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Five Reasons Why EM Local Markets May Not Tantrum to this Tapering

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It's not surprising that an expected tapering announcement from the Federal Reserve is causing some consternation among investors. Safe havens and risk assets sold off sharply during the Taper Tantrum of 2013—the U.S. 10-year Treasury yield jumped 141 bps from May to December 2013, while the yield on the benchmark index for EM local rates, which was one of the more affected fixed income asset classes, surged 168 bps and posted a total return of -11.9% over the same period.¹ We previously addressed [the economic and technical rationale for the timing of the Fed's potential tapering](#), and this post focuses on the Five Reasons why EM local rates may be more resilient to the onset of its latest reduction in asset purchases.

Our Five Reasons are based on the perspective of current conditions in the EM local markets compared to those that existed in 2013.

1 Fed Communication

In 2013, the Fed's QE tapering signal from former Chair Bernanke jolted the markets only a few months after it launched "QE Infinity." The Fed also initially failed to de-link QE taper from being regarded as a signal on its policy rate. However, realizing the confusion within the markets, it subsequently set a clear delineation between a tapering signal and a policy-rate signal.² This time, while the timing of a formal announcement remains uncertain, the markets widely expect the start of the tapering process, and some Fed governors are also signalling that the taper timeframe is approaching.

2 Portfolio Flows and Market Performance

Leading up to the Taper Tantrum, EM portfolios received substantial inflows and, more importantly, rate expectations failed to reprice higher. In contrast, as anticipation for a Fed tapering announcement in 2021 has mounted, EM (ex-China) portfolio flows have generally remained negative, and EM rate expectations have recently repriced higher (Figure 1). The monetary policy landscape is different as well: select EM central banks have raised interest rates, and the market has priced in interest-rate hikes for several other EM central banks. The combination of flows, rate expectations, and monetary policy developments create a more supportive backdrop for EM local markets going forward.

¹ The referenced index is the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified.

² Transcript of Chairman Bernanke's Press Conference June 19, 2013.

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Figure 1: The Technical Picture in EM Local Rates Appears More Supportive Compared to 2013

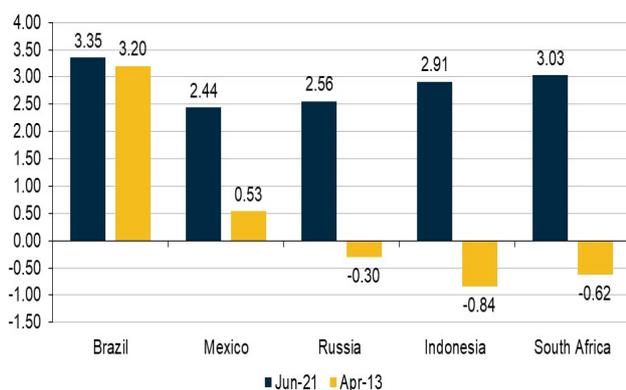
	Change in Index Yield	Return (USD)	EPFR Flow (\$ bln)
2021 (Jan- May)	70bp	-2%	4 (ex-China)
2020	-100bp	2.69%	-13.5 (ex-China)
2013 (May to Dec)	168bp	-11.9%	-16.7*
2013 (Jan to Apr)	-30bp	3.3%	26.4*
2012	-120bp	16.76%	26.2*

Source: Bloomberg, J.P. Morgan, and EPFR. The referenced index is the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified. *The flows in 2012 and 2013 include China, but China was not included in the benchmark index, so flows were insignificant.

3 EM Valuations

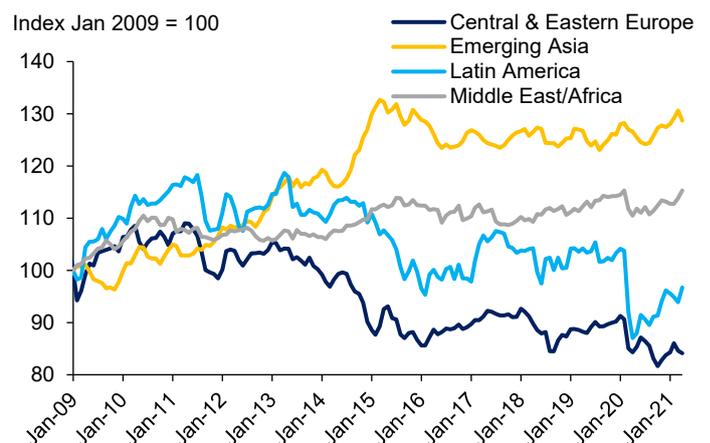
Select high-yielding local rate curves, such as those in Figure 2, remain very steep and, in comparison to 2013, are more appropriately priced to absorb a potential rise in U.S. real yields. In addition, real effective exchange rates in LatAm and emerging Europe are notably weaker since 2013 (Figure 3), thus may already be braced for expectations of higher long-term rates in the U.S.

Figure 2: 10-year Local Market Real Yield Differentials vs. the U.S.*



Source: PGIM Fixed Income and Bloomberg. *Credit-risk adjusted real yield differentials involve the following for April 30, 2013: Generic 10-year local yield – 10-year Sovereign CDS spread (for Brazil data is as of April 26th) – CPI Forecast for 2014 – U.S. 10-year Real Yield. For June 2021: Generic 10-year local yield – 10-year Sovereign CDS spread – CPI Forecast for 2022 – U.S. 10-year Real Yield.

Figure 3: LatAm and CEE Real Effective Exchange Rates Appear Well Braced for Potential Taper-Related Volatility



Source: IMF, JPM, PGIM Fixed Income as of April 30, 2021

4 Global Growth and Commodities

Our real global GDP forecasts of 6.4% in 2021 and 4.2% in 2022 are stronger than the global growth backdrop of about 3.5% in 2012 and 2013. The commodity backdrop is on better footing as well. In 2013, commodities were in the midst of a two-year downtrend, whereas the current recovery in



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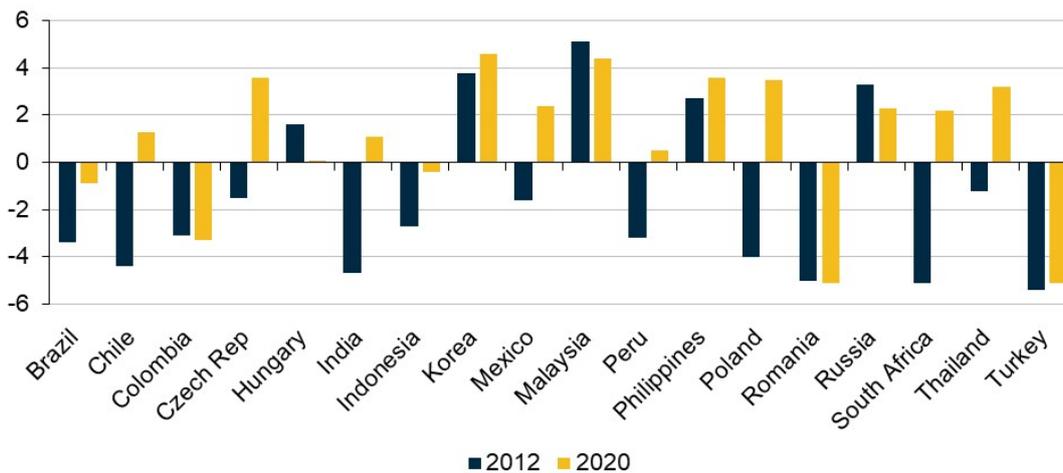
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commodity prices not only put the major indices on track for their best year-over-year performance since the early 2000s, but it also set the stage for improvement in EM fundamentals.

5 EM Fundamentals

EM external balance sheets are currently in better shape than they were leading up to the Taper Tantrum. In 2012, the “Fragile Five” of Brazil, Indonesia, South Africa, India, Turkey had sizable current account deficits. Today, with the exception of Turkey, these countries have markedly improved current account balances (Figure 4), which greatly reduces their vulnerability to capital flow reversals.

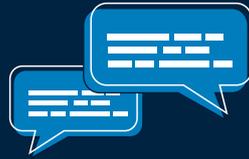
Figure 4: EM Current Account Balances (% of GDP): 2012 vs. 2020



Source: Haver Analytics and PGIM Fixed Income

While investors may have concerns about the effects of the Fed’s latest tapering on the fixed income markets, we find Five Reasons why the EM local markets are better positioned than they were in 2013. Therefore, we see a low probability for a sustained underperformance once a tapering announcement arrives. Furthermore, in a scenario where a tapering announcement leads to a depreciation in EMFX, a notable increase in local yields, or both outcomes, we would view that result as an attractive opportunity to add risk in these asset classes.

This material reflects the views of the author as of June 10, 2021 and is provided for informational or educational purposes only. Source(s) of data (unless otherwise noted): PGIM Fixed Income.



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