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Emerging markets re-emerging?

2018 has proved to be an unfriendly year for the broad performance of emerging markets (EM). Several major emerging markets have encountered headline risk related to adoption of poorly received economic policies – especially, Turkey and Argentina – and reports of widespread government corruption – especially, Brazil and South Africa – which have sparked outflows of investment for the whole EM sector. The U.S. shift toward a more protective trade policy is also not helping sentiment nor is the seemingly relentless gradual uptrend in U.S. interest rates.

Figure 1: SPX and MSCI emerging market 50 performance

Source: Eikon – Click on chart to request a free trial

As shown in figure 1, emerging market equities (as measured by the MSCI to 50 index) closely tracked the U.S. SPX in recent years, but the paths diverged in June. Both indices peaked in the early days of this year and then were subject to painful pullbacks; but while the SPX recovered, the EM index remains in a downtrend and is well below the January peak. While it is not unprecedented for these two indices to delink in this manner, divergence generally does not persist more than six months. The lower part of figure 1 shows the ratio of the EM index vs the SPX which serves as a proxy for the relative value of these two markets. The EM market based in August as the ratio hit 30% just above 2016's record 28% low. It appears that the relatively low EM valuation may be a source of support that could bring the two markets back into alignment.

Figure 2: Stronger dollar weighs on emerging market stocks

Source: Eikon – click on chart to request a free trial

There is more than one way for markets to converge

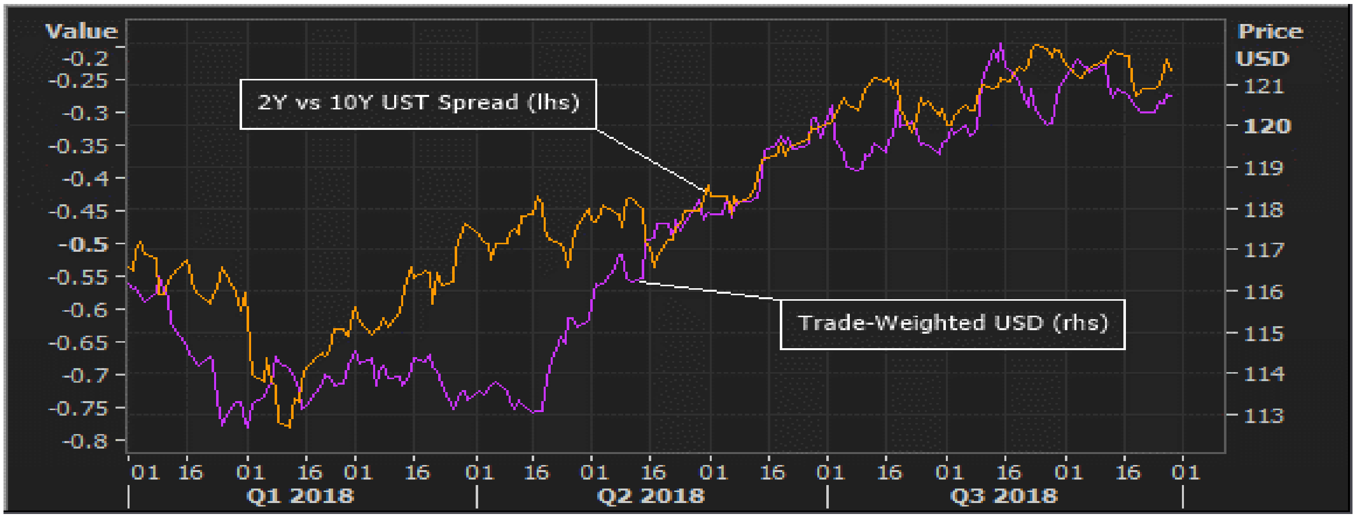
We believe relative valuation is reaching levels where the trend divergence between U.S. and EM equity performance should soon end. But that leaves open how convergence will manifest; will the EM market be pulled into the U.S. positive trend or the U.S. head lower with EM markets – or both turn sideways. Figure 2 shows that for all the noise from negative headlines, the timing of the EM market downturn was closely linked to a USD surge (the USD index is inverted in the chart) and the recent EM bounce back tracked a USD reversal.

It seems counterintuitive that a strong dollar would be negative for emerging markets since it makes their exports more competitive. But the competitive effect is gradual while there is an immediate negative impact from the increase of the local currency cost of servicing dollar denominated debt. Thanks to super-low U.S. rates, global USD-denominated financing has skyrocketed in recent years so the strong dollar is adding to the impact of higher rates creating tremendous funding pressure on EM debtors. It appears for EM markets to latch onto the U.S. equity uptrend would require an end to the USD rally; there is reason to believe the USD rally is over.

As was outlined in the July Market Voice, the Fed tightening per se has not been driving the dollar but rather how tightening has been reflected in the yield curve. More specifically, steepening of the 10Y vs 2Y yield curve has been USD negative while flattening has been USD supportive. Figure 3 shows that this relationship persists, the USD has run out of steam in the third quarter as the yield curve stabilized.

2Y rates are unlikely to rise much near term since the market is already priced for roughly three more Fed hikes of 25 basis points by the end of next year. The market would have to price in additional tightening for the 2Y rate to move materially higher. But with inflation threatening to continue increasing, there remains significant scope for higher long-term rates. (There is also some evidence that the Fed would welcome some curve steepening given the widespread presumption that curve inversions are a prequel to recessions.)

Figure 3: U.S. yield curve and the trade-weighted dollar

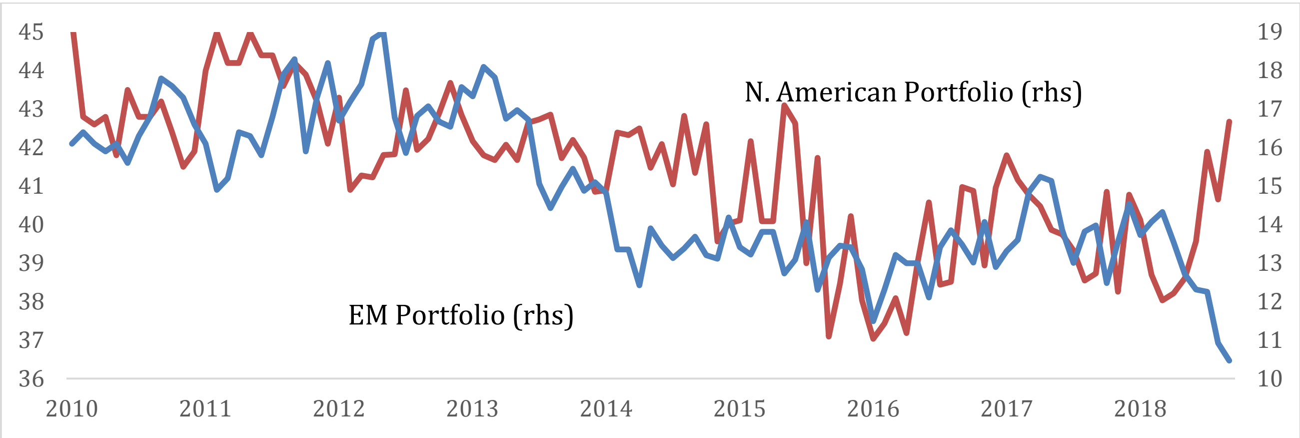


Source: Eikon – click on chart to request a free trial

Exposure to emerging markets has truly submerged

Figure 4 is derived from our poll on the allocation of market holdings across a regional portfolio. Consistent with the divergence in market performance, the proportion of portfolios dedicated to North American (the survey does not distinguish between the U.S. and Canada) equities has risen from about 38% to almost 43%, close to a five-year high. EM holdings have plunged almost 1/3rd from near 15% to just above 10% - the lowest exposure in the history of the survey. The extremely low portfolio exposure should also become a factor of support in the coming months.

Figure 4: Global regional equity holdings as a % of global portfolio



Source: Eikon

Figure 5: Currency value tracker filter for 1Y carry

Currency	1Y Annualized Net Carry Value	1Y Annualized Net Carry Percentile	1Y Net Carry / Implied Vol Value
USDTRY	25.81	79.39	1.08
USDIDR	6.07	79.39	0.61
USDMXN	5.58	6.87	0.42
USDINR	4.92	96.18	0.62
USDZAR	4.77	64.12	0.27
USDRUB	4.20	84.73	0.30
USDBRL	3.96	90.08	0.23

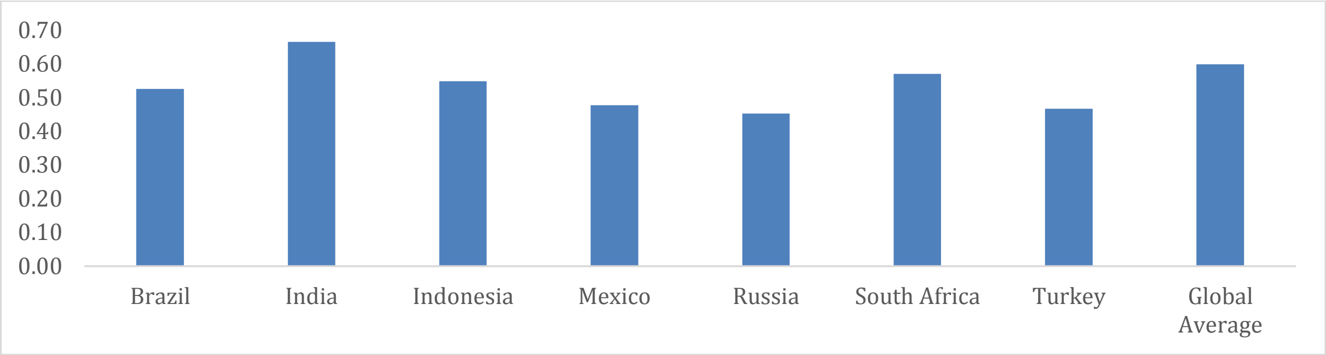
Source: Eikon (Red denotes top 25%, while blue denotes bottom 25%) – click on chart to request a free trial

But which emerging market looks most interesting?

Figure 5 shows the filtering for the highest 1Y offshore FX forward implied yields. The red in the first column denotes these currencies offer carry in the top quartile for all available currency pairs. The second column shows the percentile for current rate compared to the past six months (i.e., since the recent bear emerging market trend emerged). The third column shows the 1Y rate on a risk adjusted (i.e., vs 1Y implied volatility) basis. Turkey offers the best outright carry on both an outright and risk adjusted basis, but the Indian rate dominates compared to how they have traded since the EM bear market began. Although the Indian rates outright are also below Indonesian and Mexican 1Y rates they compare favorably on a risk adjusted basis. MXN rates are particularly unattractive on a risk-adjusted basis and compared to where they recently traded (i.e., in the 10th percentile).

Figure 6 is the 2017 World Bank average assessment of six country risk indicators: accountability, political stability, government effectiveness, regulatory quality, rule of law, and corruption. India's high political stability score stands in sharp contrast to the other high yield countries. South Africa is also high, but offers lower carry and political uncertainty arising from Presidential elections earlier this year which may not be reflected in the World Bank numbers. India and Indonesia are relatively attractive on this measure dominating both Turkey and Mexico. While the recent announcement of a NAFTA replacement treaty is good news for Mexico, it probably will not materially change the risk readings since the low score is primarily driven by indicators of corruption and rule of law.

Figure 6: World Bank indicator of political stability – end 2017



Source: World Bank political country risk guide

Although the World Bank indicators suggest India has relatively low political risk, the StarMine Equity Risk Index shown below in figure 7 indicates that the Indian equity market is pricing in higher risk than either Indonesia or Turkey. This implies that the Indian markets are priced cheap relative to what is priced in for Indonesia. The Turkish equity markets appear particularly overpriced given that the risk premium priced in is barely above U.S. levels.

Figure 7: StarMine Equity Risk Index

Source: Eikon – click on chart to request a free trial

Indonesia and India a close call but India wins on exchange rate value

Figure 8 below shows the real (PPI deflated) trade-weighted exchange rate indices for the Indonesian rupiah (IDR) and Indian rupee (INR). Both currencies have trended lower in real terms (i.e, the countries have become more competitive) over the past 18 months reversing the gains made during last year's EM rally. While the IDR is at a two-year low, it remains well above its average levels over the past decade whereas the INR is testing the decade's real lows. This suggests the INR offers better value.

Figure 8: Real Trade-Weighted INR and MXN

Source: Eikon – click on chart to request a free trial

The bottom line

There has been an atypical divergence between the SPX and emerging market equities; the strong U.S. economy has favored U.S. equities and the resulting rise in interest rates and the dollar created financial stress in emerging markets. We believe the U.S. dollar uptrend is turning and with EM equity valuation near historic lows vs the SPX, we see potential for EM equities to rally in tandem with U.S. gains. Four EM currencies stand out on a carry basis: Turkey, Mexico, Indonesia and India. From a political standpoint, India and Indonesia seem better options as Turkey and Mexico face political challenges that call for caution. Turkish equity market valuation is also unattractive as the risk premium is close to U.S. levels. While India's equity valuation is modestly better than Indonesia, currency valuation clearly favors INR. We think it is time for the re-emergence of emerging markets and India broadly offers the best value.

About the author

Andrew Hollins is the Director of Cross-Asset Trading Desktop at Refinitiv, formerly the Financial & Risk business of Thomson Reuters. Prior to this, from 2002 he worked at Thomson Reuters in various roles in product development, product management and proposition management. Prior to this, Andrew was the manager of the Emerging Markets Rates Derivatives desk at Prebon Yamane, London and worked on the Equity Derivatives team at Merrill Lynch in Sydney. Andrew studied at the University of Leicester and postgraduate at the London School of Economics in the UK.

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