A capital market participant throws light upon market developments based on TAC ECONOMICS research

The Market Insight

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Capital markets commentator David Wigan offers his quarterly thoughts on the key trends shown by TAC ECONOMICS models and impacting the global financial landscape.

Key Messages

- European bond vol likely to persist, U.S yields rising
- EM foreign currency bonds over-valued
- EM inflation picks up pace
- Mid-sized country payment pains in 2018

Sell in May and Go Away?

Take-away

Recent volatility in European bond markets is set to continue over the summer, but yields may decline before year end.

The old stock market maxim that investors should "Sell in May and go away" to avoid the traditionally volatile period over the northern hemisphere summer and Autumn may well be applied to bond markets this year, with recent sharp moves in government yields set to continue over the coming months. The 10-year Bund yield is in focus following ECB head Mario Draghi's more hawkish tone in his 27 June comments in Sintra, Portugal. Draghi spoke of a "strengthening and broadening (euro zone) recovery" in his speech, and despite his insistence that he central banks stimulus programme must continue, European government bonds have seen a wave of selling pressure in recent weeks. The 10-year Bund yield rose as much as 34bp to 57bp, and is on its way to a year-end mark of 90bp, according to some bank analysts. We are not so sure the bond market bears should be so confident. Our modelling suggests continuing volatility over the summer, but then a reversal or stabilisation in the latter part of the year, with yields ending the year below where they are now as the ECB remains cautious on its exit strategy. In the medium term we see 10-year Bund fair value at 70bp.

In the US our quantitative early warning signals and directional trend outlook paint a different picture, with the belly of the curve likely to see continuing upward pressure on yields up to the end of 2017. That is based on our view of continuing robust growth in the world's largest economy up the middle of next year, with the Fed likely to hike 75bps before the end of 2018. That might seem a relatively cautious policy response, but Fed balance sheet deleveraging is set to start in October, and that will de facto add another 75bp to 100bp of tightening before the end of next year.

Action in European sovereign markets is not yet reflected in our modelling of corporate spreads, and we expect "no sudden change" up to September 2017, with some tightening into year-end consistent with a recovering eurozone economy. Equities models also are signalling "no sudden change", albeit with a positive directional trend outlook.

Watch out for EM Foreign Currency Bonds

The fairly correlated moves in EM asset classes in the first few months of this year have given way to a more complex picture characterized by rising levels of dispersion. In the fixed income space, local currency bonds have continued to perform relatively well, but foreign currency debt is showing signs of strain. Spreads on foreign currency bonds at the end of June were around 60bp below their three-year average, a potentially uncomfortable valuation given the securities' high level of sensitivity to the US yield curve. The EM local currency bond market by contrast has continued to see yields trend lower, supported by generally stronger currencies.

A supporting factor in the EM foreign currency bond markets is tight US HY spreads, but that may be insufficient to prevent a return to a more neutral valuation.

On an individual country basis, our broader measures of country risk have highlighted a growing differentiation between the largest EMs (which show stabilization and modest improvement in country risk) and mid-size markets (which have seen deterioration over the past four quarters).

South Korea stands out as having registered a substantial deterioration, with bond and equity markets moving into expensive territory, measured as the spread between our Global Country Risk Premium and JP Morgan EMBI+ global spread. The country is also facing rising geopolitical risk. Conversely, both Brazil and Turkey are offering better value than previously, though neither are out of the woods economically and, along with China, remain vulnerable to shocks. In China that may take the form of monetary tightening or cyclical uncertainty, while in Brazil it may be due to political factors or slower-than-expected recovery. Our model shows Brazilian equities are starting to look expensive. Across our core set of 30 EMs, Polish local currency debt offers the best combination of risk and valuation.

An EM Inflation Inflection Point?

Macro economy watchers will be interested to note that after more than 10 years of secular decline, emerging market inflation may be reaching an inflection point, amid a strengthening labour market, rising wages, booming real estate prices in some countries and largely accommodative monetary policies. Our projections show that inflation in EMs should increase modestly to 4.7% in 2017, from 4.2% in 2016. Countries including Indonesia, Korea, Mexico and Poland are likely to see faster inflation this year, while Russia and Brazil see declines. We expect inflation in Turkey will hit 10.3 percent, compared with 8.5 percent in 2016.

After years of high prices, inflation is currently below central bank targets in key EMs (China, India, Indonesia, Russia, Brazil), and we don't see price pressures getting out of control. EMs have accumulated significant FX reserves, which should offset any currency depreciation arising out of Fed rate rises.

Beware the Squeezed Middle in 2018

The biggest EMs (outside Brazil and China) are largely set fair on the back of relatively firm commodity prices and an expected US fiscal boost. In addition, monetary policy remains loose, international trade continues to accelerate and currencies are not overvalued as they were in 2011-2013, meaning they are much less sensitive to rising US rates. However, the apparently rosy outlook cannot be extended to the mid-sized second Tier, where we are predicting currency, cyclical and payment difficulties from 2018.

TAC ECONOMICS unweighted average economic and financial risk rating (currency, cyclical, payment, with an average time-horizon of two years ahead) across the 95 economies included in our RiskMonitor service has continued to deteriorate: in Q1 it matched its 2013 peak (which accurately announced the difficulties in H2 2015). Our models indicate that currency depreciations, negative reversals in economic activity and more intense payment and liquidity problems will occur in the second half of 2018 and early 2019. However, the trend is divergent, with the largest EMs avoiding problems, while the next 10 (including, Saudi Arabia, Argentina, Egypt, Iran, the Philippines, Philippines and Columbia) and 30 mid-sized (including Qatar, Ecuador, Myanmar and Ethiopia) face potential difficulties. We define mid-size as having a GDP between $50 billion and $300 billion.

Payment risk in the next-10 and mid-sized EMs is particularly noteworthy as it is increasing from very low levels. Indebtedness in mid-sized EMs has shifted from governments to corporates in recent years, and that is where we expect to see most stress. A red flag, perhaps, for bond investors.