Emerging Market Debt Update

Aberdeen

Overview

Emerging market debt rebounded strongly in July, continuing the recovery from the May sell off, which had been triggered by the European fiscal situation. The JP Morgan EMBI Global Diversified index (EMBIGD) rose 4.1% while the spread tightened 45 basis points to +310 basis points over US Treasuries. While in June emerging debt had outperformed markedly, in July we had a broad risk asset rally with the S&P 500 index up over 7%, and Spanish 5yr CDS dropping from 260 basis points to 187 basis points. Local currency debt outperformed hard currency debt with the JPM GBI-EM local currency index returning 5.5%, as the pick up in the euro and increased risk appetite pushed the US dollar index sharply lower.

Argentina was the best performer in the EMBIGD during July, rising 13.4% as the successful debt exchange led more investors to focus on this relatively high yielding credit. Argentine growth remains strong, and with over 90% of the total defaulted debt restructured, credit rating agencies are likely to start upgrading Argentina. With risk markets and energy markets performing well in July, Venezuela was the second best performer, even though fundamental news flow remained poor. Smaller, less liquid credits such as El Salvador, Lebanon and Georgia underperformed the index as investors typically target larger, more liquid credits at this stage of a rally. In local currency debt, Poland, South Africa and Hungary outperformed as the euro rebounded from 1.20 to 1.30, while Malaysia and Thailand underperformed as a result of their defensive characteristics.

Though a number of economic indicators have turned lower, the picture has been surprised somewhat by the resilience of others. Markets are also beginning to price in the end of the tightening cycle in China, shown by the near 10% move in China's domestic stock market. Furthermore growth data in most emerging markets remains impressive, with Indian growth actually picking up further. In light of the economic uncertainty though, the Brazilian central bank reduced the size of their rate hikes to 50 basis points from 75 basis points, which quickly led markets to price out some of the future rate rises. With GDP still expected to grow over 7% in 2010, growth is still arguably above trend, but with a strong currency and a potentially weaker global economy inflationary risks are less of a concern. Growth also beat expectations in Argentina and Colombia over the month, and Mexico's forward looking IGAE indicator rose to a record high of 8.9% year-on-year. Asia on the other hand is likely to lose momentum in coming months, as the Chinese PMI remains somewhat subdued and the authorities are unlikely to allow loan growth to pick up without a sharper downturn in the economy. Importantly, the slowdown in loan approvals and growth has been carefully orchestrated by the Chinese administration and therefore is largely welcome for a previously overheating economy than a major risk at present.

After completing its restructuring, Argentina was upgraded by Fitch to B from B-. This rating action reflected a "positive step towards normalising relations with creditors" according to Fitch. Relatively manageable public sector financing needs improved the near term economic prospects and the proven ability to cope with the shocks of 2008 and 2009 were further factors in the upgrade.

Though investors now seem to be looking past the fiscal crisis in peripheral Europe, as evidenced by the sharp fall in their bond yields, EMEA credits generally performed poorly. Hungarian markets were riled once again, this time by the government not reaching an agreement with the IMF/EU delegation regarding the proposed fiscal package, particularly for 2011. Though the market reacted poorly initially, a strong appetite for risk caused the bond market to fully recover by the end of the month.

Outlook

The market has now recovered strongly from the Eurozone sovereign crisis of May, and though lingering concerns remain about the effect of fiscal austerity and the Chinese tightening cycle, strong fundamentals in the emerging markets and generally weak prospects for the developed world continue to lead investors into emerging market debt and equity markets. With commodity markets now also performing more strongly, many of the risks that investors had previously been concerned about have dissipated somewhat. The outlook though is still somewhat cloudy, with growth likely to slow in a number of developed countries later in the year, potentially causing some bouts of weakness and volatility. In general we expect both local and external markets to be well supported as G3 bond yields look likely to remain relatively low and global financial conditions relatively loose.

- Emerging market debt rebounded strongly in July, continuing the recovery from the May sell off
- Local currency debt outperformed hard currency debt as the pick up in the euro and increased risk appetite pushed the US dollar index sharply lower
- The JP Morgan EMBI Global Diversified index rose 4.1% and the GBI-EM Global Diversified index rose by 5.5%

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Performance of Emerging Market Debt (to 31 July 2010)

Spread over US Treasuries (basis points), USD

	31/07/10	30/04/10	31/12/09	31/07/09	31/07/07	31/07/05
JPM EMBIGD (hard currency)	310	268	288	402	236	280
JPM CEMBI (corporate)	371	310	345	528	216	195

Note: A comparable spread is not available for the local currency index (GBI-EM GD)

Total Return %, USD

	1mth	3mth	YTD	1 year	3 years	5 years
JPM EMBIGD (hard currency)	4.06	4.49	9.85	19.44	33.44	53.95
JPM GBI-EM GD (hard currency)	5.52	1.83	9.07	16.49	35.71	77.71
JPM CEMBI (corporate)	3.23	3.27	9.23	19.20	33.86	–

Source: JP Morgan, Bloomberg.
Past performance is not a guide to future performance.

Important information

For further information

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