Should emerging Asia be worried?

Stocks sell-offs and a resurgent USD, are these a harbinger for EM Asia market pain?

Possibly, but more likely just more volatility

The last time we saw EM Asia assets and FX come under some serious selling pressure, was back in 2018. The cause back then? The Fed was on a tightening path after the global financial crisis and was expected to do quite a bit more. At the same time, the USD was appreciating, putting local Asian currencies under weakening pressure.

Having just emerged from a miserable export slump in 2016/17, Asia was enjoying what looked like an export boom. Though it was a very narrow one based almost solely on electronics and it looked very vulnerable to a shift in demand or a loss of competitiveness.

With local currencies under pressure, there was little central banks in Asia could do to boost their economies. Rate cuts were not a viable option as they would undermine currencies and allow inflation to pick up. Fiscal policy was operated under a different rule book pre-Covid, and having just emerged from a stagnant patch, there wasn't much fiscal firepower available anyway.

On the face of it, aside from the fiscal backdrop, there do seem to be some parallels between now and then. The USD is confounding expectations appreciating in what looks more like a typical risk-off move, rather than anything that would follow a synchronous global recovery. This is being matched by occasional jitters in stocks, which aren't exactly bombed out but also are certainly struggling to remain buoyant, especially in the tech sector.

We also have an electronics export surge, though this is being held back by supply issues, and a number of countries are showing a broader export recovery than just electronics, so at least on that front, things look a little different.

This time is certainly different in many other respects too. Even if you have been caught out by the recent Fed shift in intentions from 2024 to 2023 as hinted by the latest dot-plot diagram, actual rate hikes are still clearly years away. Hawks like the St Louis Fed's Bullard, who believes a 2022 hike is a possibility, remain the glaring exception rather than the rule. And even if his view does eventually hold sway, markets currently see rates going little higher than 1% by 2025. Is this really enough to snuff out hopes of reflation?

On this date back in 2018, the Fed had already been normalising rates for more than two years and had just raised rates again in June to 2.0%. Markets were pricing in a further 75bp on top of the prevailing 2% Fed funds rate, and within a few months, were pricing in a much more imminent peak of close to 3% fed funds. By November of 2018, yields on 2Y US Treasuries had risen to around 3%, almost inverting the yield curve, with 10Y yields only about 3.3%. Market chatter was full of talk of recession, as well as why this time would be different.

The 2s10s yield curve is currently a little under 120bp. It was more, but I think talk of recession is still massively premature and does not gel with expectations of Fed rates that peak at only 1%. If 1% is enough to bring the US and global economy to their knees, then we really do have problems. But if that really were the case, then I suspect it would require a policy mistake by the Fed, remaining on a tightening path long after such an outcome began to spook markets and derail the real economy. In contrast, the Fed has made it very clear that instead, they are prepared to allow inflation to run a little hot, and I suspect they will be prepared to allow it to run "quite a lot hot" before they do anything that might imperil the growth outlook.

No, to me, this looks like a market that got too invested in the prior Fed story, which it may have taken far too literally. It is now struggling to come to terms with a version of future events that is a little less supportive, but that is still very moderate. This is hardly a "taper-tantrum" in the classic sense of the phrase. The lesson to be learned may be for central banks to stop trying to manipulate markets with forward guidance. It always seems to end in tears.

Central banks don't seem to be able to control the reality shock that hits markets when a more plausible version of future events is revealed to them after initially being force-fed a fairy-tale version of the future to give them courage. This time it has led yields to fall, not to spike. Who knows what the next version will resemble. Though like the taper tantrum, it should not last, and more normal conditions can be expected to resume before too much longer.

If anyone has any suggestions for a new phrase to replace taper tantrum, I will be very happy to hear from you - I am having no luck coining such a phrase this morning.

Week ahead - quiet

Talking of the Fed's Bullard, he is speaking this week, so we should probably be on-watch for any more hawkish comments from him, as well as Kaplan, who is in a similar camp. Williams may provide some balance this week. We also have Jerome Powell testifying on pandemic emergency lending and asset purchases, so the taper seems likely to remain a driving force in markets this week. We can probably expect some soothing words from Powell. Though a sharp "get a grip!" might be more appropriate.

Elsewhere, it is fairly quiet, with a couple of central banks meetings. In the G-7, the Bank of England Monetary Policy Board meets but will likely leave policy rates unchanged. In Asia, we also have the Philippine Central Bank and also Bank of Thailand. Neither is expected to change policy.

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