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Featured G

Emerging vs. Developed Market Yields: Not an Apples to Apples Comparison (Part 2)

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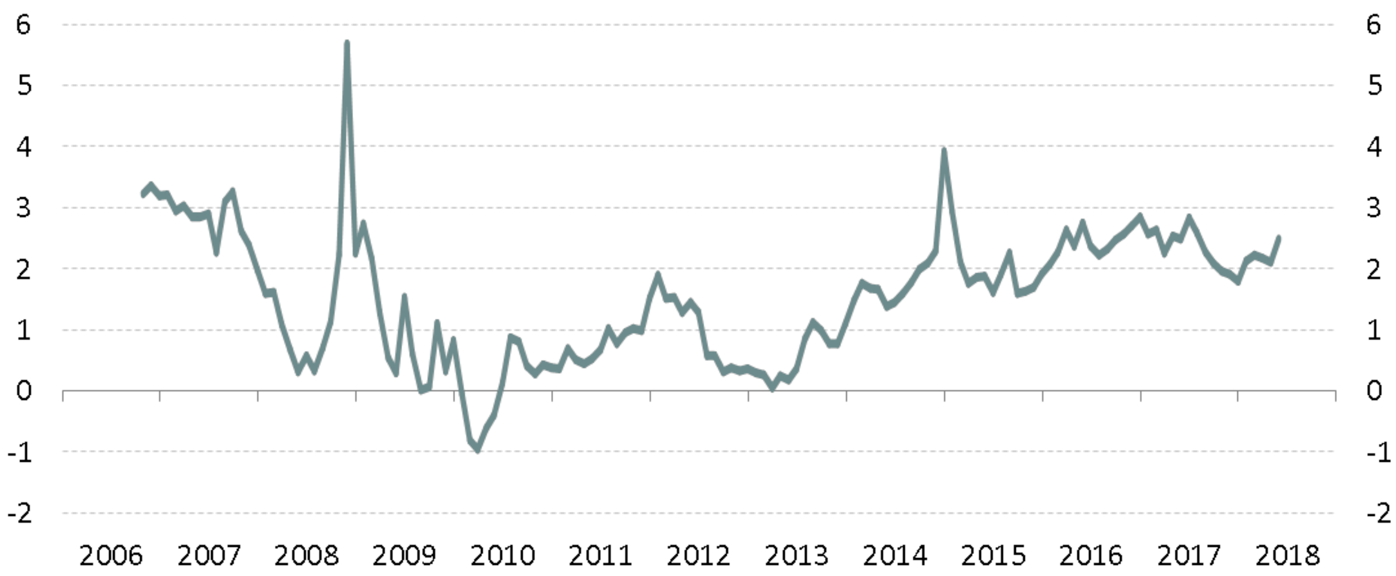
When talking about developed market tightening and the potential impact on emerging economies, it’s worthwhile to also look at the spread in short-term rates. In terms of short-term rates, there are two different themes and they're somewhat in conflict. The first theme looks at the level of real short-term interest rates in emerging markets, which is closer to the high end over the last 10 years, although not quite as extreme when looking at the 10-year part of the curve. Nonetheless it is still reasonably high—and in our opinion—that's important because it’s telling us that emerging market central banks are approaching monetary policy very differently than U.S., European, and Japanese central banks. In response to the decline in inflation, emerging market central banks are keeping real interest rates stable. In G3 countries, when inflation declined, the central banks scrambled to reflate their economies, dropping real interest rates sharply in the front end of the curve. The emerging market central bank response has been very different.

Divergence in Policy Rates

Emerging market central banks are communicating that they want inflation to stay low. So as we buy bonds further out on the curve, that's encouraging. We think that's the most important message from this chart:

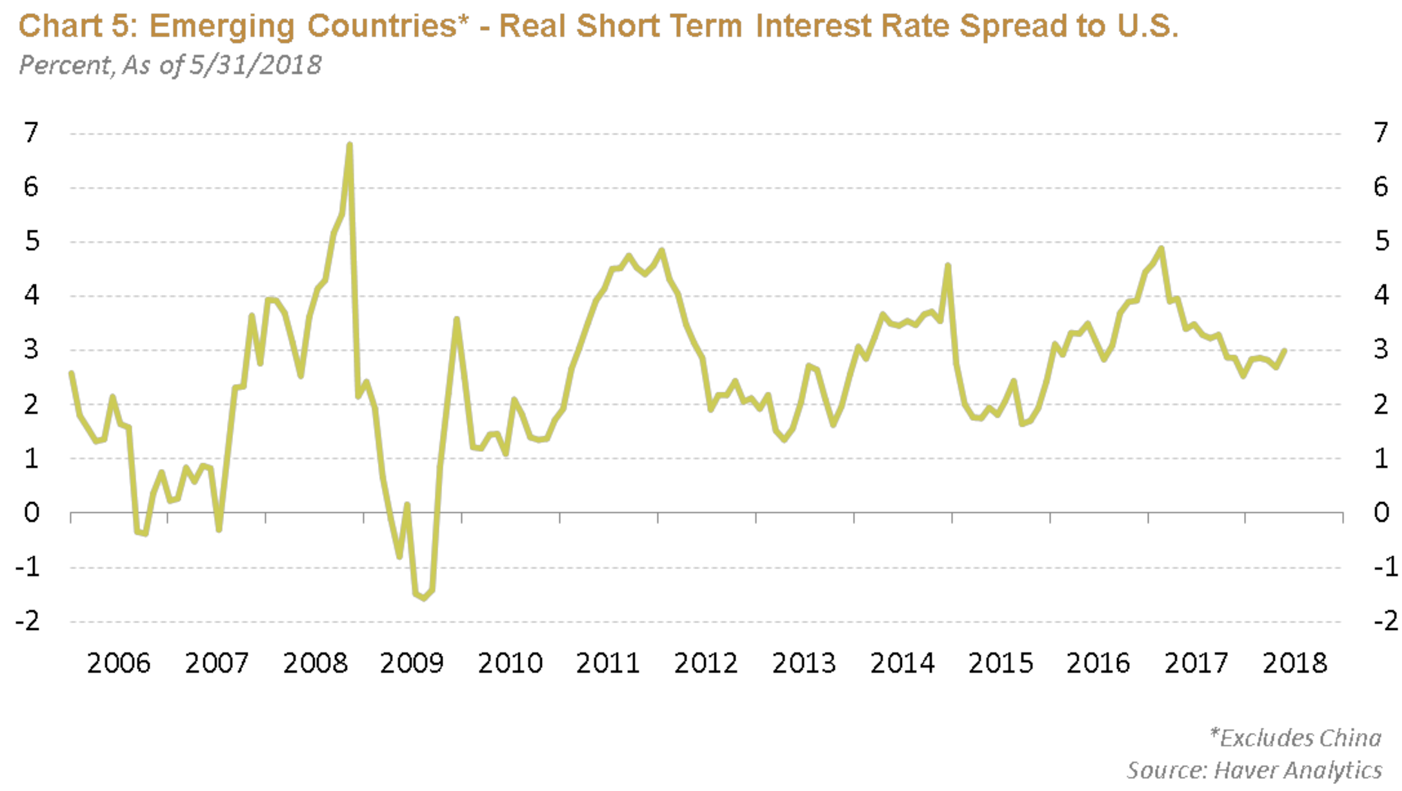
Chart 4: Emerging Countries* - Real Short Term Interest Rate

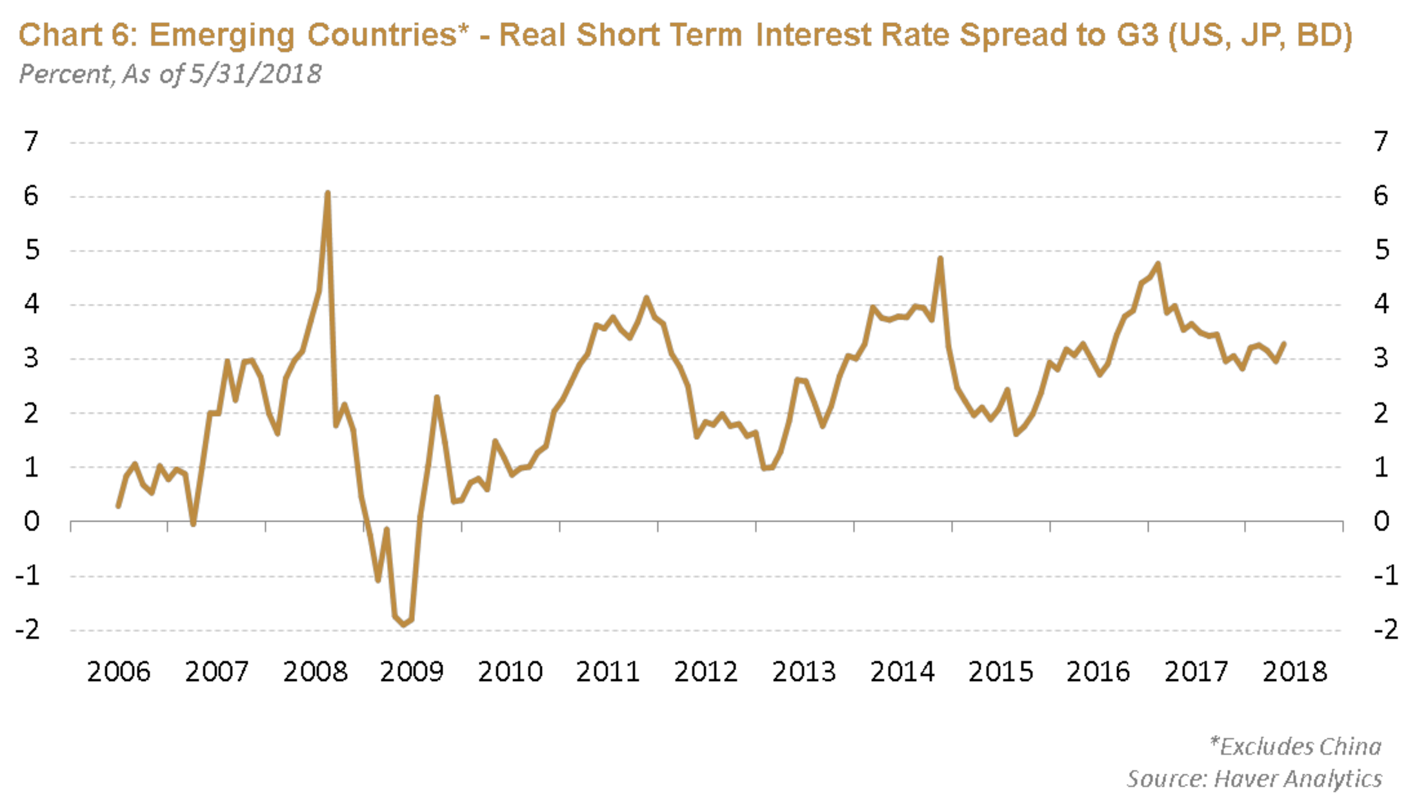
Percent, As of 5/31/2018



**Excludes China*
Source: Haver Analytics

The challenge is what's happening in these two other charts:





Here, we are comparing emerging market spreads to the U.S. and also against the broader G3, but this time with

shorter-term rates. Unlike the 10-year part of the curve, the asymmetry is less evident. In the case of short-term rates, spreads aren't at the top of the range—maybe they are near the middle of the range— and on a forward looking basis, the critical question is where this spread is headed over the coming year. That could be driven by monetary policy out of the G3. The Fed seems inclined to raise rates further whereas most of these emerging market central banks don't need to raise interest rates because their economies are weak. The concern here—and that's perhaps partly what's been driving some of the weakness in exchange rates in recent weeks—is that this spread on a forward basis may in fact decline toward the bottom of the range. The market is concerned there may not be enough of a risk premium from a policy perspective—because of the spread compression there—and instead we are getting currency weakness. We think this is a risk. However, by looking forward, we think there's a reasonable case to be made that the Fed is unlikely to raise interest rates as much as the market expects, and the global economy is likely to show improvement into 2019, which could change the path of these emerging market central banks.

Emerging Market Business Cycles

Emerging market countries are not all at the same stage of the cycle. European emerging markets, for example, are notably ahead of many other emerging market countries. The Czech Republic just raised interest rates, and the economies in Poland and Hungary have performed very well. These countries' economies are further advanced in the cycle. The countries that are further behind the cycle tend to be the more commodity-related countries like South Africa and much of Latin America, and parts of Asia. They have less of a reason to raise interest rates today given the degree of domestic slack. The lack of synchrony in economic cycles creates the risk of short-term policy rate convergence between emerging markets and the U.S. However, it's worth noting that the other two major central banks, the ECB and BoJ, remain disinclined to raise short-term interest rates any time soon. The emerging market policy spread —at least relative to those remaining G3 countries—should remain stable. Hence, capital is still likely to flow from Europe and Japan into emerging markets.

Potential Risks

Our outlook on emerging market valuations has been based on a few overarching themes, including global growth, commodity prices, economic conditions in China, and the trajectory of the U.S. dollar.

The rising political themes around populism, income inequality, and protectionism are affecting a number of countries around the world, in both developed and emerging markets. There are signs of reform fatigue in countries across the income spectrum, from the U.S. to Italy to Brazil. The balance between growth and fairness—the distribution of gains from growth—raises new risks that we will have to consider for emerging markets as well.

Part of the recent emerging market weakness is also related to a lack of clarity on what's happening to growth outside the U.S. While the American economy has benefitted from significant pro-cyclical tax cuts, growth outside of the U.S. has underwhelmed. Europe has decelerated. China has decelerated and there is a lack of clarity as to when that might turn the other way. China has focused less on growth and more on making sure the economy stays balanced; part of that meant slowing down growth in the housing and credit markets. The nature of the Chinese economy is also shifting to other sectors. But a slowdown in housing and infrastructure has implications for commodity prices and import demand. And that's partly weighing on the emerging market story at the moment. China's recent cuts to the reserve requirement ratio (RRR) may suggest that policy is beginning to shift to some more accommodative. In other words, policy has been more restrictive but may perhaps become more balanced. If China were to actually ease policy further, the 2019 story becomes more compelling for emerging markets. We think Chinese growth is moderating but nothing to be concerned about. The real question is whether China is running tighter policy than we think. While Chinese officials will eventually respond to a meaningful slowing by easing policy, the concern is that we might not yet be at a threshold that generates a response from the government.

One of our final concerns is the stage of the commodity cycle. We liken the current cycle to the previous commodity boom from the 1970s, during which time there was an enormous boom followed by a bust in the 1980s. After that bust from the mid-80s to the mid-90s, commodity prices traded sideways. That's a reasonable path to consider for commodities now. We had a boom in the 2000s and then the bust into 2015, and now

they’ve had a bounce. Outside of the surge and top in 2010-11, this is about as high as prices have gotten—it's about as high as prices got in 2008. So the risk is that commodity prices may already be near the top of their range. That doesn't mean prices have to go right back down—they could go sideways—which could still generate income and support external balances in emerging markets.

While we remain constructive on prospects for emerging market spread compression into 2019, these are some of the tenuous factors within the global economy that we will continue to watch closely.

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