Bond Investors' Eyes Are Fixed On The Fed

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"Buy the rumor and sell the fact."

EXECUTIVE SUMMARY

- The sharp increase in U.S. interest rates has inflicted collateral damage on other areas of the fixed income markets, especially emerging market (EM) debt.
- We believe that U.S. Treasury yields may begin to stabilize if the Federal Reserve confirms market expectations and begins scaling back quantitative easing in September.
- Stronger growth in the United States, Japan, and euro area might be a catalyst for a cyclical improvement in EM performance going forward.
- However, risks remain including potential volatility caused by changes in leadership at the Fed and the vulnerability of some EM countries to further foreign capital outflows.

U.S. INTEREST RATE SPIKE INFLICTS COLLATERAL DAMAGE

The U.S. Treasury market has largely priced in the probability that the Federal Reserve will begin tapering its quantitative easing (QE) program at its September 17-18th policy meeting. Indeed, 10-year U.S. Treasury yields increased from a low of 1.65 percent in early May to around 3 percent in early September before pulling back modestly. Investors went so far as to price in hikes in the federal funds rate during the latter half of 2014, despite the Fed's insistence that short-term interest rate hikes will remain on hold until at least the middle of 2015.

This sharp increase in U.S. interest rates has inflicted collateral damage on other areas of the fixed income markets, especially emerging market (EM) debt. Indeed, the J.P. Morgan Global Emerging Market Bond Index (EMBI) has tumbled more than 11 percent year-to-date as higher yields in developed markets dampen the global search for yield which had been fueling capital inflows into EM economies.[1]

1 Bloomberg. September 10, 2013.

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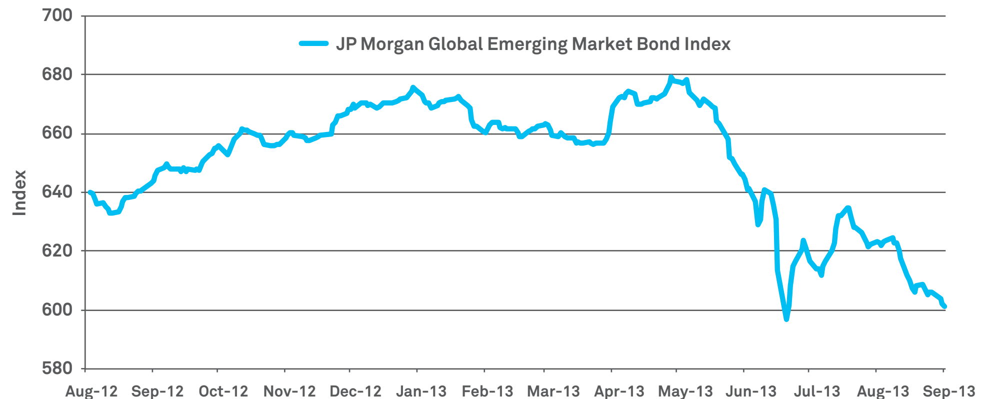
Looking ahead, if the Fed confirms market expectations and begins scaling back QE in September, it would not surprise us if Treasury yields temporarily stabilize and possibly even retrace some of their recent increase particularly at the short-end of the curve where the Fed is likely to reiterate its forward guidance. If we are proven correct, EM debt markets may finally get a respite. Stronger growth in the United States, Japan, and euro area might even be a catalyst for a cyclical improvement in EM economic performance going forward.

Figure 1: JP Morgan EMBI Total Return Index



Source: JP Morgan, as of September 2013.

However, risks remain including the upcoming change in leadership at the Fed and geopolitical uncertainty in the Middle East. Both events have the potential to increase Treasury market volatility in either direction. In addition, although we believe the sell-off in emerging markets is generally overdone, several emerging markets, including Turkey, South Africa, and India, have large external imbalances which makes them particularly vulnerable to capital outflows. Therefore, while our valuation models suggest that EM dollar-denominated and local currency debt are amongst the most attractive sectors of the fixed income markets, we think investors should be selective about where they add risk.

HOW WILL TREASURIES REACT TO THE FED'S TAPERING?

Despite a disappointing August employment report, the Fed still seems likely to reduce its $85 billion in purchases of Treasurys and agency mortgages when it meets in mid-September. Nonfarm payroll employment increased by 169,000 in August compared to an expected gain of 180,000 jobs. The prior two months' data were also revised downward by 74,000 jobs. Even though the unemployment rate fell to 7.3%, the decline was due to more than 300,000 discouraged workers dropping out of the labor force.[2] In general, we would characterize the performance of the labor market over the summer of 2013 as mediocre at best.

Nevertheless, as Fed governor Jeremy Stein indicated in a speech back in June, the Fed is focused on the cumulative progress of the economy over the past year rather than "the last payroll number that comes in just before the meeting."[3] The U.S. economy has added more than two million jobs since QE3 went into effect in September 2012. Moreover, the August employment gains were roughly in-line with the average monthly gain of 184,000 over the prior year. Therefore, we continue to believe that the Fed will taper its asset purchases by $10 to $15 billion come September 18th, with a slightly larger reduction in Treasury purchases than in agency mortgage purchases. This is generally the market consensus view at this point, though some argue that postponing tapering until the October or December Fed meetings may be appropriate given the recent data.

When the Fed finally tapers, we believe that the Treasury market may stabilize with yields possibly rallying a bit at the short end of the curve if the central bank reduces its economic growth forecast and reiterates that its policy rate will likely remain unchanged until mid-2015. Historical experience appears to support our case. Indeed, Treasury yields actually declined by more than 100 basis points in the six months that followed the first and second rounds of QE. Part of the reason for this reaction is that the bond market is forward-looking and it began pricing in a Fed exit and interest rate hikes.

Yet, there were extenuating circumstances in both instances. For example, following the end of QE1, concerns about a double dip recession in the U.S. began to build. When the Fed was wrapping up QE2, the European sovereign debt crisis was intensifying and the U.S. was on the verge of losing its AAA credit rating following the debt ceiling debacle. Today, by contrast, the U.S. economic recovery appears to be on firmer footing and strains in Europe seem to have eased.

Nevertheless, the market consensus seems overly optimistic about the outlook for the U.S. economy in 2014 with most forecasters anticipating a return to 3 percent-plus growth. We believe those with such expectations will be disappointed, which should keep a cap on Treasury yields. At the same time, geopolitical uncertainty surrounding the situation in Syria

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2 Bureau of Labor Statistics. "Employment Situation." August 2013.

3 Jeremy Stein. "Comments on Monetary Policy." Board of Governors of the Federal Reserve System. June 28, 2013.

could trigger a flight to safety into U.S. Treasurys in the short-term. The selection of Fed Chairman Ben Bernanke's successor also has the potential to increase volatility in the Treasury market, though it is difficult to gauge market reaction without knowing who the nominee will be. Overall, 10-year U.S. Treasury yields currently lie near the middle of our 2.7 percent to 3.4 percent fair value range.

A RESPITE FOR EMERGING MARKETS?

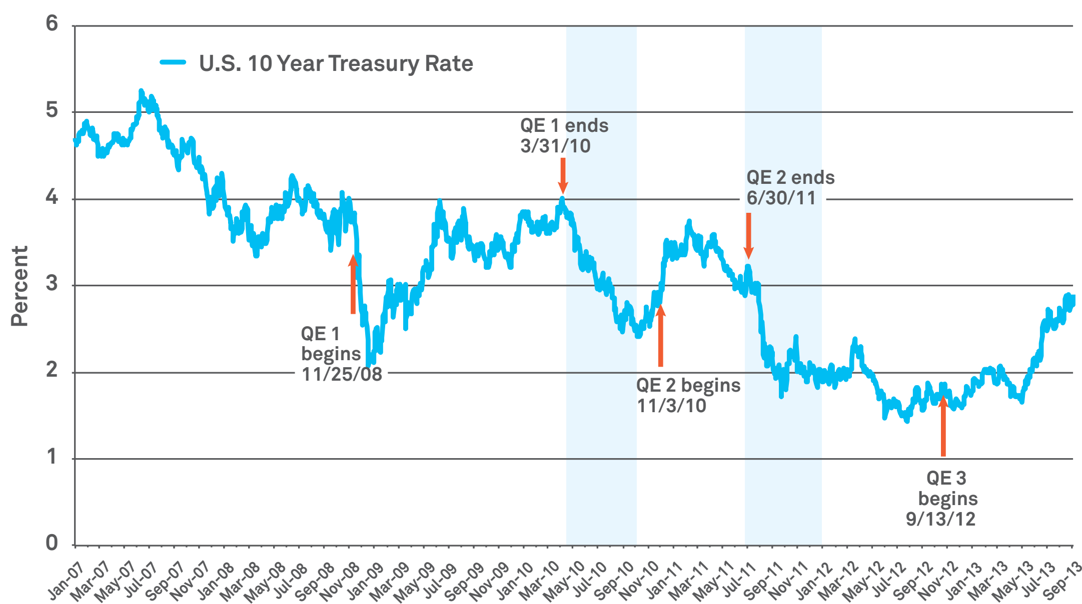
Any stabilization in U.S. interest rates would be welcome news for emerging markets, which have been under pressure ever since talk about tapering QE began in early May. However, not all emerging markets are created equal. There are idiosyncratic factors that may weigh on the performance of some countries more than others.

Specifically, we remain cautious about countries with large current account deficits and external borrowing requirements that are vulnerable to capital flow reversals. For example, both Turkey and South Africa have current account deficits approaching 7 percent of GDP. Not surprisingly, the Turkish lira and the South African rand have fallen more than 12 percent since early May. Although India's current account deficit is somewhat smaller at 4.5 percent of GDP, the government is running a budget deficit in excess of 5 percent of GDP. This has undermined the Indian rupee which has tumbled more than 20 percent since early May.

By contrast, countries such as Mexico and Russia have much healthier external balances. Indeed, Mexico's current account deficit is less than 1.5 percent of GDP and Russia is running a surplus due to higher oil prices. Despite this, both currencies have suffered and are down roughly 10 percent since early May as investors have indiscriminately fled emerging markets. In our view, the declines in these currencies are overdone.

Speaking more broadly, our models indicate that emerging market dollar and local currency debt are among the cheapest sectors of the fixed income markets. The dollar-denominated J.P. Morgan EMBI Global Diversified index is currently yielding 6.2 percent and the local currency-denominated JP Morgan Global Bond Index (GBI-EM) is yielding 6.9 percent. While investor outflows from the asset class have the potential to cause further volatility, we believe that pockets of value are already being created. Specifically, dollar-denominated cross-over names in the quasi-sovereign and corporate space are beginning to look attractive. As emerging market currencies settle in at new equilibrium levels, we will explore local currency opportunities as well.

Figure 2: Market Response to Quantitative Easing



Source: Federal Reserve, as of September 2013.

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