Macro Hive Pro: EM Focus – What Peak Fed Funds Means for EM

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Summary

- US FCI shifts led by data provide more compelling support for EM assets.
- Peak Fed Funds, combined with macro stabilization are drawing equity flows back to EM, which we think will extend local FX gains over next two months.
- Active managers are likely to rebuild duration overweight in local markets, though valuations have become challenging after this month's rally.

History Favours Bonds and EMFX

Historically, the end of rate hikes by the Fed has been a great time to buy bonds.

According to our analysis of 12 hike cycles since July 1973, 10Y Treasury yields have fallen by 50bps on average 60 days after the last hike, with a hit ratio of 90%. For 2Y yields, the stats are 90bps decline and hit ratio of 100%. Charts 1 & 2 track 10Y and 2Y bond yields around "T", the date of the final hike in a series of rate hikes (we excluded 'orphan' hikes).

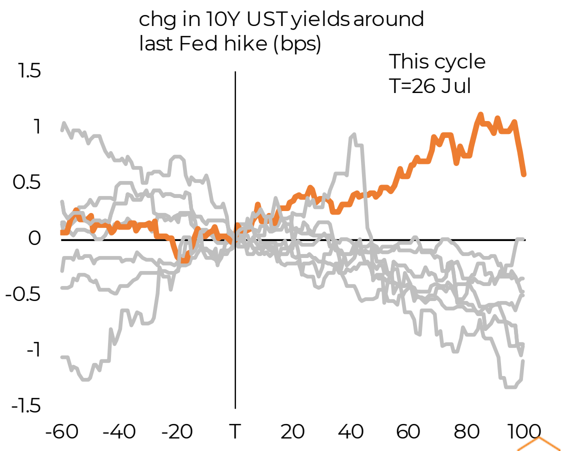
This cycle has been an exception to the norm. In March, after the SVB crisis, the market became convinced that tightening was over, only to see the Fed hike again in May. Since the last FOMC meeting on 1 November, front-end SOFR contracts have again priced out further hikes. Markets have concluded that the hike on 26 July was the last in this cycle.

The 50bps rally in 10Y since 1 Nov is on par with the historical mean, while the rally in front-end has scope to run further.

In contrast to US fixed income, we did not find a consistent pattern in EM currencies when we aggregated data across the last 12 cycles. On some occasions, end of hikes triggered a rally in EM, while in others it triggered financial crisis (e.g. 1997 Asia Crisis). The market structure and capital account regimes were also substantially different say 15-20 years ago.

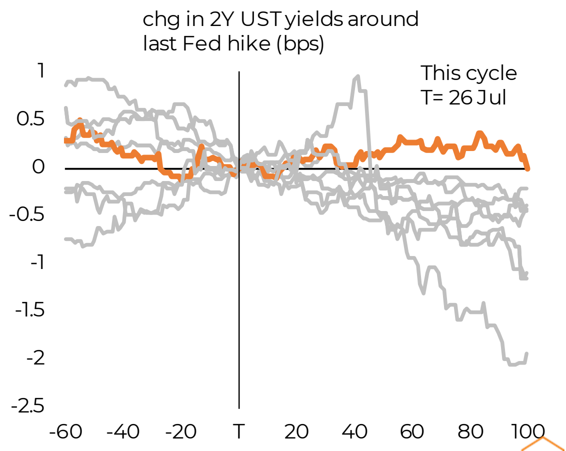
We think the last two cycles, when the final hikes were on 29 June 2006 and 19 Dec 2018, are more relevant to the current situation. As both of those cycles concluded, EM was not in crisis and the relief rally over next 60 days was substantial: +5% and 3.5% respectively, in the MSCI-weighted basket of EM currencies.

Chart 1: US Bond Yields Tend to Fall After the Last Hike – 10Y…



Source: Macro Hive, Federal Reserve

Chart 2: … and 2Y



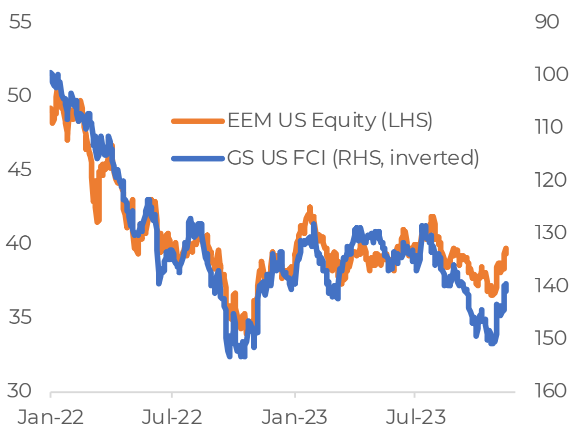
Source: Macro Hive, Federal Reserve

Inverse FCI

EM local markets have been highly correlated to US FCI over the last two years, as tightening liquidity forced investors to liquidate risky positions. Since July, cumulative selling of EM equities has been third highest in history. When FCI turned since the 1 Nov FOMC, outflows stopped, and EM assets rallied sharply (charts 3 & 4).

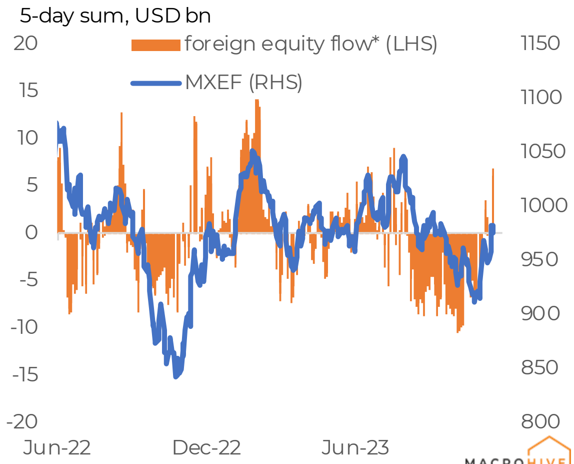
In our network of macro portfolio managers, appetite for EM has been low, as investors were concerned about US real rates and weak macro data in China. The sentiment is shared by active real money managers as well, who had positioned for rate cuts in EM but were scarred by the duration sell-off in Developed Markets since July.

Chart 3: EM Assets Have Been Inversely Correlated With US FCI



Source: Macro Hive

Chart 2: Foreign Selling in EM Equities Is Reversing



Source: Macro Hive

*CN+IN+TW+SK+TH+ID+MY+PH+BZ+ZA

Summary of Our Views on Local Markets

We believe this relief rally has scope to run further. Here are our top picks:

- We expect rates in Latam to extend their rally as the market prices in terminal rates in Brazil and the start of an easing cycle by Banxico. We like receiving BRL DI25 at current level (circa 10.45%) targeting 9.5%. We expect slower easing by Banxico than priced by the market but would look to receive 5Y TIIE on upticks over 9% for an eventual move down to 8.5%.

- BRL and MXN should remain supported by carry, but with both having rallied sharply of late, we are reluctant to chase. We recommended selling USDMXN earlier this month but exited the trade too early. We are now looking to re-establish the same on upticks.

- In Asia, the receiving trade is less compelling. China is likely to ease further, but rate cuts are not the main tool. Central banks in Korea, Taiwan and Thailand are unlikely to cut until before the Fed. We think RBI and BI may cut ahead of the Fed, but FX stability is critical to these central banks, which could make them more patient. We would be happy to receive 5Y CNY NDIRS and front-end (1Y-2Y) in INR NDOIS, though we would wait for better levels. We expect the MAS to remain on hold in January, but think the risk-reward now favours selling SGD NEER around 1.8% over mid-point, as any further tightening is unlikely.

- We expect Asian currencies to extend their recent gains, supported by revival of equity inflows, bullish year-end seasonality, and lower risk of geo-political escalation. Unfortunately, we find current levels quite challenging to initiate bullish trades, though if an opportunity arises, we would be focused on the bullish seasonality in THB, PHP and CNY, and the election scenario in TWD. We expected more muted performance in MYR, INR and IDR, where local central banks are likely to rebuild FX reserves.

- In CEEMEA rates we see the most value in South Africa. Markets are pricing only limited rate cuts (in contrast to substantial cuts in Czechia and Hungary) despite less fiscal risks and inflation momentum continuing to improve. Real rates are the highest in the region. We are received 5Y swaps and reiterate our target of 7.55%. In Czechia almost 300bps in rate cuts are priced over the next year. But with the easing cycle yet to start and an exceptionally steep disinflation profile from January 2024 we think the market pricing is valid. Less so in Hungary with almost 500bps priced in 1yr and the easing cycle already well underway. Poland also looks fairly priced, particularly with inflation set to move 1pp above NBP forecasts if the 5% VAT rate on food is restored in January.

- CEEMEA FX is a bit of a mixed bag. We remain bullish on the zloty with the change of government expected by year end a key catalyst for continued gains in PLN. A now more hawkish NBP, widening C/A surplus and a better environment for EM are other reasons. Our view on CZK is the opposite. Monetary conditions remain very restrictive despite exceptionally weak growth, significant fiscal consolidation and ongoing disinflation in core CPI. The CNB have yet to start the easing cycle with CZK currently the preferred way to loosen monetary conditions. On HUF we are neutral despite still-high carry and a commitment to positive real rates. Tensions with the EU including still frozen cohesion and recovery funding, and limited fiscal consolidation are main negatives. As a risk sensitive currency the rand could extend recent gains, with reduced fiscal risks also helping. High exposure to China and significant structural constraints to growth nevertheless limit the scope for ZAR strength.