Fed talks dollar: implications for emerging market debt

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The Fed's unusual mention of dollar strength yesterday may fuel a rebound in emerging market debt sentiment. After the dollar posted the sixth largest quarterly gain in the dollar index in 34 years, emerging currencies which were faltering at interest rate hike prospects, may now gain much needed traction.

The combination of the dollar rally and an increase in macro volatility in September led to a 4.5% fall in emerging market currencies. This was even greater than the drop May 2013 as the 'taper tantrum' took risk appetite out of markets. On a real exchange rate basis, all emerging market currencies are, without exception, below the levels of April 2013, before the May volatility hit markets. Local rates – especially in those countries with wide differentials to developed economies – have actually performed well in September, falling less than a percentage point. Yet they still offer spreads over dollar-denominated emerging market assets approaching historic levels.

Dollar-denominated emerging market debt also slid in relative value. Like most global fixed income instruments, absolute yields are not cheap; but investment-grade sovereign spreads over Treasuries have widened from 173 basis points (bps) to 211 bps, as of yesterday. This is slightly above its historic two-year average. Should the idea proliferate that the Federal Reserve (Fed) is looking for reasons to delay a rate hiking cycle, that spread should compress.

The extant risks for emerging markets are still prevalent, but the regional impact of certain concerns is diverse. For example, the sharp drop in commodity prices is widely thought to pose a significant risk to emerging markets in general, but its effects differ across regions and countries. Emerging Asia is a likely net beneficiary, while Latin American growth is widely expected to be negatively impacted. Yet the story is not quite that straight forward. In Chile for instance, although copper represents 40% of exports, the terms of trade have not suffered, given the country's net imports of oil. Emerging Europe may also prosper despite the turndown in commodity prices. As interest rates move lower across the region as a whole, emerging European growth should outpace developed Europe. Indeed, emerging market growth as a whole should continue to be stronger than the developed world.

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