TAPER TANTRUM REPEAT?
Donald Trump’s victory in November has been a game-changer for EM. Rather than the benign Fed outlook that was expected under a Clinton administration, markets are now pricing in a more hawkish Fed due to expectations of significant fiscal stimulus and higher inflation under a Trump administration.

On top of the US curve steepening, the recent ECB meeting has had the same effect on Eurozone yield curves. A rising US interest rate scenario typically keeps EM under pressure, and this should hold in Q1 2017. While we are nowhere near the magnitude of the 2013 Taper Tantrum, these DM yield curve dynamics remain negative for EM bonds and EM FX. Let’s compare what has happened.

The Bernanke-induced Taper Tantrum of 2013 lasted from early May until early September. During that time, the US 2-10 year spread nearly doubled from 143 bp to 248 bp. This 105 bp worth of curve steepening (along with the very quick pace of the move) destabilized markets worldwide.

Which EM countries were impacted most then? Mexico’s curve steepened 176 bp, while Colombia’s steepened 153 bp. Singapore saw its curve steepen 129 bp, while South Africa’s steepened 66 bp. And it wasn’t just the bond markets. FX was impacted too. INR fell 19% during this period, while IDR fell 16%, ZAR fell 13%, and MXN fell 9%.

Since the November elections, the US 2-10 year curve has steepened, albeit on a much smaller scale than in 2013. From November 8 until now, the US curve has steepened by 36 bp. While this pales in comparison to the 2013 steepening, we believe much more will be seen in 2017. Likewise, the German yield curve has steepened 32 bp over this same time.

Over the same period, Brazil’s curve has steepened 74 bp, while Hungary’s steepened 41 bp. Mexico saw its curve steepen 43 bp, while Hungary’s steepened 41 bp and Korea’s steepened 31 bp. Here too, FX was impacted. MXN fell 9% during this period, while TRY fell 9%, KRW fell 3%, and BRL fell 5%.

Given our outlook for US rates, turbulence in EM is likely to persist near-term. The DM curve steepening is likely to continue, which in turn should put further pressure on EM curves and EM FX.

BROADBASED DOLLAR RALLY TO CONTINUE
We believe that the hawkish Fed outlook (coupled with dovishness elsewhere in DM) will continue to fuel the broad dollar rally in 2017.
Our past work shows three major dollar rallies since the end of Bretton Woods. The Volcker Rally saw the US broad trade-weighted index (Real Effective Exchange Rate, or REER) rise 46%, while the Clinton Rally saw it rise 34%. The current Obama Rally has so far seen a 26% rise in the REER, and so we see scope for another 10% or so move that would simply match the Clinton rally.

There is a risk of a greater overshoot than that, which could put the Obama Rally closer in magnitude to the Volcker Rally. As a result, we believe most EM currencies will weaken between 5-10% over the course of this year, with more weakness possible in 2018.

**GLOBAL GROWTH AND TRADE LIKELY TO REMAIN SOFT**

Global GDP growth recovered sharply after the financial crisis but it has since slowed. The IMF forecasts global growth of only 3.1% this year, the slowest since 2009. Growth in 2017 is forecast to improve modestly to 3.4%, but this remains well below historical averages. This reflects ongoing deleveraging around the world. Of course, the debate continues: is this a structural or cyclical slowdown?

Not surprisingly, trade growth has not recovered to pre-crisis rates of growth. Indeed, growth in global trade has slowed since 2012 to half the historical norm. The IMF forecasts global trade growth in volume terms of only 2.3% in 2016 and 3.8% in 2017. This too reflects a generally weak global environment. Furthermore, rising anti-globalization sentiment bears watching. Will President-elect Trump roll back or renegotiate free trade agreements, or was this just campaign rhetoric? Clearly, the risks to global trade are to the downside.

**COMMODITY REBOUND**

One mitigating factor for EM is the bounce in commodity prices. Major industrial and energy prices are up significantly y/y, ostensibly on the prospect of greater infrastructure spending in the US. A stabilizing Chinese outlook is also helping. As of mid-December, copper is +22% y/y, WTI oil +44%, natural gas +53%, and iron ore +92%. On the other hand, foodstuffs are mixed. Wheat is -15% y/y, soy +18%, rice -15% y/y, cocoa -31%, and coffee +7%.

These include some significant positive terms of trade shocks that should help the currencies of some of the major commodity exporters, such as COP and RUB. However, we believe this will not fully offset the negative impact of rising global rates.

**WHITHER EM EQUITIES?**

EM equity markets are being tugged in two different directions. We believe negative EM sentiment will be seen the most in EM FX and EM bonds. The case for EM equities is not so clear. While weighed down by other factors, EM equities are likely to be supported by higher commodity prices and rising DM equities.

The correlation between DM and EM equity markets (as measured by MSCI) is currently around 0.55. This is low by historical standards and down from this year’s peak around 0.85, and so the beneficial impact of a rising US market on EM stocks is not as strong as one might hope.

It’s worth noting that after diverging in both 2013 and 2014, DM and EM equities (as measured by MSCI) moved in tandem in 2015. However, EM underperformed DM in 2015 at -16.6% vs. -2.7%, respectively. So far in 2016, EM and DM are still moving together, but EM is outperforming DM at +9.1% YTD vs. 4.4% YTD, respectively.

**CONCLUSION**

We continue to believe that most conditions for a sustained EM rally will remain elusive in 2017. These include low DM interest rates, a weak dollar, and strong global growth. The one mitigating condition is higher commodity prices, but this is a mixed bag for EM and unlikely to overwhelm the other three conditions.

Individual EM country risk remains important, and likely to be dominated by politics. Brazil, South Africa, Turkey, and Korea are all facing heightened political uncertainty. These risks can easily spread to other EM countries as well. We also believe downward pressure on EM sovereign ratings are likely in a slow growth, weak currency environment.

As such, we believe it is still very important for investors to continue focusing on the country fundamentals and also on hedging out currency risk whenever feasible. Regionally, Latin America is the best equity performer so far in 2016 (up 24%), followed by EMEA (12%) and then Asia (6% YTD). We expect this regional performance trend to reverse a bit as we move into 2017.
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