September 2013

Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

"U.S. Interest Rates and Emerging Market Bond Yield Spreads: A Changing Relationship?"

Cheikh A. Gueye and Amadou N.R. Sy, *The Journal of Fixed Income*, Spring 2013

The empirical evidence on the impact of global interest rates on emerging markets bond spreads is mixed. Two International Monetary Fund economists examine the 2000–09 period and find a negative relationship between U.S. interest rates and emerging markets bond spreads. However, this relationship is unstable, and can change depending on how other "push" and "pull" factors, such as investors' appetite for risk and emerging markets' economic fundamentals, interact.

Previous academic studies suggest that emerging markets bond spreads can be moved by both "push" and "pull" factors. Push factors describe conditions in the countries lending money (i.e., external financing conditions that can encourage or discourage investors to park capital in emerging markets). The variables can include the Fed funds rate, the slope of the U.S. yield curve, and the VIX. Pull factors measure macroeconomic conditions in individual debtor countries. Sovereign credit ratings can serve as good proxies for these macroeconomic variables, but oil prices are a useful added variable given the resource-intensive nature of many emerging economies. These push and pull factors had significant explanatory power over emerging markets spreads from 2000 to 2009.

What were the mechanisms behind these relationships during the last decade? The impact of pull factors was intuitive—higher sovereign ratings were associated with tighter spreads, as were higher oil prices, which swelled the coffers of key emerging markets. Among the push factors, lower investor aversion, as measured by the VIX, unsurprisingly led to tighter spreads. A steep U.S. yield curve was also associated with lower spreads. One theory about this relationship is that leveraged investors can borrow at low rates and lend attractively at longer ones when the curve is steep; another is simply that the association of a steep yield curve with higher U.S. economic growth is likewise related to higher emerging markets GDP growth.

A key difference over the 2000–09 period from prior studies was that a lower Fed funds rate was associated with higher, not lower, emerging markets spreads. Previous work had taken a low Fed funds rate as a good indicator of global liquidity, with a low rate prompting investors to "hunt for yield" in emerging markets bonds. Over the last decade, however, low rates came when the Fed was fighting recession, and risk aversion and spreads were high (i.e., 2002–03, 2008–09). High rates came when the Fed tried to push against growth in a seemingly more benign environment (2000, 2006–07).

Investors need to be mindful of how the dominance of push and pull factors might change in the next decade as compared to the previous one. The currently low Fed funds rate partly signifies good liquidity conditions, and has pushed money into emerging markets for much of the time since the crisis despite brief episodes of risk aversion. Apparently strong emerging markets balance sheets have contributed a pull. The nature of the future changes in these variables will influence the future path of emerging markets spreads. ■