Emerging markets take a breather

News Analysis

Emerging markets have enjoyed strong returns so far this year, but the recent confluence of negative news could drive a more substantial risk reversal in sentiment

by
Mark Dowding

Partner, Co-Head of Investment Grade
November 2017

Option volatility on Bunds and Treasuries continued to fall over the past week. With last week's glut of data and central bank activity out of the way, government yields continue to trade within existing ranges seemingly capped on the upside and the downside. Low volatility has continued to help risk assets in general with equities and credit in developed markets trading with a constructive tone, even though price action has been more muted than in recent weeks. We have seen that government bonds in the eurozone periphery were among the strongest performers over the past several days, with bears continuing to capitulate short positions as perceptions of political risk continues to dissipate. However, in contrast to all of this, the tone in emerging markets (EM) has been markedly different.

The threat of an imminent sovereign default in Venezuela has seen some bond prices halve from levels this time last week and with some investors caught long and wrong, negative sentiment has also had some adverse impact on other emerging markets, even if it is more the timing of default, rather than the reality of it, which stands to take most investors by surprise. Meanwhile, a crackdown by Mohammad bin Salman (MBS) in Saudi Arabia, arresting a number of other princes and oligarchs from various other tribes in the country, can be viewed as something of a coup, which is sending shockwaves across the region. A more anti-Iranian stance is likely to result and this may lead to an escalation of tension between the two largest powers in the region. The resignation of Prime Minister Hariri in Lebanon at the weekend can also be seen as a Saudi power play to wreck any compromise with Hezbollah, showing the regional dimension to events in the Kingdom. It may be that the move by MBS is a successful power grab, but with the gloves coming off, it is also possible that this tactic could make him a target and consequentially volatility and risk premia are likely to rise in the region in the near-term as a result.

One knock-on impact of events in Venezuela and the Middle East has been to push oil prices to a two year high, something that has been supporting breakevens on shorter-dated inflation-linked bonds on the view that headline inflation (CPI) may consequently surprise to the upside. Core inflation forecasts remain very subdued; though with output gaps continuing to shrink and economic growth robust, we would highlight that there may be some complacency in markets about the possibility of inflation resurfacing, so entrenched is the low inflation mind-set. Of itself, a combination of higher oil prices and robust global growth should be very supportive of other EM asset in general; however, deteriorating politics and fundamentals in countries such as Turkey, South Africa and Mexico has seen weaker sentiment in EM FX start to contaminate local rates and latterly sovereign credit. 2017 has been a strong year for EM returns and we have recently been advocating booking profits on long positions. It strikes us that events in the past week add a bit more urgency to this call and in particular we are concerned that the Middle East region could be vulnerable to a turn in risk sentiment.

Looking ahead, the next couple of weeks could continue to be quiet in developed markets. In the US, yields appear to be set to remain range bound unless, or until, inflation moves higher, tax reform is passed or unless equity markets drop in a more generic flight to quality in response to global geopolitical events. With the important news on inflation and tax reform still a few weeks away, we see early December as the most likely moment for a reflation trade to kick in and if it does so, this may coincide with the point in the year when liquidity conditions are at their thinnest. In that case we may need to be patient and bide our time for a couple of weeks and while we wait we may continue to look for opportunities to gradually de-risk.

By contrast, EM could continue to be a source of volatility. Rising tension between Saudi and Iran/ Qatar seems likely, whilst any attempt to wrest power back from MBS could be very destabilising. Maybe at a time when everyone has been worrying about the potential for conflict on the Korean peninsula, it will be another region which ends up as the real risk. What we feel we do know is that investors in EM have enjoyed notable returns so far this year and it may not take too much more negative news in the asset class to drive a more substantial risk reversal in sentiment, even if in many cases this is not wholly justified by the fundamentals. Though in thinking on the topic of injustice, take a moment to pity the princes, currently holed up in the Ritz Carlton ballroom. By the looks of the pictures, the blankets aren’t even Louis Vuitton. What is the world coming to?