OBSERVATION

TD Economics

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HUNTING BLIND: THE SEARCH FOR RETURN IN EMERGING MARKETS

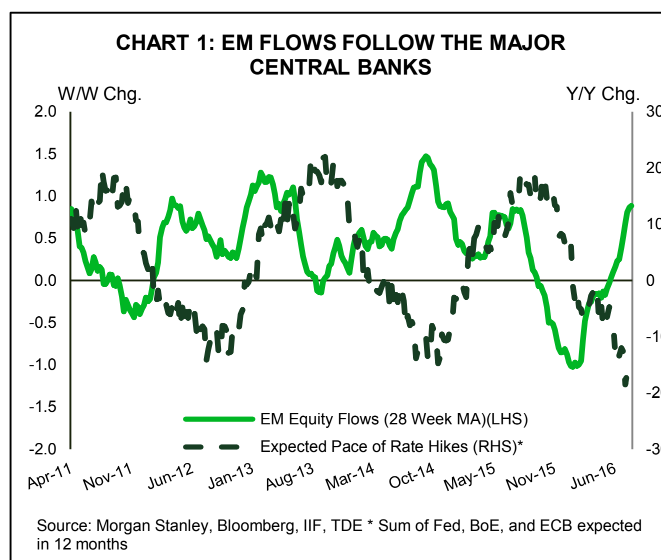
Highlights

- Emerging market equity fund flows have seen strong demand as a result of a deepening in expectations for easy monetary policy in developed markets and stimulus in China.
- In the past, we have seen that Fed policy can influence investor sentiment quickly. With Chair Yellen now signalling that the Fed is planning to hike rates in the coming months, this will cause a re-think of emerging market investments. Since this change in Fed tone, we have seen emerging market equities and currencies come under pressure.
- Flows have been more present in emerging Asian countries due to their dependency on Chinese imports. Our expectation is for China to continue through its adjustment period, though interruptions are probable.

It has not taken much for portfolio funds to flow back into emerging markets (EMs). Since the beginning of the year, when fears over a deteriorating global economy subsided, there has been a notable increase in demand for emerging market debt and equity assets. With the fundamental backdrop of EM countries little changed, the newfound faith in these high risk assets has been a surprise. This doubling down on EMs appears to boil down into two root causes. The first is the clear line of sight that global policy rates will be lower for 'even' longer. The second is that renewed confidence in China has boosted optimism in emerging Asian countries.

Central Bank policy motivating fund flows

Since the advent of the Federal Reserve's interest rate projections (Dots), the FOMC has struggled to deliver upon the promised rate hikes. The subsequent dismissal of what members say they will do versus what they actually do is apparent in the difference in the Fed Dots and market expectations. This is partly due to the divergent views held within the Committee. In recent months, a handful of Fed officials have noticeably changed course and even published separate hypotheses of both a new normal and different states of the world that justify not raising rates. This view pins down the long-term outlook for both domestic and international rates. Such changing rhetoric has a push and pull effect in EM fund flows (see Chart 1). Just as investment has sought out risk due to low rate expectations, this can quickly change on a shift in Fed tone. With Chair Yellen's statement last Friday that she expects higher rates in the coming months, this could be a turning point for risk. Forthcoming economic data will have to cooperate in order to corroborate this view, especially with GDP growth running below potential over the last three quarters. But as it stands, the third quarter is looking quite strong. We are tracking GDP this quarter at close



Source: Morgan Stanley, Bloomberg, IIF, TDE * Sum of Fed, BoE, and ECB expected in 12 months

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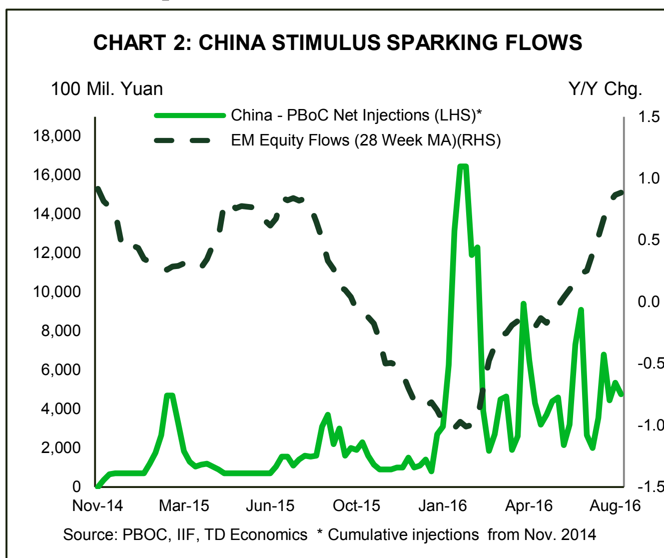
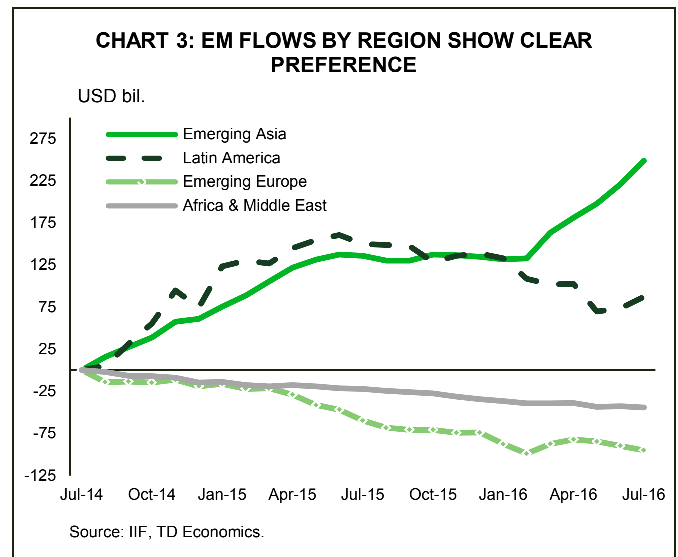
to 3% and employment growth has bounced back strongly. Outside of an unforeseen shock, this may be enough to tip the hand of the Fed to a hike in December and potentially even in September if the data proves better than expected. In this case, risk taking in emerging markets could be prone to a reversal. We have seen this flight pattern before. In the months leading up to the Fed's first rate hike at the end of 2015, over US$ 20 billion left EM equities (IIF Data). From the top of the market in the summer of 2015, until the Fed raised rates 6 months later, the MSCI EM Index underperformed the World Index by 14%. Naturally, higher rates in the U.S. can cause investors to reconsider their portfolio positioning. We may be getting some preliminary evidence that this is already occurring given U.S. dollar strength and emerging market underperformance following speeches by Chair Yellen and Vice Chair Fischer last week.

A stable China brings confidence to emerging Asia

The other major factor that brightened the allure of EM assets in recent months has been stimulus in China. Recall that part of the exodus out of emerging markets from 2015 to early 2016 was due to fears that China was in for a hard landing. Since then the country has held up better than anticipated. This cushioning of the economy and return of confidence was partly due to stimulus in financial markets by the PBoC (see Chart 2). Monetary injections into the banking system cooled the hot money that was fleeing emerging Asia. The depreciation of the renminbi and fixed asset investment have also been facilitators. These actions stabilized forecasts of economic growth for the Chinese economy and that of its neighbors who depend on a strong China as an export market. It is for this reason that EM fund flows have gravitated to emerging Asia versus other regions (Chart 3). That being said, China is still in adjustment mode. Debt levels appear overextended and credit growth cannot continue to carry the weight of the economy indefinitely. An economy in adjustment is ripe for regular interruptions. As China goes, so goes its neighbors.



Source: PBOC, IIF, TD Economics * Cumulative injections from Nov. 2014



Source: IIF, TD Economics.

Motivation to hold EM assets may be fading

Accommodative monetary policy has created the skewed incentive for investors to chase return. A more dovish stance by the Federal Reserve and outright stimulative policy by other major central banks have further incentivized risk taking this year. This, combined with a more stable Chinese economy has pushed money into a number of risk assets – particularly in emerging Asia. Stable Chinese growth is welcomed, but a lot of the recovery is built on stimulus and a devaluation of the renminbi. Demand for emerging Asian assets will depend on whether these actions will allow for further strengthening of the overall economy.

For the Fed, we may have seen a bottom in terms of dovishness. The impact of this is immense. The Fed is the most able central bank to raise rates and its importance to risk-on portfolio positioning is pronounced. As we have seen in the past, investor sentiment can change on a dime when new information enters the equation. The change in expectations for the Fed over the last few days could be the trigger. We are forecasting a further strengthening of domestic fundamentals in the second half of this year which could entrench this hawkishness and provide the Fed with justification to raise rates. In this scenario, money sitting in volatile EM assets may get a little flighty.

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