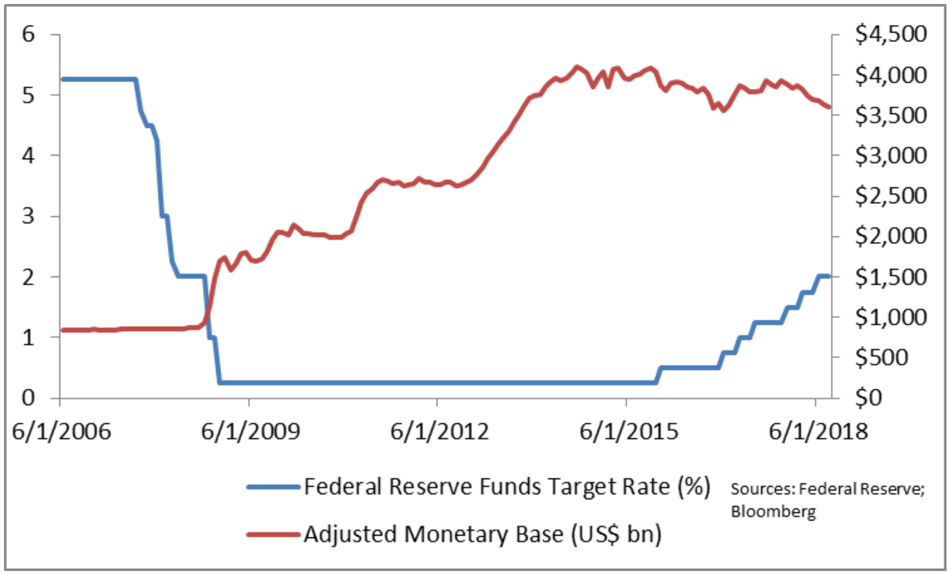
EM investors will watch the Fed even more closely than usual

The Federal Reserve's rate-setting meetings always get a lot of attention. The one happening this week, however, is even more special. Yes, everyone expects the central bank to hike its benchmark rate by 25 basis points to 2.25%. The unusual focus will be on what the institution's statement will say after the move.
Investors in emerging markets will perhaps read even more closely the post -meeting summary as it could spell the difference between more pain or relief. The MSCI Emerging Markets stock index has dropped 9.2% in 2018 so far, the equivalent currency index is down by 4.7% and the PIMCO EM Local Currency Bond Index has lost 10%.
It all probably stems from a great unwinding of leveraged bets in the first three quarters of 2018. As a decade of ultra-low interest rates in the United States is coming to an end, investments into high-yielding currencies and markets have become less appealing, prompting investors to return to American assets, where decent yields can now be obtained with lower risk. The higher cost of funding has also reduced premiums for leveraged investments into these high-yielding markets, prompting some of them to be unwound. The result has been the sell-off in emerging markets led by the highest yielding currencies and markets, where investors had gone in search of better returns.
Now, investors are packing up and going back to the US, where the virtually risk-free 10-year Treasury yields more than 3%. In their wake, they are leaving currency depreciation and falling local bond and stock markets.

"EM could suffer more unless the Fed slows its monetary tightening"

A look at the adjusted monetary base (see chart), which is the effective amount of dollars created across the world, makes that dynamic clearer: between 2008 and 2013 dollars in circulation worldwide grew nearly five-fold to US$4.1 trillion from US$870 billion. Those US$3.2 trillion dollars being drained back are leaving higher-yielding assets first. So far, only US$400 billion has been withdrawn.



Again, how much of that leaves emerging markets and how fast partly depends on what the Fed says on Wednesday. A sign of slower hikes could reverse the downward spiral into which markets such as Turkey seem to be heading.
Particularly important will be the so-called 'dot plot', or the expected trajectory of benchmark interest rates in the US. Every three months, members of the Fed rate-setting team submit their economic forecasts to the board, including where they expect rates to be in the next two years.
Most economic indicators in the US are not showing any sign of weakness, which suggests there may be no change to the current forecast of benchmark rates being at 3.375% by 2020. One of the best gauges to predict how strong US growth is, the Conference Board's Leading Economic Index, is at the highest in four years, suggesting any recession in the world's largest economy is not to be expected for at least 18 months. Unemployment is running at a 49-year low and wage gains accelerated at the fastest pace since 2009 in August too.

"The Fed is hiking because the US economy is strong, and that is where investors may want to focus."

This also suggests there is room for the current bull market in the US stock market to continue, consistent with the FAB Asset Allocation Committee's overweight position on US equities. Historically, US corporate high-yield bonds and stock markets do well in rising interest rate environments. That helps explain why the S&P 500 has been testing record highs and could still move higher.
The reverse is true of investment-grade bonds, which tend to follow the direction of US Treasuries. The 10-year US government bond yield has remained

above the 3% level for four consecutive days, breaching the 2.8%-3% band in which it has traded since February.
Amid this backdrop, senior loans of junk-rated companies could offer a good investment alternative, as long as investors ensure they are not exposed to a single company. Loans tend to have floating rates, so yields increase as rates rise, and in the case of lower-rated companies, they can offer a significant premium over Libor. Defaults are the biggest risk for the asset class. However, corporate defaults tend to drop when the economy is strong. Loans also have the first rights when it comes to recovering debts of bankrupt corporations.
The only element moving against the US right now is the strength of the dollar. As the US currency rises, American products become more expensive abroad and US growth slows. In fact, in July total US exports fell 8% to US$134.1 billion compared to June. Meanwhile, foreign products become cheaper, which helps contain US inflation. Hence, if the dollar continues to strengthen, both inflation and growth could decelerate in the US and reduce the pressure on the Fed to keep hiking rates at the current pace. That shift, however, may be a few meetings away. As for how much more the dollar will strengthen this year, it may depend on factors that are completely out of the control of the Fed.

"Much of the US dollar's direction depends on how Brexit plays out."

About 70% of the dollar index relates to the euro and the British pound. Any positive progress in the Brexit talks has been met with a rise in the euro and the pound and a simultaneous drop in the dollar index. That happened in the past two weeks, as Brussels signaled it could accept a Brexit plan presented to the European Union. This turned out not to be the case, as on Friday the EU rejected the latest plan submitted by Prime Minister Theresa May's government. The pound duly dropped 2.9% on the day while the euro fell 0.24% and the dollar rose 0.33%. The movement is likely to continue on Monday as the market discounts the possibility that Theresa May could be forced to step down. Such a chain of events just ahead of the final deadline for an agreement with the EU points to a higher possibility of a hard Brexit, a move that would further strengthen the dollar.
Emerging market economies are the unwilling participants of the messy divorce between the UK and the EU. They are already suffering from rising interest rates in dollars, and as the greenback itself rises, it puts additional pressure on developing nation currencies. The Indian rupee, for one, is down 11.8% year-to-date, even after recovering a tad late last week. Further appreciation of the dollar could worsen that currency's drop. The inflation spurred by the falling rupee could also force the Reserve Bank of India to hike rates again, even after doing so in two consecutive meetings this year. Higher rates tend to translate into slower growth and higher unemployment. Add to that rising fuel prices because of both rising global crude oil prices and a weaker rupee and it makes for an explosive cocktail ahead of India's general elections in May.

"Political uncertainty could add pressure to the rupee, making the RBI's job even more difficult."

The bright spot in emerging markets may be the oil-producing nations of the Gulf Cooperation Council. In some cases, such as the Dubai stock market, investors have endured losses of almost 18% year-to-date. Much of that can be attributed to negative sentiment spurred by falling property prices in Dubai, as well as a couple of corporate restructurings announced this year.
The future is bright for the UAE, however. The effects of a US$13.6 billion stimulus package unveiled earlier this year by Abu Dhabi will be felt more strongly in 2019. Similarly, there is a lag between higher oil prices and stronger economic growth. Simple mathematics also makes Dubai's stock market appealing. Trading at seven times 2019 expected earnings, the index is near its lowest in seven years. Lower valuations have only been seen during the 2008 financial crisis, suggesting the downside from here is likely limited.
Beyond equities, investors have been buffeted with a slew of new bond issues from the GCC in the past two weeks. Altogether, issuance from the region is up almost 20% this year compared to the same period last year. Global investors, however, still seem to have appetite for these bonds and the expected inclusion into the JP Morgan EM Bond Index may only reinforce that. Again, the reason for that interest is straightforward: GCC bonds currently offer a premium of about 75 basis points over similarly-rated bonds from other jurisdictions. The equation is made more compelling if oil prices remain above US$70, as they seem poised to. As discussed in this report previously, the supply and demand picture for the commodity continues to support the FAB AAC's expectation of Brent crude prices remaining between US$65/barrel and US$90/barrel at least until the end of 2018 and potentially through next year.

INVESTMENT SUMMARY: The FAB Asset Allocation Committee (AAC) met last week and reiterated its belief that the US economy will remain strong, underpinning that country's stock markets. Members, however, expected a small retracement in yields following the Fed meeting this week as global investors take profits on short Treasury positions. Nonetheless, that should be seen as a temporary move in a rising yields environment.
Amid this backdrop, the AAC decided not to make any changes to its current position. As for developing nations, while members said some markets have become relatively cheap, which prompted calls for an upgrade to overweight, the remaining downside risk prompted the Committee to remain neutral towards the asset class.

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com or ***Christofer.Langner@bankfab.com***

From West to East

Weekly Investment View
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