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MACROCOSM

Emerging Relief

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The worst is over for the emerging markets, but the road to recovery will be rocky.

The continued thawing of short-term dollar credit markets is having perhaps its greatest effect in relieving the all-out panic that was threatening to leave the emerging markets in smoking ruin. As we pointed out at the height of the crisis last month, the other side of the safe-haven rush to cash was the massive liquidation of higher-risk assets, including the range of emerging market instruments (see "The Fear Trade" October 24, 2008). The tentative re-emergence of a degree of risk appetite could be seen in the 28 bp narrowing overnight of the JPMorgan emerging market credit spread, the biggest one-day move in seven years. At 5.85%, the yield premium has dropped by 280 bp since October 24.

Several of the key emerging market currencies hit hardest in the panic -- including the Korean won and Brazilian real, which both lost more than 30% of their value relative to the dollar -- have made back considerable ground since last week's announcement by the Fed that it was extending $30 billion each in dollar swap lines to those countries, as well as to Singapore and Mexico. But a number of the others that were not beneficiaries of the Fed's lifeline remain very weak. The Indonesian rupiah is down 18%, the Indian rupee about 15% and the Philippine peso 11%.

Update to strategic view

EMERGING MARKETS MACRO, BONDS: The unfreezing of short-term dollar markets should continue to feed into a shift in the emerging markets, as a posture of all-out risk abhorrence continues to ease. To the extent the worst-case default scenario of is being taken off the table, spreads are likely to continue to move back in the direction of normal. The emerging market economies are not out of the woods yet -- governments may yet have to intervene to stave off debt problems, and at the end of the day, inflation will resurface as a growth-limiting concern.

[see Investment Strategy Dashboard]

But we are somewhat puzzled that more action to stabilize their currencies hasn't been taken by the developing economies. After being forced into ruinous devaluations in the financial crisis of the late 1990s, most of these countries have built up large hordes of dollar reserves. It's estimated that the Asian emerging markets are holding some $4 trillion in reserves, and that doesn’t include China's nearly $2 trillion. To date, however, it appears that only South Korea has injected a significant amount of dollars into its market, with a $27 billion intervention recorded on the central bank's October balance sheet.

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It might be that these governments are now awaiting their share of the $100 billion facility unveiled last week by the International Monetary Fund. Or it could be that these rainy day funds are being held against a potentially even more dire emergency than the recent rout of their currencies. Over the last three years, private emerging market borrowers have taken out some $1.3 trillion in new debt, most of it coming due within the new two years. With the burden of the debt magnified by the extent of currency depreciation, as well as debtors facing considerable additional stress with the industrial economies in recession and commodity prices down, a potential wave of defaults looms. These governments might have concluded that the funds would be better used to keep these borrowers -- and their lenders -- whole, if need be.

That default risk would be lower in the first place if the currency depreciation were reversed. But repeated cycles of rising and falling currencies are a familiar phenomenon in many of these economies, so the authorities are probably also betting that a turn toward the better is inevitable at some point, so they're just waiting it out. But in the meantime, the damage incurred in terms of higher inflation, loss of foreign capital and rising defaults could be highly costly.

In August, we described the challenges facing the emerging markets stemming from their links to a dollar that was having its real purchasing power eroded by the Fed's excessively easy policy posture (see "What Did They Do To Deserve This?" August 5, 2008), driving them in some cases to hike interest rates to manage inflation risks. Unfortunately these economies, through no fault of their own, are now being put in a position to be whacked from two sides. Yes, the chaos-induced spike in dollar demand is, for the moment, putting their inflation concerns on hold. But that surge is the primary culprit in the near-meltdown that has afflicted their debt markets. And once the exogenously driven dollar demand recedes, inflationary impulses will return to the fore, with the developing world once again bearing the first brunt.

BOTTOM LINE: The unfreezing of short-term dollar markets should continue to feed into a shift in the emerging markets, as a posture of all-out risk abhorrence continues to ease. To the extent the worst-case default scenario of is being taken off the table, spreads are likely to continue to move back in the direction of normal. The emerging market economies are not out of the woods yet -- governments may yet have to intervene to stave off debt problems and at the end of the day, inflation will resurface as a growth-limiting concern.