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Five Reasons Why EM Local Markets May Not Tantrum to this Tapering

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It's not surprising that an expected tapering announcement from the Federal Reserve is causing some consternation among investors. Safe havens and risk assets sold off sharply during the Taper Tantrum of 2013—the U.S. 10-year Treasury yield jumped 141 bps from May to December 2013, while the yield on the benchmark index for EM local rates, which was one of the more affected fixed income asset classes, surged 168 bps and posted a total return of -11.9% over the same period.[1] We previously addressed the economic and technical rationale for the timing of the Fed's potential tapering, and this post focuses on the Five Reasons why EM local rates may be more resilient to the onset of its latest reduction in asset purchases.

Our Five Reasons are based on the perspective of current conditions in the EM local markets compared to those that existed in 2013.

1 Fed Communication

In 2013, the Fed's QE tapering signal from former Chair Bernanke jolted the markets only a few months after it launched "QE Infinity." The Fed also initially failed to de-link QE taper from being regarded as a signal on its policy rate. However, realizing the confusion within the markets, it subsequently set a clear delineation between a tapering signal and a policy-rate signal.[2] This time, while the timing of a formal announcement remains uncertain, the markets widely expect the start of the tapering process, and some Fed governors are also signalling that the taper timeframe is approaching.

2 Portfolio Flows and Market Performance

Leading up to the Taper Tantrum, EM portfolios received substantial inflows and, more importantly, rate expectations failed to reprice higher. In contrast, as anticipation for a Fed tapering announcement in 2021 has mounted, EM (ex-China) portfolio flows have generally remained negative, and EM rate expectations have recently repriced higher (Figure 1). The monetary policy landscape is different as well: select EM central banks have raised interest rates, and the market has priced in interest-rate hikes for several other EM central banks. The combination of flows, rate expectations, and monetary policy developments create a more supportive backdrop for EM local markets going forward.

[1] The referenced index is the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified.
[2] Transcript of Chairman Bernanke's Press Conference June 19, 2013.