

What Does the Fed Delay Mean for Emerging Markets?

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Last week, I chatted with Professor Jeremy Siegel, the author of “Stocks for the Long Run,” and Chia-Liang Lian, head of emerging markets debt at Western Asset Management, about their reactions to the Federal Reserve’s (Fed) decision to delay hiking interest rates and the implications for emerging markets (EM).

Reaction to the Fed Professor Siegel pointed out that the Fed’s decision was a close call, but he was nonetheless disappointed by the outcome. He believes the markets already priced in one rate hike through the recent equity market correction, and the Fed missed an opportunity to capitalize on it. He also found the emphasis on “pressures from global events” as the reason to delay rather surprising and noted that the Fed rarely emphasizes such global issues, which explains the sharp rally in the bond markets after the meeting. Siegel still believes the Fed will move before the end of the year and reminded us that the path, not the timing of the liftoff, is more important. Additionally, the new dot plots were revised much lower in recognition that the outlook for lower rates could be with us for some time. Siegel believes such anchored rates will continue to be supportive for equity markets, particularly in the fourth quarter of this year. He added that while the overall [S&P 500](#) earnings picture for 2015 looks rather dismal, earnings outside the Energy sector have held up relatively well. **Impact of the Fed Decision on EM** Lian noted the Fed’s decision has been supportive of risky assets in EM, with sovereign bonds and local rates remaining firm. Additionally, the Fed’s dovish tilt lent short-term support to the broader EM assets. Looking into the future, the uncertainty surrounding the Fed’s liftoff will likely continue to linger and drive EM price action, but that is only one of a variety of factors the Western team is using to evaluate emerging market opportunities and risks. **Most Value in Local Currency Debt** Lian believes that the most appealing segment of emerging market debt today—when evaluating EM sovereign debt in dollars, corporate debt or local currency sovereign market—is the local currency sovereign market. He believes local currencies have become very attractive and potentially mark entry levels today, but he also reminded us to be thoughtful in navigating market cycles and that valuation are not the only consideration. Finding value in a schizophrenic market can be challenging. There are long-term considerations on fundamental fair value and shorter-term dynamics in investor flows and cyclical pressures that drive current performance in EM assets. In this market environment, Lian states that short-term factors can dominate over considerable periods. According to Lian, one way to think about emerging markets is the opportunity to extract yield. To the extent that interest rates in EM are higher than in most developed markets, EM currencies could add a lot of value. **Varied Opportunities in EM** Lian’s team continues to be constructive on Brazil despite the recent downgrade. Brazil has \$370 billion in FX reserves and promising long-term prospects—for one, it is the seventh largest economy and has the fifth largest population in the world.¹ However, the country

faces some significant challenges where political gridlock and poor fiscal balances are concerned; this warrants continued monitoring. Not all EM is built the same way. Lian believes in posturing toward a higher quality bias, while applying the theme of differentiation across EM. He favors countries with AA ratings such as China and South Korea (which recently received a ratings upgrade). In addition, he favors reformist countries that are migrating or have migrated toward investment-grade status, such as Mexico and the Philippines, where investors may be adequately compensated for the risk. While investing in EM entails a bumpy ride, the region will most likely continue to maintain its dominance in global growth, and Lian calls for cautious portfolio allocations. **China Rebalancing and Can India Take Growth Reins?** The EM rally in the past 10 to 15 years has been largely driven by Chinese gross domestic product (GDP) growth. Shifting demographics have led Chinese policy makers to move their economic focus away from exports to more domestically driven sectors such as services. Lian firmly believes that Chinese policy makers have the necessary tools to maintain 6% growth into the future. Lian is optimistic on India's potential and believes that lower oil prices have been a boon to India by helping improve its fiscal and current account balances. But will India be able to plug the infrastructure demand gap caused by a slowing China? Lian believes it will take at least another 10 years for India to match China's influence on the global economy. [Read the Conversations With Professor Siegel Series](#). 1Source: Bloomberg as of 8/31/15.

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