Weekly Market Flash

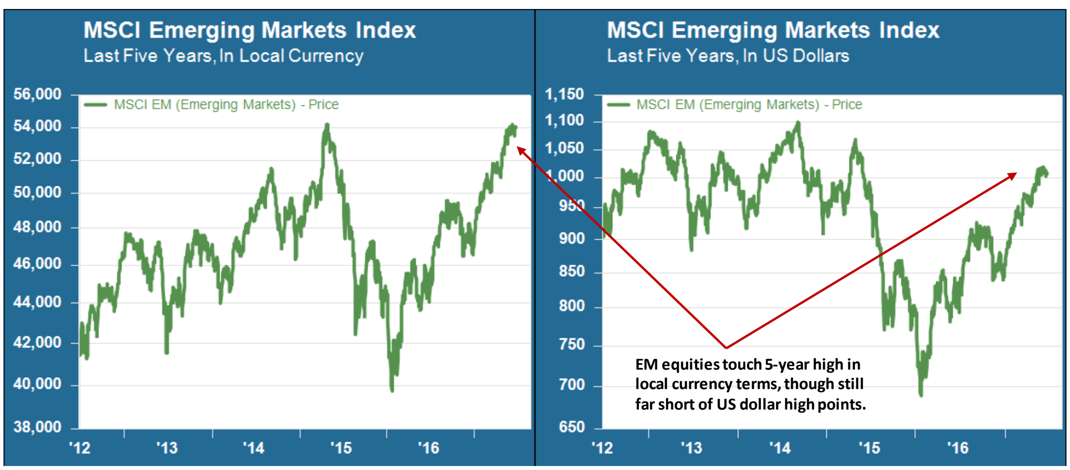
Confusing Times in Emerging Markets

June 23, 2017

It may be as good a sign of the times in which we live as any: in the space of five business days, Argentina (1) stunned global credit markets with a $2.75 billion 100-year bond (yes, a bond that will come due long after all of us reading this article have gracefully shuffled off this mortal coil), and (2) saw the Argentine peso fall to a record low after MSCI declined to upgrade the country's equity market from frontier to emerging market status. This seeming contradiction in fortunes comes at a time when emerging market equities hang on as one of the best asset class performers of the year, while investors have plowed more than $35 billion into developing market bond funds. Are there still opportunities here, or is the EM glow due for one of its not infrequent fizzles?

Unlikeliest of Success Stories

Pundits cheerleading the emerging market story were few and far between as 2017 got underway. After the surprise outcome of last November's US election the asset class fell 6.4 percent through year-end, along with everything else on the flip side of the "Trump trade." EM assets – debt and equity alike – were imagined to be in for a period of protracted weakness as US interest rates and inflation soared to the fanciful revving up of a $1 trillion tsunami of infrastructure spend. A better square on which to place your growth-and-risk-seeking chips, it would have seemed, was US small cap stocks. As it turned out, though, EM equities, currencies and bond prices all rallied. The chart below shows a 12-month snapshot of the MSCI EM stock index, denominated both in local currency and in US dollars.



Source: MVF Research, FactSet

Yield: What Matters Most

One of the factors -- not the only one, but key nonetheless -- explaining the updraft in EM equities is currency. After being pummeled by the US dollar more or less constantly since 2015, key emerging market currencies from the renminbi to the Indian rupee, Mexican peso and Russian ruble stepped on the gas after their post-Trump trade declines. That currency strength, in turn, is of a part with the remarkable push by global investors into emerging credit markets. For this there is an easy explanation. The investing world is on a collective, frantic search for yield in a world awash in central bank stimulus. Yield is the Holy Grail of the second decade of the 21st century.

Why was that 100-year Argentine bond deal thoroughly oversubscribed? Because investors could not resist the temptation of a 7.91 percent yield. Same goes for Russia, which unloaded $3 billion worth of 10- and 30-year Eurobonds into the markets this week (4.25 and 5.25 percent yields, respectively). Does it matter that Argentina has defaulted on its debt five times since 2000? Does anyone remember Russia's bailing on its sovereign debt obligations in 1998, sending the propeller-head mavens of Long Term Capital Management and their backers to the poor house? Not today, not in a world of yield above all else.

Lower for Longer, or Tantrum 2.0?

The punters who scooped up the Russian and Argentine paper this week may well be vindicated for their boldness if the market's view on the Fed turns out to be right. That view – the opposite of the reflation trade that had everyone so excited last year – is that low inflation and anemic wage growth are here to stay for the foreseeable future, just as they have been for most of the duration of the slow-growth recovery to date. If inflation and wages fail to kick in over the next several months, even with labor market conditions that according to many should suggest full employment, then it is quite possible that the FOMC will hold off even on the one further cut they have in their sights this year. That would potentially keep the dollar from embarking on another punishing rally, and the quest for yield would continue (pushing bond prices ever lower).

Then again, there is an alternative, quite valid argument to make that the low levels of volatility in asset markets today are woefully mispricing the amount of latent risk that could be unleashed at any time. It's worth noting that many of the EM currencies that have been doing so well of late have run into some headwinds recently. The Brazilian real took a tumble back in May when the newest batch of political scandal headlines hit the wires. The ruble and the renminbi are both well off their recent highs, while the rupee and the Mexican peso are marking time in a relatively narrow corridor. The year's gains to date have been impressive. Experienced EM investors know that they are anything but certain to last.

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