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WEEKLY INVESTOR RESEARCH

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Emerging Markets central banks begin to stir

Central banks in Emerging Markets (EM) began to stir over the past week. Brazil and Indonesia both launched currency swap facilities and raised rates, while India put in place facilities aimed at easing US Dollar access for state oil importers. However, in our view, Emerging Markets are far from firing their bazookas, partly because they see no need and partly perhaps, because they are biding their time for maximum effectiveness. Last week also saw Argentina's long-running battle with a small group of holdout investors from 2001 suddenly take a meaningful step forward due to legal developments in New York and the government's response in Buenos Aires. We review the main developments and put them into context.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	936		0.44%
MSCI FM	543		-2.84%
GBI-GD	6.92%		-1.20%
ELMI+	4.74%		-0.65%
EMBI GD	6.16%	337 bps	-0.43%
EMBI GD IG	5.21%	243 bps	-0.15%
EMBI GD HY	9.56%	694 bps	-1.02%
CEMBI BD	5.94%	355 bps	-0.10%
CEMBI BD HG	5.08%	267 bps	-0.05%
CEMBI BD HY	7.90%	555 bps	-0.31%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,633	-1.40%
VIX Index	17.01	13.48%
5 year UST	1.64%	5 bps
10 year UST	2.79%	0 bps
10 year Bund	1.92%	3 bps
EURUSD	1.3217	-1.14%
USDJPY	99.33	0.64%
Brent	$114	1.87%
Copper	$330	-2.76%
Gold	$1393	-0.07%

Emerging Markets

The other notable development in Emerging Markets in the past week was that central banks in the small handful of countries afflicted with macro-economic imbalances stepped up intervention. The increase in intervention followed further weakness in several currencies in the past week, especially in India. Brazil launched a USD 60bn swap facility and raised the Selic policy interest rate by 50bps to 9%. India produced a swap window for government oil importers. Indonesia also raised interest rates, launched a USD 12bn bilateral swap arrangement with the Bank of Japan, and shortened the withholding period for BI certificates (thus encouraging more inflows from abroad). It is also widely expected that Brazil, China, India, Russia, and South Africa will reach agreement to create a pooled USD 100bn currency reserve fund by the time of the G20 summit next month.

These developments mark an escalation in what has so far been a very modest official sector response to the current wave of EM pessimism. Intervention levels have so far been remarkably limited, because, in our view, Emerging Markets central banks: (a) have so far been comfortable with a measure of currency weakness, (b) are now reaching the stage where they want to re-establish greater stability, and, perhaps, (c) estimate that markets are reaching a technical position, where large scale intervention could be extremely potent. Clearly, considerations regarding timing also have to take into account wider considerations, such as the fact markets are still caught up in the summer doldrums, and that a key meeting of the Fed's Open Markets Committee is coming up on 18 September to decide the future of Quantitative Easing. We see no real danger of genuine crisis, because Emerging Markets have formidable capacity to control their currencies. The measures taken in the past week are merely a taster of the overall potential intervention powers. Cyclical weaknesses in a small number of larger Emerging Markets does not justify blanket selling across the entire universe of credits, particularly since the main reason for market weakness is technical, not fundamental.

Things have suddenly begun to move quickly in the long drawn out death match between Argentina's government and the remaining 10% of holdout investors from the 2001 default. For those who have not followed every blow in this sordid saga here is a brief background:

- Argentina defaulted on some $120bn of debt in 2001.
- In 2005 and 2010 it re-opened the original exchange offer to holdout investors, but each time a small group of hard-core holdouts refused the 70% haircut on offer. Instead, they opted to pursue their full claim in Judge Griesa's Second District Court of New York.
- Then, last year, in a landmark ruling, Griesa supported not only the claim of the holdouts as legitimate but also required financial intermediaries – such as payment agents – to enforce his ruling, meaning that payment agents have to divert payments from the Argentinean government intended for holders of performing bonds to holdouts.

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Emerging Markets

This means, of course, that even if Argentina services its performing bonds in the normal fashion it can still end up defaulting on performing bonds if all or even part of the payment is diverted to the holdouts. Argentina immediately appealed Griesa's ruling.

Fast forward to this week. The Court of Appeals rejected Argentina's appeal. Argentina immediately appealed to the Supreme Court of the United States and pending a possible decision by the Supreme Court – Griesa's ruling is, for now, stayed which means that it is not yet in effect. However in a new twist President Cristina Kirchner of Argentina has now presented bills to Argentina's houses of parliament to permanently offer remaining holdouts to swap their defaulted bonds into new bonds (on the same terms as previous re-openings), and, crucially, to offer holders of performing New York Law Dollar bonds to swap their holdings into identical bonds under Argentinean Law (i.e. outside Griesa's jurisdiction). This latter caused jitters in the market, because holdout investors may now have grounds to file a motion to lift the stay on Griesa's ruling. Their argument will be that Argentina is changing the terms of the bond contracts in the middle of proceedings. Why then, given the risk that the stay is lifted, has President Kirchner proceeded with this new legislation?

First, the re-opening of the exchange meets a major demand from the US courts. Second, the offer to swap bonds to local law demonstrates continued willingness to pay. As far as Argentina is concerned, the risk of non-payment is entirely due to the actions of a faraway court rather than their own ability or willingness to pay, which they claim to be very good. So far the market agrees with the Argentines: In one of the more ironic pricing developments in the history of Emerging Markets fixed income, Argentina's local law Boden 2017 bonds now trade nearly 400bps inside the New York Law Global 17 bonds. If Griesa's ruling stands (which seems likely) we may eventually see further outperformance of local law bonds versus bonds issued under New York Law. Not that this would be against the broader trends. The vast majority of fixed income in Emerging Markets is already issued under local law.

Global backdrop

As we have noted in previous publications, the resilience of the housing sector in the United States has been sitting somewhat oddly alongside the recent collapse in mortgage applications brought on by a sharp rise in mortgage rates. The inconsistency was at least partly resolved on Friday 23rd September, when the monthly release of data showed that new home sales had dropped by 13.4% in the month of July. Then on Monday the volume of durable goods sales (also sensitive to the cost of debt financing) declined by 7.3% versus -4.0% expected. In the course of the rest of the week we saw a slowdown in Case Schiller home prices (+0.89% versus +1.05% last) and then July's pending home sales dropped 1.3% versus expectations of a flat print. What is going on? We think debt, the issue that dares not speak its name, made an indirect appearance via the US data releases of the last week. The US economy carries a debt burden equivalent to 405% of the country's GDP. At such debt levels, even a moderate increase in borrowing costs will produce a significant drag on current disposable income and probably also deter would-be buyers from taking new mortgages. This underlines a broader point in our outlook. The size of the debt stock in most developed economies is far too large to make a rapid normalisation of monetary policy a realistic possibility anytime soon. There is plenty of denial about this fact, not least because inflation and treasury yields are still very contained. But the US economy's overall debt burden will become ever more apparent as household deleveraging progresses. Eventually, in our view, it will force real rates into deeper negative territory as the US opts to pass the cost of reducing its debt stock onto foreigners and future generations via currency weakness and inflation, respectively.

Oil prices are nearly 20% higher than in April and in the past week alone they rose more than 5% on the back of escalating tensions in Syria. The crisis in Syria clearly has very strong global overtones, because at its heart it is a battle between the West on the one hand and Russia and China on the other over influence over the Middle East and its immense energy resources. Despite the rise in oil prices this week, oil is still trading close to its average price since the end of 2010 and at current levels the oil prices will not change the macro-economic outlook for most Emerging Markets economies. Still, Syria is a reminder of just how important the end of the Cold War has been for Emerging Markets. In the vast majority of Emerging Markets today, political accountability is to local electorates, rather than foreign superpowers. These local electorates have strong preferences for growth and stability due to their lack of inflation hedges and social safety nets. This bottom-up pressure is the key reason why most Emerging Markets continue to maintain strong macro-economic conditions.

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