Strategy Insights | Fixed Income

EM local rates and currencies look attractive; DM tapering looks priced in

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Overview

- The extent of Fed tapering already implied in EM markets suggests that the eventual announcement of tapering may (counterintuitively) lead to a rally in EM rates.
- The most attractive relative value opportunity remains on the EM currency side, in our view, as the probability of continued US dollar strength ebbs.
- Country spotlight: Chile's higher than expected central bank rate hike in August suggests potentially faster policy normalization and movement toward tightening than previously expected.

We believe solid global growth and benign financial conditions are supportive of emerging market (EM) local debt. We are focused on EM fundamentals (the Delta variant will likely not prevent country reopenings) and the divergence among central banks: some are being forced to react to inflationary pressures (Brazil, Chile, Russia), some are hiking gradually (Mexico, Hungary, Czech, Peru), some are likely to begin hiking in the next few months (Colombia, Poland and possibly South Africa), and some are unlikely to hike (Indonesia, Thailand, India).

While our thesis of positive EM local debt performance played out in the second half of August as fears of accelerated tapering subsided, our view has not fully materialized year-to-date. This is despite the supportive macroeconomic backdrop of good global growth, easy financial conditions, and attractive valuations. If US data remain moderate, as we expect, and US rates remain rangebound, EM rates could enjoy a rally similar to the one seen in the US in June, providing investors with potential capital appreciation over the balance of the year. In other words, EM has effectively anticipated a US Federal Reserve (Fed) taper announcement to such an extent that the eventual announcement of tapering may, counterintuitively, lead to a rally in EM rates.

That being said, the larger relative opportunity remains on the currency side, in our view, as the probability of continued US dollar strength ebbs. We expect more effective Fed communication and the paring down of the Biden administration's last sizeable fiscal stimulus package to weigh on the US dollar. Negative US real yields and over-owned US dollar positioning could also provide a supportive backdrop to EM currencies. To be sure, US dollar weakness in the medium-term depends on improvements in growth and Delta metrics in non-US countries, combined with US economic performance generally in line with market expectations. In the short term, however, US developments will likely have an outsized impact on the rest of the world, as excess savings gravitate toward perceived "safe" assets (including US equities) versus perceived "risk" assets, such as EM local debt.

Market pulse

In EM interest rates, we have become more cautious on Brazil and continue to find value in Russia and Indonesia. Also, we remain cautious on the Central and Eastern European (CEE) countries but think Mexican short-term, South African long-term, and Russian medium-term interest rates are attractive. In currencies, we favor the Thai baht, Polish zloty and South Korean won. In terms of regions, we have become less cautious on Asia and favor euro-like EM currencies, especially the Polish zloty.

August was an active and hawkish month for EM central banks, with continued rate hikes in CEE (Czech Republic and Hungary), an acceleration in rate hikes in Latin America (Brazil and Chile), gradual hikes in Mexico and first-time rate hikes in Peru and South Korea. It is interesting to note that the average key policy rate of 20 EM central banks has risen from a low of 2.65% one year ago to 3.5% today (Figure 1). In contrast, no rate hikes have materialized in developed market (DM) countries during the same period, with most large DMs only "talking" about announcing tapering, let alone hiking rates. In EM, we expect this average to increase in the next few quarters, though gradually, as the early hikers are nearing the end of their current cycles and the number of new hikers should be limited.

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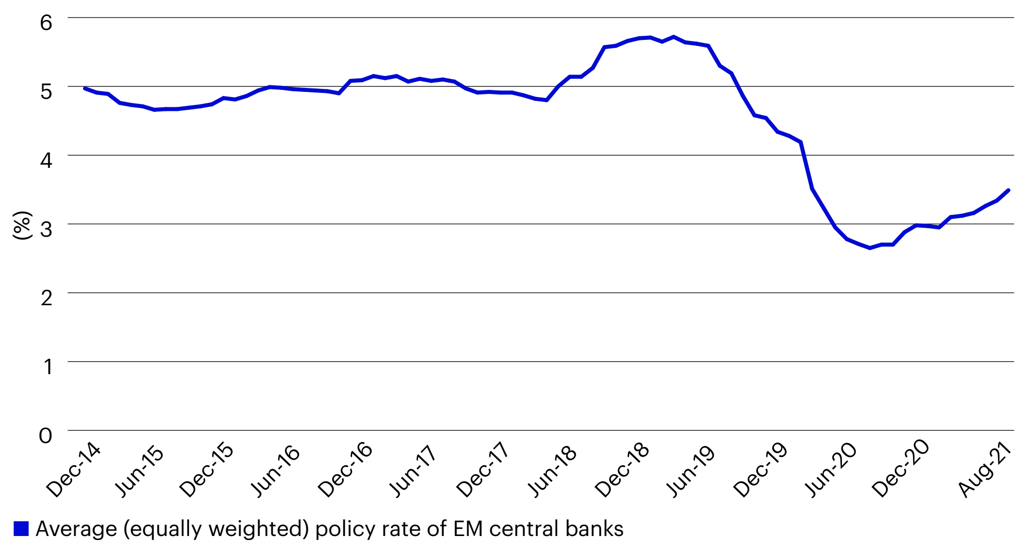
Figure 1: Average (equally weighted) policy rate of EM central banks



Source: Bloomberg L.P. Data from December 1, 2014 to August 1, 2021. Countries are Indonesia, South Korea, Malaysia, Philippines, Thailand, India, China, Czech Republic, Hungary, Poland, Romania, Russia, South Africa, Turkey, Egypt, Brazil, Chile, Colombia, Mexico, Peru.

Country spotlight: Chile

The Central Bank of Chile ended August on a hawkish note. Before the policy meeting, the market was split in expecting either the continuation of gradual policy normalization (25 basis point rate increase), or a slightly faster pace (50 basis points), given recent strong economic data and higher than expected inflation. Our team was in the latter camp, expecting the pace of normalization to be accelerated. In the end, the market was surprised with a hike of 75 basis points, taking overnight rates to 1.5% from 0.75%.[1]

The central bank's communication of its rate decision, combined with its quarterly Monetary Policy Report, laid out concerns about the macro environment. The central bank now expects policy to move from accommodative to neutral by mid-2022. We believe the risks to this projection are to the upside, and there may be a need to move toward restricting growth. The government's potential approval of a fourth round of early pension withdrawals and additional cash transfers related to the pandemic could push growth and inflation higher in the coming months, but these are not included in the bank's base case. We, therefore, remain cautious on Chilean interest rates. We are neutral on the currency as well due to political risks, with both a presidential election and constitutional reform on the horizon.

1. Source: Central Bank of Chile, August 31, 2021.

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