US Rate Hike Impact On Emerging Markets Equities

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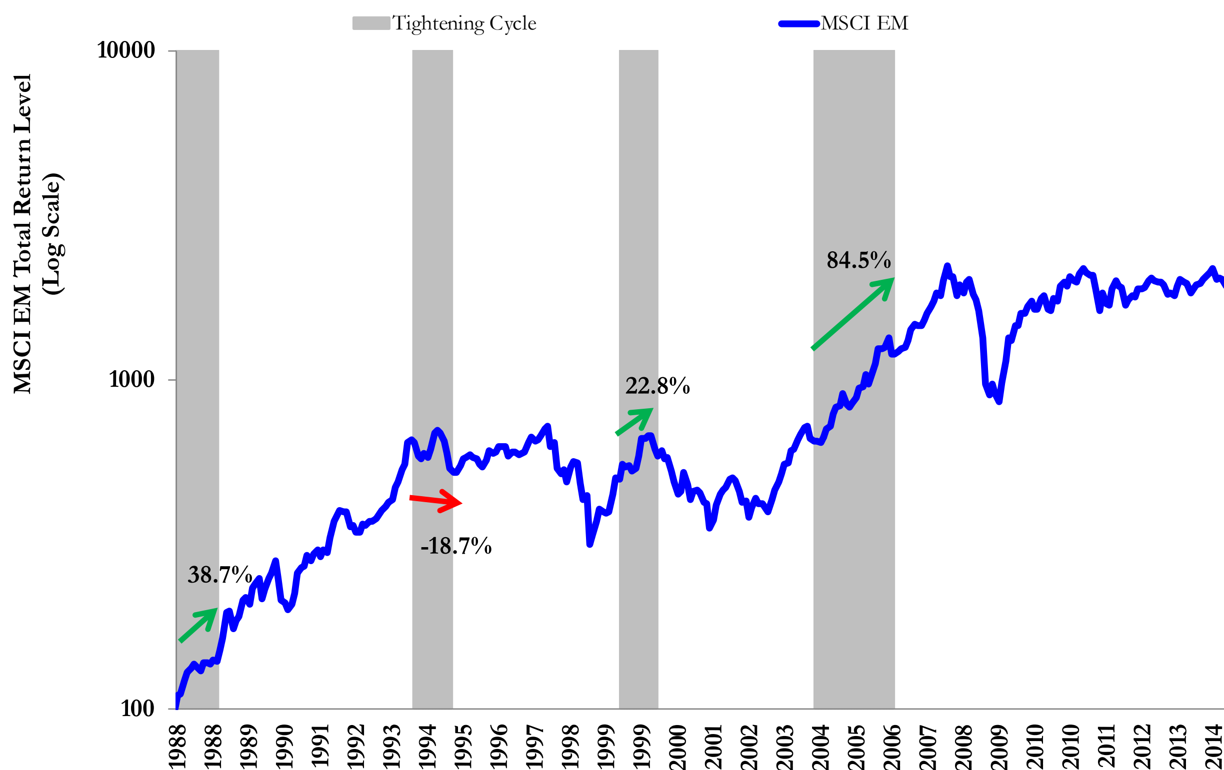
A US Federal Reserve fed-funds rate hike does not inevitably spell trouble for Emerging Markets (EM) equities. Performance after US rate hikes is mixed, implying no established relationship. Today, EM countries are in a financially stronger position than they were throughout the 1990s and early 2000s. Fewer currency pegs and greater foreign exchange (forex) reserves allow for flexibility to deal with internal and external market-related problems. Because equity markets are efficient discounters of all widely known information, much-discussed fed-funds rate hikes lack the surprise power to derail EM equities.

Performance Is Not Tied to US Monetary Policy

Despite a limited sample size, Exhibit 1 demonstrates EM does not necessarily underperform when the Fed tightens monetary policy.

Exhibit 1: MSCI EM Performance during US Tightening Cycles



Source: FactSet, as of 3/25/2015; MSCI EM cumulative returns during fed-funds rate tightening

Following US rate hikes, EM equity returns are not uniformly negative. Although the historical dataset is limited, EM performance following the initial rate hike in the near- and intermediate-term is, on average, positive. In fact, as Exhibit 2 shows, average EM performance is consistently positive 6 to 18 months after the Fed initially hikes rates. And markets do not always react negatively in anticipation of the initial hike.

Exhibit 2: MSCI EM Total Returns After Fed-Funds Rate Hikes

Date	12 Months Prior	6 Months After	12 Months After	18 Months After
3/29/1988	-	10.9%	29.3%	64.9%
2/4/1994	67.7%	6.0%	-20.5%	-12.9%
6/30/1999	25.2%	18.3%	7.7%	-19.3%
6/30/2004	29.9%	25.4%	30.8%	63.5%
Average	**41%**	**15%**	**12%**	**24%**

Source: FactSet, MSCI Emerging Markets Index monthly returns, as of 10/31/2014

As we have previously written, EM countries tend to exhibit significant performance dispersion, highlighting the importance for managers to accurately select countries to over- and underweight. The same applies following US rate hikes. While individual EM country performance data are mostly unavailable prior to 1988, Exhibit 3 demonstrates large performance spreads, measured by total returns, for select EM countries before and after the first rate hike in a US tightening cycle. In the 12 months preceding policy tightening, as well as six, 12 and 18 months after, wide spreads consistently occurred between the best and worst performing countries.

Exhibit 3: EM Country Total Returns Before & After Fed-Funds Rate Hikes

12 Months Prior				
Country	03/29/1988	02/04/1994	06/30/1999	06/30/2004
China	--	0.7%	40.3%	37.7%
Brazil	--	108.7%	-21.1%	36.4%
Mexico	--	61.7%	28.3%	29.1%
Korea	--	57.4%	301.7%	24.7%
Russia	--	--	-2.6%	21.1%
Taiwan	--	24.6%	34.1%	21.1%
Thailand	--	46.5%	159.5%	47.8%
Indonesia	--	71.4%	238.2%	28.4%
Turkey	--	22.1%	-21.4%	61.7%
Malaysia	--	77.9%	72.9%	16.6%
India	--	65.2%	26.0%	34.2%
Average Spread Between Top 2/Bottom 2	**--**	**81.9%**	**291.2%**	**35.9%**

Substantial dispersion persists six and 12 months after the first rate hike.

6 Months After				
Country	03/29/1988	02/04/1994	06/30/1999	06/30/2004
China	--	-12.8%	-30.8%	13.1%
Brazil	10.3%	30.9%	39.0%	52.5%
Mexico	15.9%	-4.2%	18.1%	28.4%
Korea	10.2%	5.0%	8.1%	20.6%
Russia	--	--	48.4%	2.0%
Taiwan	150.5%	30.9%	6.8%	10.2%
Thailand	17.3%	21.7%	-7.2%	13.2%
Indonesia	34.9%	-7.2%	-8.5%	44.6%
Turkey	-42.3%	-9.6%	142.6%	54.2%
Malaysia	12.5%	5.1%	19.6%	9.6%
India	--	2.6%	36.3%	43.3%
Average Spread Between Top 2/Bottom 2	**108.7%**	**42.1%**	**115.2%**	**47.5%**

12 Months After				
Country	03/29/1988	02/04/1994	06/30/1999	06/30/2004
China	--	-38.1%	-31.6%	16.4%
Brazil	63.0%	-8.2%	35.5%	67.0%
Mexico	23.6%	-64.6%	10.2%	39.1%
Korea	71.0%	-3.1%	3.5%	32.4%
Russia	--	--	39.4%	11.8%
Taiwan	119.5%	23.4%	3.4%	11.8%
Thailand	10.0%	2.1%	-41.0%	7.1%
Indonesia	219.8%	-22.7%	-48.7%	57.8%
Turkey	-45.1%	-18.5%	115.8%	61.6%
Malaysia	31.9%	-7.9%	24.1%	5.9%
India	--	-22.2%	30.4%	55.4%
Average Spread Between Top 2/Bottom 2	**187.2%**	**64.1%**	**122.5%**	**57.8%**

Even 18 months into the hawkish program, spreads remain substantial.

18 Months After				
Country	03/29/1988	02/04/1994	06/30/1999	06/30/2004
China	--	-37.4%	-53.1%	31.1%
Brazil	47.0%	0.1%	19.2%	128.7%
Mexico	122.9%	-48.6%	-7.3%	86.5%
Korea	62.9%	5.8%	-46.3%	86.1%
Russia	--	--	3.3%	72.9%
Taiwan	210.7%	-10.6%	-41.6%	13.8%
Thailand	62.1%	4.1%	-59.8%	18.7%
Indonesia	483.0%	-18.4%	-66.2%	62.8%
Turkey	70.2%	7.6%	30.6%	133.8%
Malaysia	60.0%	-4.2%	-1.0%	7.9%
India	--	-28.8%	5.2%	94.0%
Average Spread Between Top 2/Bottom 2	**293.3%**	**49.7%**	**87.9%**	**120.4%**

Source: FactSet, as of 10/31/2014; Performance is based on the monthly returns for the MSCI benchmarks of the countries indicated above.

Although data are limited, neither the broad EM category nor its individual constituent countries produce consistently positive or negative returns following US rate hikes. Though average returns for the category are positive, the sample is too small to determine the existence of an established relationship. However, the data reinforce the need to examine EM countries individually. A differentiated analysis of EM can help investors avoid fundamentally weak markets while identifying those with favorable political, economic and sentiment drivers.

Fundamentals Drove Past EM Crises

While some may argue rate hikes trigger EM crises—Mexico in 1994, the Asian Financial Crisis in 1997, the Russian Ruble Crisis in 1998 or Brazil in 1999—and fear one looms today, severe fundamental problems already persisted in each of these situations. EM rate hike fears stem from a false assumption: EM stability and growth are linked to low US interest rates, and rising/high US interest rates trigger EM capital flight and the occasional crisis. This seems to be grounded in an oversimplification of history. While EM crises over the past 20 years happen to have coincided with Fed tightening, higher US interest rates alone did not necessarily cause them.

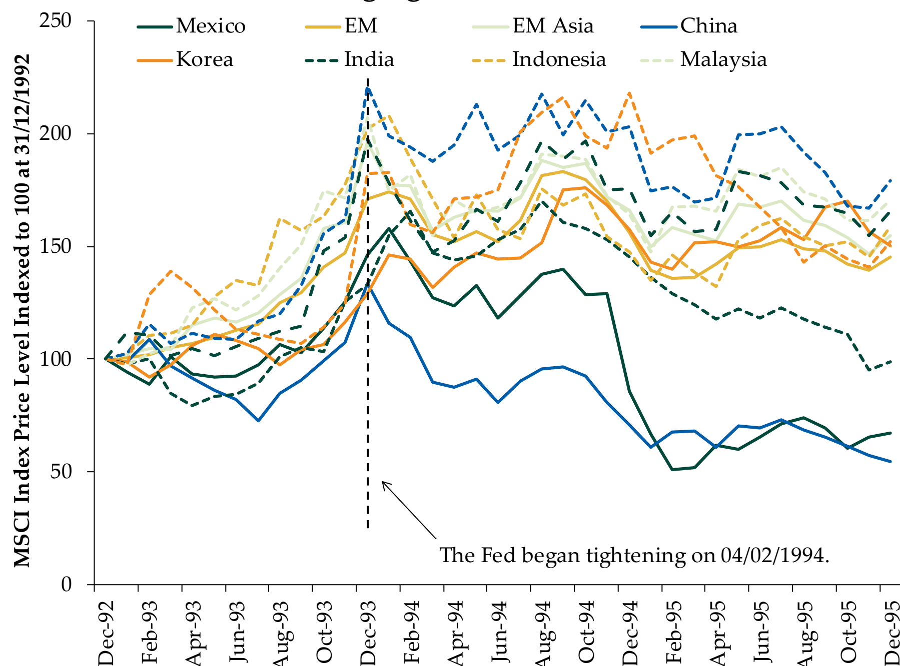
“Tequila Crisis”

Mexico’s 1994 “Tequila Crisis” metastasised after the Fed began a tightening cycle in February 1994. Mexico enjoyed a flood of foreign investment in the early 1990s as investors seized opportunities created by market-oriented reforms spearheaded by former President Miguel de la Madrid and his successor, Carlos Salinas de Gortari. Bolstered by strong inflows, low short-term rates and a stable currency, due in large part to the peso’s dollar peg, banks lent profligately without much consideration for risk. Additionally, as 1994 was an election year, Salinas’s government spent heavily to boost the popularity of his Institutional Revolutionary Party (PRI) and hand-picked successor, Luis Donaldo Colosio, driving debt higher. When the Chiapas uprising and the assassination of Colosio in March startled foreign investors, officials chose not to hike rates to stem the tide, lest they stifle the economic expansion and drive debt service costs higher. Instead, they intervened in foreign exchange markets to defend the peso.

As reserves dried up, Mexico issued dollar-linked short-term debt using the proceeds to continue its peso defense and rolled over the new bonds as they matured. Investors continued fleeing, and interest rates soared. The government finally bowed to market pressure in late December, devaluing the peso by 15% on 12/20/1994 and allowing it to float two days later. It plunged, making external debt impossible to service, and short-term rates rose north of 37% in January 1995. GDP shrank about 6% in 1995, and Mexican equities fell -23.2% (compounding 1994’s -44.4% drop).[i]

Mexico's troubles impacted other Latin American nations as fear spread throughout the region, but Emerging Asia held firm, mostly performing sideways in 1994 and 1995 as Mexican equities fell sharply (Exhibit 4). The notable exception, China, was dealing with unrelated fundamental issues of its own, including the closing of its capital account, devaluation of the renminbi and imposition of a dollar peg.

Exhibit 4: MSCI Mexico and Selected Emerging Asian Returns



Source: FactSet, as of 4/5/2015. MSCI Mexico, Emerging Markets, Emerging Markets Asia, China, Korea, India, Indonesia, Malaysia, Philippines, Taiwan and Thailand price returns, 12/31/1992 – 12/31/1995. Price returns used in lieu of total due to data availability.

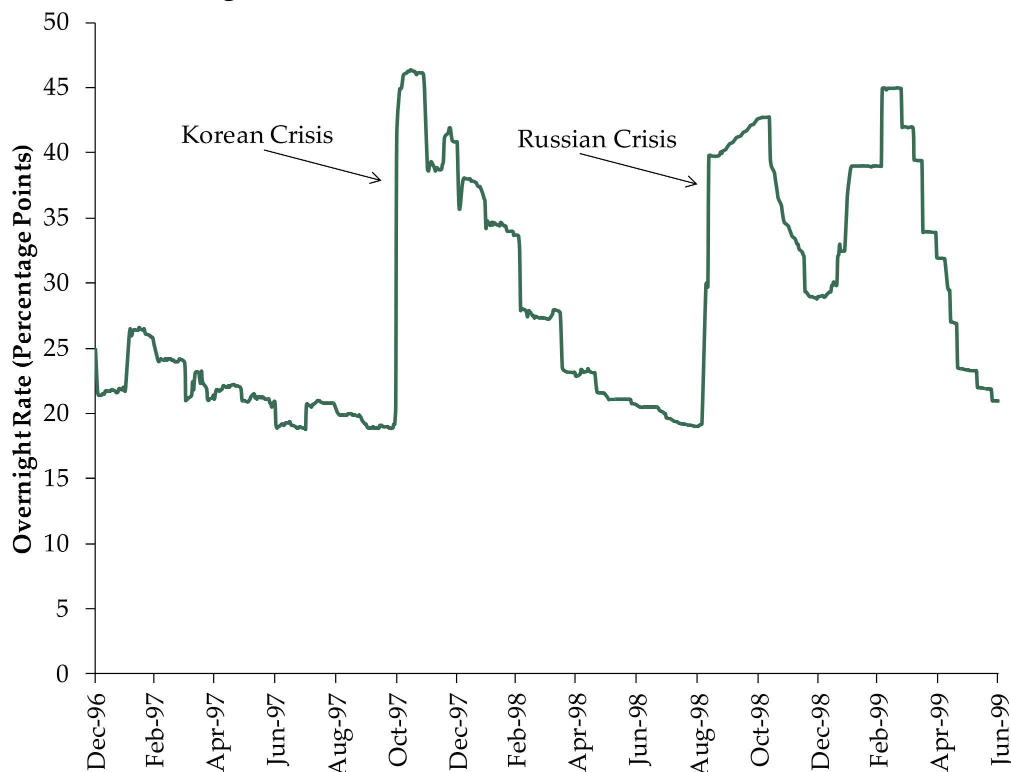
Asian Financial and Russian Ruble Crises

The Asian Financial and Russian Ruble Crises of 1997 and 1998, respectively, were similarly fundamentally driven—they did not even coincide with a Fed tightening cycle. Korea, Thailand and Indonesia, all of whom pegged their currencies to the dollar, had run up sizeable dollar-denominated debt as they took advantage of low rates to finance swift growth. This worked for a while, but when the dollar appreciated versus the yen, the pegged Asian nations were forced to defend their currencies in order to prevent trauma in their dollar-denominated bonds. Ultimately they were unsuccessful, and all three discarded the pegs, devalued and required bailouts from the IMF. Russia followed the next year, forced to drop its peg as falling oil prices crushed its energy price-dependent economy. All the while, there was no tightening cycle—the Fed cut rates from 6.0% in June 1995 to 5.25% in March 1996, where they stayed until a 25-basis point hike in March 1997. Rates stayed there until September 1998, when the Fed loosened again.

Real Trouble

Brazil's 1999 devaluation was a late offshoot of Asia's troubles, though the country's fundamental issues dated back to 1994 and some unintended consequences of the "Real Plan"—the government's effort to battle inflation (then running at 900% annually), which included pegging the new currency (the real) to the dollar to foster stability. While it succeeded in the first few years, by the late 1990s, Brazil flirted with deflation, and investors began suspecting the real was artificially high. Contagion fears spiked during Korea's and Russia's crises, and overnight rates surged as the central bank tried to stem capital flight (Exhibit 5).

Exhibit 5: Brazilian Overnight Rates



Source: Global Financial Data, Inc., as of 5/6/2015.

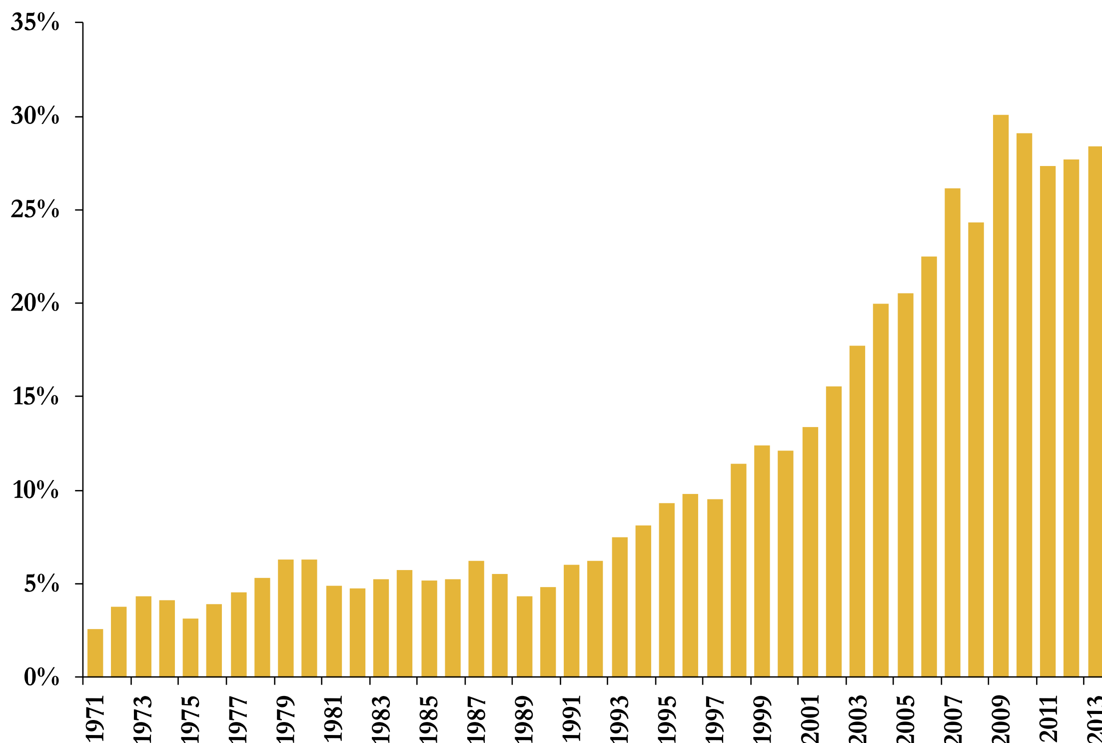
Yet capital outflows continued, and Brazil depleted half its foreign exchange reserves to defend the peg in 1998 (forex reserves began that year around $70 billion). As Brazil's deficit rose that year, confidence in the peg's long-term sustainability eroded, the market for long-term debt dried up, and Brazil was forced to rely on short-term debt to finance spending, making the country increasingly vulnerable to speculative attack. Officials arranged a pre-emptive $45 billion IMF loan in late 1998 to shore up confidence, but markets were not assuaged. Capital flight escalated to $350 million daily by year-end, Brazil dropped the peg in January, and the real plummeted.

Larger Forex Stockpiles

EM countries overall have evolved considerably since the 1990s. Forex reserves are much larger, growth does not depend wholly on foreign investment, and capital markets are more mature. Moreover, few fixed exchange rate regimes remain after the late-1990s Asian Currency Crisis. China does have a fixed float, but it also has strict capital controls, limiting the risk of fund flight, $3.8 trillion (as of 12/31/2013) in forex reserves and little external debt.[ii] Economic weak spots are largely in commodity-dependent countries—well-known issues for nearly a year, and markets reflect much of this weakness already.

After remaining relatively flat throughout most of the 1970s and 1980s, forex reserves rapidly grew during the next two decades, nearly tripling between 1997 and 2008 (Exhibit 6).

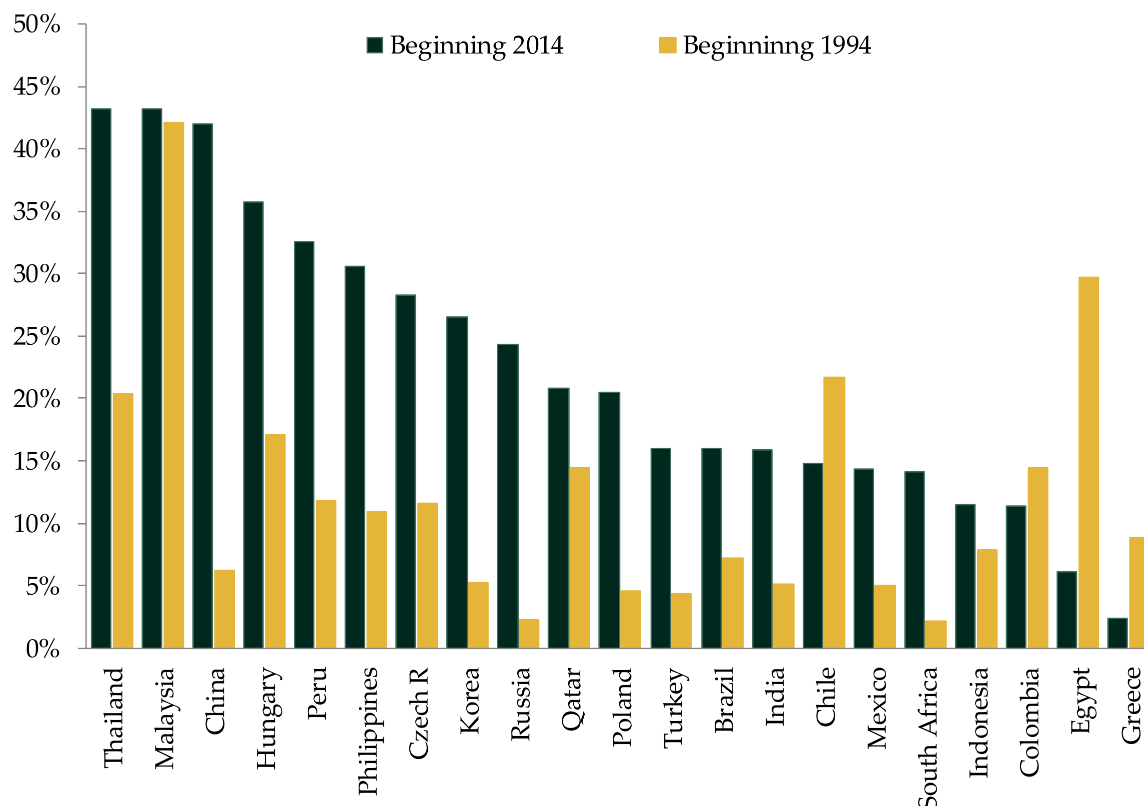
Exhibit 6: EM Foreign Exchange Reserves as a % of GDP



Source: World Bank, GDP (current USD), as of 3/24/2015; Sample includes MSCI EM constituents

Some of the countries most affected by the wave of crises in the mid- to late-1990s have markedly grown their reserves. Exhibit 7 compares today's forex reserves with those witnessed at the outset of 1994.

Exhibit 7: EM Country Foreign Exchange Reserves as % of GDP (2014 vs. 1994)

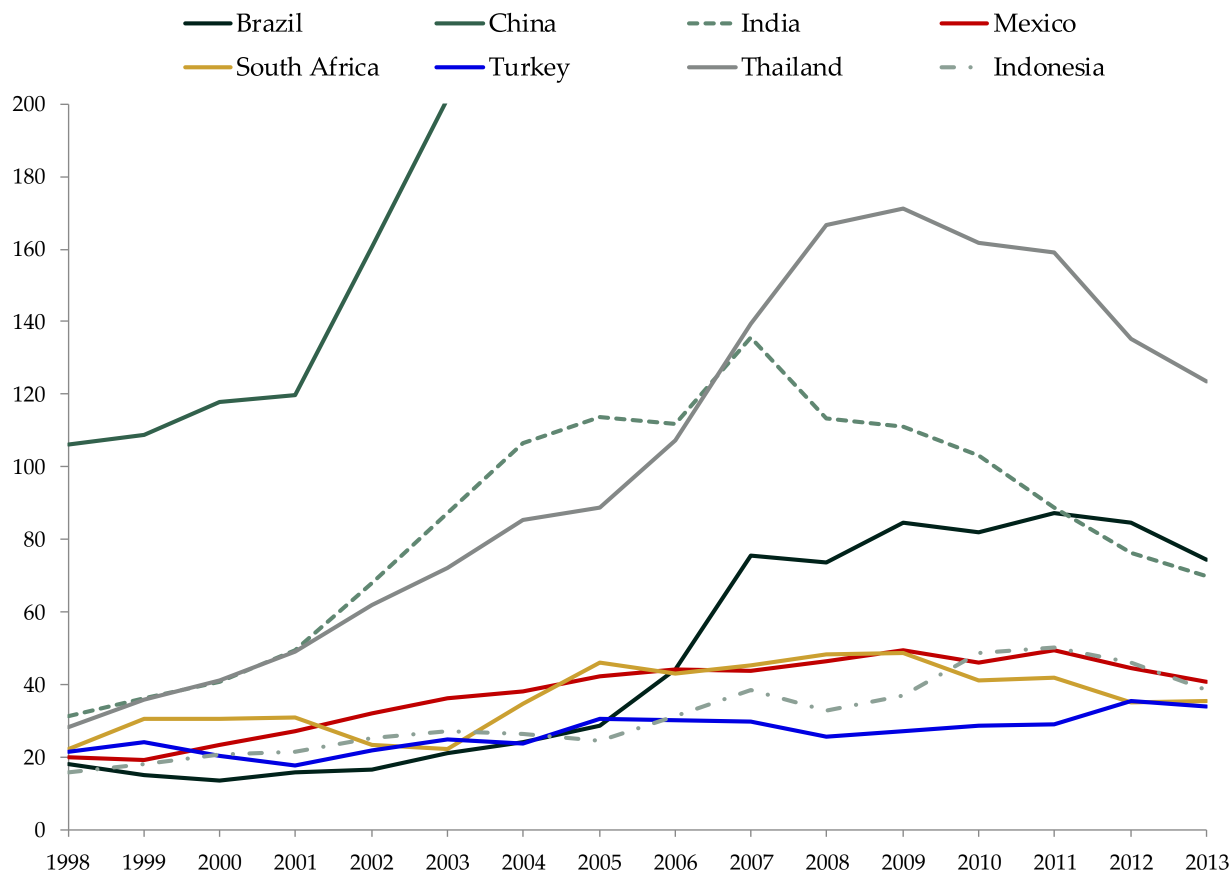


Source: World Bank, GDP (current USD), as of 3/24/2015

Largely Improved Debt Profiles

The benefit of larger reserves becomes apparent when compared to external debt stocks, a broad indicator of a country's foreign currency-denominated debt. As forex reserves ballooned across some of the major EM countries during the 2000s, they began to dwarf external debt levels, providing a buffer in the event of strained finances or trade deficits (Exhibit 8). To highlight this point, one can examine China foreign reserves—443% of external debt as at the end of 2013 and obscured by the below exhibit's scale.

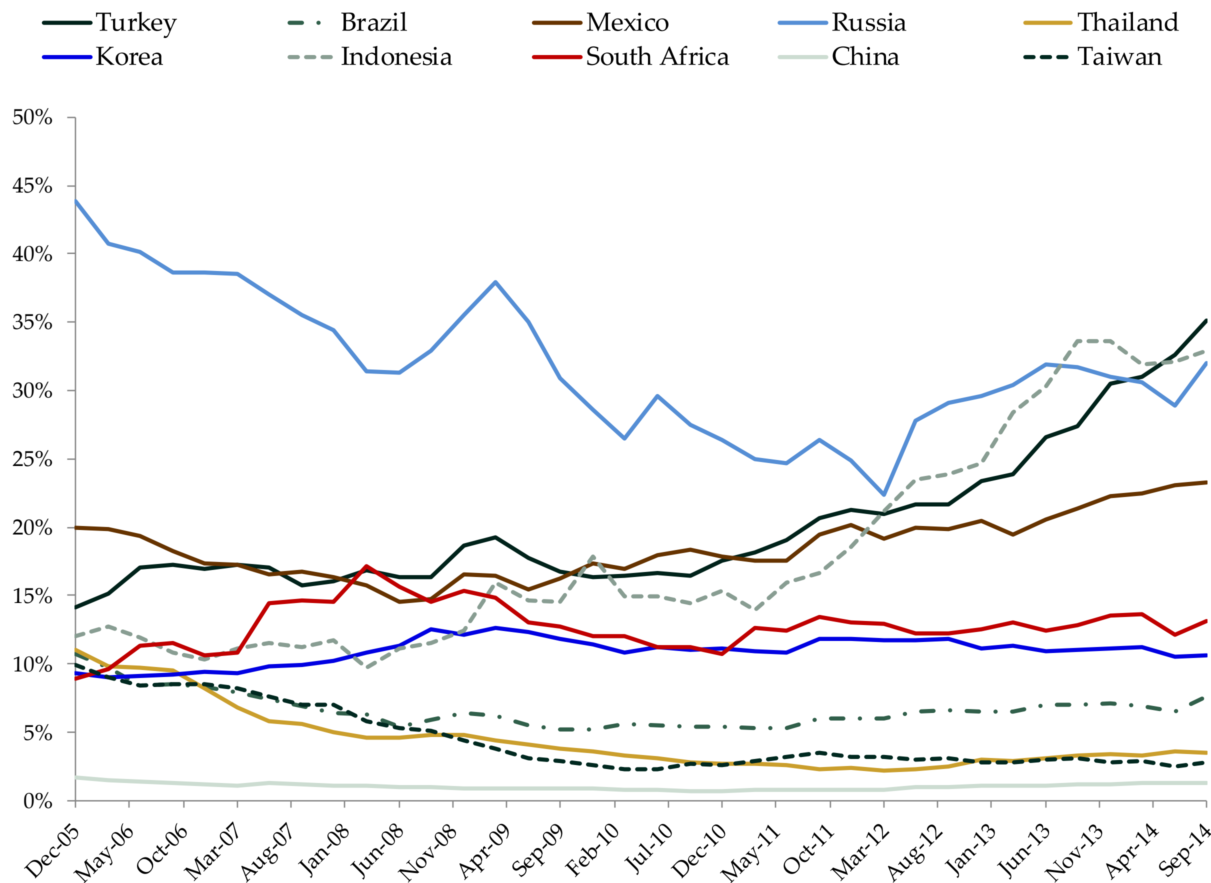
Exhibit 8: Select EM Foreign Exchange Reserves as a % of Total External Debt Stocks



Source: World Bank, International Debt Statistics, as of 3/24/2015

Furthermore, many of these same countries experienced decreasing external debt relative to total outstanding debt over the previous decade (Exhibit 9). This suggests financing was increasingly sourced from domestic lenders. Higher levels of domestically sourced debt relative to external debt improve a country's debt profile because it is typically less affected by erratic exchange-rate fluctuations.

Exhibit 9: Select EM Total External Debt as a % of Total Debt Outstanding



Source: Bank for International Settlements, Quarterly Review: June 2015; Includes debt from all issuers by country indicated.

Not included above, India's external debt relative to GDP actually rose during the last decade-from 16.8% in 2005-06 to 23.2% at the end of 2014. However forex reserves relative to total external debt remain high at 69.4% as of the end of 2014, below the peak of 138.0% reached in 2007-08 but significantly higher than the 1998 level of 31.0%. Additionally, India's short-term external debt, the more immediately burdensome category, is only 18.5% of total external debt.[iii]

While some investors fear US rate hikes will cause trouble in EM by driving away foreign capital, hurting economies and equities, markets efficiently discount widely anticipated actions and oft-discussed fears. EM rate hike fears have swirled since early 2014, appearing in news articles near-daily, major reports from the IMF and others and even the Fed's meeting statement. The US dollar has appreciated and short-term interest rates ticked up amid rate hike chatter, implying markets have discounted the eventual move. Because all similarly liquid markets digest widely known information near-simultaneously, we see little likelihood these fears are not already reflected in EM equities.

[i] FactSet, as of 5/4/2015. MSCI Mexico Index price return for 1994 and 1995; price returns used in lieu of total returns due to data availability.
[ii] According to the Bank for International Settlements (BIS) Quarterly Review: June 2015, China's total external debt was 1.21% of its total outstanding debt as of 12/31/2013.
[iii] India's External Debt as at 12/31/2014, Ministry of Finance, Department of Economic Affairs, External Debt Management Unit, March 2015

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