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GEMS

EM Multi-Asset Strategy Focus

Not 2013

- USD strength has been the main problem for EM, not US rates. US rates would have to sell off much more to lead to a second tapering sell-off.
- EMFX already had a comparable sell-off to 2013. EM credit also repriced significantly. But EM rates have behaved much better.
- Valuation going into the sell-off much is more favorable to EM than in 2013.
- Fundamentally, EMFX is in better shape. EM rates benefit from lower inflation. But EM credit fundamentals suffer from higher debt loads.
- Bias to re-enter EMFX longs, as EUR bottoms.

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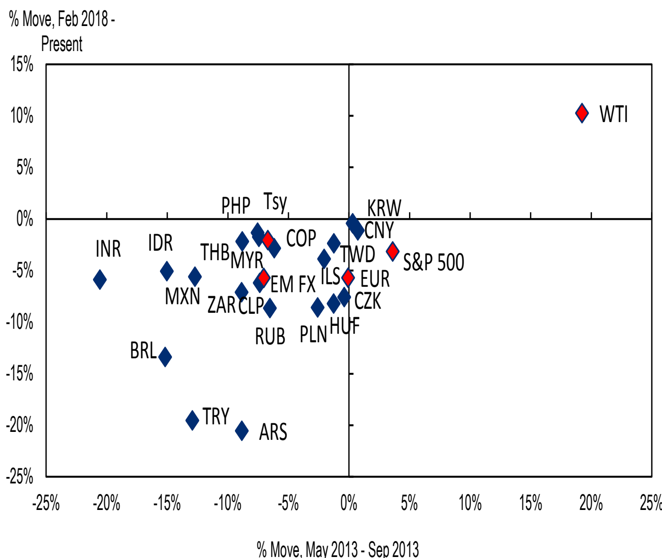
Not 2013

USD strength has been the main problem for EM. What has started as a great year for EM has more recently turned into a disappointment. Over the last weeks we have mostly blamed the weak EUR for this change of price action, based on our long held view that EM cannot survive both higher US rates and a stronger USD. After all, EMFX was performing quite well early this year while US rates rose but while the USD remained weak. And higher global growth should be supportive, even if it leads to higher global rates. In our view, just lopsided US growth is a problem for EM.

US rates would have to sell off much more to lead to a second tapering sell-off. However, recently, more and more comparisons have been made to the 2013 tapering, which was an episode where higher US rates undermined EMFX even without a stronger USD. While this was indeed the case, we would note that during tapering the move in US rates was much larger than what we have seen so far. As such for us it would require much higher US rates still to make this comparison our base case. Still, we think that a more detailed comparison to tapering can be instructive.

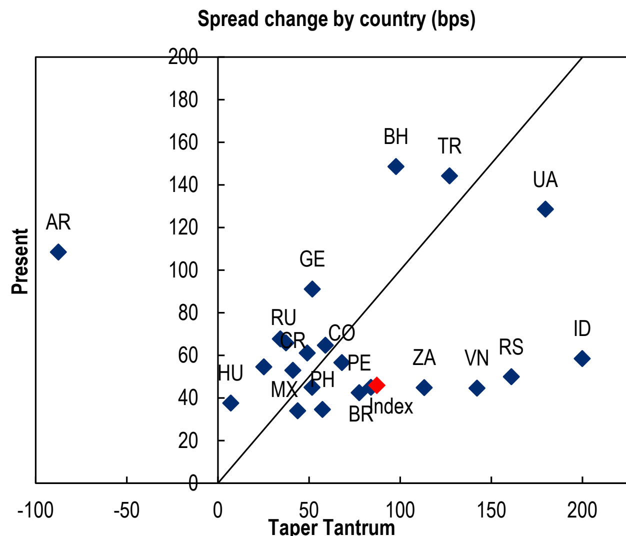
EMFX already had a comparable sell-off to 2013. Figure 1 to 3 show how the EM fixed income asset classes have reacted so far in this sell-off compared to tapering. To be precise we compare the period from the end of April 2013 to September 2013 (which was the peak in US rates), to the period from the end of February 2018 to May 21st. We pick the end of February as a starting point since this was the start of the EM sell-off, even though US rates were already rising earlier. One interesting take-away is that the current EMFX sell-off is already of the same size as in 2013. Furthermore, a fair amount of EMFX has already sold off by more than saw during tapering in 2013. This is in particular the case for the countries with weak fundamentals (TRY, ARS), for EUR crosses (PLN, HUF, CZK), and also for RUB. Some other currencies had already a very similar sell-off (BRL, MXN, CLP). Only a few have significantly outperformed 2013: IDR, INR, ZAR, as we will see below, partly on the back of stronger fundamentals. The macro drivers are slightly different, now. This time US rates sold off a lot less, but EUR sold off more.

Figure 1. FX Moves closing in on 2013 performance



Source: Bloomberg, Citi Research

Figure 2. EM credit also with meaningful sell-off when compared to 2013



Source: Bloomberg, Citi Research

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EM credit also repriced significantly. Figure 2 shows the same analysis for EM credit. As can be seen, for the index overall the sell-off has been more somewhat more benign. But there are also plenty of credits where spreads widened by more than what happened in 2013. Of the larger credits, Argentina, Turkey and Russia have traded worse. Indonesia, once again, is performing much better, as is South Africa.

But EM rates much better behaved. On the other hand, Figure 3 illustrates that EM rates are much better behaved. Not a single country traded significantly worse than in 2013, and the only significant sell-off has happened in Turkey (and Argentina). To us this is a confirmation that the problem for EM is much more the USD, rather than US rates, as a focus on US rates presumably would have led to much higher rates in EM, too. Of course, if EMFX is going to weaken by too much, inflation pressures are going to rise, putting pressure on EM rates, too. But for now EM rates have been quite contained.

Figure 3. EM rates much better behaved than in 2013

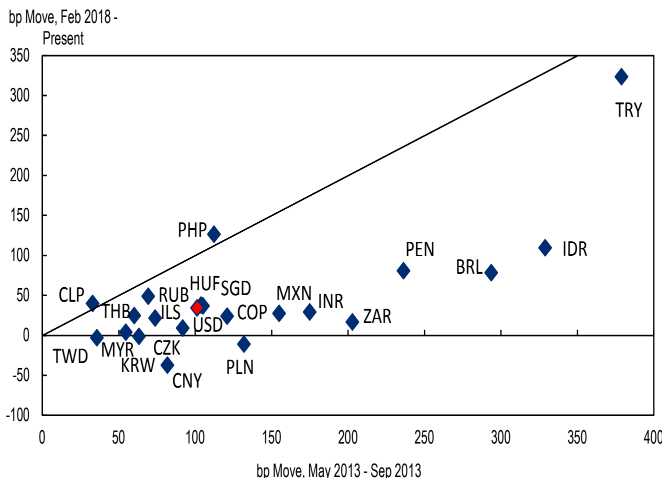

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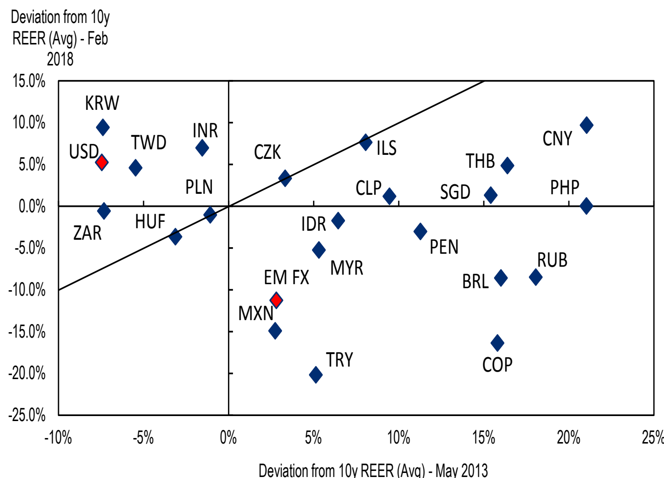
Figure 4. FX went cheaper into the sell-off



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Valuation going into the sell-off much more favorable to EM than in 2013. One interesting question is whether valuations and/or fundamentals are very different this time around compared to what we had going into tapering. Starting with the valuation question, Figure 4 focuses on currencies. As can be seen, most currencies were meaningfully cheaper going into this sell-off than they were going into 2013. In particular, MXN, TRY and COP, but also BRL and RUB are much cheaper. Only a few Asian FX are more expensive, as well as ZAR. In terms of credit, Figure 5 shows a similar story. Credit spreads were mostly wider going into the sell-off starting in Feb 2018, compared to the 2013 analog. The same is true for EM rates. Real rate differentials to the US (deflating 10yr bonds with current inflation) also suggests that most countries have been cheaper going into the current sell-off when compared to 2013. Exceptions are among the low yielders in CEEMEA (HUF, PLN, ILS) and a few other low yielders.

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Figure 5. Credit was cheaper as well prior to the sell-off

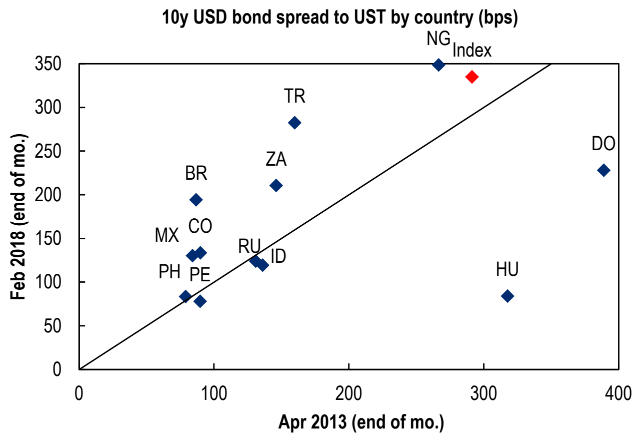

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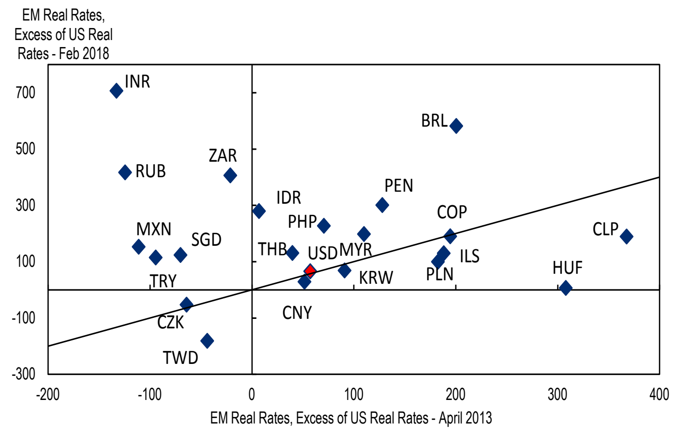
Figure 6. As were local rates in real terms



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Fundamentally, EMFX in better shape. To our mind the key fundamental variable at times of rising US rates are external positions, given that it is much harder to attract the necessary capital during periods of rising US rates. It was no coincidence that the fragile five in 2013 were the countries with large current account deficits. Figure 7 plots the current accounts going at the end of 2012 on the x axis and at the end of 2017 on the y axis to illustrate how fundamentals shifted since the 2013 tapering sell-off. As can be seen, most countries are now in a much better position.

EM rates benefit from lower inflation. For EM rates, many emerging markets have been characterized by quite low inflation rates, being supportive of local rates. There are clear exceptions when compared to 2013, such as Turkey, Philippines, Colombia, and Chile. But broadly speaking inflation is slightly more favorable than it was going into the 2013 episode.

Figure 7. Current accounts improved

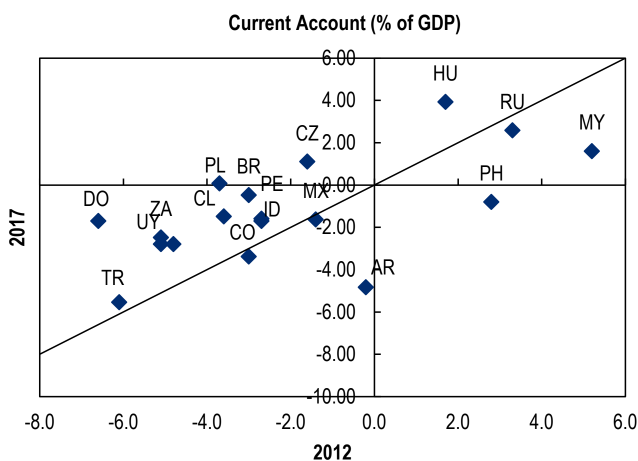

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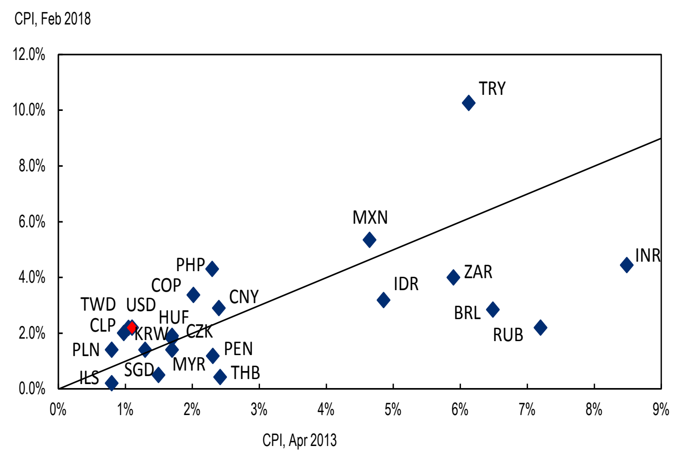
Figure 8. CPIs often lower



Source: Bloomberg, Citi Research

But EM credit fundamentals suffer from higher debt loads. While EM credit should also benefit from improved current accounts and fiscal numbers, debt loads have largely gone up since 2013. This is the case both for gross public debt as % of GDP (where almost no country shows any improvement), and for total external debt (including corporates), where debt loads also are mostly increased.

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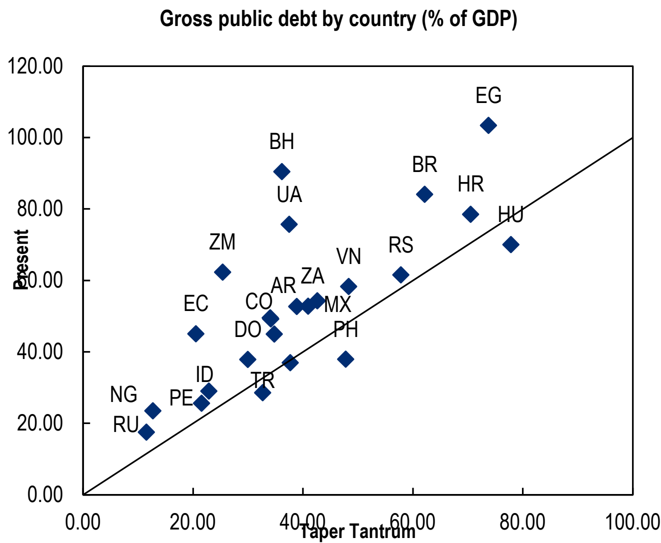
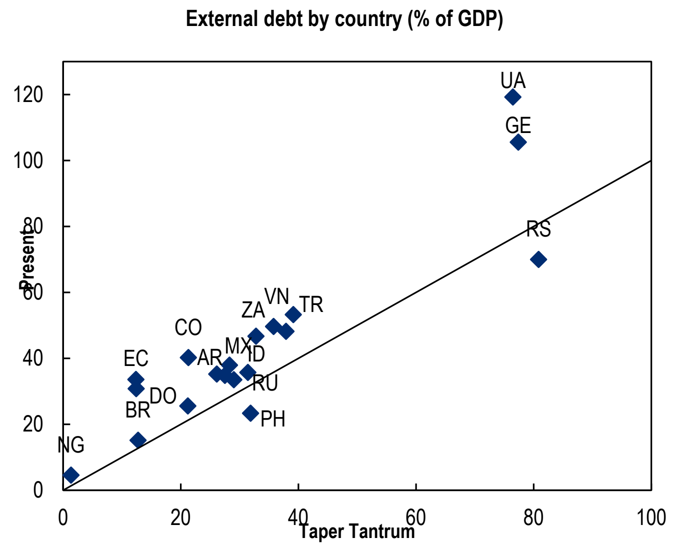
Figure 9. Gross Public Debt by Country (% of GDP) is higher



Source: Bloomberg, Citi Research

Figure 10. External Public Debt by Country (% of GDP) mostly higher



Source: Bloomberg, Citi Research

Bias to re-enter EMFX longs, as EUR bottoms. In summary, we don't think that tapering is the best analog to understand the current EM sell off. At least so far the problem is more the USD than US rates. Other interesting points to make are that EMFX already had a sell-off very similar to what we experienced during tapering, credit also corrected, while EM rates barely moved when compared to 2013, and EM valuations are more favorable going into this sell-off compared to 2013 for all three asset classes. And fundamentals are mostly improved for EMFX and EM rates, though the assessment has to be more mixed for credit, where debt loads have increased since 2013. This analysis leaves us with a bias to re-enter EMFX longs if and when we can make out a EUR bottom. To our mind the EUR bottom needs a combination of better European data and calm in Italy. With respect to the former tomorrow's PMI numbers will be the key. We already hold a put spread in USDCLP (LatAm FX Trade Idea - Swap short USDCLP NDF for option), but would consider adding risk if the narrative on European growth should change again.

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