FEDERAL RESERVE TAPERING PART I: EMERGING MARKET CURRENCY PERFORMANCE

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On December 18, 2013, the Federal Reserve (Fed) announced that it would begin to reduce the pace of its asset purchase program through a series of gradual steps referred to as "tapering". When this program was first hinted at some seven months prior, U.S. interest rates rose rapidly through the end of the year, and many emerging market (EM) currencies fell in value against the U.S. dollar. Since that time, the Fed has reduced its bond-buying program from $85 billion per month to $25 billion through a series of measured cuts. With current projections forecasting that the Fed may end its asset purchase program on October 29,[1] we thought it might be helpful to see how these currencies have reacted to the change in Fed policy thus far. **Interest Rates "Carry" Performance** While many investors tend to focus on changes of currency spot rates, a primary reason we have long advocated that investors allocate to EM currencies is the income potential driven by the higher interest rates in many emerging market countries. In today's yield-starved environment, EM currencies remain one of the most significant means of generating income in a portfolio while limiting interest rate risk. Additionally, these higher levels of interest rates can help dampen the volatility associated with investing in emerging markets from a total return perspective. As we show in the table below, 11 out of 23 currencies appreciated against the U.S. dollar over this period. However, when adding in carry from higher rates, 15 out of 23 EM currencies generated positive total returns.[2] **Currency Performance: December 18, 2013 – July 31, 2014**

Country	Total Returns	Spot Returns
J.P. Morgan ELMI+	1.09%	-1.30%
Indonesia	9.98%	4.97%
Brazil	9.44%	3.17%
India	7.17%	2.45%
Colombia	5.35%	3.64%
South Korea	3.50%	2.28%
Peru	2.96%	-0.36%
Malaysia	2.78%	1.86%
Israel	2.76%	2.36%
Philippines	2.24%	1.82%
Thailand	2.10%	0.51%
Singapore	1.10%	0.96%
Turkey	0.90%	-4.61%
Hong Kong	0.14%	0.03%
South Africa	0.07%	-3.57%
Mexico	0.02%	-1.78%
Romania	-0.61%	-1.61%
China	-0.84%	-1.67%
Poland	-1.19%	-2.68%
Taiwan	-1.92%	-0.99%
Czech Republic	-2.88%	-2.81%
Russia	-3.50%	-7.92%
Chile	-5.53%	-7.89%
Hungary	-6.69%	-7.86%

Region	Total Returns	Spot Returns
Latin America	2.40%	-2.48%
Asia	2.09%	0.77%
Europe, Middle East & Africa	1.17%	-1.21%

Source: J.P. Morgan, as of 7/31/14. Past performance is not indicative of future results. Subject to change.-

Regional Focus

Continuing on the theme of income, when investors look at the currency returns by regional breakdown, the concept of carry is even more clearly illustrated. In fact, the region with the most negative spot returns actually ended up with the greatest total returns over the last seven months. Brazil, whose performance we have noted in previous blog posts, has been not only one of the strongest spot currency performers, but also boasts some of the highest interest rates in the emerging world. Shifting the focus to Asia, we note that while spot currency performance was the best across regions, lower interest rates yielded lower opportunities for carry compared to other parts of the world. Finally, given the continued uncertainty in Russia, Europe, the Middle East and Africa countries lagged Latin America and Asia with respect to total returns. Also, through a series of interest rate cuts, Hungary has continued to lag other markets in both opportunities for carry and currency performance. In closing, while emerging market currencies have delivered positive total returns since the Fed began tapering in 2013, these returns have largely been attributable to the carry advantage most of these countries have over the U.S. While emerging markets may be susceptible to a pullback once we have greater clarity about the pace of future Fed interest rate increases, we believe these markets still may enjoy some upside as the drivers of returns shift from higher carry to spot currency appreciation. Additionally, the long-term story for EM currency appreciation remains intact. Faster economic growth and higher levels of economic productivity will continue to support EM currencies against developed market alternatives in the long run.

[1]Source: J.P. Morgan, 7/9/14.
[2]Sources: J.P. Morgan, Bloomberg, WisdomTree, as of 7/31/14.

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DEFINITIONS

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Spot price : The current price at which a particular security can be bought or sold at a specified time and place.

Volatility : A measure of the dispersion of actual returns around a particular average level. .