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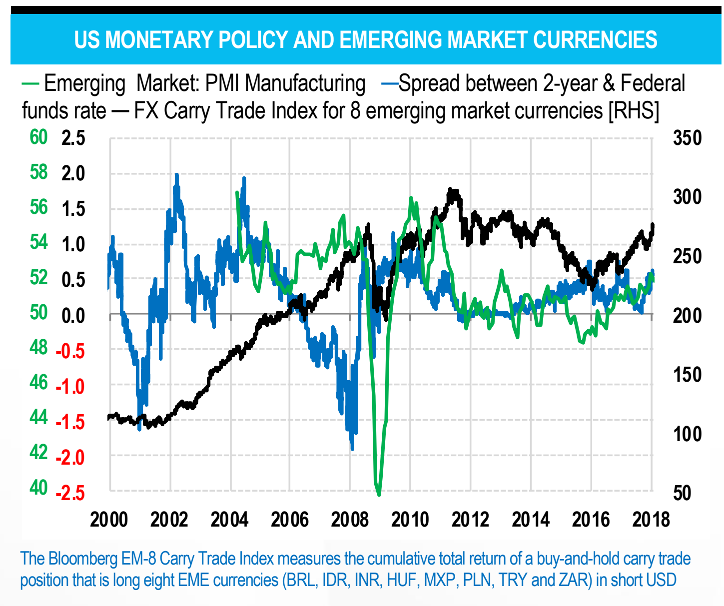
US rates and emerging markets – no spillover yet

■ Historically, a rising rate environment in the US has been a matter of concern for developing economies ■ It seems that this time is different: despite rising US yields, emerging market currencies have strengthened ■ This has contributed to a weakening of the effective exchange rate of the dollar and an easing of financial conditions in the US

Back in 2015, BIS research based on a sample of 22 emerging market economies and 8 small developed economies showed that between 2000 and 2014, US interest rates (policy rate, short and long term rates) had significant spillovers. This means that, a priori, recent US rate developments should have triggered some discomfort, all the more so given the build-up of emerging corporate debt in USD in recent years. In reality the opposite happened. The spread between emerging corporate debt yields in dollar and US treasury yields has narrowed and, as shown in the chart, after a dip last autumn, the Bloomberg FX Carry Trade Index, which tracks the performance of deposits in emerging markets currencies funded by borrowing in USD, has also increased. This has happened despite rising US bond yields and an increasing differential between the 2 year US treasury yield and the federal funds rate, a development which reflects market expectations of a more hawkish Fed stance. This is quite different from what happened in 2014 and 2015 when an increase of the same differential was accompanied by a weakening of emerging market currencies, thereby extending a trend which started back in 2011. Judging by the Markit PMI for the manufacturing sector in emerging markets, the economic environment had weakened a lot in 2011 and remained rather subdued until the end of 2015 so it shouldn't come as a surprise that this weighed on the currencies, especially when the US rate outlook was changing. Since the end of 2015, the emerging markets PMI has been on a rising trend and, starting early 2016, when oil prices bottomed out, the FX carry trade index has shown a similar evolution. Several conclusions can be drawn from this: 1/ whether rising US yields will cause spillovers in emerging markets very much depends on the economic environment in these countries (the bullish environment between 2002 and 2007 enabled a relentless rise of the FX carry trade index irrespective of US rate developments). At present, yield hungry international investors are happy to have exposure given the better economic situation 2/ this, in combination with a stronger euro fuelled by speculation that the ECB may toughen its tone, has caused a weakening of the effective exchange rate of the dollar. This implies an easing of US financial conditions (via its impact on US exports and hence growth) 3/ this in turn may require a more hawkish Fed stance in order to 'slow the train'. Ironically, the absence of international spillovers, while creating relief in the short run, may confront us with more rate hikes in the medium run.

US MONETARY POLICY AND EMERGING MARKET CURRENCIES



The Bloomberg EM-8 Carry Trade Index measures the cumulative total return of a buy-and-hold carry trade position that is long eight EME currencies (BRL, IDR, INR, HUF, MXP, PLN, TRY and ZAR) in short USD

Sources: Bloomberg, Markit, BNP Paribas

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