Emerging Market Debt Update

Aberdeen

Summary

- **Emerging market debt ended the first quarter of 2010 on a positive note, posting strong gains in March.**
- **Local currency debt outperformed hard currency debt, reflecting stronger emerging market currencies.**
- **The JP Morgan EMBI Global Diversified index gained 2.48%, and the GBI-EM Global Diversified index gained 4%.**

Overview

Emerging market debt ended the first quarter of 2010 on a positive note, with both hard and local currency debt posting strong gains in March. The JP Morgan EMBI Global Diversified index gained 2.48%, while the benchmark spread narrowed 51 basis points to +256 basis points over US Treasuries. Argentina was the top performer in the index, rising 14.5% on the back of supportive developments with regards the reopening of the 2005 debt exchange. Local currency debt outperformed hard currency debt, reflecting stronger emerging market currencies. The GBI-EM Global Diversified index gained 4%, with Indonesia and South Africa up over 6%, while Mexico, Malaysia and Russia were each up over 4%.

Argentina announced that it has US regulatory approval to swap the untendered bonds they expect to launch in early April. Economy Minister Boudou said they expect more than 60% of outstanding defaulted bonds, which have a notional value of about US$20 billion, will be tendered. The restructuring offer is expected to be similar to one offered in 2005, but terms have not yet been disclosed. Argentina officials remain hopeful they will be able to attract new money into the new 7-year US$ bond that will be included in the debt exchange, which would be a positive sign for the financing outlook.

Brazil's quarterly Inflation Report had a hawkish tone, highlighting the strong economic recovery, strong inflation and deteriorating inflation expectations. The central bank increased its inflation forecast for 2010 to 5.2% from 4.6%, and to 4.9% from 4.6% in 2011. With inflation moving above the 4.5% target, the central bank is expected to commence with its interest rate tightening cycle in April with a 0.5% move, after surprising the market in March by maintaining the 8.75% Selic rate. The foreign exchange market saw strong inflows at the end of March, with net inflow of US$3.9 billion, following five weeks of deficits - bringing the monthly inflow to US$1.5 billion.

Turkey provided the market with a reminder of one of the key risks to the asset class in 2010, with February inflation coming in more than double market expectations. CPI rose 1.45% month-on-month and 10.1% year-on-year due to sharp rises in food and tobacco prices. Core prices remained broadly under control, but the central bank will come under pressure in the coming months given market concerns about falling behind the curve. With real rates now negative, we see little value in Turkish rates.

While most central banks are expected to increase policy rates in 2010, South Africa went against the grain with an unexpected 0.5% cut to 6.50%, highlighting the stronger rand, favourable food prices, and an improved inflation outlook. Recent inflation expectations show a significant improvement for 2010 from 7.5% to 6.5%, and for 2011 from 7.7% to 6.7%. The South African Reserve Bank's downward adjustment for electricity price hikes to 20% in their inflation model (from 25% previously) has also helped lower their forecasts. February CPI inflation declined to 5.7% year-on-year from 6.2% in January, while core inflation fell to 5.3% from 5.8%, within the 3-6% inflation band.

The political landscape continued to change in Ukraine, with PM Tymoshenko ousted in a no-confidence vote, and replaced by an ally of President Yanukovich. Meanwhile, discussion with the IMF on renewed financial support resumed, with the fiscal deficit and the 2010 budget the key areas of contention. Ukrainian Eurobonds have posted strong gains on the year, reflecting an improved political outlook. The political backdrop also prompted S&P to upgrade the sovereign rating to B- from CCC+, with a positive outlook.

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China CPI rose 2.7% year-on-year in February, up from 1.5% in January, reflecting stronger than expected food price inflation. Industrial production also surprised on the upside, growing 20.7% year-on-year in Jan-Feb, up from 18% in the fourth quarter of 2009. Retail sales growth continued to accelerate, to 17.9% in Jan-Feb. The data points are likely to provide support for more policy tightening, with more reserve requirement increases occurring first before policy rate hikes. The market is expecting 81 basis points of rate hikes in 2010, but the risks are on the upside due to severe drought conditions that will result in rising food prices in the coming months.

Outlook

The positive tone in emerging market debt is likely to continue heading into the second quarter of 2010, although we would caution that a backup in US Treasuries, and rising inflation in developing countries may at times prompt some profit-taking.

Performance of Emerging Market Debt (to 31 March 2010)

	31/03/10	31/12/09	31/03/09	31/03/07	31/03/05
JPM EMBIGD (USD), spread over US Treasuries (basis points)	256	288	680	180	391

	1mth	3mth	1 year	3 years	5 years
JPM EMBIGD (USD) Total Return (%)	2.48	4.27	30.35	23.40	54.77

Source: JP Morgan, Bloombery, as of end March 2010.
Past performance is not a guide to future performance.

For more information

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