

# Flash Comment

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Lars Rasmussen, Analyst, + 45 4512 8534, [laras@danskebank.dk](mailto:laras@danskebank.dk)

## Emerging Markets: Jitters after rising bond yields

Ten-year treasury yields climbed a whopping 17bp yesterday as the fixed income markets sold off across the board. This morning we have seen more softness in the US bond market, which now leaves 10-year yields at 5.24%, while two-year yields have risen to 5.04%.

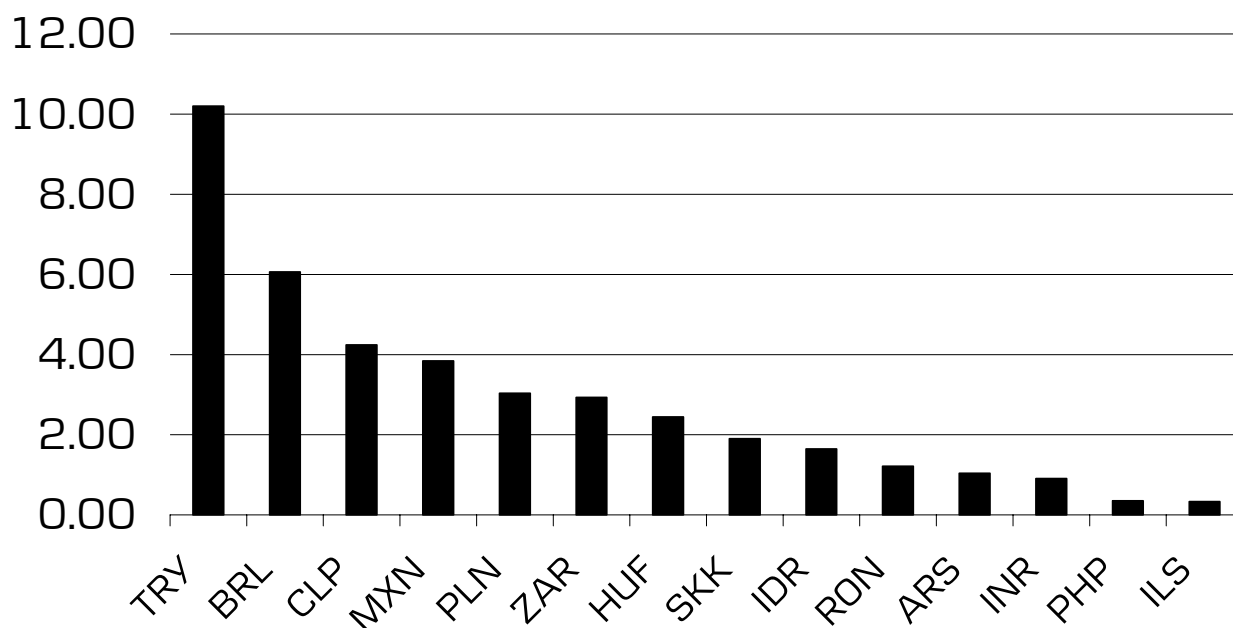
Rising US bond yields normally tend to weigh negatively on high-yield / high-beta Emerging Markets (EM) currencies such as BRL, MXN, IDR, PHP, ZAR, TRY, HUF etc. Remember that the broad-based sell-off in May-June last year was preceded by an 80bp rise in 10Y US bond yields between the end of January and the beginning of May. Looking at US yields since the beginning of March this year we note that 10Y yields have now moved up by almost 65bp. *Last year* yields and rates were mainly driven up by rising inflation fears and that led to a spike in risk aversion and consequently a major sell-off. *This year* things look a bit different, as bond yields mainly are driven up by a stronger-than-expected outlook for US (and global) growth without large (short-term) fears on inflation - see *Global Scenarios June 2007*, June 1, 2007. Strong global growth weighs positively on performance in EM currencies and this had until a few days ago counteracted the negative impulse from rising US yields as risk appetite has remained at high levels.

The global markets have aggressively priced in this Goldilocks-scenario in most EM currencies. Looking at performance over the last couple of months, we note that currencies such as the BRL, MXN, ISK, ILS, IDR, PHP, INR and TRY have performed remarkably well, while ZAR stands out as an exception. Most of these currencies are, according to our empirical models, the most sensitive to rising US bond yields - c.f. the chart below - and it is therefore only natural that they take a beating at the moment..

Over a longer-term perspective we expect that USD related currencies will outperform EUR related currencies, due to our longer term view of a stronger USD. Having said that, we would recommend investors in the short run to stay away from BRL, MXN, IDR, and PHP, which in spite of improving fundamentals are always vulnerable during periods of rising yields and volatility. In the Eurozone we think that especially HUF (and to some extent PLN and SKK) could suffer as well, whereas we think that the CZK will probably not move much weaker - see *Flash Comment - Czech Republic: The Czech economy keeps speeding ahead*, June 08, 2007. Regarding the South African rand (ZAR) which has already underperformed over the last months, we do not see any support for this currency and it could very well go above USD/ZAR 7.50 in the coming days.

The Turkish lira (TRY) has during the last few days outperformed its peer EM currencies as it has only faced limited weakening so far. As TRY is by far the most yield-sensitive EM currency and given the high degree of political uncertainty, we think that the TRY is facing more weakness in the coming days - also compared with BRL, MXN, IDR, ZAR etc. *See chart overleaf*

## Sensitivity towards 10Y US bond yields



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