



# Taper Tantrum 2.0?

## Why EM is Much Better Positioned to Weather Rising US Yields

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### Introduction

The sharp move higher in US Treasury yields earlier this year, fueled by the strong economic recovery, substantial policy stimulus, and upside inflation surprises has evoked memories of the 2013 “taper tantrum” which triggered sustained underperformance of EM debt, especially local currency debt. While US rates have partially retraced recently, markets could quickly revert to embrace the reflation theme again and concerns remain about the potential impact on EM debt of another rapid repricing in US rates.

Our baseline outlook foresees a gradual move higher again in US rates. Better Fed communications and more experience with tapering of QE should help avoid large market surprises. But we recognize the risk of a more rapid and disruptive repricing, especially if inflation pressures fail to dissipate over the summer and early fall.

**However, in stark contrast to 2013, we see EM markets now much better positioned to perform even if these risks materialize.** Several key factors were responsible for poor EM performance in the aftermath of the 2013 taper tantrum: large current account deficits, reliance on sustained capital inflows, appreciated currencies, and significant foreign positioning in EM local markets.

These factors have fundamentally changed since then. EMs on average are running current account surplus with little reliance on net capital inflows in most EMs. Even the Fragile 5's<sup>1</sup> current accounts are close to balance. Foreign investor positioning is low. And finally, valuations are much better, both for EM FX and EM rates. We believe, this leaves EM assets in a good position to perform when the global reflation theme resumes.

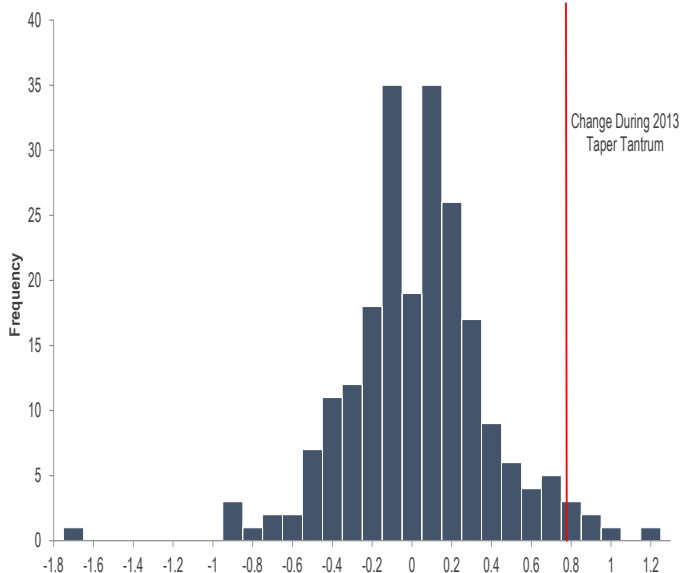
When Federal Reserve (Fed) Chairman Ben Bernanke first publically revealed the Federal Open Market Committee's (FOMC) thinking about tapering bond purchases in May 2013, markets did not take the alleged paradigm shift very well. Treasuries sold off sharply, triggering risk-off moves across various financial markets. This was the infamous “taper tantrum.” But while most markets quickly recovered, boosted by the continuing US economic expansion, the impact on emerging markets (EM) was both more severe and enduring. The taper tantrum caused a sudden stop of capital inflows that had previously supported EMs. As capital flows reversed, EM currencies depreciated, triggering negative feedback loops affecting EM balance sheets, inflation, and economic growth.

Looking at 2021, given the rapid economic rebound in the US, combined with substantial fiscal and monetary stimulus, markets are now contemplating the possibility of another “taper tantrum.” The key questions for EM investors are: (1) what can we expect from the Fed if inflation continues to surprise on the upside, and (2) how would EM economies and markets react to a more hawkish Fed? To help assess these risks, we outline in this paper first our thinking on the Fed, and then take a closer look at current conditions in EMs compared with the environment just prior to the 2013 taper tantrum. We disclose some crucial differences to suggest that EMs are more resilient this time around, despite some arguable deterioration, as indicated for example by the higher level of public debt.

<sup>1</sup>Brazil, India, Indonesia, South Africa, and Turkey

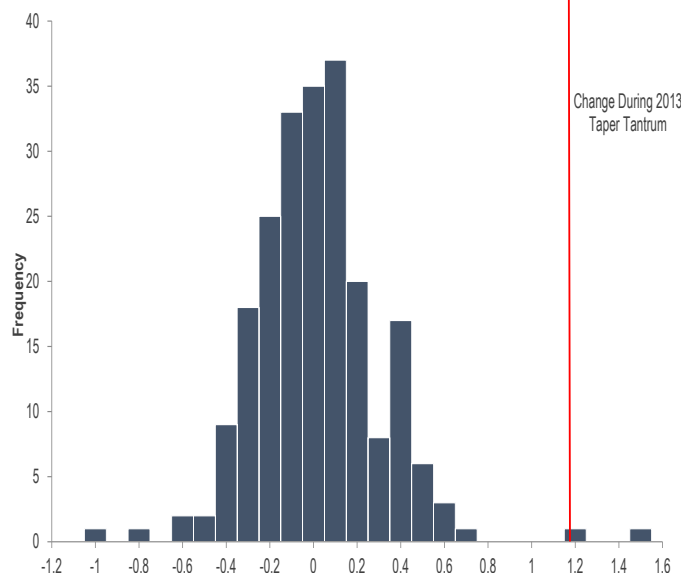


**Figure 1: Nominal UST 10-Year, 2-Month Change in Yield (1999 -2021)**



As of 30 June 2021  
Sources: Federal Reserve Board, Haver Analytics

**Figure 2: Real TIPS 10-Year, 2-Month Change in Yield (1999-2021)**



As of 30 June 2021  
Sources: Federal Reserve Board, Haver Analytics

### The 2013 Experience

Chairman Bernanke’s May 22 testimony to the Congressional Joint Economic Committee, triggered the 2013 taper tantrum. In response to a question about the potential for a “step down” in the pace of asset purchases, Bernanke responded:

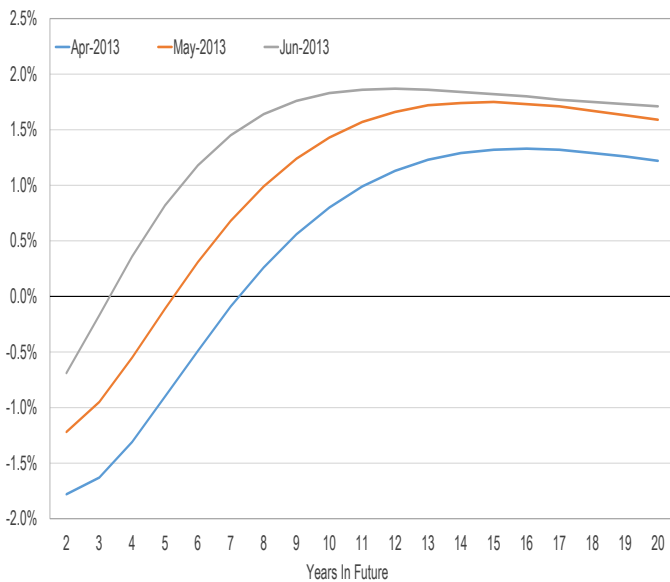
“We are looking at, we’re trying to make an assessment of whether or not we have seen real and sustainable progress in the labor market outlook. And this is a judgment that the Committee will have to make. If we see continued improvement and we have confidence that is going to be sustained, then we could – *next few meetings* – we could take a step down in our pace of purchases.”

The italicized text above—the next few meetings—was what surprised the market. Though there was an expectation that at some point the Fed would start to taper the pace of purchases, that expectation was considerably further off than the next few meetings. In response, over the following 6 weeks or so, interest rates increased substantially along the whole curve. At the end of April, 10-year rates were trading at about 1.6% (higher than current levels). Over the last few weeks of June and early July, they were closer to 2.6% and almost touched 2.75%—an increase of about 100 basis points (bps) in a short time frame.

What stood out even more than the increase in nominal yields was the rise in real yields. Figures 1 & 2 show histograms of the 2-month change in nominal and real yields over the history of the UST and 10-Year TIPS market, with the period from 30-April-2013 to 30-June-2013 indicated for each. The change in nominal yields is large, but there are several periods that show similar or slightly smaller changes. In contrast, the move in real yields is much larger than any other move, except during the throes of the financial crisis, when liquidity issues in TIPS massively distorted pricing. Note also that Figure 3 shows the increase was across the entire curve, not just a recalibration of the timing of the first rate hike. Figure 3 shows forward rates, what the pricing of the interest rate curve implies for future short-term rates (abstracting from issues of risk- and liquidity premiums). The forward real rate 10 years out increased by about 100 bps, the market was pricing in significantly higher yields even in the relatively distant future.



**Figure 3: Real Forward Rates, TIPS Implied**



As of 30 June 2021  
Sources: Federal Reserve Board, Haver Analytics

There are several noteworthy points about the economic environment in which this substantial increase in real yields occurred. First, there were no signs of inflationary pressure; core CPI dropped to 1.65% in May 2013, down from 1.90% at year-end 2012. Second, the economy, while performing decently, was not accelerating sharply since job growth, except a strong February report, was below 200,000 per month. Third, there was no sign of any sort of shift in US fiscal policy.

In comparing 2013 to our current situation, we see several similarities. The recovery is well underway but employment is still well below its previous peak, and the Fed is looking towards tapering their Quantitative Easing (QE) program while the policy rate remains at zero. But perhaps the most striking similarity between early 2013 and now is the very low level of real yields. As Exhibit 4 shows, the current TIPS implied 10-Year real yield is quite similar to its 2013 level. The Covid-19 pandemic and the period from late 2012 until the taper tantrum started are the only times that real yields have been this low—and at -1% real rates are indeed very low, perhaps too low to be sustainable.

That said, *our baseline expectation is that although rates may drift higher over the next year, we don't expect a repeat of the taper tantrum.* Several factors underlie our expectation: (1) the Fed has experience exiting QE and raising short-term rates with a large balance sheet; (2) the Fed has already previewed a

**Figure 4: TIPS Implied Real 10-year Rate**



As of 30 June 2021  
Sources: Federal Reserve Board, Haver Analytics

timeline for communicating how it will taper purchases without causing undue market turbulence; (3) the market has the advantage of the experience of the last taper; (4) the new flexible average inflation targeting framework pushes back against thoughts of premature withdrawal; and (5) we expect lower inflation and growth readings over the next several months.

### What Could Cause Another "Taper Tantrum"?

While our baseline is for a gradual move higher in yields, we recognize that the process of withdrawing exceptional monetary stimulus could lead to increasing volatility, especially if it results in a significant rise of (real) yields. We see several potential triggers for such a disorderly repricing:

- Sustained higher inflation.**  
 Inflation has risen sharply over the last several months due to the combination of base effects as year-over-year readings compare to depressed readings from mid-2020 and higher sequential readings driven by reopening-related categories (e.g., airfares, hotels and used car prices most notably). We expect both sources of upward pressure to dissipate over the course of the summer and early fall, but as there are no historical precedents for the current situation, there is a risk that inflation does not move back down. Such stickiness could prompt a reassessment of the level of real rates that will be needed to keep inflation under control.



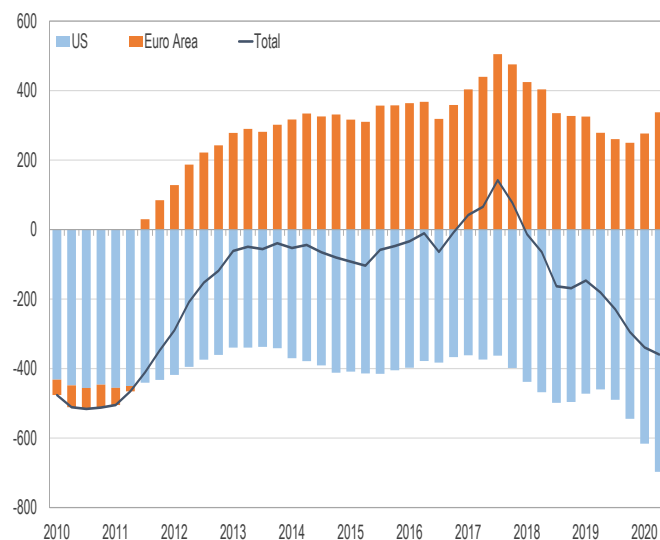
- Reassessment of the neutral rate<sup>2</sup>.**  
 Evidence that underlying growth is substantially above current expectations could lead to a reassessment of the neutral rate. During the 70s and 80s, when growth was substantially higher, neutral real rates were higher as well. There have been some promising, though tentative, signs of higher growth and productivity over 2021, potentially induced by business process changes induced by the pandemic. By the end of Q3, output will likely surpass pre-Covid levels, but with fewer employees. This outcome is somewhat similar to the higher inflation scenario in the bullet point above, in that both would require a higher path for the Fed Funds rate, but a better outcome as economic activity grows more quickly.
- Change in the composition of the Fed.**  
 Jerome Powell's term as Fed Chair expires soon, as do the terms of the two vice chairs. If none of the leadership were to be reappointed, a lot would depend on who President Biden chooses to appoint. If he appoints a Chair less committed to the flexible average inflation targeting framework, it could lead to a reassessment of the amount of support that the Fed is willing to provide to the economy.
- Sustained further fiscal expansion.**  
 Under current law, most projections (e.g., the Congressional Budget Office) show deficits declining rapidly over the next several years, though to still high levels. After the rapid passage of large fiscal support in early 2021, progress on further spending—the hard and soft infrastructure packages—has slowed significantly. However, the outlook could change if both packages passed and were substantially larger than markets currently expect.
- Faster tapering.** Based on how the FOMC executed the 2013 taper, market expectations appear to be for another slow and well-telegraphed reduction in the pace of purchases. Though there are variations, the broad consensus appears to be that going from purchases of US\$120 billion per month to \$0 will take about a year. The Fed announcing a faster pace could cause a similar reassessment as in 2013.

With that backdrop, one key question for EM investors is how vulnerable or resilient are EMs to a potential repeat of the 2013 taper tantrum? In 2013, EMs turned out to be fairly exposed. Thus, a good starting point is to take a close look at the global macro conditions in 2013 prior to the taper tantrum.

### EM vulnerabilities in 2013

EM countries had recovered relatively quickly from the 2008/2009 global financial crisis supported by strong growth in China, high commodity prices, and accommodative monetary policy in developed markets (DMs). This triggered virtuous cycles of strong investment, capital inflows, appreciating currencies, and improving fiscal accounts. Moreover, DM current account deficits allowed EMs to run current account surpluses. The DM current account dynamic had already started to change in 2012 with the European debt crisis as the contraction in demand triggered a sizable swing in the Eurozone's current account. The combined US and European current account moved by about US\$500 billion annually over just two years (figure 5).

Figure 5: Developed Markets Current Account (4Q Total)



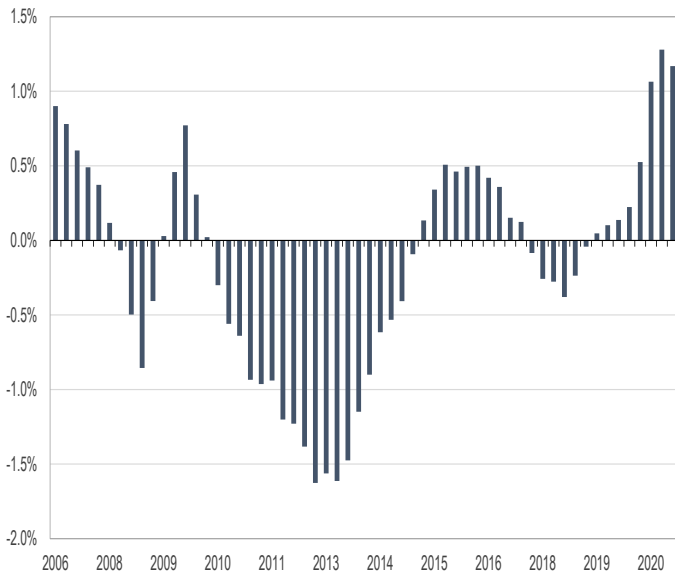
As of 31 March 2021  
 Sources: BEA, ECB/H, Haver Analytics

Obviously, this required an offsetting current account deterioration elsewhere in the world, in particular in EMs. Initially, the virtuous cycle of capital inflows and growth in EMs remained in place. Markets were willing to increase investments in EMs and thus fund their rising current account deficits (figure 6).

<sup>2</sup>The neutral rate is the short-term real interest rate consistent with the economy maintaining full employment and attaining the FOMC's inflation target.



**Figure 6: Current Account Balance (EM Ex China 4Q Moving Average)**



As of 31 March 2021  
Sources: Haver Analytics

Strong growth was a key factor supporting these inflows. While China's GDP growth had moderated from an annual pace of 10% in 2010-11 to 8% in 2012-13, this was still a very rapid pace, and other EMs also continued to grow at a fast rate, e.g., Turkey at almost 10% in Q2 2013.

Foreign investor positioning in EM local bond markets at that time highlighted investors' willingness to keep increasing exposure in EMs and provide the funds needed to finance the increasing current account deficits (figure 7).

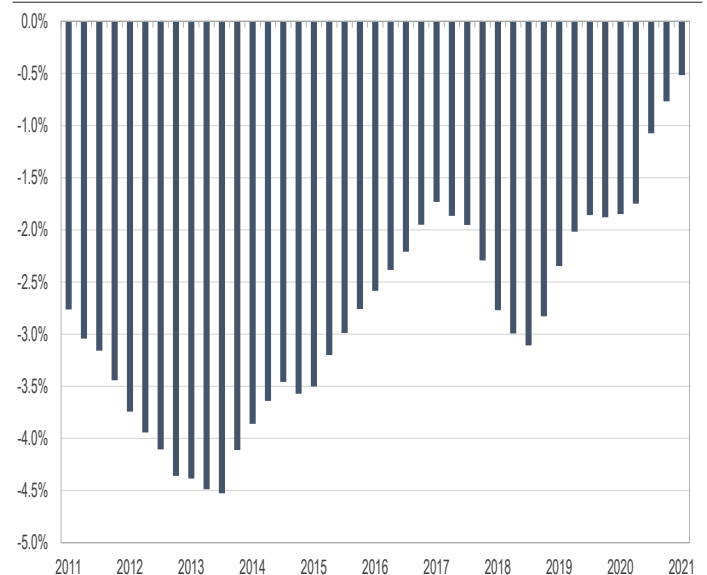
**Figure 7: Non-Resident Ownership Share of Local Government Bonds**



As of 30 April 2021  
Sources: Haver Analytics  
Weighted Average

However, once the Fed started to discuss tapering their bond purchases, markets became increasingly concerned that these inflows to EM could reverse. With investors hesitant to further increase exposure, the inflows stopped, thus forcing market repricing and current account adjustments. The market quickly focused on the so-called Fragile 5 countries, singled out for their large current account deficits and reliance on sustained capital inflows. Their average current account balance had risen to exceed 4% of GDP in 2013 (figure 8). The process of this forced adjustment involved FX depreciation, higher inflation, slowing growth, higher local rates, and higher credit spreads.

**Figure 8: "Fragile 5" Average Current Account Deficit (4Q Moving Average)**



As of 7 July 2021  
Sources: Haver Analytics  
Brazil, India, Indonesia, South Africa, Turkey, Current Account as % of GDP (SA, %)

### Very Different Conditions Now

The macro conditions across EMs have changed fundamentally since 2013. The average current account deficit of the Fragile 5 was less than 0.5% of GDP in Q4 2020. EMs ex-China are now running a current account surplus, thus not requiring any net capital inflows, on average. This adjustment was enabled by an opposite move in the US and EU current accounts: a roughly US\$500 billion deterioration in the annualized current balance over the past three years. Moreover, we believe the large DM current account deficit is likely to persist given the rapid recovery in demand fueled by significant monetary and fiscal stimulus.



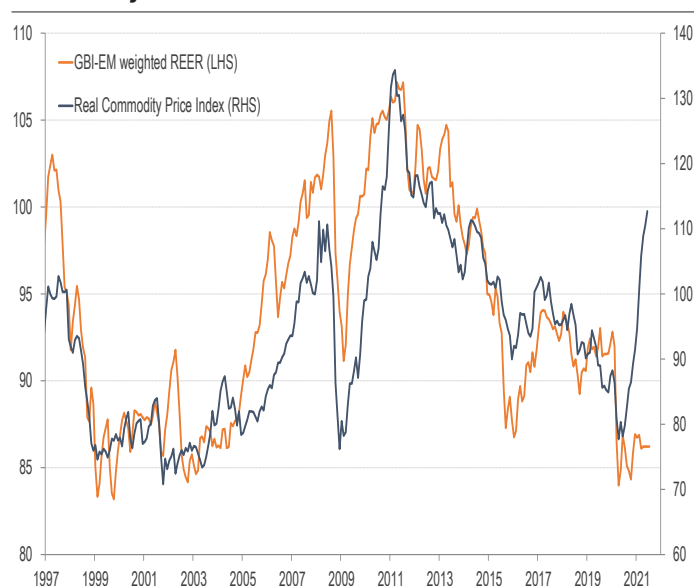
The current account position, however, is not the only material difference from 2013. Foreign investor positioning in local EM bond markets has declined from 29% in 2014 to only 18% on average currently. Positioning declined gradually as EM local debt performance disappointed over the years. Foreign investor positioning then took another hit in 2020 when investors de-risked portfolios after the onset of the Covid pandemic. Despite the economic recovery since then, foreign investors have not rebuilt their positions in EM local markets. Clearly, the smaller foreign investor exposure implies that the potential for disruptive portfolio capital outflows is also smaller now. Moreover, we believe that investors currently invested in local markets have a better understanding of the potential risks than in 2013 when the rapid buildup of positions was in part driven by attractive past returns and expectations of continued high GDP growth.

### Cheaper Currencies

The large swing in EM external positions since 2013 was accompanied and supported by substantial FX adjustments. By 2020, EM real effective exchange rates<sup>3</sup> on average had given up all the cumulative appreciation over the previous 15 years when the emergence of China and the commodity super cycle lifted EM currencies. The large multi-year retracement of currency valuations was further reinforced by the downward trend of commodity prices. Historically, EM currency valuations have been closely correlated with commodity prices due to the fact that many EMs are commodity exporters, while other EM countries have a strong correlation to the global growth cycle, which in turn correlates with commodity prices.

This correlation, however, appears to have broken down during the Covid pandemic. EM currency gains over the past year have been very small compared to the run-up in commodity prices. This leaves EM currencies not only close to the bottom of the valuation range over at least 25 years but also remarkably lagging the recent surge in commodity prices.

**Figure 9: EM Real Effective Exchange Rates vs. Real Commodity Prices**



As of 30 June 2021  
Sources: BIS, Bloomberg, Haver Analytics  
Base year is 2007=100

We believe this clearly tilts the distribution of risks compared to 2013. At that time, expensive currencies had to adjust once capital inflows dried up. And that adjustment process triggered negative feedback loops through balance sheet and inflation effects. *Now, cheaper valuations and lower reliance on inflows reduces the potential for further EM currency weakness.*

### EM Markets Anticipating Rate Hikes

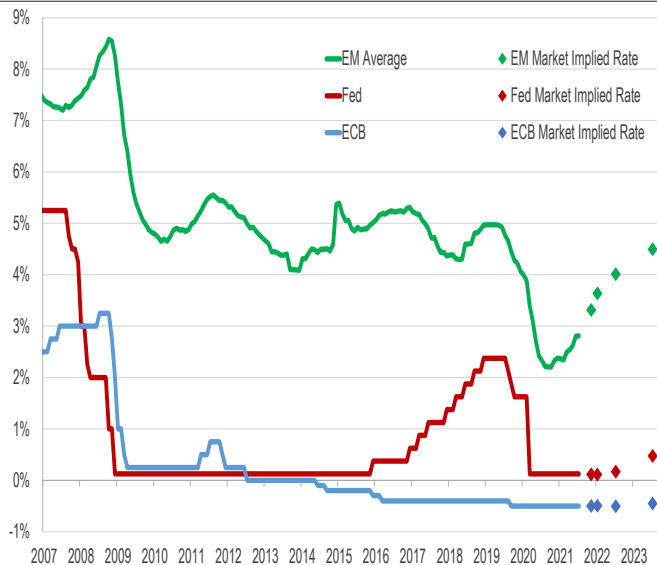
Another area where we see a meaningful contrast between current market conditions vs 2013 is the pricing of local rates. At the end of April 2013, the last month before the taper tantrum, EM local markets priced moderate rate cuts on average over the following 12 months. When global market conditions changed, key EM markets had to reprice and rates ultimately ended up higher in most EMs.

Now, several EM central banks have already started their rate hiking cycles and markets are anticipating meaningful additional monetary tightening. EM local markets are currently pricing about 100 bp hikes on average over the next 12 months and more beyond that (figure 10). In contrast, no Fed rate hikes are priced until late 2022 and markets price no European Central Bank (ECB) hikes over at least 24 months.

<sup>3</sup>The real effective exchange rate of a country is the trade-weighted index of inflation-adjusted bilateral exchange rates with the country's main trading partners. A low value indicates that the country's currency is cheap in real terms relative to its trading partners.



**Figure 10: Global Policy Rates**

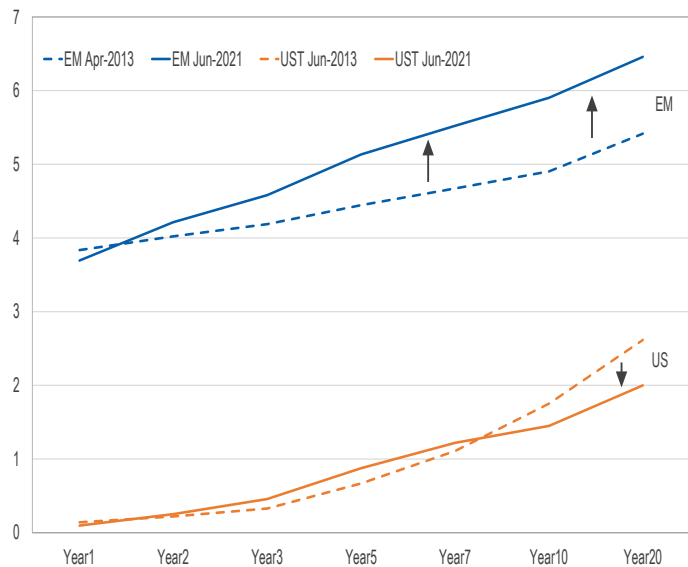


As of 30 June 2021  
 Sources: Haver Analytics, J.P. Morgan, Stone Harbor Investment Partners LP  
 Benchmark: J.P. Morgan GBI-EM Global Diversified  
 Information above contains forecasts based on implied forward rates. China, Dominican Republic, Indonesia, and Peru are excluded from forecasts

### Steeper Bond Curves

This pricing pattern extends beyond just the short end of local yield curves. EM bond curves are significantly steeper now than in 2013, including the long end. Meanwhile, the US Treasury curve is slightly flatter (figure 11).

**Figure 11: Average Yield Curves**



As of 30 June 2021  
 Sources: Stone Harbor Investment Partners LP

This should allow EM central banks to react to a potentially more hawkish Fed without requiring a large repricing of local rates curves. In 2013, local curves were on average flatter than US Treasuries. This included some of the higher-yielding and more heavily positioned markets such as Mexico, Indonesia, and South Africa, which usually include a significant term premium. These markets were forced into very rapid repricing during the taper tantrum which fed into the cycle of capital losses, risk reduction, capital outflows, and currency weakness. *We believe current local bond pricing is much more cognizant of the risk of a more hawkish Fed.*

### Conclusions

We believe the process of tapering and ultimately exiting the latest Fed QE program should be much smoother than during 2013. Both markets and the Fed have more experience in that respect and the first steps in announcing tapering have already been taken without much market disruption. However, US real rates remain exceptionally low and with a strong recovery underway, expansionary fiscal policy, and upside inflation surprises, we see a risk of a more disorderly adjustment in US rates.

The last time this happened, during the 2013 taper tantrum, EM markets did not perform well. The key reason, in our view, was EM's reliance on continuing capital inflows to fund large current account deficits. Once the flows were disrupted, markets and EM economies had to adjust.

In contrast to 2013, EMs are now much less reliant on capital inflows as current accounts have adjusted, foreign investors are less exposed to EMs, in particular EM FX risk, real exchange rate valuations are more attractive, and markets have more realistic expectations regarding EM growth and local rates. ***This leaves EMs in a much stronger position to weather potential volatility in US rates.***



## Endnotes

Indices referred to herein are broad-based securities market indices. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

### Benchmark Definitions:

The J.P. Morgan CEMBI Broad Diversified tracks total returns of US dollar-denominated debt instruments issued by corporate entities in emerging market countries and consists of an investable universe of corporate bonds. The minimum amount outstanding required is \$350 mm for the CEMBI Broad Diversified. The CEMBI Broad Diversified limits the weights of those index countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding.

The J.P. Morgan EMBI Global Diversified (EMBI Global Diversified) limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

The J.P. Morgan GBI-EM Global Diversified consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. The weightings among the countries are more evenly distributed within this index.

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