IIF Weekly Insight

LOOKING FOR SIGNS OF SPRING

March 20, 2014

- **Bond markets move to price in earlier Fed tightening, developed market equities resilient**
- **Fed surprises on the hawkish side**
- **Renminbi drops sharply as PBoC widens the trading band**
- **EM monetary policy—diversity of challenges**
- **Greece contemplates a return to the markets as 5th IMF program review nears completion**

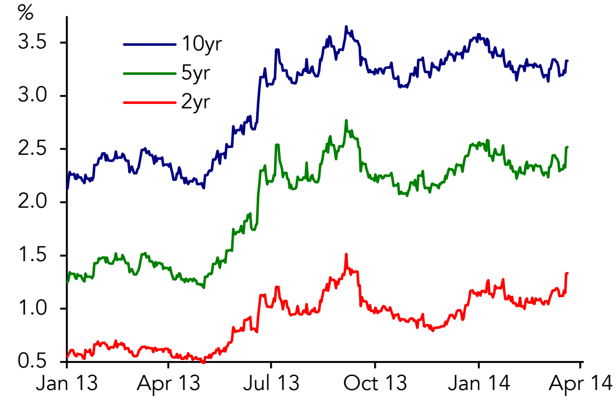
1. Pricing in an earlier U.S. rate hike: The initial reaction to yesterday's comments from Fed Chair Yellen (see below)—a 10bp jump in 10yr Treasury yields (but only about half that in 10yr Bund yields) and broad selling in global equity markets—saw little follow-through today. U.S. and most European markets bounced back, while June 2015 Fed funds futures, having fully priced in the first rate hike following Yellen's remarks, have steadied. Forward rates too have repriced, with 2yr and 5yr rates now seen 20bp higher on a one-year horizon (Chart 1.1). Of note, 10yr forward rates rose only about 10bp, highlighting the current lack of concern about inflationary pressures; soft demand for today's 10yr TIPS auction sent the same message.

While developed market equities appear to be taking the prospect of an earlier rate hike more or less in stride, emerging equity markets had a second day of losses on Thursday, with the Hong Kong market entering bear territory. Compounding broader concerns about EM growth (notably for China), equity analysts' forecasts for EM corporate earnings over the next year remain downbeat (Chart 1.2). As noted in the March CMM, with some $1.6 trillion in emerging market corporate bonds maturing in 2014-18, weak earnings in a rising rate environment highlight refinancing risk for highly indebted firms, particularly in more vulnerable EM countries.

That said, the pressure on EM asset prices remains differentiated. While EM equity mutual funds overall saw continued outflows in the first weeks of March (-$6.5 billion, following outflows of almost $28 billion in January-February), a number of equity markets, notably in EM Asia ex-China, have done quite well in recent weeks. Overseas investors bought a net $1.6 billion of Thai, Indonesian and Philippine equities in March, while Indian debt and equities have seen over $3.7 billion in inflows (bringing year-to-date inflows to some $8.0 billion). Another ray of light can be seen in emerging market bond funds, which saw their first net inflow ($0.6 billion) this year during the second week of March (Chart 1.3).

Emerging European debt markets have seen some interest this week; during a period of some easing of fears of escalation of the Ukraine crisis, which helped some regional sovereign spreads fall to their lowest levels since January, Hungary sold a $3 billion Eurobond at 287bp over—a lower spread than their last offering in November 2013. Slovenia and Romania are also reportedly planning bond sales. More broadly, EM bond issuance for the first half of March (over $10 billion) is already higher than for all of February, though well off January's robust $48 billion.

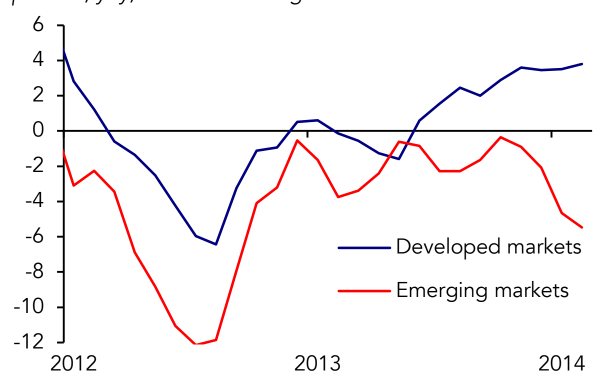
1.1 U.S. One-Year Forward Rates--10yr, 5yr and 2yr Tenors



Source: Bloomberg

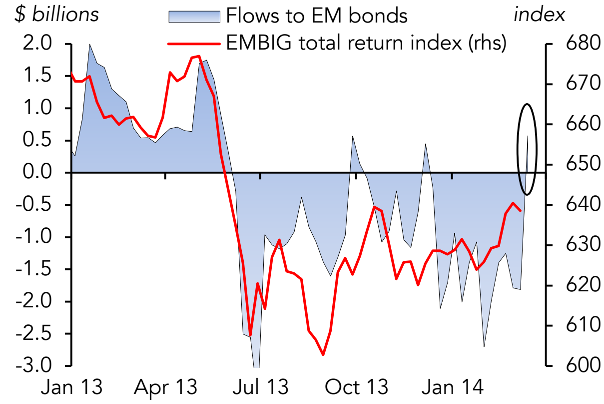
1.2 Developed & Emerging Markets: Forward Earnings Growth

percent, yoy, 12M fwd earnings



Source: BEST, Bloomberg, IIF

1.3 Emerging Market Sovereign Bond Prices and Fund Flows



Source: EPFR, JP Morgan, Bloomberg

Fed surprises on the hawkish side; Renminbi drops sharply as PBoC widens the trading band

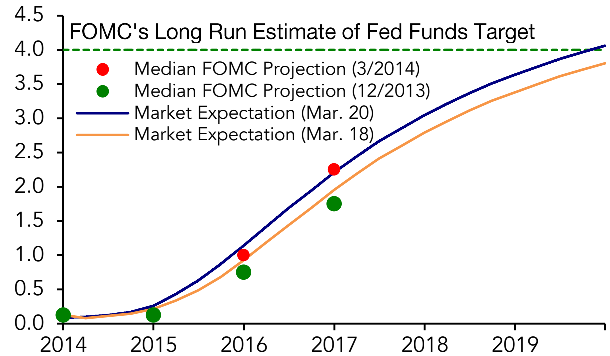
2. Fed surprises on the hawkish side: As expected, the Fed reduced asset purchases by another $10 billion and dropped its use of the unemployment rate as a threshold for interest rate increases, and shifted to a qualitative form of forward guidance. This shift reflected the rapid drop in unemployment rate in recent months to 6.7 percent, only a little above the Fed's 6.5 percent threshold, and their view that a broader range of labor market indicators suggested that there is still ample slack in the market.

The bigger surprise was that the Fed's post-meeting communication suggested an earlier exit path than widely anticipated. First, the Fed's projection materials showed that participants now expect a higher policy rate at end-2015 and 2016 relative to their December projections, with the median forecast shifting up 25 and 50 basis points, respectively (Chart 2.1). The FOMC's central tendency projections for the unemployment rate at the end of 2014 and 2015 also declined by 2-3 ticks. One caveat with all FOMC projections is that they include the views of non-voting meeting participants. The second factor that seems to have contributed to a shift in market expectations towards an earlier Fed exit was a comment by Janet Yellen in her post-meeting press conference that it may take only 6 months for the Fed to raise the policy rate after QE is completed. At the current pace of tapering of $10 billion at each meeting, this would imply a first rate hike in 2015Q2, which is several months earlier than recent market pricing would have suggested (Chart 2.2). Overall, the recent volatile data flow does not seem to have created too many headaches at the Fed as it is likely attributed to temporary factors (including adverse weather conditions).

3. Renminbi drops sharply as PBoC widens the trading band: This year's 3% drop in the onshore renminbi (CNY)— entirely wiping out the modest appreciation permitted last year—has been mainly driven by PBoC policies. Following the central bank's announcement of a wider daily CNY trading band (from 0.1% to 0.2%) on Saturday, the CNY has plunged nearly 1.3% this week, one of the sharpest weekly declines on record—presumably driven by dollar purchases from official sources. The CNY is now trading 1.34% below the daily reference rate, which has been reduced 0.8% since the start of the year (Chart 3.1). This week's movements have reinforced the PBoC's message that CNY appreciation is not a one-way bet—losses to date in offshore yuan structured products (used to take leveraged FX positions) are estimated at some $3.5 billion. It seems that the PBOC wants to discourage the surge in "carry trade" capital inflows by adding to volatility while a weaker RMB also helps to support activity at a time when the economy has slowed to a pace that may be well below the announced 7.5% growth target. Going forward, the widening of the trading bands may thus enable the central bank to reduce its intervention in daily trading and limit arbitrage opportunities between onshore and offshore renminbi.

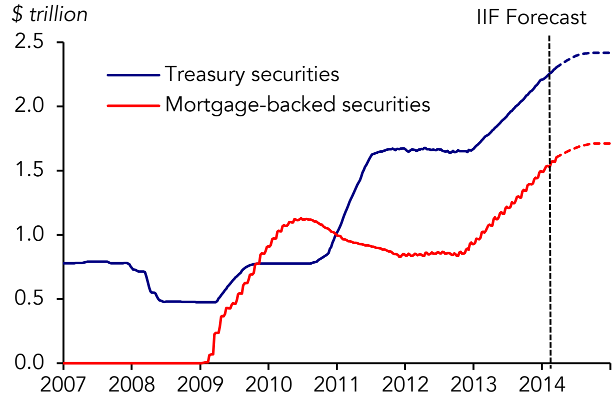
Efforts to fine-tune credit growth continue: Since mid-February, the PBoC has proactively drained around RMB880 billion (about $140 billion) from money markets. This sharp liquidity withdrawal

2.1 Outlook for Federal Funds Rate
percent, based on fed funds futures and Eurodollar contracts



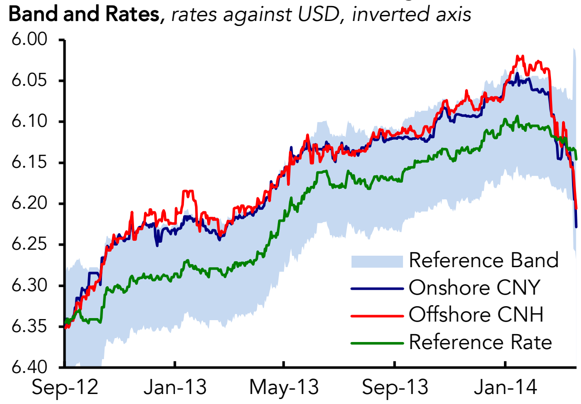
Source: Bloomberg, Federal Reserve, IIF

2.2 Federal Reserve: Holdings of Securities
$ trillion



Source: Federal Reserve, IIF

3.1 Onshore and Offshore Renminbi Exchange Rates, Reference Band and Rates, *rates against USD, inverted axis*

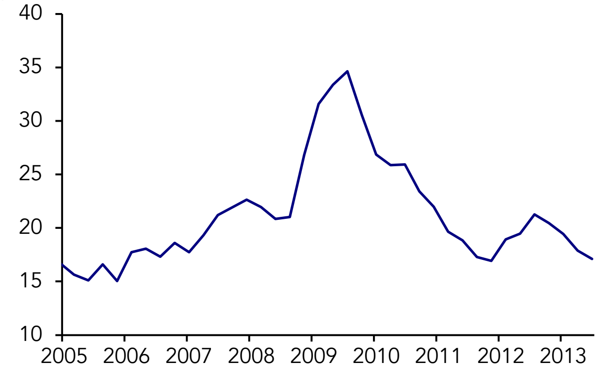


Source: Bloomberg

has contributed to a marked reduction in non-bank financing and pushed the seven-day repo rate back above 3%. While bank lending has held up relatively well still—up over 14%oya in February, total social financing has slowed (Chart 3.2).

3.2 China: Total Social Financing

percent change over a year ago

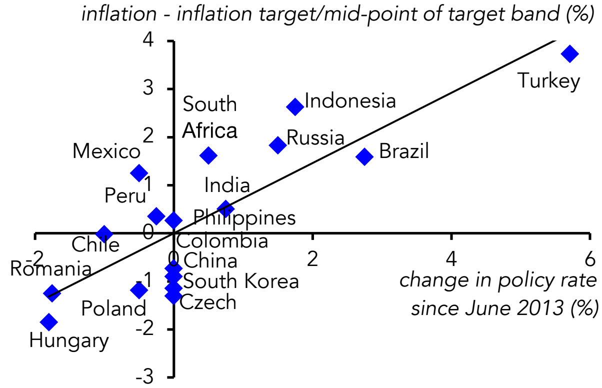


Source: Datastream, IIF

4. EM monetary policy—diversity of challenges: The turbulence in EMs since the spring of 2013 has put EM central banks into the spotlight. In fact, monetary policy has been tightened substantially in EMs in aggregate since the middle of last year with the weighted average of policy rates across EMs having risen by around 80 bps. However, this aggregate view masks substantial cross-country divergence—both in terms of the size and direction of the adjustment as well as its timing. For example, above-target inflation has led central banks in Brazil, Turkey, India, Indonesia and most recently Russia to deliver aggressive interest rate hikes, with the aim of raising real interest rates and to contain inflationary pressures emanating from a weak currency (Chart 4.1). This adjustment already started last year in Brazil, India and Indonesia and may have contributed to a more benign treatment by financial markets more recently, compared to Turkey and South Africa (where the next central bank meeting takes place next Thursday), which tightened more substantially only this year. By contrast, some Eastern European countries have been able to lower policy rates (or maintain a very easy stance as in the case of Czech Republic) as their inflation rates remain below target and output gaps are still negative. Also, with inflation expected to remain at target this year and the economy adversely affected by soft commodity prices, Chile has continued policy rate cuts, notwithstanding a weakening of the peso.

4.1 Inflation and Official Policy Rates

inflation - inflation target/mid-point of target band (%)

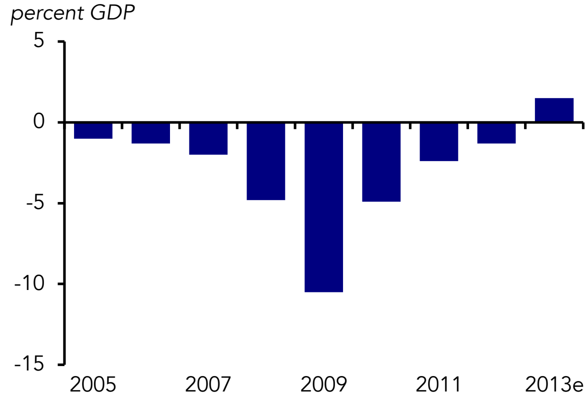


Inflation is 2014 forecast. Source: Bloomberg, National Sources, IIF.

5. Troika agreement brightens prospects: After three failed attempts over six months, Greece and the Troika have reached a staff-level agreement that should facilitate successful completion of the fifth program review. Assuming timely enactment of agreed prior actions (including legislation and administrative steps to liberalize product markets and allow the sale of shares in state-owned banks), the Eurogroup could decide to disburse €8.3bn at its April 1 meeting and the IMF €5.3bn ahead of the start of its spring meeting ten days later. A larger than targeted primary fiscal surplus faciliated agreement, along with the government's readiness to boost social spending by less than initially expected, preserving more of the primary surplus going forward (Chart 5.1).

5.1 Greece: Primary Fiscal Balance*

percent GDP



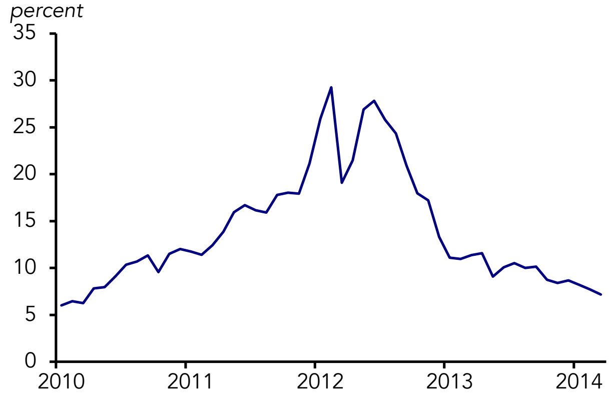
*ESA95 basis, e=estimates. Source: European Commission, IMF, IIF

News that the Troika will recommend completion of the review makes it likely that Greece will go ahead with plans to issue a five-year bond as early as April. Greek officials believe that demand would be more than sufficient to issue €1.5-€2bn in five year notes with a coupon below 6%. The three-year €0.5bn unsecured bond issued this week by Piraeus Bank, with 5.1% yield, suggests a five year sovereign bond could be issued with a yield as low as 5.5% (Chart 5.2). Whether Greece could follow an initial five-year issue with more later, across more of the curve, will depend in part on how well the governing parties do in the May

European parliament elections and how soon the economy returns to growth. Troika concerns may matter, too, since significant market borrowing would slow the pace at which the government's debt/GDP ratio is projected to decline, leaving the ratio above the 120% agreed for 2020. Even at reduced yields, bond issues would still be at higher interest rates than the further EFSF borrowing the program has assumed, with interest rates at a small margin over EFSF borrowing costs that currently average just 1.8%.

Assuming disbursement in April of the €13.6bn, the EU will have another €2.9bn to disburse after the next review and the IMF another €14.3bn in eight more tranches running through 2016Q1. Those tranches will be linked to further EU financing the Eurogroup will decide after midyear to meet program financing needs through the end of 2015. The Eurogroup will also decide then whatever debt or cashflow relief is needed to assure the projected debt/GDP ratio declines to 120% in 2020.

5.2 Greece: 10-Year Bond Yields



Source: Bloomberg

IIF Teleconference Call on Ukraine: Economic Impact of Crimea's Secession: Lubomir Mitov, IIF Chief Economist for Emerging Europe, will provide a briefing on his insights into the situation in Ukraine, and will discuss the impacts of Crimea's secession and what it means for the economy of the rest of Ukraine. This conference call will discuss developments since and delve deeper into the topics covered in our recent report "Emerging Europe: Ukraine Crisis and Its Economic Impact," published March 18.

The call will take place on **Wednesday, March 26 at 9:00 AM** in Washington, D.C. (1:00 PM London / 2:00 PM Paris / 3:00 PM Kiev / 5:00 PM Moscow / 9:00 PM Beijing / 10:00 PM Tokyo / 12:00 AM Sydney). If you are unable to call in, please note that an audio recording of the call will be available on our website after completion of the call.

Please click here for the dial-in instructions. Please confirm your participation by email to aschultz@iif.com.

What to Watch For Next Week:

Mon: Flash Manufacturing PMI (U.S., Euro Area & China)

Tues: Ifo index (Germany), U.S. Personal Consumption, Hungary Monetary Policy Meeting

Wed: U.S. Flash Services PMI & Durable Goods

Thurs: Czech Republic and South Africa Monetary Policy Meeting, Euro Area Bank Lending

Fri: Japan CPI & Labor Market Report

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