RMG Investment Management

Emerging Markets Challenging Our View of a Quiet Summer

12th August 2018

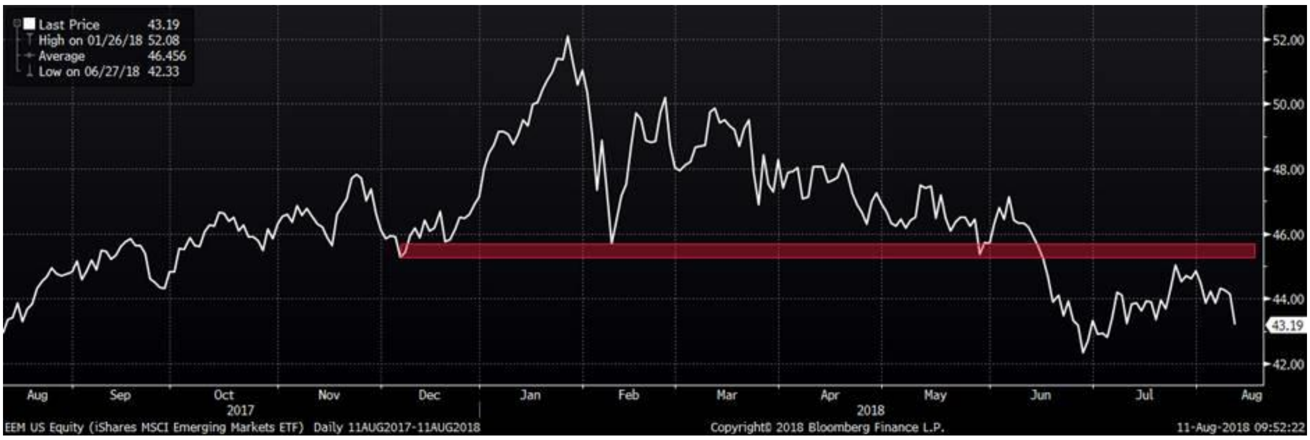
Having been plodding along seemingly quite comfortably until early last week, all of a sudden Emerging Market concerns (amongst others) did in fact matter. Although we had been expecting a pretty quiet period over the remaining weeks of Summer, we had suggested keeping an eye on the potential downside risks; these risks are close to front and centre now.

Let's start with Emerging Markets. The problem last week was Turkey which, unless Erdogan changes direction quickly, will blow up financially speaking. We suspect that being a high yielding country, quite a bit of money has flowed into Turkey in the last two years or so, and some of those investors have clearly been hitting the panic button. Interestingly, contagion has spread to other countries, like South Africa, mainly in the Foreign Exchange markets. Chart 1 below shows an index of Emerging Market currencies, which as well as being way down from the highs seen several years ago, has now plummeted to new lows.

Chart 1 – JP Morgan index of emerging market currencies

Not surprisingly, emerging market bonds and equities are being sold down too. Chart 2 below shows the main emerging market equity ETF traded in New York. The recent rally that started in late June has the look of a bear market rally that failed below the previously broken support zone.

Chart 2 – Emerging Market equity ETF



As well as rising tensions in emerging markets, headlines on the simmering trade conflict keep niggling away at confidence. And just to keep everyone on their toes, the current Brexit position and an upcoming Italian skirmish with the EU on their budget are very much in the background. Individually, these concerns may not matter too much to a market that seems capable of ignoring bad news very easily. However, the fact that markets have suddenly paid attention leaves them at an interesting juncture in our opinion.

What really caught our attention last week was the performance of EM debt and specifically EM debt denominated in US Dollars. Chart 3 plots the yield spread of the JP Morgan USD EM Sovereign Bond Index in Red, and as can be seen, yield spreads blew out to the upside. When we get the trio of Emerging Market assets (FX, Bond and Equities) under pressure as they are now, this is a much stronger signal than just an isolated EM incident that affects just one country or say the currency of one country.

So, we think we have a very strong signal from Emerging market assets here. Currencies and Bonds are under significant pressure and EM equities are underperforming. We therefore have to be very attentive to this performance spreading to developed markets. So far, this has not really happened. This lack of contagion is evident in chart 3 by looking at the performance of US High Yield Bonds alongside Emerging Market USD Sovereign bonds. High Yield bonds have actually been performing reasonably well.

<u>Chart 3 – JPM Emerging Market USD Sovereign Bond Spread and US High Yield Bond Spread</u>

At this point, we have to say that, although the headlines are all around EM and tariffs, we think that the underlying cause of market wobbles is the continuing Federal Reserve policy tightening. Yes, perhaps investors like to have a fundamental excuse to sell, and the headlines are currently providing plenty of excuses. But for months now, markets have been going generally sideways as we have pointed out before, and simplistically speaking, this sideways pattern is either a high level consolidation within an ongoing bull market, or a multi-month topping pattern that will eventually break down into a cyclical bear market.

Liquidity is the lifeblood of markets. If central banks flood the system with liquidity, this will eventually boost prices as shown by the QE exercises seen in recent years. The Fed is tightening by both raising interest rates and draining liquidity as it allows its balance sheet to decline. We know that the ECB will end QE by the end of 2018, the Bank of Japan has been tapering its QE and there is clearly a debate going on about how they can exit their current policy stance.

Global monetary policy, which has been so supportive of asset prices since the last crisis, is slowly becoming more and more of a headwind, and it is this we believe that is beginning to impact markets. We stick with our theory that this steady tightening in global policies is impacting the most speculative areas of global finance first (crypto and volatility strategies in January), and will creep ever inwards towards the core (developed markets and specifically the US). The creeping is currently manifesting itself in sideways price action in developed markets (with the US being the best of the bunch), and with Emerging Markets more at risk of already being in the process of rolling over.

We have said before that we think the Fed will keep on tightening until something breaks. It therefore suggests that if the Fed suddenly reverses course because of declining financial markets, we will have to turn bullish. This is basically just saying that watching the central bank's reaction function is important. So far, the Fed is sticking to its tightening programme; it looks like rates will be raised in September and December, with more next year, and the balance sheet will decline by $50 billion per month from October onwards. Chair Powell seems to be ignoring Trump for the time being, and with inflation still rising (Fridays inflation release shows CPI excluding Food & Energy at nearly a 10 year high and likely heading a bit higher still) and unemployment below 4%, the risk is that the Fed is behind the curve so must keep going unless something breaks.

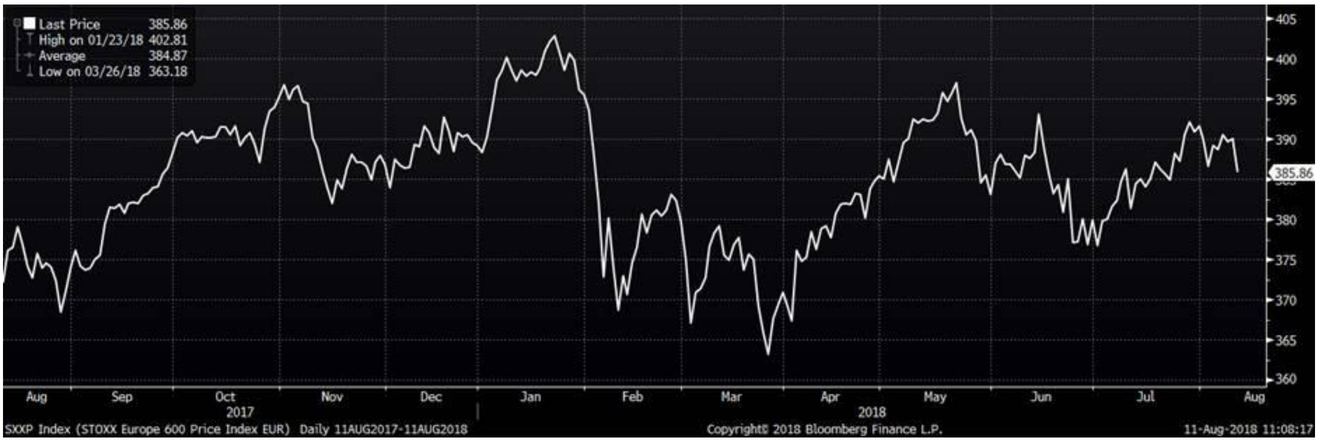
So, what of the developed markets? Let's start with the US and the S&P 500. Last week, the index traded within 0.50% of the high seen in January, and then proceed to peel away and actually closed down for the week. This leaves the impression that the market is not keen on proceeding immediately to new highs. In the worst case scenario, a failure here would leave in place a double top formation, which would be confirmed by a close below the 2600 area.

So, for those of a bearish disposition, we think that last week's high of 2858 is important, and that the 2873 high can be used as a line in the sand. Bearish traders can sell using the all time high as a stop. Investors can hedge or reduce exposure and remain that way unless the 2873 high is breached.

<u>Chart 4 – S&P 500</u>

In Europe, the position looks a bit messier to us. First, Europe has been underperforming the US year to date, and so the index has not traded near the January high and is much more rangebound than the US. There is no clear cut line in the sand looking at last week's price action, and all we can say is that Europe will most likely track the trend seen in the US.

Chart 5 – EuroStoxx 600 Index



Looking ahead, we think that the performance of High Yield Bonds in the US will be an important indicator for US equities (and by extension developed markets in general). Prior to the China inspired equity sell off that bottomed in early 2016, High Yield bond spreads has been widening for some time. In fact, history show that the performance of high yield bonds can be a very useful indicator of brewing trouble for equities. As indicated in the chart below, we believe there is a line in the sand for high yield bond spreads; if the widen past 370 basis points, this could well spell trouble for US equities.

Chart 6 – US Equities with High Yield Bond Spreads

So it's time to wrap up this week's commentary. We may well have erred in our view that financial markets would see out the summer in quiet fashion. The troubles in Emerging Markets, along with tariff worries, Brexit and Italy have suddenly coalesced into a headwind for markets. More importantly, central banks - with the Fed at the vanguard - are also increasingly a headwind, and this is all catching up with markets. Our theory that the pain will first be seen in the most far flung and speculative areas before creeping inwards to the core appears to be holding true as Emerging Markets come under pressure.

So far, the contagion from the worst Emerging Markets has been contained, but the performance late last week is not encouraging. The risk is that developed market assets begin to buckle and central banks ignore this and continue to tighten because they are already behind the curve.

As to how this relates to our multi-month topping pattern, we think this fits in really well. The January peak was either the momentum and/or price peak and we have traded mostly sideways since. The US market has tested the January high and may be peeling away. Performance has been less good in Europe and Japan and worse still in Emerging Markets. If price chooses to go down immediately from here, this will add weight to our thesis but the ultimate break of support in Europe and the US lies ahead of us.

For those that want to play the markets in the summer weeks remaining, traders may want to be short with stops above last week's highs. Investors may choose to buy some hedges or reduce exposure.

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