Emerging Market Debt Update

Aberdeen

Summary

- Emerging market debt posted further gains in April
- The JP Morgan EMBI Global Diversified index gained 0.83% and the GBI-EM Global Diversified index posted a gain of 1.57%
- Indonesia and Brazil were top performers while Poland and Hungary underperformed

Overview

Emerging market debt posted further gains in April, but was clearly on the back foot late in the month amid renewed concerns about debt sustainability in Greece, and the risk of contagion on Portugal and Spain government bond yields. On the month, the JP Morgan EMBI Global Diversified index gained 0.83% while the benchmark spread widened 12 basis points to +268 basis points over US Treasures. Ukraine, Argentina and Venezuela were among the top performers, while Emerging Europe sovereigns broadly underperformed. Local currency debt outperformed hard currency debt, with the GBI-EM Global Diversified index posting a gain of 1.57%. Indonesia and Brazil were the top performers, while Poland and Hungary underperformed.

Prior to the onset of Greece-related risk, the news flow in April was generally positive for emerging market debt. Global PMIs continued to improve, with Europe close to record highs, while Asian macro data provided further support for the cyclical recovery story. Late in the month the headlines were once again dominated by Greece, which was downgraded three notches by S&P to BB+. By month-end, the market took some solace from reports of a large EU/IMF bailout package as high as €120 billion, but clearly the genie is out of the bottle, with speculation mounting that Greece will ultimately have to restructure their debt given forecasts that it may climb to around 150% of GDP over the next few years from around 115% at present. At this point, the larger concern is to what extent the contagion spreads to Portugal and Spain, which is likely to weigh on EUR/USD over the short-term.

As expected, Brazil's Central Bank commenced its rate tightening cycle in late April, opting for a more aggressive 75 basis point hike of the Selic overnight rate to 9.5% after a split vote during the March meeting. The Copom statement cited the need to adjust monetary conditions in order to ensure the convergence of inflation to the target path, but stopped short of offering any hints on future plans. In our view the more aggressive rate hike was warranted, as inflation would continue to diverge from the IPCA target of 4.5% in 2010 and 2011 in the absence of firm action by the Copom. Brazilian long-dated rates declined following the rate hike, reinforcing our view that a more hawkish stance was necessary to stem rising inflation expectations. On that note, the latest Brazil Central Bank survey showed the consensus forecast for IPCA consumer price index rising to 5.41% from 5.32% in the previous week, while the median forecast for 2011 remained at 4.8%. The consensus forecast for the Selic overnight rate climbed again to 11.75% from 11.5% for 2010, and remained at 11.25% in 2011. The year-end exchange rate forecast remained at BRL/1.80 for 2010 and BRL/1.85 for 2011. The growth forecast for 2010 rose to 6% from 5.8% in 2010, and remained at 4.5% in 2011.

Mexico's quarter one inflation report kept its inflation outlook intact, expecting CPI to be as high as 5.25% by year-end, and converging towards 3% at the end of 2011. The 2010 GDP forecast was revised up to between 4-5% from 3%, and to 3.2-4.2% in 2011. Banxico's Governor Carstens noted that the output gap was still negative, so inflationary pressures from demand are still very tame, but acknowledged the gap is closing at faster than initially expected. He said inflation has largely been caused by supply shocks that occurred at the start of the year, namely tax increases and adjustments to public prices, but that Banxico would have to remain vigilant of any evidence of overheating.

Argentina received approval from regulatory authorities in Europe to proceed with their planned debt exchange, paving the way for the formal launch at the start of May. The final results of the swap operation will be announced June 15. In addition, Argentina received some good news on the legal front, with New York district Judge Griesa declining to rule in favor of action aimed at stopping the Argentina debt exchange, prompting a rally on Argentine bonds. Economy Minister Boudou said the next step after the defaulted debt exchange is to cure arrears with the Paris Club, which will enhance Argentina's prospects to attract foreign investment.

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Russia came to market with its first Eurobond issue since 1998, which in our view was priced at expensive levels and promptly underperformed. The US$2 billion 5yr issue was priced at a spread of 125 basis point over US Treasuries and a yield of 3.62%, while the US$3.5 billion 10yr came in at 135 basis points over US Treasuries and a yield of 5.1%. On a positive note, Finance Minister Kudrin said Russia may be able to meet all borrowing needs for the remainder of the year in local markets, which should be supportive for market technicals. At the start of the year, Russia signaled they would be coming to the market with up to US$18 billion of external debt issuance in 2010, but with oil prices running comfortably above the budgeted price, it looks like they are done for the year. The Finance Ministry has now revised the amount of foreign borrowing in 2011 and 2012 to US$ 7 billion per-annum from a previous estimate of US$20 billion per-annum.

Ukraine and Russia agreed on a larger than expected reduction in gas prices, and a lengthy extension of the lease agreement on the naval base in Crimea. Gazprom will offer Ukraine a 30% discount off the earlier agreed formula-based price for gas. President Yanukovich estimated the impact of the gas price reduction at US$4 billiom annually, or 3% of GDP. The relief on gas prices will support Ukraine's efforts to reduce the fiscal deficit to 6% this year, which is in line with IMF requirements. Earlier in the month, the Constitutional Court officially affirmed the legitimacy of the new coalition government, eliminating the risk of early parliamentary elections and allowing the government to turn its focus to the budget and IMF discussions. DPM Tyhpko hinted that Ukraine may get a new IMF deal for up to US$12.5 billion over a 2.5yr period, which would likely include some US$6 billion remaining under the current US$16.5 billion program.

Turkey's April inflation report indicated a sharp revision of the headline forecast at end 2010, to 8.4% from 6.9%. The 2011 and 2012 figures were broadly kept intact, with modest increases to 5.4% and 5% respectively. These forecasts are based on CBT's base case outlook, which indicates rates will be increased gradually starting in quarter four and be maintained at single-digit level during the forecast horizon extending to the end of 2012. The CBT increased its food and oil price assumptions to 9% and $85 pb, from 7% and 80. While the CBT language has become more hawkish as of late, we remained concerned about the inflation outlook and the risk of a policy error.

China's March PMI rebounded to 55.1, up 3.1 percentage points from February, driven by increased momentum in both export and domestic-oriented demand. The data also suggests that consumption in the third and fourth tier cities or towns is very robust, reflecting an escalation in confidence and sales in the newly urbanized areas, continued strong exports to the US and Europe, and a robust property sector, supported by rising prices, volumes, and construction activities. The macro data further underlined a goldilocks environment, with growth rising 11.9% year-on-year in Q1, and by around 11.3% quarter-on-quarter while headline inflation fell to 2.4% year-on-year in March from 2.7% in February. Meanwhile, the State Council meeting concluded a growing recognition of upside risks to the economy, namely property inflation. The State Council decided to raise the minimum down payment ration for second homes to 50% from the previous 40%, and for those buying third or more homes the down payment ratios and mortgage rates will increase sharply. Such aggressive steps should help take the steam out of the property market, resulting in a fall in high-end property prices in the major cities.

Outlook

While we remain constructive on emerging market debt over the medium to long term, the short-term focus has shifted from fundamentals to concerns about Greece and other Eurozone peripherals. The fear factor, however, has significantly declined after the shock and awe package announced by EU finance officials, which along with quantitative easing, has provided a respite for Eurozone risk premiums and other risk assets. The e750bn Eurozone financial stabilisation package, which does not include the e110bn EU/IMF package for Greece, should prompt renewed gains to emerging market debt.

Performance of Emerging Market Debt (to 30 April 2010)

	30/04/10	31/01/10	31/12/09	30/04/09	30/04/07	30/04/05
JPM EMBIGD (USD), spread over US Treasuries (bp)	268	317	288	562	178	406

	1mth	3mth	Calendar YTD	1 year	3 years	5 years
JPM EMBIGD (USD) Total Return (%)	0.83	4.74	5.13	24.52	23.47	54.05

Source: JP Morgan, Bloomberg, end April 2010.
Past performance is not a guide to future performance.

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For more information

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Important information