

EM Equity Strategy

US Rates and EM: We have seen this movie before

Equity Strategy

Emerging Markets

And - for the fourth time

The 4% rise in EM equities since last Thursday represents the fourth time (at least) in 2016 that dovish Fed comments/rhetoric or weak US macro data have pushed down fed funds futures (the chart uses December 2016 FFF) and led to a sharp rally in EM equities. Previous episodes include: i) the shift in the FOMC 'dot plot' for 2016 from 4 rate hikes to 2 (March); ii) Fed Chair Yellen's speech (late-March); iii) weak May payrolls (early-June). The average one-week gain in MSCI GEMs after these events was 3.7% but was often followed by a new pullback. The rally after the initial market shock of the UK EU vote was similar (+4.7% in a week) but more durable (+15% by mid-August).

The Hunt for Yield Resumes

Initial August US data has been soft (NFP: +151,000; Man'g ISM: -3.2 to 49.4; Services ISM: -4.1 to 51.4), easing market fears of a rate hike this month. UBS economists have, for some time, been calling for a rate hike only in December and that remains their view. As rate fears have subsided, the 'hunt for yield'/'carry trade' in EM has resumed; also helping is that US yields have dipped and the USD has fallen back. This is just more clear evidence that in this strange low-rate world EM does well simply as a 'yield play'.

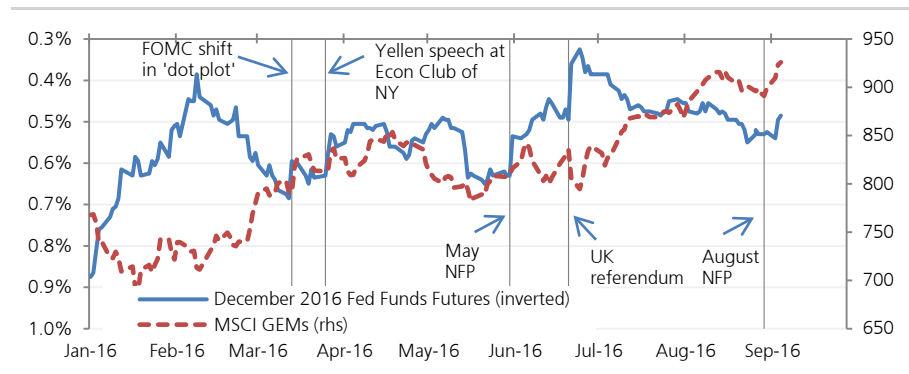
'So, all I do is watch the Fed?'

We were asked this question by an investor recently. The answer is yes, but only in the short-term. EM valuations look stretched (12.5x forward v. LT average of 10.9x) and the asset class remains at risk from weaker global conditions, such as negative China news and higher EM bond yields. However, our global macro strategy team see the USD having peaked v. DM FX and US yields falling to 1.35% at year-end. EM EPS forecasts are more stable in 2016 and there are signs of a trough in ROEs – better fundamentals.

Staying defensive

The pattern of earlier episodes in 2016 suggests that Fed talk will turn more hawkish again before long and EM equities will give back some of their recent gains. We already sit above our extant year-end target for MSCI GEMs. We would not chase the rally aggressively and stay fairly defensively positioned. We are O/W in India, Korea, Taiwan, Russia, Turkey, Hungary, Peru; we are sellers of Brazil, Mexico and South Africa.

Figure 1: MSCI GEMs and Fed Funds Futures



Source: Bloomberg, MSCI

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Figure 2: Short-Term Market Reactions to US Rate Dovishness

	MSCI GEMs	USD TWI	UST 10-Year
FOMC (March 16)			
15-Mar	790.7	102.7	1.96%
22-Mar	830.5	101.4	1.94%
Chg	5.0%	-1.3%	-2 bps
Yellen Speech (March 29)			
28-Mar	813.0	102.3	1.87%
4-Apr	826.8	100.7	1.78%
Chg	1.7%	-1.6%	-9 bps
Weak May NFP (June 3)			
2-Jun	809.3	100.8	1.81%
9-Jun	837.0	98.8	1.68%
Chg	3.4%	-2.0%	-13 bps
UK EU Vote (June 23)			
27-Jun	794.6	100.1	1.46%
5-Jul	831.7	99.5	1.37%
Chg	4.7%	-0.6%	-9 bps
Weak August NFP (Sept 2)			
1-Sep	891.1	100	1.57%
7-Sep	926.0	99	1.54%
Chg	3.9%	-1.0%	-3 bps
Average Chg	3.7%	-1.3%	-7 bps

Source: Bloomberg, MSCI

There have been several episodes this year of Fed rhetoric/weak US data pulling fed funds futures down and leading to a sharp, but usually short-term, rally in EM equities. (The EM rally, starting soon after the EU vote in the UK, proved much more durable¹.)

These rallies were accompanied by a lower USD and lower UST yields. Average 1-week changes:

- MSCI GEMs: +3.7%;
- USD TWI: -1.3%;
- UST 10-year yield: -7bp.

In the subsequent two weeks, the rallies after the March FOMC and weak May NFP data partly reversed, while the EM gains after the Yellen speech and, especially, after the UK vote, ran on longer.

The current market rally (since the day before the weak US payrolls report for August) follows this trend with EM up 3.9% in four days, the USD down 1% and US yields down 3bps. We would not chase this rally short-term and stay defensive².

¹ See "[2H Outlook: Liquidity v. Growth, EM Target Raised](#)", EM Equity Strategy, Geoffrey Dennis, July 11, 2016.

² See "[Turning More Defensive Again](#)", EM Equity Strategy, Geoffrey Dennis, August 18, 2016.

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Sell	FSR is > 6% below the MRA.	15%	21%
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Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 June 2016.

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