ECOWEEK

No. 18-20, 18 May 2018

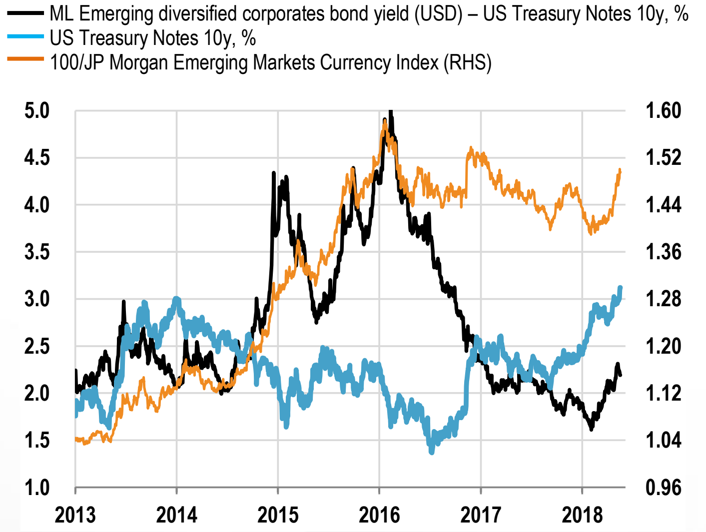
Emerging markets: a sudden chill

■ In recent years, emerging market issuers, in particular corporates, have raised huge amounts of USD debt, thereby increasing their sensitivity to an appreciation of the dollar ■ Rising US treasury yields, a sudden strengthening of the dollar and country-specific issues have triggered considerable portfolio outflows and a weakening of emerging currencies

Emerging markets have gone through rough times in the past four months. This is quite a change from last year when, as reported by the BIS, there was an unprecedented 22% increase in debt issuance in USD.

Since 2013, debt in USD contracted by emerging market issuers, in particular corporates, has risen considerably so as to benefit from low US rates but at the risk of creating problems further down the road if the dollar were to rise. This is exactly was has happened as of late and the sudden strengthening of the dollar (as shown by the rise of the orange line) has become the proverbial straw that broke the camel's back. Interestingly, rising US treasury yields as of the fall of 2017 initially did not cause a spread widening (black line). Sentiment started to deteriorate when market volatility in general picked up in February. More recently, the combination of dollar strength, rising US yields, concern about trade wars and specific issues in several countries (Turkey, election uncertainty in Brazil and Mexico, Russia, Argentina) created a kind of perfect storm, including contagion effects to other emerging countries. However it is worth emphasizing that the emerging corporate bond spread is still below the level reached after the taper tantrum in May 2013 when Ben Bernanke mentioned that at some point QE would need to be scaled back. The 2013 experience also reminds us that after a number of months, things calmed down. Whether history will repeat itself will depend on five factors: 1) US rates. Our base scenario of 3 more hikes this year and one in 2019 is benign because it would limit the rise in US treasury yields and sustain investor appetite for carry strategies such as emerging debt; 2) The dollar. We expect a renewed weakening of the dollar versus the euro, which should be beneficial for emerging currencies and will alleviate the debt burden of USD-indebted countries; 3) A weaker dollar should support commodity prices which is good news for commodity exporters (though the net gain may be negative); 4) The growth environment in emerging markets (although the PMIs in general have softened a bit, certain countries did see an improvement recently); 5) Policy credibility in individual emerging markets (sustainability of public finances, central bank autonomy). Based on these points one would expect that calm will return.

EMERGING MARKET DEBT AND CURRENCIES



Source: Thomson Reuters, BNP Paribas

Eco WEEK

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world