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Global Rate Hikes Raise Contagion Risk Beyond Emerging Markets. Here's Where to Look.

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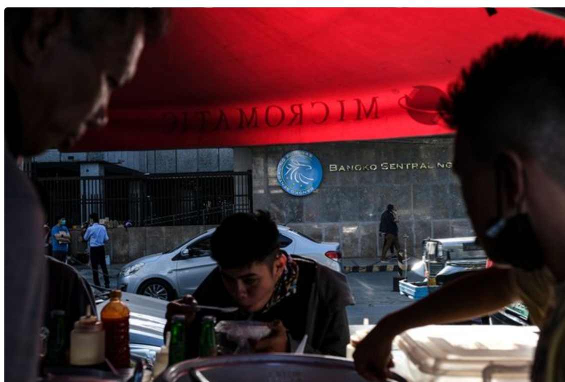

The Federal Reserve's rate hikes could create liquidity-related shocks to other markets. Here: a food stall complex in Manila, the Philippines,
Veejay Villafranca/Bloomberg

The parade of central banks—from the Bank of England to the Central Bank of the Philippines—that followed in the Federal Reserve's footsteps with interest rate hikes this week has strained pockets of the market investors typically monitor for contagion risk. But the stress is also showing up in some areas this time: developed markets.

One concern investors have had as the Fed has pushed rates higher and taken a more aggressive stance to dampen inflation is that some parts of the market could "break," potentially creating ripples to other markets or even a liquidity-related shock to financial markets.

Often these strains show up in the far corners of the market, like emerging and frontier markets or leveraged loans. And cracks are beginning to form there, but strategists are beginning to worry about stress in developed markets that have piled on debt in recent years as the British pound sinks to its lowest level in 37 years against the dollar."Many developed markets are now facing the combination of steep currency depreciations, rising government bond yields, and tightening

policy constraints that have long characterized periods of economic and financial stress in emerging market economies," cautions Eswar Prasad, an economist at Cornell University and senior fellow at Brookings Institution.

The typical place to find this combination is in frontier markets—and countries like Sri Lanka, Argentina and Egypt are showing financial stress as they contend with political instability, soaring food and fuel costs and waning confidence in their ability to pay back their debt.

The average sovereign spread of the 15 largest frontier economies has soared to a distressed level of 1000 basis points over U.S. Treasuries, notes Gavekal analyst Victor Tsui in a note to clients. A strong dollar makes it harder for indebted countries to finance their liabilities since their own currencies are worth less—and that in turn can hit confidence in their ability to repay their debt thereby adding even more pressure on their currency—what Tsui describes as a "self-reinforcing downward spiral." While these countries aren't heavily represented in equity investors' portfolios, Tsui notes they make up almost a fifth of the JP Morgan EMBI global diversified index, creating "a sizable risk of contagion" to the broader emerging market debt ecosystem if stresses rise further.

Other traditionally vulnerable parts of the market, like the leveraged loan market, are also beginning to show cracks, Wolfe Research's Chris Senyek wrote in a note to clients. "Several banks have written down the value of inventory on their books, and we believe that there is a growing reluctance to fund news deals among banks, collateralized loan obligations and private credit funds," he writes.

But what is even more worrying is that the strain is popping up in developed markets with the sharp declines in the euro, Japanese yen and the British pound, down to a 37-year low against the dollar. "The world is upside down," says Jens Nordvig, founder of Exante Data. "The biggest risks aren't in emerging markets in this cycle. High debt G-10 countries are in serious trouble. Wild times ahead." The starkest move may be in the collapse of the British pound, which hit a 37-year low as officials introduced the biggest tax cut in half a century to offset the sharp spike in energy prices hitting households. The move exacerbated concerns the country's debt is on an unsustainable path.Contagion concerns are typically limited to the world of frontier and emerging markets because they tend not to have less cushion to deal with a weakening currency than the likes of the U.K., Europe or Japan. But these developed markets could become more vulnerable as countries grapple with surging inflation. Additional monetary policy tightening that raises borrowing costs for governments is increasing in these markets as well.

"Many developed markets are now facing the combination of steep currency depreciations, rising government bond yields, and tightening policy constraints that have long characterized periods of economic and financial stress in emerging market economies," Prasad says, adding that even developed markets could be vulnerable to contagion.

Indeed, strategists are cautious. In a note to clients, Senyek writes that key measures of risk for potential contagion, like interbank lending spreads, dollar swaps, commercial paper markets and emerging market currencies, are showing weakness. His advice to clients: Don't try and catch a bear market bounce yet.

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