



Aberdeen

Emerging Market Debt Update

Overview

Emerging market debt rebounded in June following a sell-off in May, with the JP Morgan EMBI Global Diversified index rising 1.9% while the spread widened 17 basis points to +355 over US Treasuries. This highlights a noticeable outperformance of emerging market debt, as the S&P 500 index fell over 5% and Greek bond yields rose by 250 basis points in June. Hard currency debt outperformed local currency debt, benefiting from a sharp drop in US government bond yields, while the latter gained 0.9% on the back of firmer currencies.

The Dominican Republic was the best performer in the EMBIGD index during June, rising 4.5% as the market focused on the recent new issue and the relative cheapness of this arguably under-rated credit. Debt from Kazakhstan also performed well, recovering from the sharp sell-off due to contagion from Greece in previous months, which was deemed inappropriate. Other EMEA countries such as Croatia, Poland and Hungary continued to perform poorly as peripheral European credits such as Spain and Portugal also weakened. In local currency debt, Colombia, Indonesia and Mexico outperformed, while Poland and Hungary sold off, reflecting lingering concerns about the Eurozone.

Argentina completed its debt exchange after delaying the closing to gain higher participation from the smaller, retail investor. This succeeded, with the overall participation reaching 70.4%, higher than the government's goal of at least 60%. Though initially this is unlikely to cause a near term rating upgrade, it has improved sentiment towards the country and should they gain market access, S&P have stated an upgrade is more likely.

The announcement by the People's Bank of China (PBOC) to proceed further with the reform of the Renminbi and to enhance exchange rate flexibility was welcomed by markets. The Yuan appreciated by almost 0.7% over the month, the first significant move since June 2008. Other Asian currencies also strengthened though global growth concerns tempered much of their gains.

Though a number of economic indicators are beginning to turn lower, the macro news in emerging markets was generally positive in June. The Brazilian central bank recently increased their 2010 growth forecast to 7.3% from 5.8%, supported by the robust growth of 9% year-on-year in the first quarter against expectations of 8.5%. Brazil unemployment continued to decline to decade lows while inflation trended higher, prompting the central bank to increase interest rates by another 75 basis points to 10.25%. It is worth noting that Brazil inflation expectations have, however, been falling somewhat in recent weeks as the fiscal crisis takes the steam out of global commodity prices. Growth also beat expectations in Argentina and Colombia over the month, and Mexico's forward looking IGAE indicator rose to a new cycle high of 7.2% year-on-year. Asia on the other hand is likely to lose momentum in the coming months, led by China. Loan growth is broadly slowing, which combined with the recent fall in the Purchasing Managers Index (PMI) probably means that slower growth will occur through the rest of the year in China. Importantly though, this was a planned slowdown by the Chinese administration and is likely to be managed carefully over the rest of the year should growth slow too much.

Concerns over the fiscal situation in peripheral Europe continued to be at the centre of the markets attention. Greek bond yields in particular suffered as Moody's downgraded their credit rating, forcing them out of the WGBI index and thus causing mass selling from index funds into month end. Hungarian credit spreads reacted badly to comments from the newly elected Fidesz party, comparing their debt situation to that of Greece which was then exacerbated by comments that they would increase their fiscal deficit target from 3.8% to 7-7.5%. Though meetings soon after with the EU resulted in somewhat more tempered comments by Hungarian officials, credibility has been damaged and needs to be rebuilt rapidly given current market conditions.

Outlook

The market has had a plethora of bad news this year; sovereign fiscal concerns, heightened financial regulation, and weakening Chinese growth indicators have all contributed to the increased risk premiums across all markets. The market is largely already reflecting these negative points, with little regard for potential upside surprises. Looking ahead, we see emerging markets as relative outperformers, as they have limited public/private debt overhang, and still have the ability to cut interest rates further should it be required. In this respect local market debt is likely to be well supported through the rest of the year, while external debt is likely to continue to attract investors as a result of extremely low G3 bond yields.

- Emerging market debt rebounded in June following a sell-off in May
- Hard currency debt outperformed local currency debt, benefiting from a sharp drop in US government bond yields
- The JP Morgan EMBI Global Diversified index rose 1.9% and the GBI-EM Global Diversified index also rose by 0.9%

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Performance of Emerging Market Debt (to 30 June 2010)

	30/06/10	31/03/10	31/12/09	30/06/09	30/06/07	30/06/05
JPM EMBIGD (USD), spread over US Treasuries (bp)	355	256	288	437	190	304

	1mth	3mth	YTD	1 year	3 years	5 years
JPM EMBIGD (USD) Total Return (%)	1.94	1.24	5.56	18.44	26.87	47.83

Source: JP Morgan, Bloomberg, end Jun 10

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