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Markets

US jobs data provides boost for EM debt and currencies

The slowdown in US jobs growth highlighted by Friday's non-farm payroll data is a significant positive for emerging markets, their debt and their currencies.

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James Barrineau

Co-Head of Emerging Markets Debt Relative

We had recently expressed caution on two of three key investment themes for the emerging market (EM) debt asset class. Chinese yuan (CNY) stability had been threatened by a steady but quiet depreciation, and major central bank support wobbling with hawkish talk from the Federal Reserve (Fed), though oil prices and fundamentals continued to be steady.

All three will now be flashing green for investors absent new macroeconomic developments. It is notable that even before today, the weekly mutual fund flow numbers remained positive – an indicator for us that the global search for yield was raising the bar for investors to flee the asset class. Friday's developments should add fuel to those flows.

Summer rate hike less likely

Following the weak job numbers (a rise of just 38,000 versus expectations of 160,000), the market-implied probability for a June hike fell from 20% to 4%, and from 52% to 20% for July. The Fed would have a massive task ahead of it to get the market onside for even a July hike given that pricing; possible, but difficult.

The dollar – key for EM – fell in tandem as two-year yields took their largest tumble in nine months. In May, the dollar index had climbed 3.5% and returns on the local currency index fell 5.44% - a typically correlated result.

Unless the market shifts its current stance on the Fed markedly and that boosts the dollar, EM local currency now has a much better macroeconomic environment in the coming months. EM currencies jumped on Friday morning by about 2% on average in response to the US data.

The CNY follows from the dollar. Though the Chinese insist the currency is managed against a basket, its performance has become a mirror image of the dollar just like the broader EM universe. On Friday morning the CNY was at 6.58 prior to the jobs number and at the time of writing is at 6.55 – about a 50 basis point appreciation. So it is fair to conclude that the weaker dollar reduces China tail risk fears, which already seemed to be muted.

Better environment for EM debt

So, what could go wrong with what seems like a sunny scenario? Perhaps an overall risk-off sentiment, and indeed US equities fell as the economic growth perception shifted to a more negative outlook. However, the fall was not very sharp and the VIX volatility index is up a mere 0.24% as of the time of writing. So, for now, we are managing our EM exposures to reflect a much more robust environment for

EM debt, particularly for local currency.