Market Insights

DON'T FEAR THE FED

May 2017

Emerging markets investing tends to be a story of financial crises and panics. Historically, emerging market (EM) crises have started with an overvalued currency peg, which leads to an overheating domestic economy built on rising leverage. In the face of an external shock—commonly an appreciating US dollar (USD) and Federal Reserve (Fed) hiking cycle—the system de-levers and the peg ultimately breaks. Also consider that Fed hiking cycles tend to put downward pressure on economic growth rates, in the US and abroad. For an EM economy, the combination of a broken currency peg and lower domestic growth means that external debt burdens (i.e., USD-denominated debt) become unsustainable. This can have distinct implications for returns.

As we illustrate in Exhibits 1 and 2, in the 2000-2016 period, the JPMorgan EMBI index total return distribution skews positively when the USD is weakening. If US GDP growth is above trend at the same time, then you're in the sweet spot of EM investing. However, the combination of below-trend US GDP growth and an appreciating USD creates an environment where negative total returns are historically more common.

This has been the cautionary tale for EM investors, and the mechanics are relatively simple: Overvalued exchange rate pegs, a reliance on free-flowing foreign capital, and inadequate reserves make countries susceptible to classic bank run behavior. An overvalued peg generally leads domestic borrowers to take on excessive amounts of leverage. And the peg's promise of low exchange rate volatility means corporate borrowers could issue that debt in USD. But this means you are only one macroeconomic shock away from having to burn through your reserves, break the peg, and lock capital inside the country, or else face waves of defaults at the sovereign and corporate level. Furthermore, when overvalued exchange rate pegs break, the subsequent depreciation hurts the risk takers most acutely. The capital providers fueling the domestic economy retrench to protect and repair their balance sheets, and this behavior ripples through the system.

We think the situation is markedly different today, despite the familiar risks of an appreciating USD and Fed hiking cycle. Here's why.

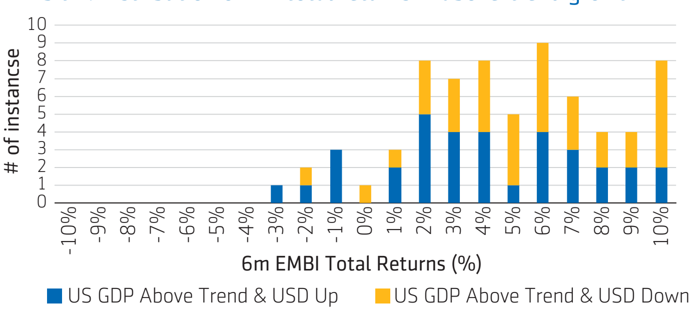
1. Few important EM countries have pegged currencies.
2. EM currencies and the EM asset classes are generally fair-to-cheap in valuation terms.
3. The Fed's hiking cycle will likely be exceptionally moderate relative to past experience. Today's Fed is not facing-down rampant inflation pressures, but rather trying to right-size policy settings a decade after the worst economic crisis of a generation.

Consequently, we see the next 2-3 years with ample global macro flexibility for EM countries to grow and continue favorable reform agendas.

The global economy is in the early stages of a synchronized cyclical growth upswing, creating an environment which can be a sweet spot for EM investors. Given our view that today's EM countries are structurally different, we think the sector has potential to outperform regardless of the USD's performance. Flexible currency regimes, relatively cheap valuations, and a favorable GDP growth backdrop supports this thesis.

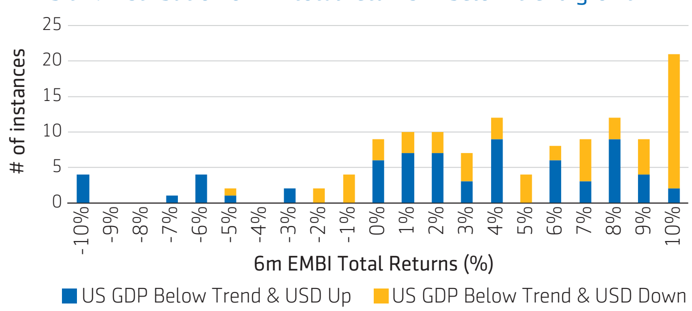
Of course, there are always exceptions. Venezuela, for one, maintains a fixed exchange rate to the USD, but its ability to maintain that peg is about politics first, and economics second. Astute readers will be quick to point out that there is one other obvious EM country that plainly still manages a well-known peg: China. It is true that the CNY is not free-floating and China has a number of signs typical of old-style emerging market crises. For a variety of reasons we think China is likely unique in its ability to handle its situation without a typical crisis. This is a subject we will explore more fully in a forthcoming note…

Exhibit 1: Distribution of EM total returns in above-trend growth



Source: Bloomberg , AUIM As of Sept 2016

Exhibit 2: Distribution of EM total returns in below-trend growth



Source: Bloomberg , AUIM As of Sept 2016

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