EDITORIAL

A PREMATURE RALLY

Since mid-April, calm has been restored in the financial markets of emerging economies. In most countries, exchange rates have begun to appreciate again, while money market rates and bond yields have eased thanks to 1) the general easing of policy rates and greater use of quantitative easing by national central banks, 2) external financial support, and 3) the return of portfolio investment. As is often the case, the equity markets have exuberantly – and prematurely – welcomed this return to normal. Indeed, the economic recovery seems to be taking shape, but it remains very fragile.

Since mid-April, financial tensions have been easing in the emerging countries. Bolstered by the very gradual return of portfolio investment, exchange rates have stabilised. Since mid-May, cumulative net inflows of non-resident portfolio investment into bond and equity markets amounted to USD 22 bn (according to data from the Institute for International Finance (IIF) for a selection of 20 emerging countries), compared to cumulative net outflows of USD 100 bn from the end of February to mid-May. As a result, the emerging market currencies have regained some of the ground lost in the first 3 to 4 months of the year (+1.6% on average since mid-March, vs. -6% in Q1). Equity prices, in contrast, have erased most of their losses (+17% on average since the end of March, vs. -20% in Q1). Is this normalisation process, which is very advanced in the equity markets, truly justified?

SIGNS OF A RECOVERY MUST BE EXAMINED CAREFULLY

Economic activity is effectively picking up again, with China leading the way with the easing of lockdown restrictions (technical recovery) and the acceleration of public investment projects since March. Excluding China, there have also been very clear signs of a recovery since April-May. For the vast majority of the main emerging countries, the Markit PMI diffusion indexes based on business survey data have regained between 10 and 20 points from April's lows. Only a few countries continue to slide into recession, notably those in which governments have defaulted and the economy is paralysed by currency restrictions or tighter currency controls (Argentina, Lebanon). According to the PMI sub-indices, the economic recovery is primarily driven by foreign trade. Although the sample is still small, exports from some countries have rebounded – or at least contracted less sharply – in May or June compared to the year-earlier period.

Yet interpreting diffusion indexes can be misleading during this very exceptional period. For the vast majority of countries, the indexes are still holding below the 50 threshold that separates expansion from contraction. This means that even though activity has rebounded strongly, it has yet to return completely to normal. Granted, we can reach a more positive interpretation if we use the same month of the previous year as our reference period for the purchasing managers and business leaders surveyed on sales trends, order books, stocks and employment (although the Markit survey refers to trends with respect to the previous month). It is sometimes "natural" to refer to the year-earlier period for this type of survey, and there is a better correlation between diffusion indices and the year-on-year change in the variables under review than with quarterly variations. An index that is near 50 would indicate that things have almost returned to normal compared to spring 2019. In other words, the gap has been virtually closed. Yet this seems hardly possible over such a short period of time.

STAY ALERT

In any case, cyclical indicators suggest a recovery in H2 2020. Yet the size and diffusion of the recovery remains highly uncertain. For this reason, the rebound in local equity markets seems a bit excessive and even premature.

In Brazil, India and Mexico, the pandemic is not under control, and some governments have even imposed new, selective lockdowns.

Despite the surge in fiscal deficits, for the moment we have not observed any difficulties in refinancing public debt. Bond yields have been held down through conventional monetary easing (via policy rate cuts, which have been widespread throughout the emerging countries) and/or through quantitative easing (by expanding the ways in which central banks can refinance banks and indirectly companies, or through the monetary financing of fiscal deficits). Yet if the pandemic persists, this financial support will not prevent an upsurge in delinquencies and non-performing loans.

Lastly, higher risk premiums on sovereign debt in the local currency increase the attractiveness of carry trades and the inflow of volatile capital at a time when the emerging countries need financial stability even more than usual. For of a selection of 17 emerging countries, the median yield spread between the sovereign bond and a bond with an equivalent maturity in the financing currency (USD, EUR or JPY) remained stable at about 450 basis points (bp) between end-December 2019 and end-June 2020. But this spread must be looked at in terms of foreign exchange volatility to evaluate the profitability of the carry trade. After taking into account the policy rate differential, and thus the possibility of short-term foreign exchange coverage of positions (via the futures market or currency swaps), the median yield spread has nearly tripled, from 80bp to 200bp. For investors ready to take the risk of rolling over very short-term forex hedges, the spread is very attractive.

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