EMD: potential fallout from US monetary policy

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Historic links between the performance of US Treasuries and emerging market debt make the actions of the US Federal Reserve an important consideration in analysing the asset class, according to Urban Larson, Standish senior product specialist, emerging markets debt.

Despite the market volatility of the past two years, emerging market (EM) economies remain fundamentally sound, by and large. Valuations of both US dollar-denominated and local currency emerging markets bonds remain reasonable, particularly given the strong credit quality of the asset class, reflected in an overall investment grade rating.

Going forward, the potential for higher US interest rates will be an important theme in (emerging market debt) EMD, but the asset class does not and will not behave in a synchronised fashion. The increased uncertainty over the global monetary environment has affected all types of EMD, but in stark contrast to 2013, the uncertainty of 2014 was purely over the timing of an eventual tightening of US monetary policy. This is likely to continue through the first half of 2015.

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The correlation between US dollar-denominated EMD and US Treasuries is only logical as the former are priced off the latter. Generally the lower the spread between their respective yields the higher the correlation. Additionally, dollar-denominated debt is mainly held by international investors who are particularly sensitive to monetary conditions in the developed markets. That is why in mid-2013 when the 'taper tantrum' was set off by the US Federal Reserve's (Fed's) first comments regarding a potential end of quantitative easing, there was also a sell-off in emerging market dollar-denominated debt. This affected higher quality, longer duration EM sovereign bonds the most as global investors rushed to cut their duration exposure. Corporate bonds were less affected by the sell-off than sovereign bonds, given their higher spreads and shorter duration.

While the correlation between US Treasuries and EM local currency bonds is less direct, these have also been very sensitive to US Treasury yields in the past. EM currencies – by virtue of their high degree of liquidity – have borne the brunt of this. Currency volatility has risen as investors have moved to reposition themselves and as the US dollar has

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strengthened. Local yield curves have been more stable as they continue to be driven primarily by local monetary conditions, while local bond markets continue to be dominated by local investors who naturally have a home country bias.

All eyes on the US

The market has been pricing in the first US rate hike either in the second half of 2015 or in early 2016, in line with our expectations. When the Federal Reserve does begin to hike rates, it is likely to move gradually, given the recovery in the US has been slow and shallow. There is no real inflationary pressure and the average citizen in the US has been slow to feel the recovery.

Meanwhile, market forces are also likely to keep US Treasury yields from rising quickly, with weak growth in Europe and Japan keeping rates low elsewhere in the developed markets. By comparison with the near-record low yields on some European bonds even the current very low yields on US Treasuries are attractive.

The correlation between the US dollar-denominated EM sovereign bonds in emerging markets has been quite striking during this period of unusual monetary policy. We have also seen similarly high correlations among EM local currency bonds. Yet over the next 12 months we expect a lot more differentiation among dollar-denominated bonds, and between local currency debt markets, as US monetary conditions gradually normalise.

The differing degrees of vulnerability of EM countries in an environment of rising US interest rates should drive increased divergence in the performance of their bonds.

A focus on quality

In both US dollar and local currency debt we believe investors should focus on those sovereign and corporate issuers that are less dependent on cheap international financing. This means holding the bonds of countries with the greatest flexibility in fiscal and monetary policy, the currencies of those countries that have healthy external accounts and the bonds of corporates that have sound credit profiles.

Within the US dollar space – and aside from corporate debt – quasi-sovereigns provide an alternative to sovereign bonds, particularly in the larger countries such as Mexico, Indonesia and Turkey. The bonds of quasi-sovereigns – which are 100% state owned – benefit from an implicit (and sometimes explicit) government guarantee and so share the credit quality of the sovereign. Both corporates and quasi-sovereigns can offer an attractive spread pick-up to the higher quality sovereigns which often trade at very tight spreads, given limited new supply. In addition to a more reasonable valuation, the wider spread generally means that corporate and quasi-sovereign bonds are less correlated to US Treasuries.

EM local currency bonds do not offer as many liquid alternatives to pure sovereign exposure. This asset class is the most liquid among emerging market debt since the bigger, higher-quality, sovereign issuers can borrow long term in their own currencies and are not generally issuing new dollar-denominated debt. When investing in EM local currency bonds it is essential to look separately at currencies and at local yield curves. While the valuations of both will ultimately reflect a country's fundamentals, currencies can be much more volatile in the short term as they are affected by such external factors as global risk appetite and the outlook for the US dollar.

The ongoing but gradual transition to less supportive, more conventional, monetary policy in the US may lead to some volatility in EMD, but the surprise factor that led to the 2013 sell-off is gone and the asset class continues to offer opportunities to investors who focus on the fundamentals. Valuations remain reasonable compared with history and versus other asset classes where credit quality is not as strong.