Trend Macro

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MACROCOSM

Can the Emerging Markets Keep It Up?

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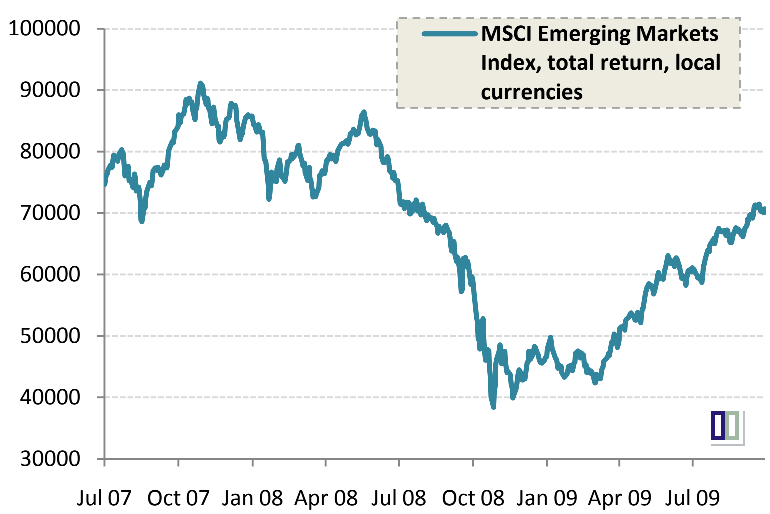
To control inflation, they may have to choose between high rates and rising currencies.

Update to strategic view
EMERGING MARKETS MACRO: The impressive rebound of emerging market economies has been aided by the easy policy stances of the monetary authorities, limiting the appreciation of their currencies against a weak dollar. The inflationary consequences of such a strategy will someday threaten economic and market performance as policymakers are forced to respond. Fallout could be limited if policy is adjusted less by raising rates than by reducing reserve acquisition so that the currencies are allowed to appreciate.
[see Investment Strategy Dashboard]

Last week we described how the Fed's exceedingly easy policy stance was setting up a carry trade that was keeping long term Treasury yields in check (see "Carrying On" September 23, 2009). The Treasury market is not alone in capturing the benefits of borrowing at exceptionally low short-term rates to gain leveraged exposure to potentially high-return assets. The emerging markets are now the most palpable illustration of the carry trade in action, with equity and debt markets having launched into extraordinary rallies since the pall of crisis-induced risk abhorrence lifted earlier this year.

After enduring harrowing routs in the worst of the panic last fall into early this year, the MSCI Emerging Market equity index is now up in dollar terms almost 65% on the year and about 90% since hitting its lows for the year in early March. The debt market has also witnessed a similarly spectacular rally, with the EMBI credit spread now at 332 bp, after spiking above 800 bp in the panic last fall. The spread is now below the levels at the time of the Lehman collapse last September.



This embrace of risk has been supported by an impressive rebound in virtually all the major emerging market economies.

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For example, Thailand, where GDP contracted at an annual rate of 21% in the fourth quarter last year and more than 7% in this year's first quarter, saw growth of more than 9.5% in the second quarter. South Korea, which contracted at a rate of nearly 19% in the fourth quarter last year, expanded at a rate of 11% in the second quarter this year. Brazil went from contracting at an annual rate of nearly 13% in the fourth quarter last year to growth of 7.8% in this year's second quarter. Similar economic performance has been seen across the emerging markets.

After seeing their exports decimated in the worst of the global contraction, foreign sales have taken off. The Philippines, where exports fell at a three-month annual rate of more than 70% last winter, recorded 95% export growth through July. China's exports declined at a 90% rate in the three months through February, but are now growing at an 86% clip. Brazil reversed an 80% export decline with a 47% three-month gain reported as of July. Indonesia went from a 70% export collapse to 43% growth reported through last month. Absolute export volumes remain well below pre-recession levels, but nevertheless the recovery has been impressive.

It's important that this export performance has been buttressed by the central banks of most of the emerging market economies maintaining very easy policy postures to keep the appreciation of their currencies in check. Since early May, while the dollar has fallen by 13% against gold and 10% against the G-6 index, for the most part the emerging markets have kept dollar appreciation of their currencies to less than 5%. In addition to holding down interest rates, with a number of the central banks posting policy rates of 2% or less, the emerging markets authorities have also been intervening to buy dollars, injecting domestic liquidity in the process. Global foreign exchange reserves have grown by more than $400 billion in the last several months, with the bulk of that explained by the emerging markets.

In June we described the early stages of this process, but that was before most of the dollar's recent depreciation had been seen (see "Strong Enough, Thank You" June 15, 2009). To an extent, the inflationary effect of limiting their currencies appreciation against a weakening dollar represents welcome relief for several of these economies that suffered sharp -- if short-lived -- bouts with deflation during the panic. Thailand's CPI fell at an annualized rate of more than 15% through the last three months of last year, and China saw deflation at a three-month rate of nearly 15% through February. In Malaysia, the three-month annualized price decline as of last December was nearly 10%, and in the Philippines it was 7%.

But prior to that episode of deflation, many of the emerging market economies were battling a rising inflation environment arising from their links to a depreciating dollar, even though a number of them had taken steps to keep from having the real value of their currencies erode by as much as the dollar was falling (see "What Did They Do to Deserve This?" August 5, 2008). We expect much the same result to unfold now. And bear in mind, the Fed shows no inclination at this point to begin reversing its ultra-easy stance, so the decline of dollar purchasing power should continue, compounding the inflationary effects in the emerging markets unless authorities take steps to avoid it.

To date, inflation has remained moderate, with most of the emerging market economies showing CPI gains in a range of 3% to 5% on a three-month annual basis, so the issue has not yet appeared on policymakers' screens. A few central banks have acknowledged that policy will shift as recovery takes hold, but none has yet indicated when the process will begin. Some could attempt to keep rates steady while allowing their currencies to rise against a weak dollar. China is reportedly considering such a strategy, which presumably would involve cutting back on its acquisition of dollar reserves. The Chinese yuan has been held in a tight range around 6.8/$ since July 2008.

BOTTOM LINE: The impressive rebound of emerging market economies has been aided by the easy policy stances of the monetary authorities, limiting the appreciation of their currencies against a weak dollar. The inflationary consequences of such a strategy will someday threaten economic and market performance as policymakers are forced to respond. Fallout could be limited if policy is adjusted less by raising rates than by reducing reserve acquisition so that the currencies are allowed to appreciate.