More To Emerging Markets Than Free Money

Can emerging markets keep on emerging forever, or is there some point at which like famous groundhog Punxsutawney Phil they emerge, look around and re-submerge into the burrow of underperformance after having left one of the better run-on sentences combined with mixed metaphors yet seen on these pages in their wake?

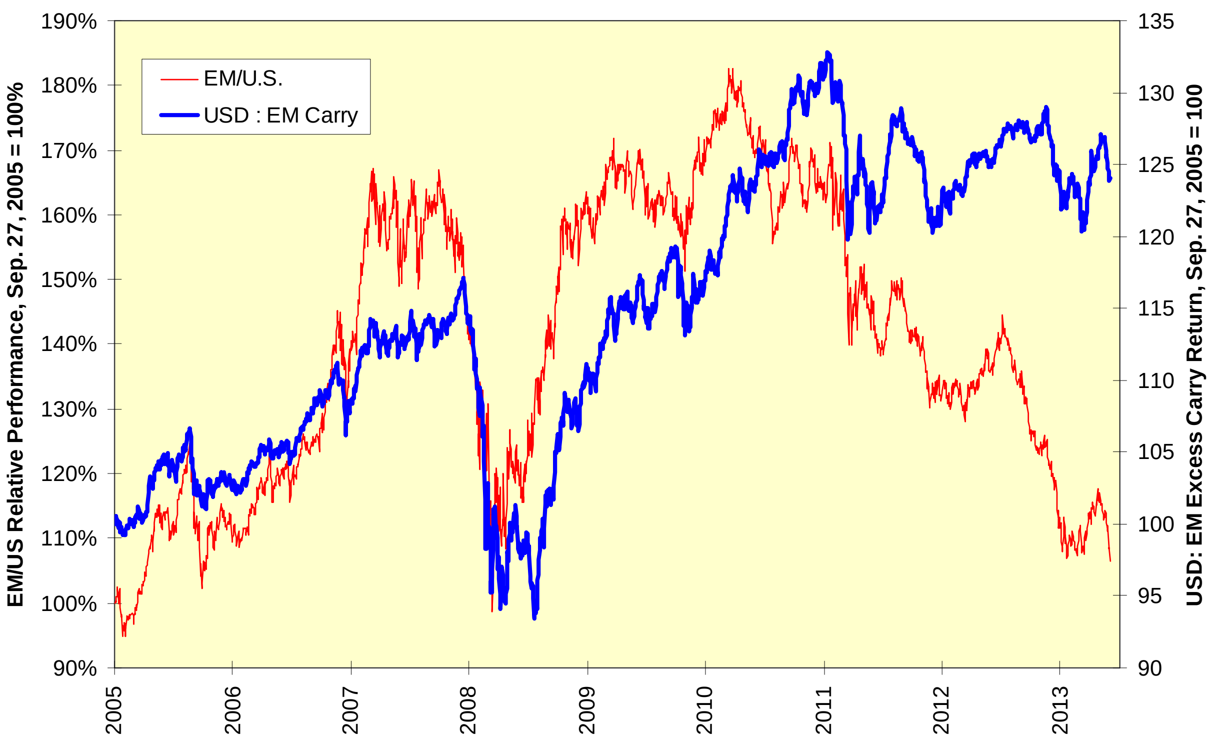
Non-Dependence

One of the worst parts of monetary excess is it allows the intellectually lazy to blame the Federal Reserve or some other central bank(s) for everything, including higher food and energy prices. This crowd has some 'splainin' to do when monetary policy becomes even more excessive and commodity subindices turn lower as discussed last week.

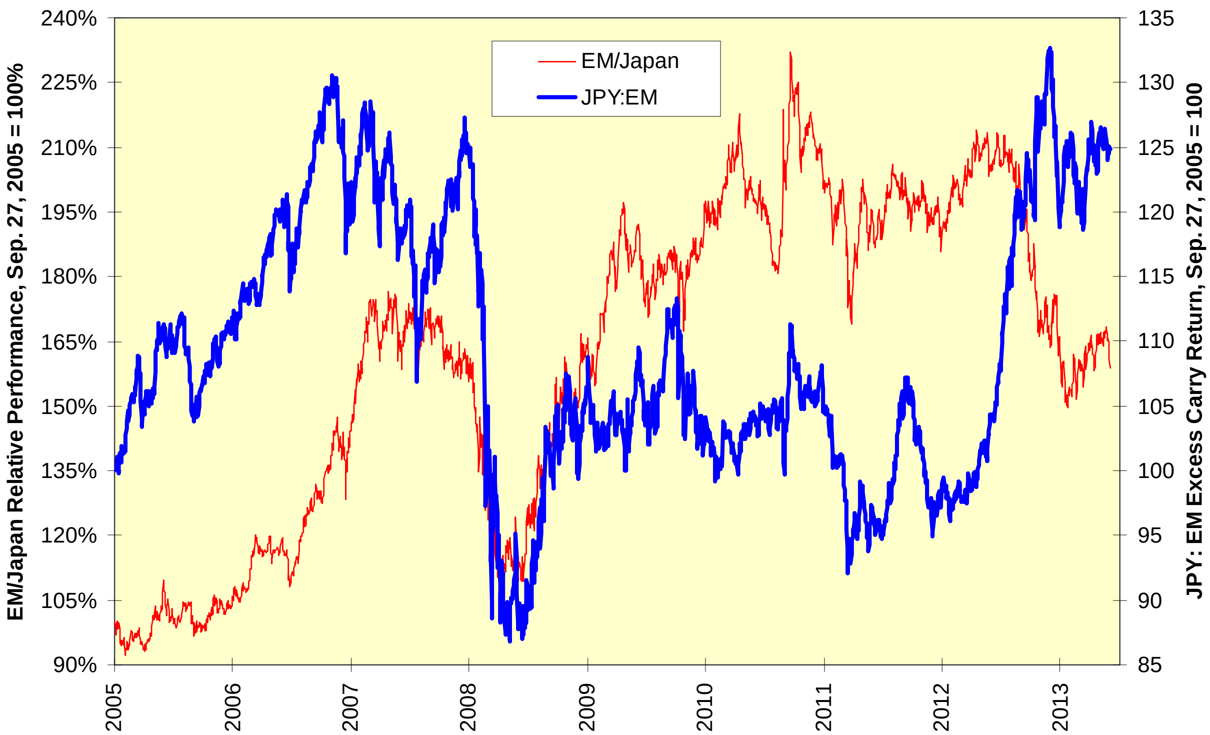
A similar notion permeates the notion of emerging markets, measured here by the MSCI-Barra Emerging Market Free index, the underlying asset for the iShares MSCI Emerging Markets ETF (EEM). This index has underperformed the U.S. market since October 2010 and Japan since April 2011 by 23.5% and 16.5%, respectively, in USD terms. As we economists say, that is a lot.

Were these underperformances a direct function of carry trade unwindings? Not in the least; the excess carry return between the USD and a basket of emerging market currencies weighted as the equity index has been flat since October 2010, while the excess carry return between the JPY and this basket has increased by 12.1% since April 2011. The comparative return maps are presented below.

Emerging Market Underperformance And The Dollar Carry Trade



Emerging Market Underperformance And The Yen Carry Trade



But Wait! There's More!

Just as Federal Reserve officials return to the counterfactual argument the world would be a far worse place had it not been for their actions since 2008, defenders of emerging market performance might chime in things would have been worse off had it not been for the dual yen and dollar carry trades.

Nonsense: Emerging markets managed to outperform the U.S. by 10.0% between September 2005 and November 2007, a period when the U.S. was completing a series of seventeen consecutive rate hikes. They outperformed Japan by 32.9% between September 2005 and the beginning of Japan's massive yen-weakening campaign in November 2012.

We thus have a situation where emerging markets outperformed both the U.S. and Japan before aggressive monetary ease and underperformed both the U.S. and Japan when carry trades were both open and in the Japanese case expanding. There is much more to emerging markets' relative performance than free money and carry trades. That lesson will apply domestically again at some point just as it did between August 2007 and December 2008 when the U.S. first went to a 0% interest rate policy.