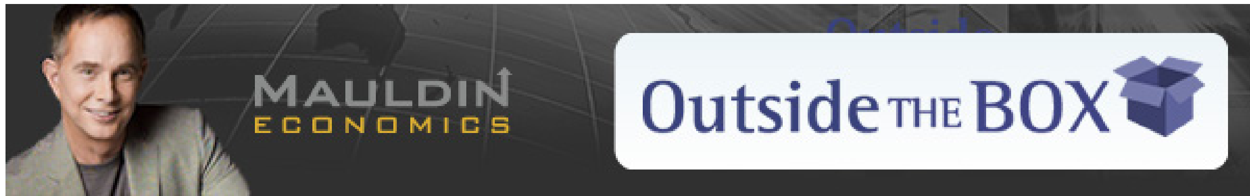


EM Carry Trade Looks Vulnerable

JOHN MAULDIN | May 14, 2014

Last year, post-taper tantrum, the story was all collapsing BRIC walls and emerging-market doom. This year the so-called "fragile five" – Brazil, India, Indonesia, Turkey, and South Africa – the countries that were most vulnerable last year, are looking downright robust. Since their January lows, the Turkish lira has climbed 13%, the Brazilian real 10%, the South African rand 8%, and the Indonesian rupiah and Indian rupee 6% each. In the last two months, the MSCI Emerging Markets Index is up 7% in US dollar terms, a whole lot better than the 1% the developed markets have logged.

But not so fast, says Joyce Poon, Gavekal Asia Research Director (and for my money the best of the young generation of analysts working the Asia markets). "The trouble," says Joyce, "is that this rally has been driven primarily by investors' growing enthusiasm for carry trades in an environment of declining global volatility. Experience teaches this is an engine which can all too suddenly be thrown into reverse."

Joyce's concern was echoed in a tweet just yesterday from Global Macro Investor's Raoul Pal – who we are delighted to have joining us at the SIC conference this week, by the way. He tweeted:

Raoul Pal @RaoulGMI · May 12

With asset class vols low & CESI index rising, we should see frontier markets strengthening further. When the cycle turns you need to be out

And before we move on, I just have to share with you a marvelous bit of whimsy concocted a couple days ago by my associate Worth Wray (who always seems to be two steps ahead of the game in sensing these macro trends). As I mentioned over the weekend, you'll be hearing from Worth every day during the conference, as he and I summarize all the goings on for you in a special *Thoughts from the Frontline* series. But first this:

And that is the name of that tune.

I am in San Diego, and my Strategic Investment Conference has started. They tell me they are setting the room for over 650 attendees. Old friends and new gather, economic junkies and those who are trying for the first time to figure things out. (It seems we have more young people every year, or it might be that I keep getting older and the standard of "young" keeps rising along with the markets.)

And late at night a few resilient souls gather in my room, debating the topics of the day. David Rosenberg, polite but never shy, weighs in with his bullish calls, while Darth Vader (aka Bloomberg Chief Economist Rich Yamarone) waves the yellow flag. Wait, who is that flapping her arms and hooting? It is Joan McCullough, that rarely seen, beautifully plumed bird who has graced us with her presence. And she schools both David and Rich with a dose of real world. And sets the tone for the next hour's debate.

Maybe 15 people, free thinkers all (or maybe some of us are free of thought?), weigh in as the conversation morphs and finds its own path. Gods, I live for these nights! I am such an unrepentant idea and information addict. And for the next three days be the fastest game in town will be right here – it will be like drinking new ideas and views from a fire hose.

I confess to being nervous about my speech on Thursday, something that doesn't happen often any more. I have spent more time on this one than on any speech I have ever done, and may have overthought it. Too much in my head trying to get out; too much for 40 minutes. Kind of like trying to get your 100,000-year-old human brain to truly understand exponential change. It feels like too much is rushing to the front of the brain, all begging to be set free. The rehearsals have not gone well, at least in my opinion.

And perhaps that is due in part to the fact that I have seen the presentations of some of the other speakers. Patrick Cox is doing a 260-slide PowerPoint deck in 40 minutes. Seriously. And it's captivating. And Grant Williams truly makes his Apple whatever-it-is software literally sing and dance. At least I don't follow them or Kyle Bass or Newt, although Dylan Grice will blow the place out before I get my shot. Rosie (David Rosenberg), my lead-off hitter, steps up to the plate in 8 hours, at 8 am, and then it never slows down. Until Saturday, maybe… I kicked everyone out of the room at 11, came in, checked email, and finished this note. And Rosie, who I firmly believe is the first true android, will get his daily out tomorrow morning.

You have a great week, and if you do the Twitter thing, shoot me a note as to what you want me to ask the speakers. You can see the list here (click on the Speakers tab). Worth and I will be writing notes every day about what we are hearing and thinking and sending them your way as shorter editions of *Thoughts from the Frontline*.

Your thinking about Investing in an Age of Transformation analyst,

John Mauldin, Editor
Outside the Box

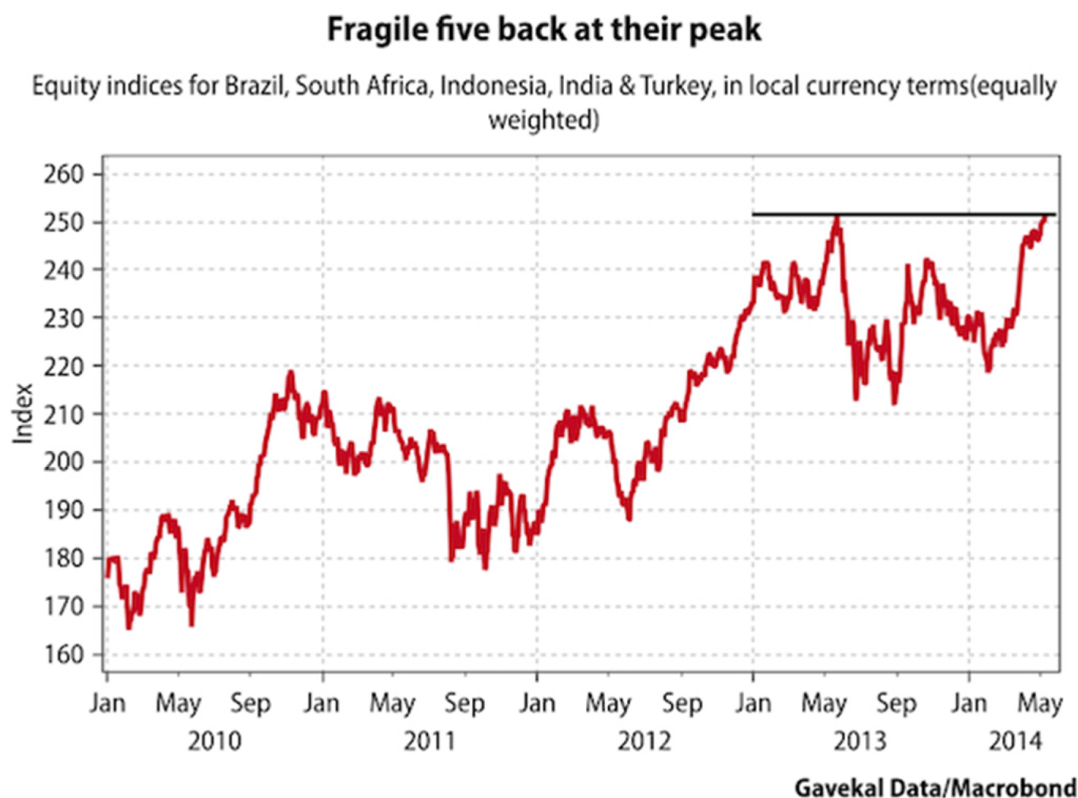
EM Carry Trade Looks Vulnerable

By Joyce Poon, Gavekal Asia Research Director

Over the last two months, emerging markets have delivered a handsome rally, with the MSCI emerging markets index recording a 7% return in US dollar terms, compared with just 1% for the developed markets. The trouble is that this rally has been driven primarily by investors' growing enthusiasm for carry trades in an environment of declining global volatility. Experience teaches this is an engine which can all too suddenly be thrown into reverse.

The defining feature of the current run-up in emerging markets is that the greater the sell-off a country suffered last year, the stronger the rally it has enjoyed this year. As a result, the so-called "fragile five"—Brazil, India, Indonesia, Turkey, and South Africa—the markets most reliant on foreign capital and so most vulnerable during last year's taper tantrum, are no longer looking quite so fragile. Since their lows in January, the Turkish lira has surged 13%, the Brazilian real 10%, the South African rand 8% and the Indonesian rupiah and Indian rupee 6% each.

It hasn't taken long for the rebound to flow through to stock markets. In local currency terms, an investor with an equally-weighted allocation to each of the fragile five's equity markets will already have seen his portfolio regain its previous high reached in May 2013 (see chart below).



As investors, we like equity rallies to be propelled by fundamental factors, like earnings re-ratings or growth surprises. But there is little behind this rally to suggest any sustainable economic healing. Sure, there are pockets of earnings re-ratings because of last year's currency depreciation, but we see little in terms of broad-based economic surprises. According to the Citi Eco Surprise Index, economic data in the emerging market has largely surprised on the downside so far this year. Most forward-looking indicators, especially in Asia, are signaling no prospect of any decisive upturn in the growth outlook. What's more, the prevailing direction of economic and monetary policies is hardly investor-friendly. Credit moderation remains the order of the day in China, while policy settings have been on hold among many of the other major emerging markets in the run-up to national elections. And with food prices turning up, monetary easing is now off the table for emerging market central bankers.

That leaves the search for carry as the principal engine of the current rally. The markets which sold off most violently last year, and which have rebounded most strongly over the last couple of months, are those offering the most attractive yields. As volatility in global financial markets fell this year, and lingering fears of emerging market contagion evaporated, the lack of yield on cash prompted investors to turn once again to the high yielding emerging market currencies and fixed income markets which took such a beating last year.

The widespread return of calm which has underpinned the revival of the emerging market carry trade is marked, and even ominous. Unless you are trading the renminbi or the Russian market, volatility levels in major equity markets, currency pairs, CDS spreads and basis swaps are once again approaching, if not already below, the lows seen last April. Even Chinese CDSs are at year-to-date lows, despite the worries over China's growth trajectory, while volatility in the Brent crude market has fallen even as geopolitical uncertainty has mounted. While low volatility is nothing new in the era of financial repression, it still signals a remarkable rebound in confidence given expectations that the Fed will halt its balance sheet expansion within a few months.

On this premise, the moment that volatility returns, the emerging markets will be extremely vulnerable to investor repositioning. Quite what the trigger might be is impossible to say. But history teaches us that volatility rarely stays this low for long.

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