Insights
Fixed Income

October 2021

EMD and Fed Tapering: Why This Time is Different

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The US Federal Reserve has been gearing up to slow the pace of its bond purchases. But unlike the Taper Tantrum of 2013 that saw an outsized negative impact on emerging market debt, the Fed's more careful communication this time around makes it unlikely that today's more resilient emerging bond markets will experience the same fallout.

A recurring theme in our recent conversations with investors is the tapering of the US Federal Reserve's quantitative easing (QE) programme. It is widely expected that the Fed will start reducing its monthly purchases before the end of this year with the programme concluding around the middle of 2022. For investors in emerging market (EM) debt, this is an especially acute concern as EM debt performance depends to a great extent on the broader macro backdrop, with the monetary policies of developed markets central banks, and the Fed in particular, key factors in this. Furthermore, the memory of the "taper tantrum" in the summer of 2013 is still fresh in the mind of many EM investors; at the time, then Fed Chairman Ben Bernanke's unexpected QE tapering announcement led to a significant sell-off in both EM Local and Hard Currency debt, which lost 14.3% and 9.6%, respectively, over the course of four months.[1] However, we believe this time is different for a number of reasons.

On the one hand, the Fed seems to be a lot more careful in its communication of the likely start date for tapering and how it will be implemented. At its meeting on 22 September, Fed Chairman Jerome Powell reiterated that this will be a gradual process. On the other hand, both the fundamental and technical backdrops are more supportive to EM debt today than in the run-up to the 2013 taper tantrum.

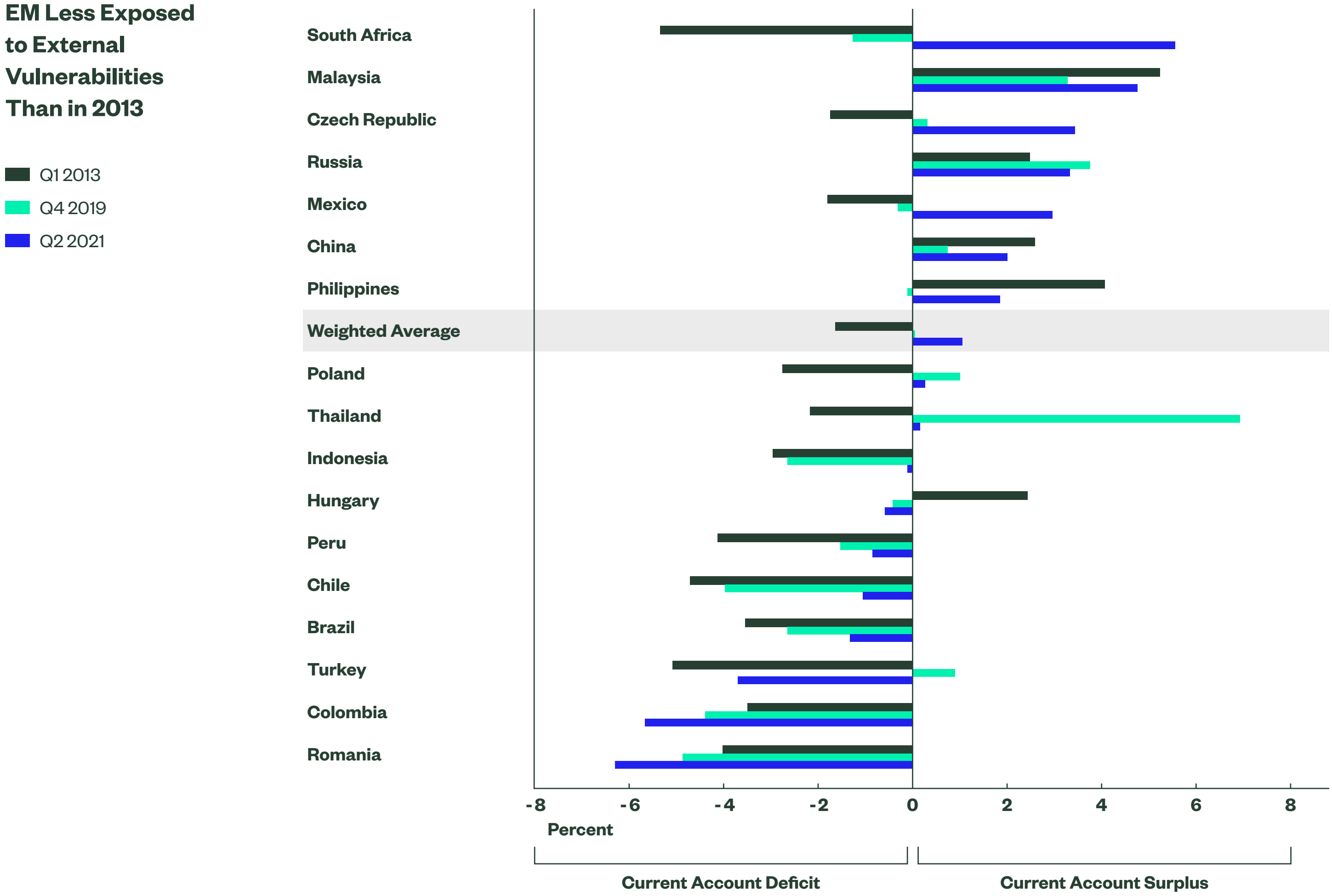
Local Currency Debt Better Protected This Time

Casting a look back to the summer of 2013, we see that EM Local Currency bore the brunt of the sell-off with the flagship JPM GBI-EM Global Diversified Index (the GBI-EM) losing 14.3% of its value from 30 April to 30 August 2013. Local currency debt tends to underperform during sell-offs as EM FX is the most liquid part of the EM universe and tends to act as an adjustment valve. However, we do have reasons to believe that this time around EM LC is better protected.

Firstly, the countries in the EM Local Currency index are much less exposed to external vulnerabilities than they were in 2013. We estimate that in Q1 2013, just before the taper tantrum, the countries in the GBI-EM GD index had an average current account deficit of -1.6%, whereas in Q1 2021 they had a current account surplus of 1.2%. There has been significant improvements in the current account balances of South Africa, Thailand, Indonesia, and Brazil to a lesser extent — making these countries less vulnerable to the effects of tapering. Although the improvements are not across the board and other countries such as Turkey, Romania and Colombia continue to have large current account deficits — the experience of recent years has shown that localised crises typically don't have the capacity to cause the kind of contagion we've witnessed in the past.

Figure 1
EM Less Exposed to External Vulnerabilities Than in 2013

Evolution of EM Current Account Balances



Source: State Street Global Advisors, Bloomberg Finance as of Q2 2021. All data is weighted, based on the country weights of the JP Morgan GBI-EM Global Diversified Index as on the respective dates.

Secondly, according to our Purchasing Power Parity (PPP) currency model, the currencies of the countries in the GBI-EM GD Index are currently significantly undervalued versus the US dollar — our FX team estimates that this undervaluation stood at -10.3% at the end of September 2021 (Figure 2). By contrast, at the end of April 2013 — just before Bernanke's announcement on the 22 May 2013 that triggered the taper tantrum — EM FX was nearly 19% overvalued versus the US dollar. We believe that the significant richness of EM currencies at the time was one of the reasons for the sharp losses that EM LC registered; conversely the current cheapness of EM FX is likely to act as a cushion against potential losses.

Figure 2
EM FX Undervaluation Presents Cushion Against a Sell-off

Source: State Street Global Advisors, Bloomberg Finance as of 30 September 2021. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance is calculated in USD. Estimate of fair value versus the US dollar as of 30 September 2021 — valuations above 0% imply overvalued and below 0% imply undervalued. The information should not be considered a recommendation to invest in a particular currency. It is not known whether EM currencies will be profitable in the future. Composite valuation based on weights of the JPM GBI EM Global Diversified Index.

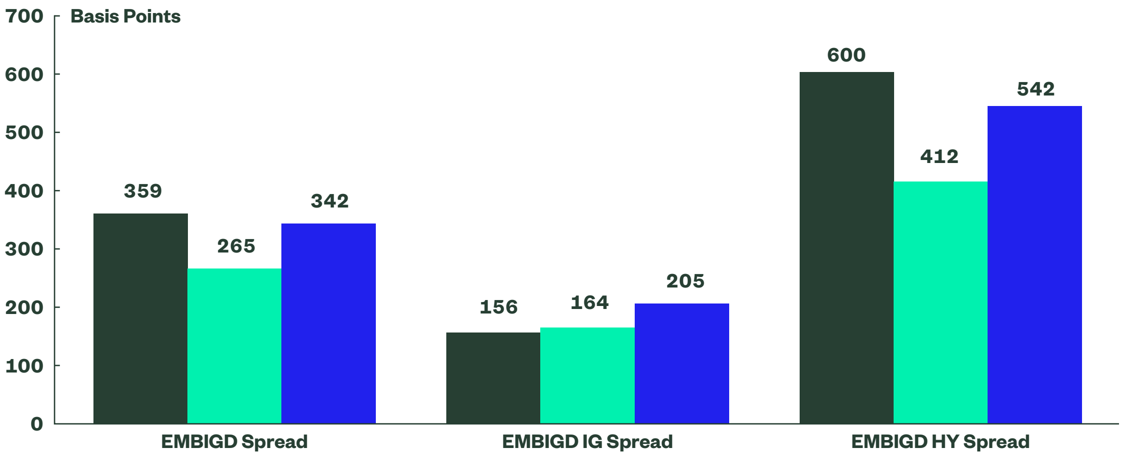
Hard Currency Valuations More Supportive

In the EM Hard Currency (EM HC) space, valuations are overall also more favourable than they were back in the summer of 2013. The spread of the EMBIG Diversified index is 94 basis points (bps) wider than it was in May 2013 when it stood at 265bps. This was not only much tighter than the current spread, but also significantly tighter than the 15-year average of 342bps. The relatively wider EMBIG spread today should give some protection to EM Hard Currency assets when the Fed begins to taper. However, we should caveat this by saying that the overall EMBIG spread is wider today compared to its level in May 2013 because of the High Yield (HY) sub-index, where the spread is 187bps wider. The spread of the Investment Grade (IG) sub-index, on the other hand, is slightly tighter than its pre-taper tantrum level. Also, the wider spread of the HY sub-index is somewhat justified given the significant increase in debt load and deteriorating fiscal situation that a number of EM economies are facing.

Therefore, all things being equal, EM Hard Currency debt could be more vulnerable to the effects of tapering. However, as noted, things are different this time and EM HC is unlikely to plummet like it did in 2013. Furthermore, EM HC spreads already demonstrated their resilience in the opening quarter of 2021 when they were almost unchanged through a sharp US Treasury sell-off. By comparison, during the 22 May–30 September 2013 period, the EMBIG index spread widened by 74bps — this was driven by the HY sub-index which widened by 198bps over this timeframe.

Figure 3
The EMBIG Spread is 94bps Wider Today Than in 2013

Current Spread (17/09/2021)
Pre-taper Tantrum Spread (22/05/2013)
15-Year Average



Source: State Street Global Advisors, Bloomberg, JP Morgan as of 18 October 2021.

Positioning More Favourable

Positioning in EMD, and particularly EM LC, is also more favourable this time. According to data from JP Morgan, EM debt registered total net flows of $220bn in the three years before 2013, split between EM HC ($123bn) and EM LC ($98bn). By comparison, from January 2019 to the beginning of October 2021, there were total net flows of $138bn with $102bn going into EM HC and just $36bn into EM LC. It is important to note that $37bn of the EM LC inflows were into China local currency debt; therefore, flows into EM LC were actually slightly net negative for this period.

EM Resilience to UST Sell-offs Already Tested in Q1

Finally, we should note that there was something akin to a mini tantrum at the start of 2021, even in the absence of an official Fed statement. EM yields sold off by 83bps from the start of January to the end of March 2021. This is not too far off what happened in the summer 2013 when EM yields went up by 110bps over the course of four months. However, in Q1 2021, the hit to EM asset prices wasn't anything as deep as it was during the taper tantrum of 2013. EM LC was down 6.7% in Q1 2021 and EMD HC was down 4.5% — these are considerably smaller drawdowns than the 14% and 10%, respectively, recorded in 2013 and they illustrate the greater resilience of EMD this time around.

The key risk to our view is that lingering, or accelerating, inflation pressures the Fed to act faster. The minutes to the Fed's latest meeting in September reveal concern that the bank is falling behind the curve. However, we believe that for all the reasons mentioned above, even if this risk materialised, the impact of the Fed's tapering on EMD will be a lot more subdued than in 2013. Currently, there are risks to EMD prospects coming from China's slowdown and stagflation, but we believe a taper tantrum is one of the lesser ones. As the broader macro backdrop becomes more challenging for EM debt, we expect a "muddle through" scenario is more likely than a sharp correction. The primary rationale in favour of EMD remains intact — cheaper valuations — particularly in EM FX and EM HC High Yield, light positioning particularly in EM LC, and relative attractiveness compared to other fixed income assets. Although the period ahead is likely to remain volatile, we see sell-offs as a potential opportunity to build exposure.

Further Reading

Why China remains Attractive Despite Risks
http://ssga.com/insights/why-china-remains-attractive-despite-risks

Endnote

1 EM Local currency performance as measured by the JPM GBI-EM Global Diversified index and EM Hard currency performance as measured by the JPM EMBI Global Diversified index from end of 30 April 2013 to 30 August 2013.

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* Pensions & Investments Research Center, as of December 31, 2020.
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ID782606-3880586.1.1.GBL.RTL 1021
Exp. Date: 31/10/2022