

Rising Yields & Emerging Markets: Resilience in The Face of Adversity

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Highlights

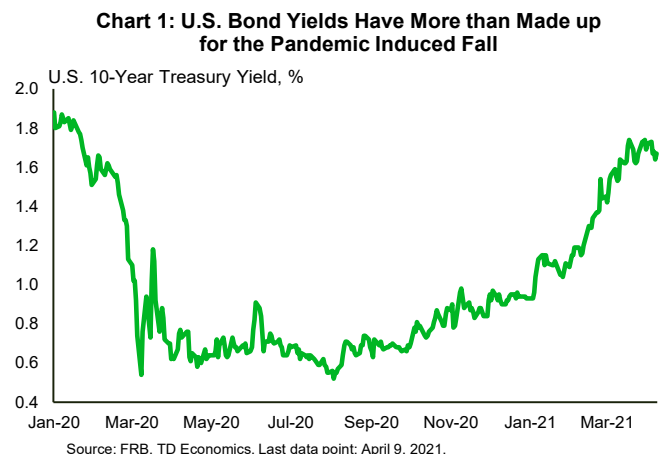
- U.S. Treasury yields have spiked in recent months on the back of higher inflation expectations and a more optimistic growth outlook. This raises the risk of sudden capital outflows from Emerging Markets (EMs), which could derail recovery.
- Fortunately, EM's favorable external balances and less positioning overhang makes them less vulnerable to a sudden outflow of capital than in past periods of rising U.S. rates.
- Multilateral support to low-income EMs in the form of additional SDRs and temporary debt relief will also cushion against a sharp reversal of capital flows.

The U.S. bond market has led a global pullback in demand for government debt since the start of this year. Higher inflation expectations and a more optimistic growth outlook are partly to blame. The U.S. 10-year Treasury yield climbed to 1.67% at the time of writing, up around 75 basis points since the start of this year (Chart 1). Yields on shorter tenors have also risen recently. Late last month, the U.S. 5-year yield hit its highest point since February 2020. The jump in yields of shorter duration fixed-income assets reflects investors' concerns that the Fed might raise interest rates sooner than previously expected.

Emerging Markets Are Braving the Storm

Rising U.S. yields make EM assets less attractive and EM investors jittery (Chart 2). But it's too soon to sound the alarm. Favorable external balances and relatively modest inflows prior to the pandemic make EMs less vulnerable today to a taper tantrum à la 2013. But EM currencies remain under pressure. Nearly all EM currencies have weakened against the dollar since February of this year. EMs with high levels of dollar-denominated debt are particularly vulnerable.

Weak currencies and rising inflation pressures, particularly in Brazil and India, mean that EM central banks may be forced to raise rates faster than they would've like. But raising rates could stop the nascent economic recovery, or worse, reverse it. Still, EMs are likely to weather the storm. Here's why:



- EM's overall external position has improved during the pandemic. The average EM current account balance has shifted from deficit to surplus.
- Unlike 2013, the EM exchange rate is likely undervalued by 5-10%. This undervaluation will act as a buffer against further EM currency weakness.
- Though EM currencies have weakened in recent weeks, the EM trade-weighted U.S. dollar is still plumbing the depths at around its late-February 2020 level (Chart 3).

Moreover, there are several developments working in EMs favor. These include higher commodity prices and growth spillovers from the \$US 1.9 trillion Biden stimulus (Table 1). And, while the pandemic is still raging across some EMs such as Brazil, most of them have become reluctant to tighten restrictions. This is allowing EMs to operate at a higher capacity than most AEs.

Of course, EMs are not a monolith. Take Turkey's example. The recent sacking of the Central Bank's Governor led to the Turkish Lira stumbling by as much as 15%. Equities and bonds also fell on the news. A persistent tightening in financial conditions via Lira depreciation, widening credit spreads and rise in local currency yields will weigh on Turkey's growth this year.

Multilateral Support Puts A Floor Under Emerging Market Economies

In related news, the IMF is likely to approve a new SDR allocation of US\$650 billion by August 2021 at the ear-

Chart 3: The U.S. Dollar is Once Again Strengthening Against EM Currencies



Source: FRB, TD Economics. Last data point: April 2, 2021.

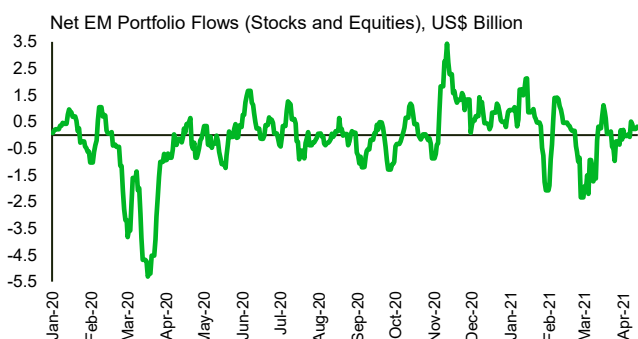
liest. This should help EMs faced with dollar funding pressures. SDRs are IMF issued international monetary assets. They are used by countries as reserves and can be sold and used as payment to other central banks. We had proposed almost a year ago for the IMF to inject additional SDRs (see [report](#)). We are glad to see it finally being done.

Low-income EMs also have another reason to cheer about this year. The G20 recently extended its Debt Service Suspension Initiative (DSSI) until end-2021. The DSSI was due to end in June and was launched last May. It offers temporary debt relief to low-income EMs reeling from the impact of the pandemic. So far, 46 countries have requested debt relief worth \$12.5 billion. The new extension would cover an estimated \$9.9 billion in bilateral debt payments.

Emerging Markets' Recovery on a Stronger Footing

Despite the rising U.S. bond yields, the outlook for EMs is brighter today than it was late last year (see our latest [Quarterly Economic Forecast](#)). EMs are benefiting from relatively few restrictions, rising commodity prices, recovering global trade and accelerated vaccinations thanks to the COVAX facility. Support from the G20 and the IMF has also put a floor under EM economies. Still, all this is not to paint an overly rosy picture of the EM outlook. Its to acknowledge EM's resilience in the face of rising yields and to highlight what is working in EM's favor.

Chart 2: Rising U.S. Bond Yields Have Made EM Assets Less Attractive



Source: IIF, TD Economics. Last data point: April 12, 2021.
Note: Data presented as a 7-day moving average.

Commodity Price Outlook												
Commodity	2020				2021				2022			
	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, \$US/bbl)	46	28	41	42	58	63	65	60	59	58	57	56
Natural Gas (\$US/MMBtu)	1.91	1.71	1.99	2.53	3.51	2.70	2.60	3.00	3.10	2.90	2.80	3.15
Gold (\$US/troy oz.)	1582	1708	1909	1874	1795	1725	1700	1675	1650	1625	1600	1575
Silver (\$US/troy oz.)	16.90	16.38	24.34	24.45	26.24	26.25	26.00	25.75	25.00	24.50	24.00	23.50
Copper (cents/lb)	255	243	296	326	385	395	384	370	355	347	363	399
Nickel (\$US/lb)	5.76	5.53	6.45	7.24	7.96	7.60	7.40	7.37	7.35	7.37	7.60	8.05
Aluminum (cents/lb)	77	68	77	87	95	94	87	85	83	81	82	84
Wheat (\$US/bu)	6.60	6.46	6.36	6.84	7.41	7.35	7.25	7.15	7.10	7.05	6.95	6.90

F: Forecast by TD Economics as at March 2021. All forecasts are period averages.
Source: Bloomberg, TD Economics, USDA (Haver).

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