Fed Tapering and its Implications for Emerging Markets

Ongoing uncertainty surrounding Fed QE tapering and fears of the potential reduction of global liquidity have shifted focus to markets especially vulnerable to possible capital outflows. Indeed, there have been increased capital outflows and visible currency depreciation in EM countries with large external deficits, especially in Indonesia and India.
The United States Federal Reserve (the Fed) is expected to begin tapering following the 17-18 September meeting, scaling down bond purchases from US$85 billion per month probably to US$60 billion, while signalling its intention to end the programme around the middle of 2014.

Moreover, the Fed is likely to accompany the start of tapering with other announcements, in particular, lower forecasts for the jobless rate, a signal that the jobless threshold for rate guidance may be reduced below 6.5% over time, and outline projections by the Federal Open Market Committee (FOMC) members for the path of the economy and Fed Funds in 2016. The Fed’s overall message may shift its emphasis from asset purchases to keeping rates on hold until recovery is well advanced and gradual tightening thereafter. This prospect appears to be already reflected in the prices of US asset markets. US financial conditions remain highly supportive of growth prospects and would continue to be supportive even if conditions tighten slightly).

**Impact to Emerging Markets**

However, it is unclear whether the inevitable declines in global liquidity amidst slowing Emerging Market (EM) growth is fully discounted in prices of non-US assets. Sluggish EM growth reflects various country-specific factors, but common themes are weak export growth due to modest advanced economy growth, the deterioration in private sector balance sheets, and the vulnerability of many EMs to Yen depreciation and China’s slowdown.

With US long-term interest rates on the rise, it is not surprising that EM countries with current account deficits have seen their currencies under pressure. Hence, the last two weeks have seen accelerating capital outflows and currency depreciation in EM countries with large external deficits, especially in Indonesia and India. These countries remain vulnerable to the scaling back of the Fed’s asset purchases with limited policy options to revive growth, given the worsening current account, thin reserves and high inflation rates.

**India and Indonesia**

Although Citi analysts expect both currencies to weaken further, they do not expect a full-scale crisis given that both countries retain far greater capacity to contain the outflows in the current environment than previously, suggesting that a repeat of earlier episodes is unlikely. While countries with stronger fundamentals may begin to stabilize as soon as the cyclical recovery gathers pace, those countries with the largest current account deficits and the weakest domestic fundamentals will need to prove their policy credentials.
**United States**

Job growth and private demand have held up well

- Recovery appears to be weathering the worst of the fiscal headwinds with growth estimated at a 1.5% annual rate in 1H and signs that activity was picking up heading into Q3. Housing, capex, car sales and payrolls all are on healthy upswings and new cyclical lows in jobless claims in mid-August suggest little spillover from cuts in federal spending.

- Fed officials continue to emphasise that scaling back QE still would leave policy on a highly accommodative path where no rate hikes are planned for a long time. Citi analysts expect that tapering in September could mark a shift to greater reliance on forward guidance to supplant QE and possibly enhance accommodation by altering thresholds for exit strategies. Citi analysts think unemployment may be below 7% before QE ends and that rate hikes may be delayed until the jobless rate is closer to 6%.

- From an equity perspective, with more than 92% of companies in the S&P 500 having reported 2Q results, EPS trends appear to have come in about $0.20–$0.25 below forecast at $27.33. Moreover, lower tax rates have been supporting profits and this may not be sustainable in the future. Accordingly, some downward adjustments to forward estimates are required as recent guidance has become more negative.

- Citi’s 2013 and 2014 S&P 500 EPS estimates are being trimmed to reflect a revision of margins and earnings results, recognizing that the 2H13 “hockey stick” consensus bottom-up trend seems quite unlikely. Indeed, investors may have been a tad too focused on a rising stock market in recent weeks rather than earnings, especially since many management teams highlighted back half optimism that some have just started to cut in the past few days with more probably coming in the next month. Citi’s new roughly 6% EPS growth outlook for 2014 is meaningfully lower than the 10%-like bottom-up view, though more inline with buy-side surveys.

**Equity markets**

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**Euro-Area**

No longer expect the ECB to cut rates in Q4

- The better-than-expected 2Q GDP data, showing the first gain in seven quarters, together with the more constructive tone from recent surveys, lead Citi analysts to raise their 2013 GDP forecasts by 0.2ppt to -0.5% and the 2014 average by 0.4ppt to 0.6%.

- As a result of better growth dynamics, Citi analysts no longer expect the ECB to cut rates in Q4, with the main refi rate and the deposit rate staying unchanged (at 0.5% and 0% respectively) for a long period. A cut in one or both interest rates could come back on the agenda in the event of a sharp strengthening of the euro or "unwarranted" increases in market rates, but even then the authorities would probably aim to talk down the currency and rate expectations first.

- In terms of strategy, Citi analysts have backed Defensive Growth since mid-2009. These are companies which had low (or no) earnings drawdown during the 2008-09 earnings recession, but which also offer investors 2-year compound earnings growth at/above market growth rates. Defensive Growth includes many Health Care and Food & Beverage stocks.

- Indeed, Defensive Growth has outperformed the market by 70% over the past 5 years. This low beta group has led a strong rise in European equity markets. Defensive Growth has out-gunned Financials and Offensives since the 2008-09 financial crisis with an attractive combination of less risk and more growth. But the prospect of higher GDP growth and lower macro risks in the US and Europe over the next 1-2 years suggests that: 1) there may be less need for investors to seek downside protection, 2) there may be a broader growth menu to choose from, and 3) recovery plays become more important within the market.
Japan
Consumption tax hike is key event to monitor

- Citi analysts expect solid growth to continue until the 1Q14 before the consumption tax hike in April 2014 puts a strong brake on activity. The most important factor to monitor over the near-term is PM Abe’s final decision on whether or not to implement the consumption tax hike (likely in late September or early October). In Citi’s view, the probability that PM Abe will go ahead with the current plan is 60-70%. If the tax hike is implemented, the government is very likely to introduce another fiscal stimulus package in order to mitigate its negative impact.

- Citi analysts have revised up their TOPIX EPS estimate given corporate revenues and profits may rise in both FY3/14 and FY3/15. Even if nuclear plant restarts are slower than expected this would only cut around 1.8pts from the TOPIX EPS in Citi’s view.

Asia Pacific
Accelerating capital outflows

- EM Asia countries with large external deficits recently have seen accelerating capital outflows and currency falls especially in India and Indonesia. Moreover, policymakers in these countries probably have limited options to revive growth, given worsening current account and fiscal balances, declines in reserves and high interest rates. Although Citi analysts do not expect a full-scale crisis, these countries remain vulnerable to the rising US rates on the rise, and their currencies remain under pressure.

- In China, better earnings, expectation of policy support and economic stabilization had triggered recent market rebound from June’s low. However, the market may remain choppy and its upside may likely be capped by ongoing earnings downgrades, Fed tapering, and 4Q growth uncertainty.

Emerging Markets
Neutral on Latam equities

- Although Emerging Europe is often considered to be the most ‘risky’ part of EM, currency sell-offs in the past 3 months have treated EMs in the European time zone relatively lightly. While the ZAR and TRY have depreciated sharply given large current account deficits financed by volatile capital flows, other currencies in the region have fared better. Better Eurozone data is one reason for this, and another is the relative lack of direct exposure to China among Emerging Europe economies.

- Although valuations are attractive, sentiment on Emerging Europe remains poor and growth prospects remain uninspiring. Preferred market is Russia due to cheap valuations. Both South Africa and Turkey sit as neutral, given their shaky social and political backdrops, as well as valuations which shows neither market looks particularly cheap.

- Collectively, Latam currencies face fairly adverse headwinds, including: weak macro (BRL, CLP, COP); twin deficits on the current and fiscal accounts (all four); commodity reliance (all four); deep China exposure (BRL, CLP) and, except for COP, relatively overvalued currencies.

- Within Latin America, Citi analysts have downgraded their 2013 and 2014 real GDP growth estimates for Brazil to 2.1% and to 2.0% (from 2.2% and 2.5% respectively). In Mexico, they have cut their 2013 growth forecast to 2% from 2.7%.

- As for Latam equities, Citi analysts are neutral. Despite expected double-digit EPS growth for 2013, Latam's relative earnings momentum has been weak. Preferred market is Mexico. The market has been held up by close links to the improving US economy, lower commodity exposure, low debt levels and prospects for structural reforms.
Currencies

- Short term consolidation in USD exchange rates over 0-3m may likely give way to further moderate USD upside over 6-12m. Indeed, Citi’s forecasts still envisage generalised USD strength medium term, driven by: (i) a relatively strong cyclical performance in the US; (ii) an expected shift towards relatively less expansive US monetary policy as QE3 is first tapered and then ended altogether by mid 2014; (iii) relatively looser monetary policies elsewhere focused on rates guidance and, in Japan, ongoing QE; and (iv) deteriorating fundamentals and rising risk premia in EM economies.

- EUR/USD has recently moved back to the upper end of the 1.28-1.34 range holding over the past 6 months. A generalised USD correction reflecting rally fatigue and excessively long positioning contributed to this. But there were also EUR positives in play. One factor is the recovery in European financials which tend to be correlated with EUR performance. Another factor arguably helping EUR is the stance of ECB monetary policy.

- USD/JPY fell slightly since the last forecast and is currently close to last month’s 0-3m projection of 98 which Citi analysts leave unchanged this time. In recent months, the exchange rate has entered a relatively large sideways consolidation pattern with still rising lows in corrections but highs receding in rallies since May. The expected fundamental drivers for USD/JPY remain the same. Over time, Citi analysts expect the Fed to begin to withdraw maximum monetary accommodation, first tapering in Q4 and then stopping QE3 altogether in around mid 2014. This is consistent with further moderate upwards pressure on US 10y yields and similarly on yield spreads to Japan.

Bond markets

Overweight High Yield

US Treasuries
Diminished liquidity and elevated volatility is likely to persist as carry trades and long positions continue to unwind, fostering choppy market conditions in the months ahead. Citi analysts prefer to maintain only short-dated positions in Treasuries and to use any rallies to shed duration.

Investment Grade Corporates
While Citi analysts are relatively constructive in 2H13, they remain defensive. The biggest risk is a further significant rise in interest rates. Therefore, Citi analysts prefer to be selective and favour maturities in the 3-year to 7-year range.

High-Yield
The sell-off in high yield has not been fundamentally driven. Concerns about higher US interest rates and the potential impact on the broader macro environment have weighed heavily on valuations. Indeed, valuations have become attractive given that Citi analysts expect default rates to remain low for the next several years.

Emerging Market Debt
External (hard currency) and local currency emerging market sovereign debt remains volatile as investors re-evaluate risk exposures. Citi analysts prefer to keep duration short and hedge currency exposures.

Euro Bonds
While central bank actions (such as forward guidance introduced by the ECB and BoE, or tapering of asset purchases by the Fed) are critical to rate expectations, any sustainable divergence in longer-term yields is more likely to be fuelled by economic factors, not central bank policy. As such, Citi analysts continue to expect “lower for longer” yields in the Eurozone to bolster Bunds and Gilts relative to Treasuries.

Japan Bonds
The Bank of Japan’s (BoJ) easing measures far exceeded market expectations. It introduced monetary base in order to aggressively expand Japan’s aggregate money base. Also it expanded the JGB purchase amount and the maturity of JGBs eligible for purchase to 40 years to keep JGB long-term yields low. With these measures in place, long-term interest rates are setting record lows for the time being.
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