

Will Fed Liftoff Cue the Swan Song for the Emerging Markets Risk Assets Party?

By Tina Byles Williams

The circumstances and policy response to the 2007–2008 crash have few historical parallels, but one aspect likely will be repeated: Fed tightening against a backdrop of tepid global growth likely will increase the volatility of emerging-market (EM) equities, interest rates, and currencies. During the past two tightening cycles (1994–1996 and 2004–2006), EM risk assets stumbled before and after the anticipated tightening. This article focuses on the 1994–1996 period as the most instructive because today, as then, the U.S. economy was recovering from a credit-induced bubble amid a similar disparity in global growth and monetary policy. We posit that after a short-term broad-based sell-off, relative performance will be driven by each EM country’s fundamentals. Our analysis suggests that 2013’s “fragile five” most-vulnerable countries have been whittled down to the “threatened three” of Brazil, South Africa, and Turkey. These three countries exhibit characteristics that render them most vulnerable to a reversal in the risk seeking/search for yield trade that was supported by abnormally low interest rates. Additionally, two—Brazil and South Africa—are net commodity exporters. The next tier of vulnerable countries includes Malaysia, Mexico, Poland, Indonesia, Colombia, Russia, and to a lesser extent, Chile.

From a tactical investment perspective, the most prudent six-month strategy would be to underweight EM as a whole. The fallout could, however, provide an opportunity to overweight commodity consumer-driven countries, particularly those undergoing investment-friendly structural reform, i.e., primarily countries in North Asia and India. Over the long term, we believe that

“Our analysis suggests that 2013’s “fragile five” most-vulnerable countries have been whittled down to the “threatened three” of Brazil, South Africa, and Turkey.”

the deepening of certain EM countries’ indigenous capital-markets infrastructure will render them less vulnerable to Fed policy and more vulnerable to endogenous factors. However, measures to deepen financial infrastructure can engender volatility. The volatility in China’s A share markets is symptomatic of the missteps and growing pains that undoubtedly will occur as China attempts to deepen local participation as well as internationalize its capital markets.

Are the 1990s a Relevant Playbook?

During the first half of the 1990s, the U.S. economy was still struggling from the savings and loan crisis of the late 1980s. Despite aggressive monetary stimulus, the 1990s recovery—and its global context—was viewed with skepticism. Japan, the second-largest economy in the world at the time, was struggling with debt deflation, collapsing profits, and looming price deflation. Though not exact, Japan of that decade foreshadowed the eurozone until last year and China after 2010. In the 1990s, Japan was hampered by the Bank of Japan’s stubborn anti-inflation stance. Similarly, until 2012 in Europe and Japan and 2014 in China, restrictive policies exacerbated deflationary forces.

Importantly, this disparity in global growth rates also led to asynchronous monetary policies. Consequently, in February 1994, the Fed was the first major central bank to tighten monetary policy while the Bank of

Japan and the German Bundesbank still were easing.

The other key parallel was the performance of the U.S. dollar and commodities. Similarly, in the 1990s the U.S. dollar was relatively weak pre-tightening and then strengthened significantly in response to a combination of the U.S. economy’s relative strength as well as the anticipation of monetary tightening. As now, the strengthening U.S. dollar represented a headwind for commodities, which in turn significantly impacted several EM economies. Today, the strengthening dollar compounds commodities’ structural challenge of unfavorable supply-demand dynamics.

During the easing phase in the 1990s, EM stocks rallied but stumbled after the Fed funds rate was increased by 200 basis points in 1994. This unleashed a full-blown bear market in EM risk assets. The Mexican peso crisis in late 1994 short-circuited the Fed’s tightening and the subsequent Asian crisis and devaluation in 1997 brought an additional dose of deflationary pressure into the global system. After initial volatility fueled by the first round of Fed rate hikes, bond yields actually declined over the decade. These deflationary crises, plus renewed policy easing by the Fed, brought down bond yields, which further fanned the speculative flames of the U.S. stock market bubble that ended in 2000. For the

entire bull market the dollar appreciated 36 percent (January 1995–December 2000) in trade-weighted terms. Commodities and gold prices mirrored the dollar/yen exchange rate through all of the 1990s.

Shifting Economic Importance and Asynchronous Growth and Policy

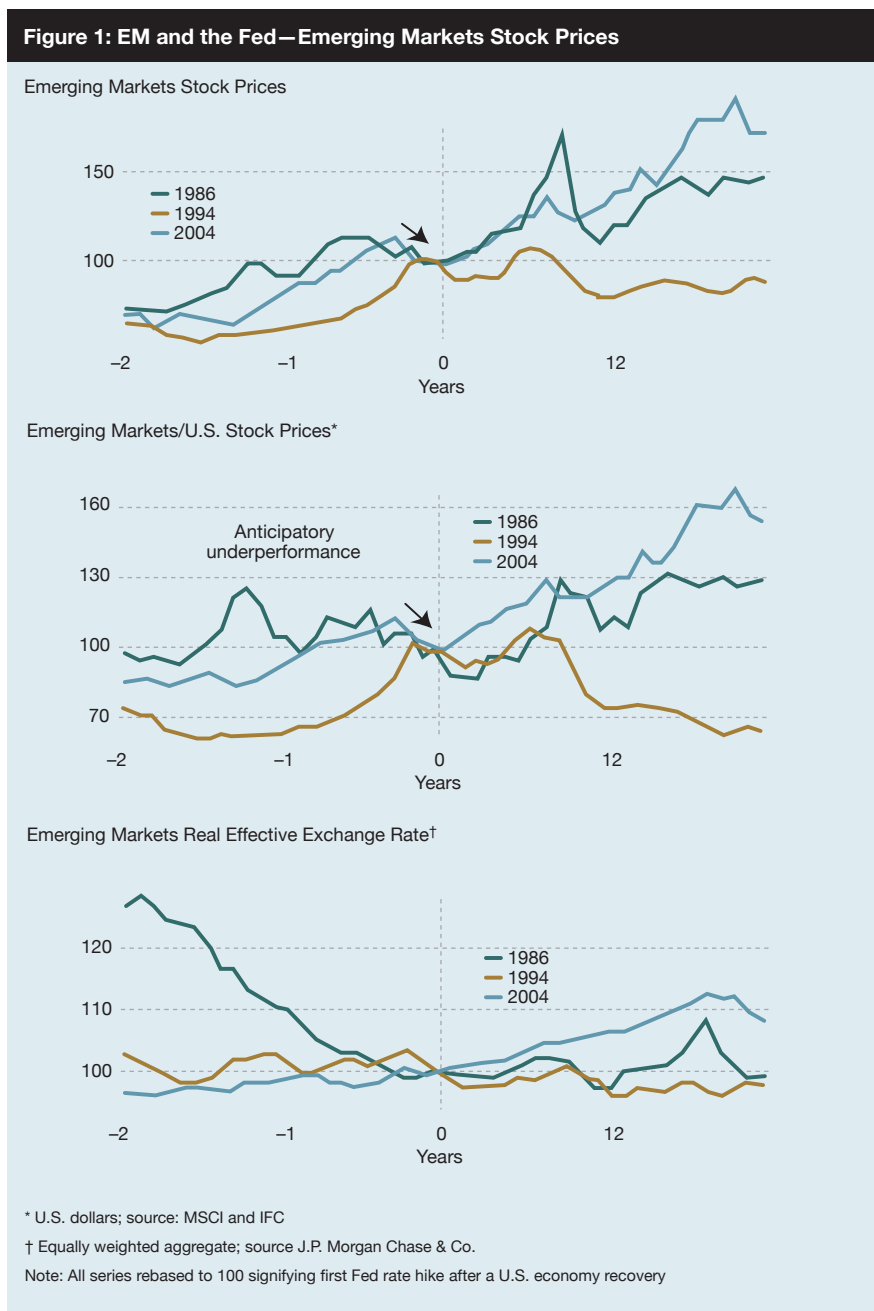
What complicates using previous Fed tightening cycles as a guide is the shifting importance of different regions and countries, their asynchronous recoveries, and central-bank policies. China’s role and Japan’s diminished role relative to both the United States and the eurozone is what’s new this time.

The United States. The U.S. economy is on the cusp of self-reinforcing and improving economic fundamentals. Indeed, for the past two easing/tightening cycles, the United States has led the recovery and was the first to tighten. The difference this time is more-tepid growth both in the United States and globally as well as stronger deflationary headwinds.

China. China has replaced Japan as the world’s second-largest economy. It accounts for about 15 percent of global output; in the past five years, it has accounted for one-half of global growth. Additionally, China accounts for around 45 percent of EM exports. Therefore, China’s ability to deleverage its excess industrial capacity and transition to a more balanced and market-based allocation of resources is key to EM resilience and global growth.

The eurozone. The eurozone economy ex Germany finally is responding to supportive monetary policy and abating austerity measures. Importantly, the eurozone is behind both the United States and China in share of global output, but it has an out-sized impact on global trade. Therefore, it is key to the recovery of global aggregate demand, particularly for export-oriented Japan and China.

Japan. Like Europe, Japan faces headwinds due to poor demographics. Short of drastic supply-side reforms, Japan’s labor-force and productivity trends imply real growth



that averages less than 0.5 percent. Prime Minister Shinzo Abe’s efforts to reflate the Japanese economy through aggressive monetary accommodation and other supply-side reforms mean that Japan is no longer the chief exporter of deflation that it was in the 1990s.

The Fed already has begun to taper its asset purchases, and central banks throughout most of the rest of the world are either increasing quantitative easing programs or

dropping interest rates. Federal Open Market Committee (FOMC) communications suggest that the Fed will gradually reduce its balance sheet to normal levels by 2020. However, we believe that downshifting growth in China will continue to anchor the magnitude and severity of tightening. The likely result will be a flattening yield curve (followed by a steepening if growth expectations pick up) and dollar appreciation (which would further undermine commodity prices).

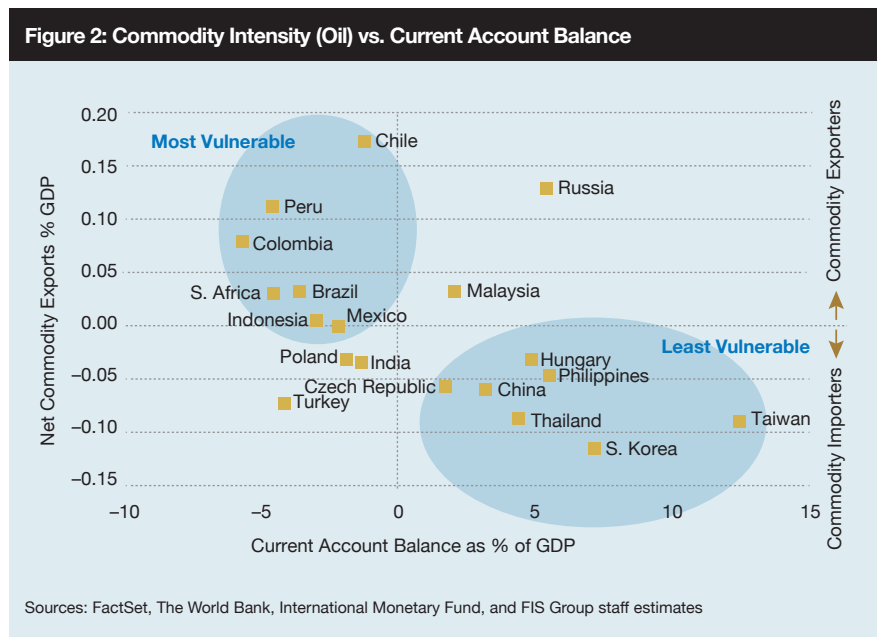
As the tightening phase progresses, carry trades (such as the reach for yield in EM debt) and corporate-cap-structure arbitrage (such as stock buybacks) will become more challenged. On the other hand, increased short-term rates likely would bring forward capital expenditures as corporations increase investments to take advantage of a strengthening economy while rates are reasonably low. Among publicly traded assets, which are typically the most sensitive to dollar liquidity and an increased term premium, certain EM risk assets and credit spread sectors will be most challenged. The onset of tightening would foster a hiccup in risk assets, but not until the Fed funds rate rises above real gross domestic product (GDP) growth would a genuine cyclical downturn be likely to occur.

Figure 1 shows the impact on EM risk assets in three of the past tightening regimes (1986, 1994, and 2004). In all cases, EM risk assets stumbled for the first six months to a year up to and after the anticipated tightening occurred. As noted, we believe that global conditions today are best paralleled by the 1994 episode with some important exceptions, which we discuss below.

What Is Different This Time?

One key difference relative to previous tightening cycles is the level of growth, inflation, and interest rates at the inception of tightening. Specifically, a much weaker macro backdrop and extraordinary monetary policy accommodation have resulted in a negative to historically low term premium that is well below its level at either the end or beginning of the past two tightening cycles, which effectively has boosted risk-seeking behavior. Longer term, weak final demand outside of the United States and the United Kingdom likely would anchor both bond yields and inflation. On the other hand, the extraordinary monetary policy measures adopted to encourage risk taking and spur final demand have taken us into uncharted territory, which potentially increases the probability of either a policy misstep or market confusion/overreaction to Fed policy.¹

Additionally, the dramatic response to the Fed's 1994 tightening was caused partially



by the market being caught off guard, whereas today's Fed is more transparent. The net effect of these factors likely would result in a substantially more moderate and data-driven tightening, a more gradual rise in the dollar, and a more nuanced fallout in EM risk assets.

That said, faster-than-expected tightening would result in greater-than-anticipated long-term rates through both higher policy rates and term premia. Both would be expected to foster increased volatility in risk assets. In fact, from this perspective, transparency actually could increase the likelihood of market confusion.

Relative EM Fundamentals Will Determine Vulnerability

During much of the 2000s, strong economic growth, buoyant commodity prices, a cheap currency, and low interest rates in the United States (fostered by Fed accommodation) fueled the chase for EM assets. In fall 2014, anticipation of an impending change in Fed policy led to a 20-percent appreciation in the U.S. dollar through January 2015. EM currencies with basic balance deficits depreciated an equivalent amount relative to the dollar during this period. The dollar's consolidation since February 2015 has been associated with relief for EM currencies, with little

differentiation between economies with negative or positive basic balances.

A short-term broad-based sell-off is likely, and relative performance thereafter will be driven by each EM country's fundamentals along the following dimensions: economic growth and relative commodity intensity; the trajectory of their basic balance, indebtedness, and dependence on foreign relative to GDP, as well as the degree of and mix between stock vs. bond mix of foreign ownership in local financial markets.

Current account-deficit countries facing inflationary pressures will be constrained in their ability to revive growth through accommodative fiscal or monetary policies because doing so would further undercut their currencies. Alternatively, measures to defend their currencies, such as raising interest rates or reducing liquidity, would stymie growth. Figure 2 illustrates countries by relative account balance and commodity intensity. We would expect the countries in the north-west quadrant (Chile, Colombia, Brazil, and South Africa) to be most vulnerable as the Fed tightens, particularly if the dollar continues to strengthen (thus challenging commodity prices). On the other hand, countries in the southeast quadrant likely would be least vulnerable because of both their positive

current account reserves and a positive tailwind from falling commodity prices.

Countries that are heavily dependent on foreign capital for growth are likely to be especially vulnerable to a reversal in foreign sentiment and subsequent capital flight. Most vulnerable are those with current account shortfalls funded by short-term capital inflows. The 2013 “taper tantrum” affected nine vulnerable EM economies, although investors focused on the so-called “fragile five.” Currently six are in the vulnerable category. In order of magnitude, countries with a large negative basic balance include South Africa, Turkey, Colombia (a recent entrant), Brazil, Indonesia, and Mexico. Four previously hot-money-dependent economies—Chile, India, Poland, and Thailand—no longer need portfolio capital to any significant extent.

EM Capital Flows and Fundamental Dynamics

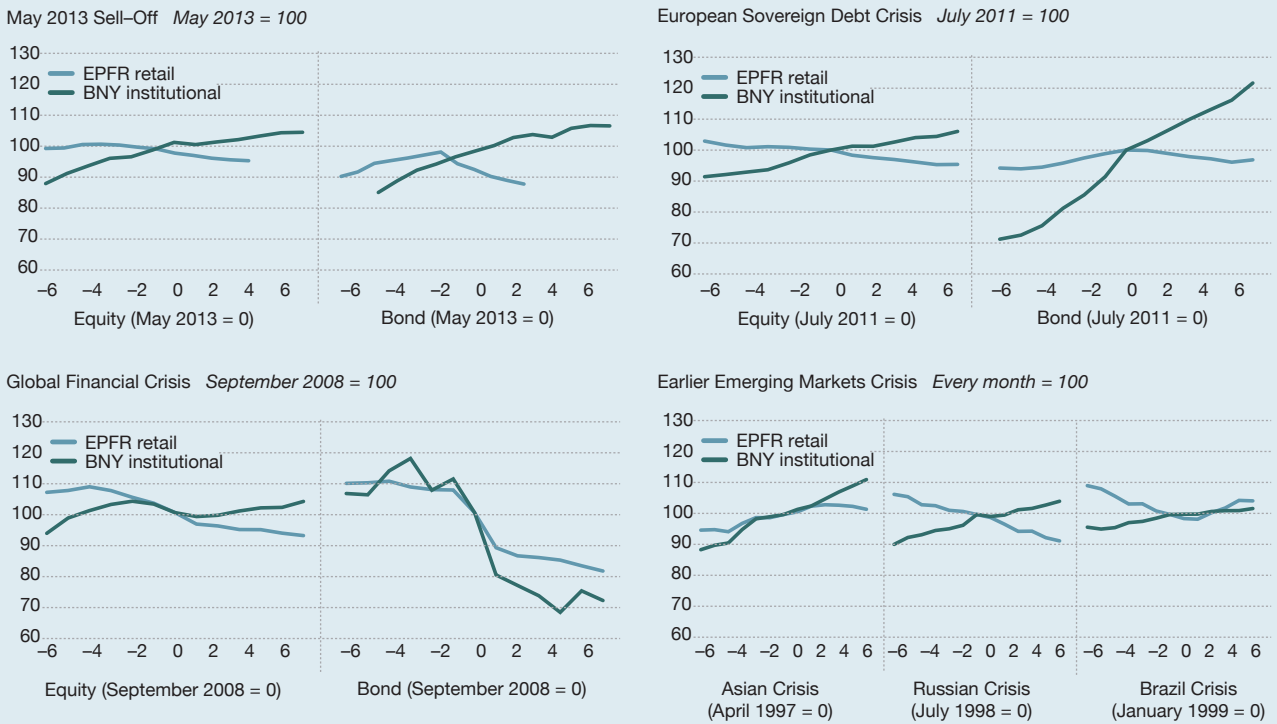
Since the early 2000s, gross capital flows to EM have quintupled. Foreign direct investments comprise the majority of flows into EM; portfolio investment—the most volatile component—has become more important. In the 2000s, changes in the mix of foreign capital inflows were concentrated primarily in fixed-income markets.

Public EM sector indebtedness remains well below 1997 levels, but private sector foreign debt in many cases has grown above levels during the EM debt crisis of 1996–1997. For larger EM companies, cross-border financial intermediation changed from primary

reliance on bank-intermediated finance to direct financing through the bond market. To take advantage of low interest rates as well as a relatively cheap U.S. dollar (before late 2014), non-financial EM firms significantly increased external borrowing by issuing debt offshore. According to Bank of International Settlements data, between 2009 and 2013 EM non-bank private corporations issued \$554 billion of international debt securities. Nearly half that amount (\$252 billion) was issued by offshore affiliates.² If the overseas bond proceeds were repatriated onshore to invest in domestic projects with limited foreign currency revenue, these firms would face severe currency risk as the U.S. dollar appreciates. If the proceeds were first swapped into local currency, an appreciating dollar likely would impair the consolidated balance sheet. In either case, the economic risks may be underestimated if external exposures are measured according to the conventional residence basis. Countries that would appear to be most vulnerable in this regard, as measured by private sector foreign currency debt as a percent of GDP, include Malaysia, Chile, Turkey, Brazil, Russia, and South Africa.³

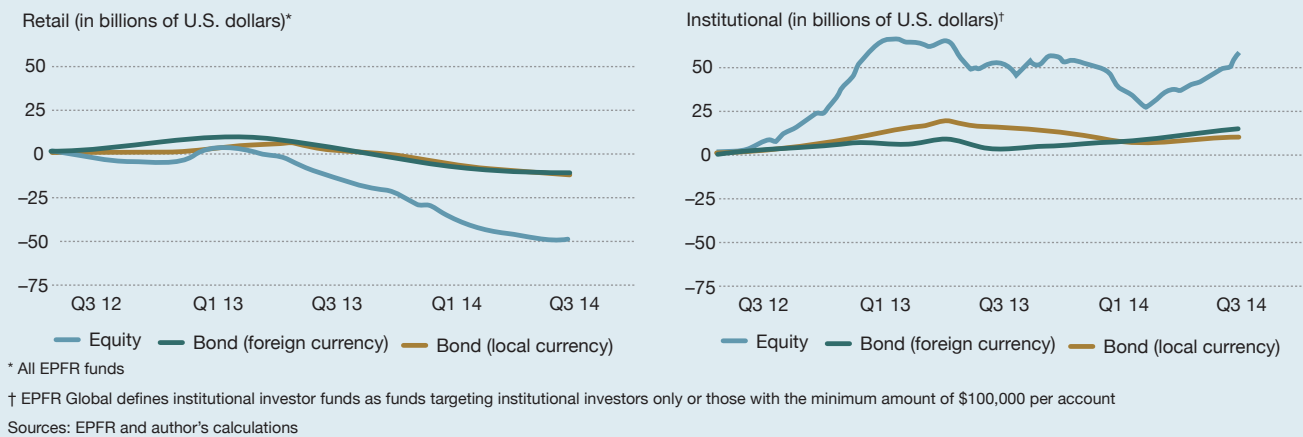
According to EPFR⁴ data, total assets under management (AUM) of equity and bond funds allocated to EM markets increased from a pre-financial-crisis peak of \$900 billion to \$1.4 trillion in May 2014. The largest growth was among bond funds, which quadrupled from \$88 billion to \$340 billion over the same period. Increased foreign investment in EM assets has boosted investment and growth and helped deepen financial markets. But the potential price of these

Figure 3: Net Flows into EM Assets over Various Financial Market Crises



Sources: Bank of New York Mellon (BNY), EPFR Global, EurekaHedge, and International Monetary Fund staff calculations

Figure 4: Cumulative Net Inflows to EM Equity and Bond Funds



flows is that during times of financial stress and Fed tightening in particular, foreign investors may destabilize EM markets by accentuating both booms and busts. The most recent example was the large outflows prompted by Fed Chairman Ben Bernanke’s announcement of future asset purchase tapering, which drove up bond yields and led to large depreciations among many EM currencies.

Equally relevant to gauging the likely impact of Fed tightening are the source and destination of the increased portfolio flows. Bond portfolio investments tend to be more short-term-oriented and more sensitive to yield differentials and volatility than stock investments. Institutional investors as a class are typically more “sticky” than mutual fund investments. Notably, according to MSCI data, institutional investors are responsible for 62.4 percent of equity portfolio flows and 55 percent of bond portfolio flows into EM assets as of mid-2014.⁵

Additionally, various studies suggest that mutual fund investors tend to crowd into similar names, exhibiting a clear pattern of momentum or return chasing.⁶ This leads to markedly greater sensitivity to periods of instability. Actual patterns in flows reinforce these results. Figure 3 shows net flows into EM assets over various financial market crises and figure 4 shows net flows between institutional and mutual fund investors during the 2013 taper tantrum. Most relevantly, total portfolio flows declined significantly after Bernanke’s tapering warning in May 2013, but institutional investors largely stayed the course and retail investors bailed.

However, institutional investors don’t always stay put relative to retail counterparts. Faced with extreme shocks, they actually have divested more vigorously. Moreover, likely as a result of minimum credit-rating guidelines, institutional investors are just as sensitive as mutual funds when a country’s sovereign credit is downgraded below institutional grade. From this perspective, South Africa’s deteriorating debt profile is concerning (South Africa is one of four EM countries in the World Government Bond Index; the others are Mexico, Malaysia, and Poland). One criteria for being an index

member is credit ratings of at least BBB–/Baa3 by S&P and Moody’s, respectively. South Africa is currently one downgrade away from the minimum requirement. A further downgrade could lead active managers to take anticipatory action and reduce exposure, possibly resulting in outflows of 2.5–3 percent of GDP.

Another potential concern is the level of concentration among institutional players in the EM market. As ultimate investors’ allocations to EM assets continued to grow, the total amount of AUM managed by the largest 500 firms doubled from \$35 trillion in 2002 to almost \$70 trillion in 2012. Additionally, among the largest 500 firms, the largest 20 firms represented about 40 percent of total AUM in EM assets, the top five firms accounted for 18 percent of total AUM, and the largest firm accounted for 6 percent of the total. A significant allocation change by one or more very large player could have a major impact on smaller and more illiquid EM markets.

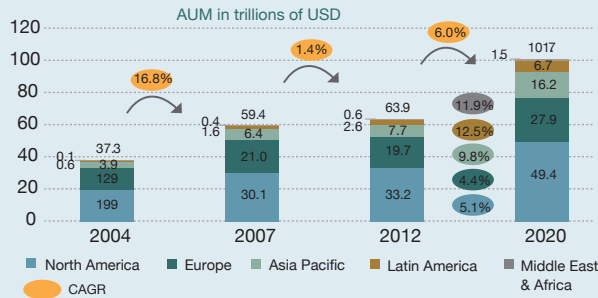
From a portfolio allocation perspective, Latin America and EM Europe would appear to be most vulnerable to Fed tightening because the region is the largest recipient of both mutual fund and bond portfolio investments. Asia was also a significant recipient of bond investments, but it appears to be dominated by institutional investors. On a country level, the most vulnerable appear to be Malaysia, South Africa, Mexico, Poland, Turkey, and Indonesia.⁷

Relative Depth of Indigenous Capital Infrastructure Should Dampen Outflows

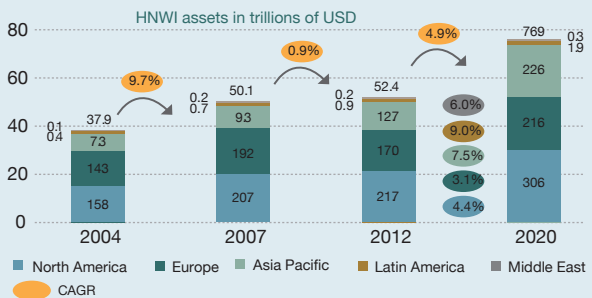
The strategic rationale for investing in emerging markets will persist despite the impending tightening cycle. The long-term allocative effects of wealth creation and investment in emerging markets from EM investors are less appreciated. This is a three-fold phenomenon: (1) High-net-worth, pension fund, and retail savings/investments in EM are projected to grow at two to three times the rate of developed-market (DM) assets over the next five to six years; (2) EM investors, like investors worldwide, exhibit a strong home-country bias, meaning that a majority or at least a heavy disproportion of the newly created wealth in EM will stay home; and (3) risk appetites for equities from

Figure 5: Global AUM Projections

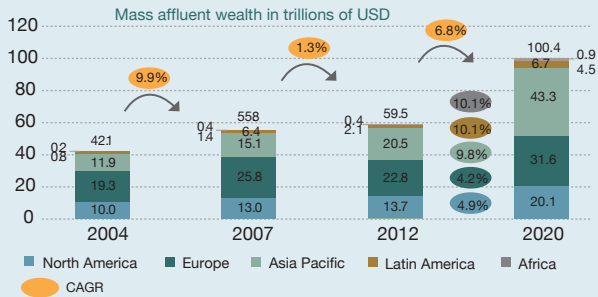
Global AUM Projection*
By region for 2020



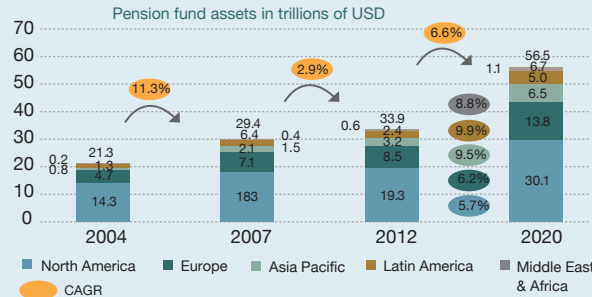
Global HNW Asset Projection†
By region for 2020



Global Mass Affluent Wealth Projection‡
By region for 2020



Global Pension Funds Asset Projection‡
By region for 2020



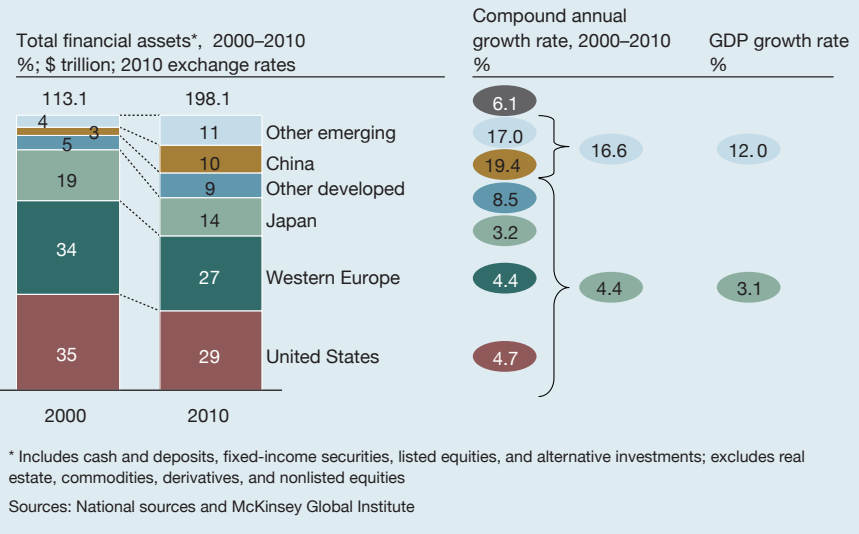
* Past data based on Hedge Fund Research, ICI, Prequin, Towers Watson, and The City UK data
 † Past data based on Credit Suisse Global Wealth Data Book
 ‡ Past data based on The City UK data
 Source: PwC analysis

local EM investors is currently low, which has been typical for past development patterns in the United States, Europe, and developed Asia. We expect the same pattern to unfold within EM.

Figures 5 and 6 contrast the current and projected growth in financial assets in EM vs. DM markets. As shown, the compound annual growth of EM financial assets has grown nearly four times as quickly as that of DM assets.

Since the early 2000s, there has been broad-based deepening in the financial infrastructure among major EM countries. Financial depth is defined by the size of financial markets relative to economic activity and by the various functions that the financial market performs. International Monetary Fund research shows that most dimensions of financial deepening are associated with lower sensitivity to global shocks for equity markets. Additionally, some effects of a larger

Figure 6: Financial Assets Growth Projections



local investor base have a stabilizing effect. Similarly, capital-market development generally lowers the sensitivity of asset returns to global financial conditions. Greater foreign

engagement in domestic markets increases price sensitivity to global financial shocks.

Continued on page 58

FED LIFTOFF

Continued from page 39

This destabilizing effect is particularly strong for local currency bond yields.

Over time, we believe that the destabilizing effect of foreign investor outflows as a result of financial stress emanating from DM could be mitigated by the growing local investor base and deepening capital-market infrastructure in several EM countries. Among emerging markets, South Africa, Colombia, and Chile are clear standouts in terms of indigenous capital-market depth. Other notables include Malaysia and Mexico,

though measures to deepen financial infrastructure also may engender volatility. ●

Tina Byles Williams is chief executive officer and chief investment officer of FIS Group. She earned a BA in economics from New York University and an MPP in finance from Harvard University. Contact her at twilliams@fisgroup.com.

Endnotes

1. These measures were adopted across the board globally. For example, the Bank of England launched its Asset Purchase Program in 2009, and the Bank of Japan implemented its program in 2010, then increased its size in 2013. The European Central Bank (ECB) has first conducted negligibly and largely sterilized asset purchases since 2010. In the first quarter of 2015, the ECB substantially increased its asset purchases to approximately €45 billion per month.

2. Source: BIS Quarterly Review (December 2014), http://www.bis.org/publ/qtrpdf/r_qt1412.htm.
3. BCA Research, Don't Catch Falling Knives (July 29, 2015), <http://www.bcaresearch.com/>.
4. EPRF refers to Emerging Portfolio Research Global, one of the most widely used data sources for foreign fund flows to EMs, particularly because of the high frequency of its data. EPRF collects data on total net assets and flows by type of investor (institutional or retail), country, and asset type. The EPRF database covers roughly 11,000 equity funds and 4,500 fixed-income funds.
5. Morgan Stanley, EPFR Global, Funds Flow Database.
6. See for example, How Do Changes in the Investor Base and Financial Deepening Affect Emerging Markets Economies? IMF (April 2014), <http://www.imf.org/External/Pubs/FT/GFSR/2014/01/pdf/c2.pdf>.
7. Source: FIS Group, Market Insights Alert: Will Emerging Markets Continue to Dance when the Fed Stops Playing? (October 2014), http://www.fisgroup.com/images/pdf/FIS_Group_Will_Emerging_Markets_Continue_to_Dance_3.pdf.

CONTINUING EDUCATION
To take the CE quiz online, visit www.IMCA.org.