	12.41%	12.41%	8.00%	-3.40%	15.98%
EURUSD	-0.13%	-0.79%	-0.79%	11.67%	-1.71%	9.89%
USDJPY	0.94%	2.33%	2.33%	-4.57%	-1.02%	-6.43%
Brent	14.07%	23.05%	23.05%	8.96%	-3.99%	83.74%
Gold spot	-3.05%	-5.64%	-5.64%	7.95%	34.46%	48.21%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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