Emerging Markets market making goes local

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We illustrate Wall Street's decline as market-maker for Emerging Markets (EM) assets. Russia and Ukraine turn to 'Debt diplomacy' as the two sides continue to make significant progress towards peace. Dilma takes the poll lead over Marina ahead of October's presidential election. Changes in the rules governing PDVSA's FX earnings improve the public finances in Venezuela. William Dudley at the New York Fed wants to see the economy "a little hot" before hiking rates. We conclude with a discussion of the Middle East in the context of military action against Islamic State in Iraq and Syria.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,017	–	-2.17%
MSCI EM Small Cap	1,065	–	-2.22%
MSCI FM	699	–	-0.91%
GBI EM GD	6.70%	–	-1.05%
ELMI+	3.40%	–	-0.59%
EMBI GD	5.31%	275 bps	-0.05%
EMBI GD IG	4.48%	188 bps	-0.20%
EMBI GD HY	7.16%	477 bps	0.23%
CEMBI BD	5.25%	292 bps	-0.17%
CEMBI BD HG	4.36%	201 bps	-0.02%
CEMBI BD HY	7.19%	490 bps	-0.48%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1983	-0.53%
VIX Index	14.85	8.47%
5 year UST	1.80%	2 bps
10 year UST	2.53%	-4 bps
US HY	6.41%	-1.26%
European HY	4.88%	-0.57%
EURUSD	1.2679	-1.21%
USDJPY	109.56	0.58%
Brent	94.94	-0.35%
Copper	313.57	-1.45%
Gold	1219.61	0.20%

Additional benchmark performance data is provided at the end of this document.

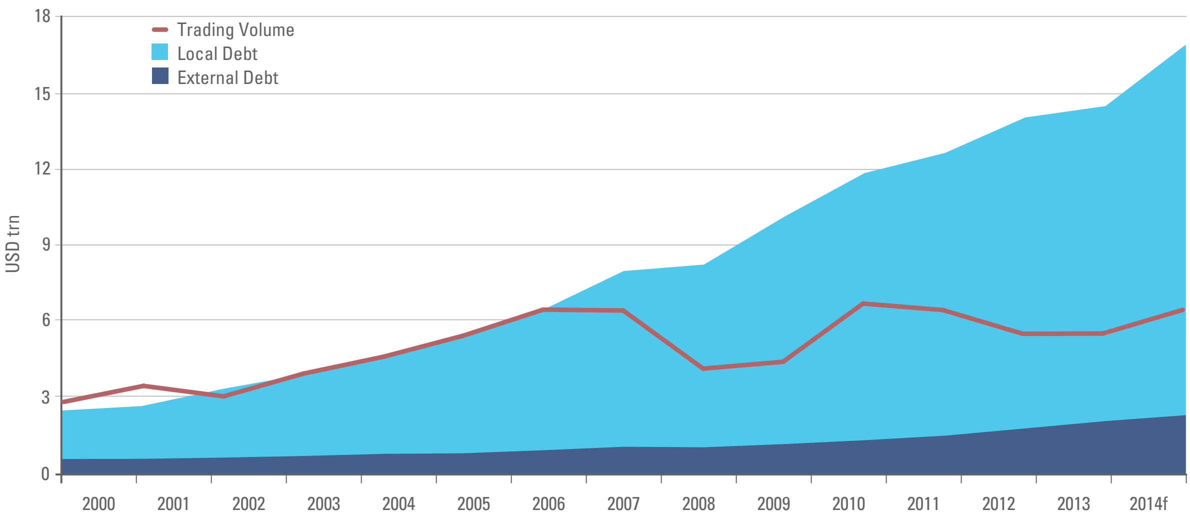
Emerging Markets

The onset of the global crisis has shortened investors' investment horizons, stoked preferences for liquid assets and dramatically shifted the regulatory regime in favour of developed market securities, particularly government bonds.

A less documented consequence was that investment banks in developed economies became poorer at making markets in EM securities. In fact, investment banks have been severely dis-intermediated by local EM banking and non-bank financial institutions since 2008/2009.

To illustrate the scale of Wall Street's retreat from EM market-making, we have combined data on EM fixed income trading volumes from the Emerging Market Traders Association (EMTA), a key industry body, with the most comprehensive source of data available on the total size of the EM fixed income universe from BAML. The EMTA data covers mainly Wall Street banks and fund managers in developed economies.

Fig 1: **EM fixed income market and Wall Street trading volumes**



Source: EMTA, BAML, Ashmore.

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Emerging Markets

As the chart shows, Wall Street banks' trading in EM fixed income has stagnated around 2007 levels. Wall Street banks today only turn over about 45% of EM fixed income in a year compared to more than 100% of the asset class per year in 2007.

While no one would question that the best liquidity for Gilts is in London, or that the best place to trade Aussie government bonds is in Australia, many investors still believe they have to go to London or New York to trade EM. This view is out-dated. Today the best trading in Peruvian bonds is in Lima; Kuala Lumpur serves up the most liquid trades in Malaysian government bonds; and Sao Paulo is the place to be to trade Brazil local.

In short, EM fixed income market making has gone local. Investors must follow suit. We believe that it is a good thing that EM markets are becoming less beholden to Wall Street's addiction to short-term momentum trading and the hysteria that accompanies it. Local trading is less risky, because local EM institutional investors today hold the vast majority of local EM bonds. This local liquidity provides a far more reliable 'buyer of last resort' backstop than Wall Street banks. Investors should demand that their managers target this local liquidity. 'Going local' would also reduce index dependence. Only 15% of local bonds are in the most commonly used benchmark index (JP Morgan's GBI EM GD index), mainly because Wall Street banks tend only to include countries and securities in their indices that they themselves trade (otherwise the banks would incur a cost in collecting pricing data, which they could not recover). Going local therefore means accessing not just greater trading volumes, but also escaping the greater and greater concentrations in index securities in favour of a much wider investment universe.

• Ukraine: 'Debt diplomacy' has increased even as Russia and Ukraine make significant progress towards peace in Eastern Ukraine. The Ukrainian government has launched an investigation of a USD 3bn bond issued by Russia to Ukraine in the dying days of the Yanukovich administration over allegations that former Finance Minister Kolobov broke Ukraine's budget law when he struck the deal. This news comes ahead of November's GDP release which, if it shows that Ukraine's public sector debt exceeds 60% of GDP, could give Russia the right to demand instant repayment.

If the probe finds that irregularities did take place, it will be a relatively small step to argue that the debt was 'odious', that is a liability incurred by a despot against the broader national interest. In 2003, the UN labelled debt issued by Saddam Hussain in the latter stages of his regime odious, a move that ultimately resulted in an 80% haircut for bondholders. Another risk is that the Russian bond, which has been issued under English Law could become a test-case for so-called 'debt sanctions', a legal measure yet to be formally adopted that would deny Russia remedy via the English Courts on the grounds that it has acted in an unacceptable manner in its relations with Ukraine. For a more in-depth discussion of debt sanctions and the Iraq precedent for odious debt see *"The road less travelled",* Weekly Investor Research, 26 August 2014.

How far the Ukrainian probe is taken, remains to be seen. This investigation gives Ukraine some counter-weight to Russia's threat to call in the debt. As for the implications for Ukraine's other external liabilities they are so far unclear. In the event the debt is labelled odious, for example, it is not a given that this would automatically adversely impact Ukraine's other external debt, say, if the contract governing the bond was annulled on the grounds of illegitimacy. In other words, non-payment due to contract annulment on the grounds of odiousness might qualify as a credit event for purposes of triggering CDS, but not for acceleration of bonds (which is what matters to bond holders). The Russian bond falls due in December 2015. Ukraine's 2015 budget provisions for all bond repayments. The Ukrainian finance ministry says it will pay the USD 3bn if required. Ukraine's debt ratios are likely to significantly exceed 60% of GDP next year, in our view.

Meanwhile, Russia and Ukraine continue to make significant progress towards peace. We note that Russia and Ukraine have now agreed on:

- A cease-fire
- An interim gas arrangement that could ensure supplies through the winter
- The composition of peace monitors and security zones
- Special status for regions in Eastern Ukraine
- A timeline for EU accession
- Russian troop withdrawal
- Prisoner exchanges

NATO last week noted a "significant pull-back" from Ukraine of Russian forces.

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Emerging Markets

- **Brazil:** Two polls published over the weekend indicate that the momentum continues to favour President Dilma Rousseff, while challenger Marina Silva's surge in support following the death of Eduardo Campos is fading. In one of the polls, by Datafolha, Dilma leads in the second round by 4 percentage points (a doubling compared to the previous poll). In addition to the fading sympathy effect, Dilma has much more money and TV time. In general, we think the markets are exaggerating the differences between Dilma and Marina in terms of how Brazil will evolve in the next few years. Regardless of who wins, Brazil will get a new and more market friendly economic team that will have to embark on a fiscal correction. But neither side would be likely to materially reorganise the economy away from heavy state interference. Brazil's central bank last week increased the Dollar liquidity extended to the market by increasing its rollover from USD 300m to USD 750m.

- **Venezuela:** PDVSA, the state-owned oil company, has been given permission to sell US dollars to the government at any of the three permitted exchange rates, which range from the official exchange rate of 6.3 Bolivars per Dollar to 50 Bolivars per Dollar. The effect could increase PDVSA's Bolivar revenues by as much as 5% of GDP, according to some estimates. This underlines the importance of devaluation to the Venezuelan economy – the country exports oil denominated in Dollars. Devaluations immediately and dramatically improve the public finances (denominated in Bolivars). President Maduro said that his government would boost investment in CITGO, a US chain of petrol service stations. This undermines speculation that saw an imminent sale of CITGO assets as a precursor for default.

Snippets:

- **Argentina:** Judge Griesa in New York has allowed Citibank to make payments on US dollar denominated Local Law bonds that were issued as part of previous exchanges. Jorge Capitanich, Argentina's Cabinet Chief, said that the country could negotiate with holdouts in Q1 2015 (when the so-called RUFO clause expires) if Griesa re-introduces a stay of his ruling that holdout investors must be paid in full. The economy was flat in real terms in Q2 compared to -0.4% yoy growth expected.
- **Turkey:** The central bank quadrupled minimum daily Dollar sales from USD 10m to USD 40m amidst a surge in the value of the US Dollar in global markets.
- **Tanzania:** The Tanzania stock exchange has liberalised foreign stock ownership. Foreigners can now own any stock, and must only declare holdings exceeding 5% of the total stock of each entity in question.
- **Mexico:** Real GDP rose 2.5% in July, or 0.4% mom. This was the fourth time in four months that the real GDP proxy has accelerated. Retail sales growth was also strong.
- **China:** HSBC's PMI reading for September rose to 50.5 from 50.2 in August. China's government re-iterated that there were no plans to change the overall direction of the economy. September's Emerging View focuses on China's USD 4.4trn domestic bond market, which is just being opened up to foreign investors. We think the current economic conditions in China are supportive of the fixed income market. Industrial profits declined 0.6% yoy in August, which is the lowest level since late 2012.
- **Costa Rica:** The government is sending a tax bill to parliament this year. This follows a recent cut in the country's sovereign rating by a ratings agency.
- **South Korea:** Daily exports rose 6.8% mom (seasonally adjusted - sa) in the first 20 days of September. This constitutes an acceleration from 4.2% mom sa pace recording in August. Korea recorded its 30th straight current account surplus of USD 7.3bn in the month of August, taking the cumulative surplus year to date to USD 54.3bn.
- **Indonesia:** In a setback from President-elect Joko Widodo Indonesia's parliament approved a bill that would allow the appointment of regional leaders by parliamentarians instead of through local direct elections. The change was opposed by Widodo.
- **Vietnam:** The economy expanded at a yoy rate of 6.4% in Q3 with significant qoq (sa annualised rate) growth in construction (19.7%), manufacturing (14.7%) and services (7.8%).

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Global backdrop

William Dudley, a key member of the FOMC, said last week that he would like to see the economy "a little hot" before raising rates. Dudley also noted that Dollar strengthening could hurt US growth. The Dollar has appreciated 4% on a trade-weighted basis since early July. Yet, we expect growth, inflation and interest rates to remain relatively contained globally at least until 2016. For example, we expect about 2% real GDP growth in the US this year. This suggests that the move is more technical than fundamental with respect to Europe and Japan and mainly sentiment driven with respect to EM. Higher yields and a stronger US dollar tighten liquidity conditions in the US and hurt the equity markets relatively quickly and the economy more broadly, given debt stocks and the importance of easy money in sustaining asset price valuations. A 10% increase in the value of the trade-weighted Dollar has historically reduced the US real GDP growth rate by 1% in absolute terms. Meanwhile, central banks in developed economies remain very dovish. Mario Draghi at the ECB reiterated that the risk of doing too little was greater than the risk of doing too much. It was announced last week that Charles Plosser, a hawk, would leave the US FOMC in March.

Turning to matters Middle Eastern, the US and the UK have now embarked on a bombing campaign against Islamic State (IS) in Syria and Iraq, accompanied by bombers from several Gulf Cooperation Council (GCC) countries. For the US and the UK, which are respectively constrained on the home front by lame-duck government and deep regional divisions and parliamentary party defections, a focus on foreign affairs is a welcome distraction. They also go some way to hide the impotence of Western leaders in terms of influencing events in Eastern Ukraine where it is increasingly clear that President Putin is securing a settlement very much to his liking.

Inevitably, the US-led coalition attacks have brought back stereotypes and misconceptions about the Middle East as a region of violence, uncertainty, destabilisation and war. Not only are the geopolitical risks arising from IS exaggerated by the media and many analysts, in our view, but more significantly the region is very far from being a single entity under the rubric of the Arab World.

In fact, there is no one Arab World, which is also why there never has been one Arab Street view. The Arab World is as widely different as Europe is from North to South and from East to West. Investors would do well to recognise this differentiation.

For example, the uncertainty and violence of Syria, Iraq and Yemen stand in marked contrast to the situation in GCC states. A commonly held view is that the event in the former could easily spill over to the latter. Similar views prevailed during the Tunisian and Egyptian revolutions of the Arab Spring. But such views ignore that Gulf leaders are well-experienced and adept in dealing with radical threats. The Gulf proved to be far more resilient than expected during the Arab Spring, helped in part by a substantial adjustment in social spending. Similarly today GCC countries have recognised the potential risk IS could pose and acted relatively swiftly. The decision to participate in the US-led raids has galvanised support and cohesion within the GCC. In fact, some would argue that through their unified action to support US-led operations, the GCC is more unified than in many years.

No doubt, Syria and Iraq face real challenges to the way their states are organised, and even to their borders, which were invented by French and British colonialists with little regard to the populations living there. Both countries are vulnerable, borderline ungovernable and, as such, their fates as nations are difficult to determine. Even so, despite all the violence in Iraq, for example, there has been no material disruption to Iraqi oil production in the south, because the conflicts that threaten Iraq are in the centre and the perennial threat of a breakaway Kurdish state in the north.

The uncertainty about Syria's future and Iraq's unity and the more recent developments in Yemen should not lead investors to downplay the economic value and opportunities offered by other countries in the region. During the first week of the attacks there was no significant sell off in regional GCC stock markets. Instead, markets have reflected seasonality and technicals surrounding the annual Hajj holiday.

The GCC economies continue to prosper on the back of strong government balance sheets, high public spending and low government debt. Saudi Arabia's debt to GDP is expected to be less than 2.5% by year-end, one of the lowest in the world. Its economy in 2014 is set to grow at 4.5% in real terms this year and private sector growth is above 5.5%. Saudi Arabia foreign exchange reserves are close to 90% of its GDP. This means that Saudi Arabia has strong cushions even as oil prices dip below $100 per barrel.

The growth story in the UAE is also gaining momentum. Historically, the UAE has benefited from a perceived safe haven status. Abu Dhabi's capital investments are growing strongly given a rapid pace of industrialisation and provision of infrastructure. Dubai's ability to position itself as a tourist, logistics and trade hub is noteworthy. Despite instances of exuberance in the property sector, the authorities have taken measures to contain excesses. Qatar, another GCC country, is this year expected to have the fastest growth in the Middle East.

And Kuwait's economy has benefitted from sustained surpluses over the last few years that offer opportunities for development spending. Kuwait's unemployment at 3% is one of the lowest in the region.

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Ashmore

Global backdrop

To many, Lebanon and Jordan could be seen as equally vulnerable to an impending crisis. However, Lebanon's banking system continues to be liquid and stable, despite perennial budgetary shortfalls. Jordan is physically impacted by the crisis in Syria. The continuous inflow of Syrian refugees, low growth and dependence on foreign aid add to the country's economic burden. Egypt's worst days have probably passed even if plenty of challenges remain, a budget deficit above 11% of GDP being one of them. Nevertheless, Egypt's equity market has rallied over 40% year to date.

In short, generalisations about the Middle East are easy and lazy. In reality, the nuances and intra-regional dynamics are both many and complex. Differentiation requires knowledge and understanding, but is likely to pay off for investors, in our view.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.3%	4.4%	4.9%	9.4%	5.3%
MSCI EM Small Cap	-4.1%	8.9%	10.0%	11.7%	7.3%
MSCI FM	0.5%	21.8%	30.2%	17.6%	8.4%
S&P 500	-0.88%	8.91%	19.15%	22.06%	16.08%
GBI EM GD	-4.30%	0.84%	-1.34%	2.69%	4.58%
ELMI+	-2.51%	-1.20%	-1.59%	0.83%	0.99%
EMBI GD	-1.19%	8.72%	9.92%	8.46%	8.33%
EMBI GD IG	-1.48%	8.56%	8.72%	6.61%	7.05%
EMBI GD HY	-0.63%	9.06%	12.48%	11.60%	10.38%
5 year UST	-0.66%	1.85%	0.99%	0.73%	3.31%
7 year UST	-1.04%	4.24%	2.38%	1.20%	4.67%
10 year UST	-1.50%	7.74%	5.16%	1.95%	5.44%
CEMBI BD	-0.59%	6.53%	8.44%	7.98%	7.57%
CEMBI BD HG	-0.53%	7.07%	8.52%	7.01%	7.12%
CEMBI BD HY	-0.72%	5.36%	8.27%	10.51%	8.91%
US HY	-2.20%	3.64%	7.22%	10.77%	11.09%
European HY	-1.01%	5.31%	9.96%	17.11%	13.32%
Barclays Agg	-2.60%	1.84%	1.85%	1.10%	2.74%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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