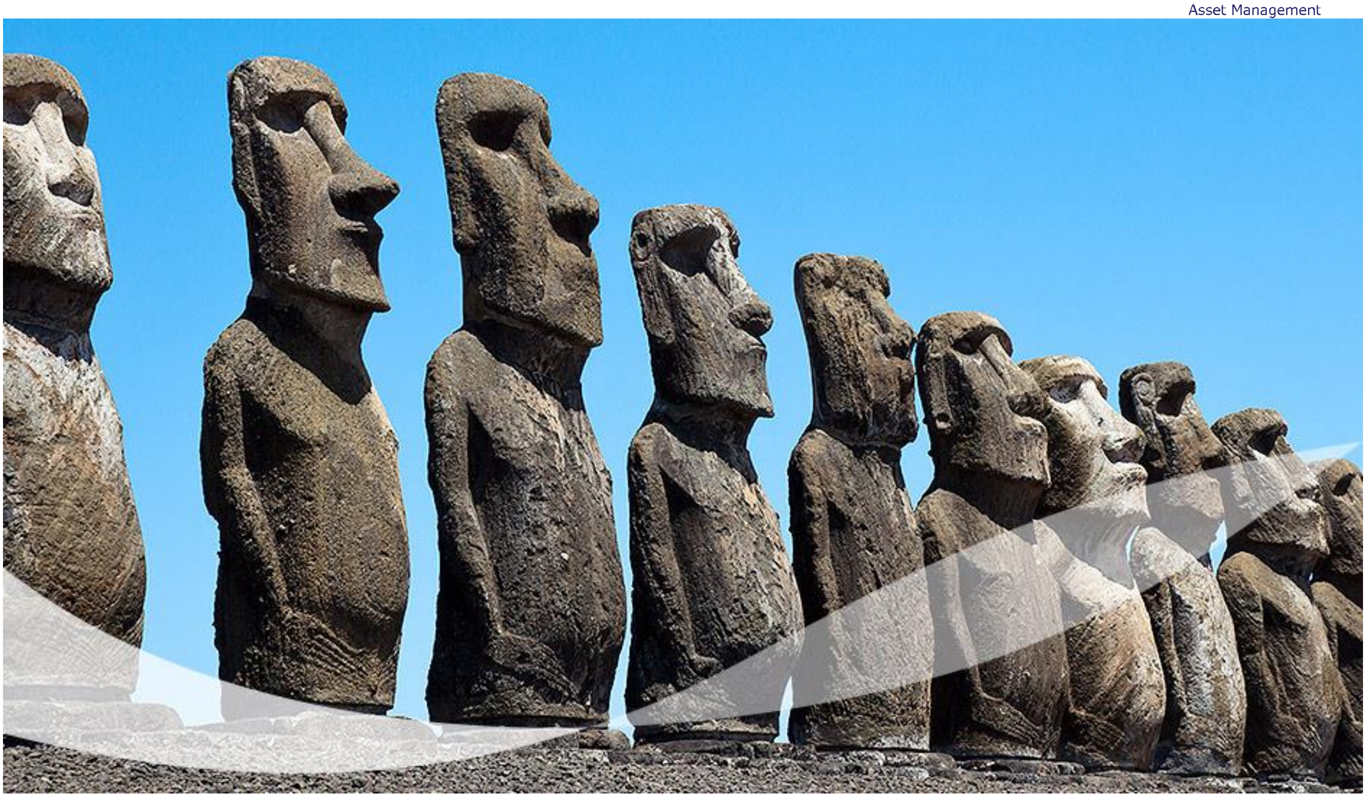

EMs stand firm in the face of the Fed

News Analysis

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Published March 2017

Emerging markets continue to perform well despite increasing expectations of a March rate hike

Last week saw a material repricing of expectations for a March rate hike, and yet the effect on the rest of financial markets was relatively muted. Speeches from Fed governors Dudley and Fischer, as well as Fed chair Yellen, clearly signalled a belief that US economic conditions were appropriate for another interest rate rise.

In the short term, risk markets have taken this as a positive signal about the resilience of the global economic upswing, rather than focusing on the potential downside of tighter financial conditions. This sentiment has been strengthened by the fact that longer-dated bond yields have remained anchored, and also the fact that President Trump's address to Congress was seen as more 'presidential' and less confrontational, even if light on policy detail.

The net result of all of this is that sentiment in EM has remained in 'risk on' mode, even if in an environment of relatively light trading volumes and low volatility. The new issuance market continues to be a fertile space, with deals coming through from El Salvador, Slovenia and Oman.

Meanwhile our cautious view on Mexico continues to be tested. Over the past week the Mexican peso was the best-performing EM currency. It was helped by favourable comments from new US Commerce Secretary Wilbur Ross who talked of a "win win" NAFTA renegotiation, and unsubstantiated rumours of a US Fed-Banxico swap line to potentially provide liquidity support to Mexico. We find this an unlikely possibility at this point; the blowback domestically on the Fed would surely be immense.

In Turkey, the February inflation release was higher than expected, which serves as a reminder of the ongoing economic challenges Turkey faces. We will continue to monitor events going into the April 16 referendum.

In summary, the change in Fed expectations has not created a change in trading conditions in EM. We have a sense of unease about growing levels of complacency in risk markets, but this is causing us merely to continue to rotate long positions and be disciplined about price targets, rather than move to a wholesale more cautious stance.

Reflecting on the first two months of this year, the biggest surprise compared to expectations has been the strength of global (rather than just US) economic data. At the same time while the market and the media is obsessing over Trump's tweets and policy intentions, the global economy is enjoying a somewhat ignored but powerful upswing. The Asian region has been the best example of this, with significant strength in both imports and exports despite initial fears of greater protectionism. Concerns about China have lessened as the country is likely to record nominal GDP growth of over 10% in the first quarter. EM growth momentum is normally a good guide to prospective asset class performance. The current "goldilocks environment" of strong global growth data and well anchored longer dated bond yields seems likely to hold for a while yet.