This Isn’t a Tantrum

By Richard Thies

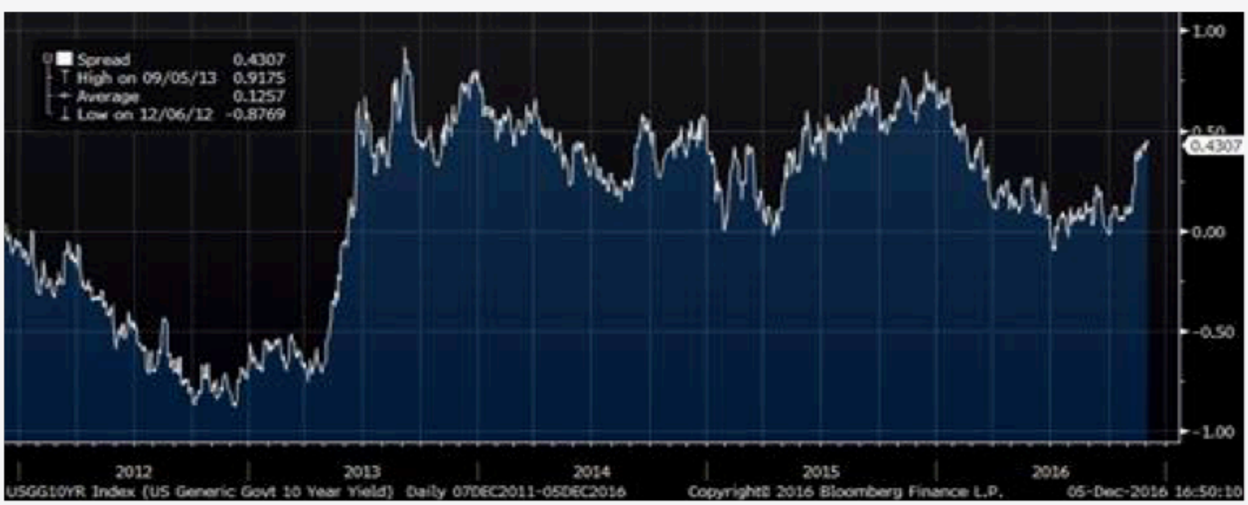
In our view, higher US interest rates do not signal that it is time to abandon emerging markets. It is easy to draw parallels between the current emerging market environment with that of the taper tantrum of 2013 and other periods where rising rates adversely impacted the asset class, but there are significant differences in the current environment.

The most obvious parallel to today is to the taper tantrum in 2013. At that time, real interest rates were at -100 basis points and the term premium level was around -75 basis points, both historically low levels. Although these rates remain low in an absolute sense now, they are nowhere near the extreme levels of 2013, as is evident in Exhibit 1.

It is worth keeping in mind the state of emerging markets today versus 2013. Many emerging markets in 2013 were close to peak credit growth rates and leverage, which magnified the effect of the rise in global real rates on financing conditions. Today, this is no longer the case. A deleveraging economy such as Brazil can weather the adverse effects of tightening global financial conditions more easily than it could during the peak of its high growth period. While rising real rates and tightening global financial conditions are generally negative, we see limited downside to growth at the current juncture.

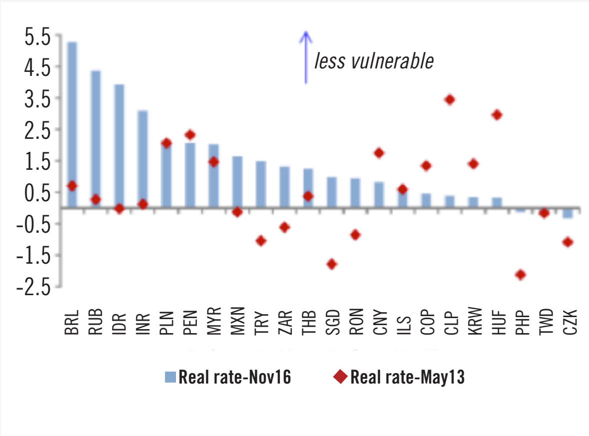
Today, the effects of a possible delayed economic recovery would not compare to the significant downturn a country like Brazil experienced as it moved from a growing economy to one in sharp recession. Similarly, real rates in emerging markets were exceptionally low a few years ago and are much higher today, offering an additional margin of safety (Exhibit 2). Corporates are also in much healthier states than in 2013 with widening operating margins, core profitability improving and free cash flow yield significantly higher (Exhibit 3).

EXHIBIT 1: Real rates



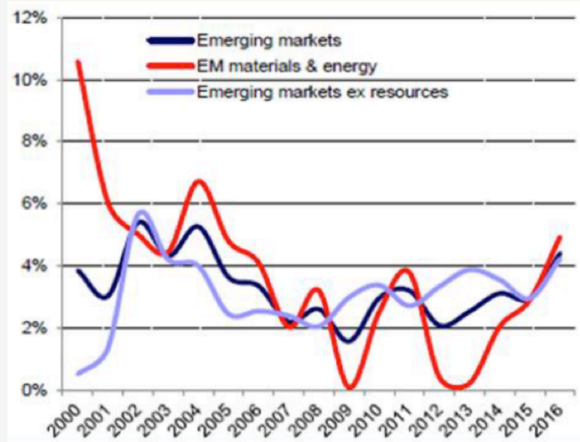
Source: Bloomberg

EXHIBIT 2: Real rates: Mostly higher than pre-taper tantrum



Source: Deutsche Bank

EXHIBIT 3: Emerging markets (with & without resources) free cash flow yield (%)

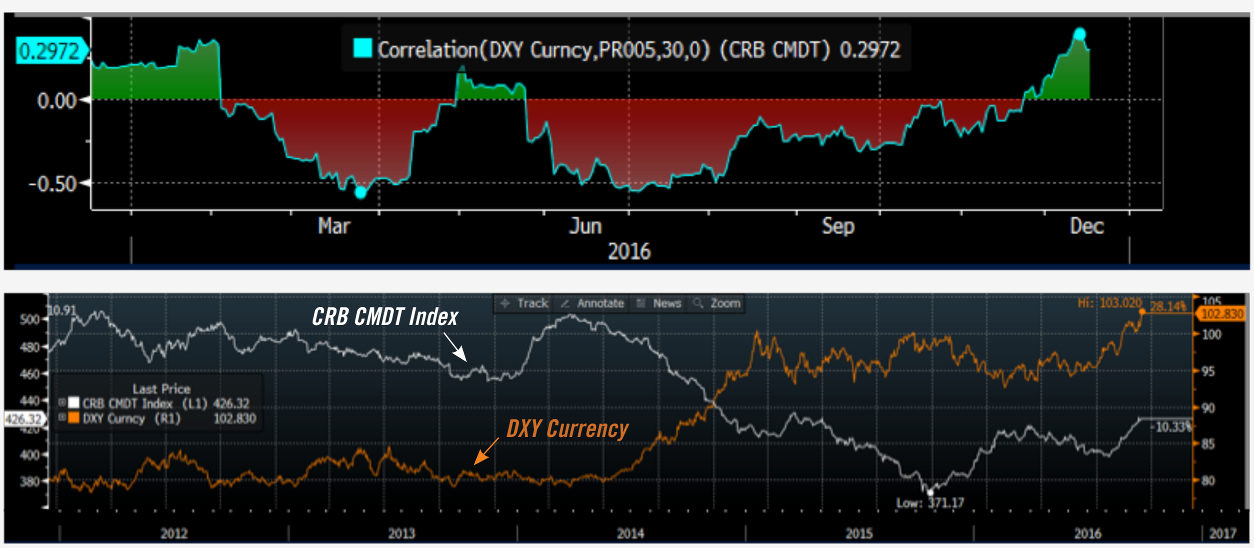


Source: Credit Suisse

Finally, the US dollar and commodity indices have become positively correlated for the first extended time since the global financial crisis (Exhibit 4), which is a major change for emerging markets. It is a rare occurrence for commodity prices to rise as the dollar strengthens, as the latter works against the former.

The reason for this change in a major market dynamic is complicated. The dollar's value is primarily driven by global yield spreads. With yields in other developed markets being held down by central banks and a breakdown in dollar-funding availability abroad preventing arbitrage, bond spreads

EXHIBIT 4:
The correlation between the dollar and commodities has been positive since the election



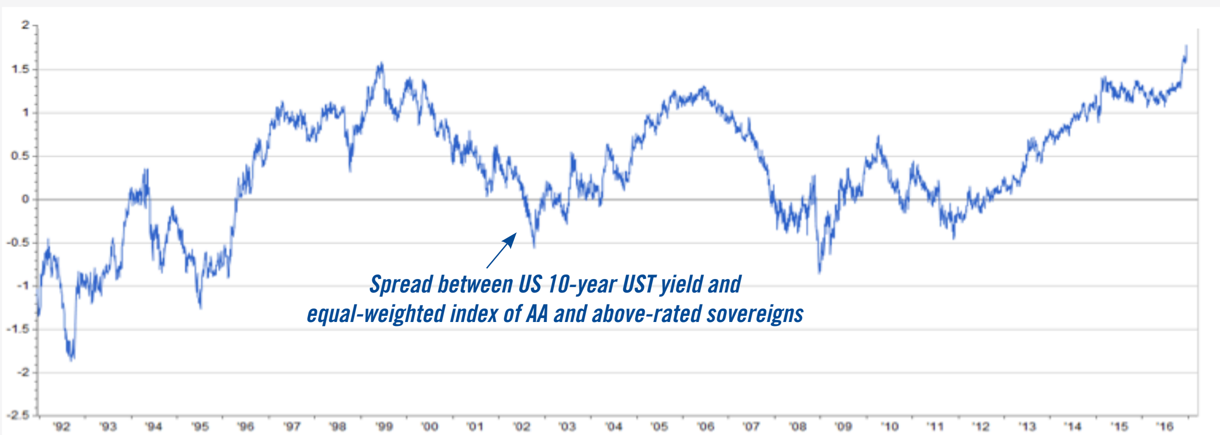
Source: Bloomberg

have widened more than previous history permitted (Exhibit 5). Because higher breakeven inflation expectations, which have been driven by higher commodities, are pushing bond yields higher, which are in turn supporting the dollar, the two have become correlated. This is important for EM because the stronger dollar has actually come alongside an improvement in terms of trade.

The real uncertainty for all equity markets is with the Federal Reserve and how it intends to move rates. To date, the real tightening of rates has been very modest. If the Fed tightens rates more than expected (but breakevens don't continue moving higher), the result would be negative for all equities, not just for emerging markets. While real rates are still low in an absolute sense, even having positive real rates is not something that equities have dealt with well the past five years (Exhibit 6).

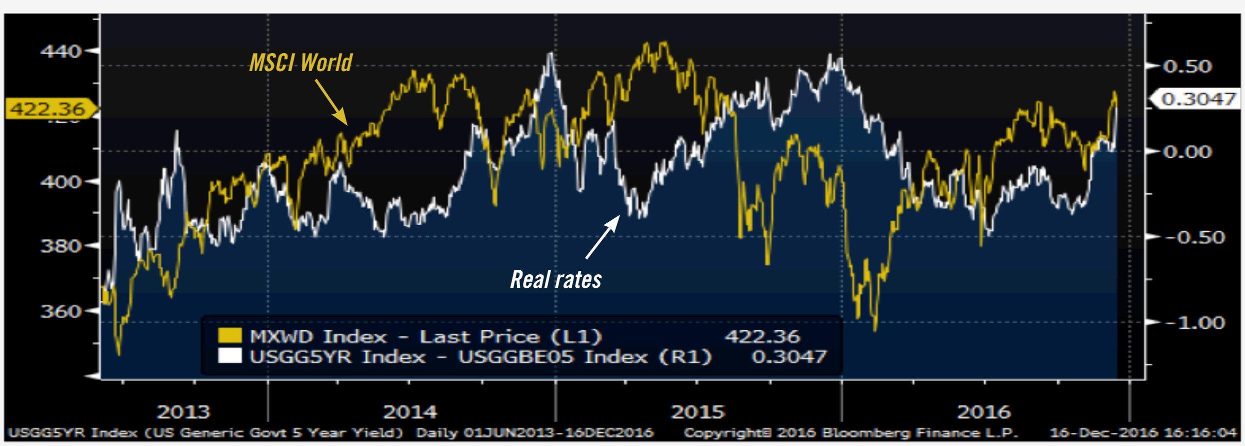
Ultimately, although parallels may exist with the taper tantrum of 2013 and other periods of stronger dollar and rising rates, the current situation is markedly different in several significant areas. The differences are enough to suggest a better outlook for emerging markets than many investors currently anticipate, with EM equities facing the same risks that all equities now face.

EXHIBIT 5: US yields have widened to previously unseen levels over developed market peers, putting more upward pressure on the dollar



Source: Factset

EXHIBIT 6: Over the past few years, higher real rates (white) have weighed on global equity performance (MSCI World, yellow) even at these levels



Source: Bloomberg

About the Author

Richard Thies is a portfolio manager. In addition to his portfolio management responsibilities, he provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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