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WEEKLY INVESTOR RESEARCH

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Ukraine's journey from pariah state to baby of the West

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Positive noises from the IMF in Ukraine bode well for early disbursement of emergency funding. Russia continues to be in the political cross-hairs as EU/US seeks a formula for punishment that both appears tough and at the same time does not damage economic European relations with Russia. The default of a Chinese domestic corporate is very good news that indicates the direction on travel in China. India's external balances make another substantial improvement. Romania is on fire. Korea prepares to cut out the Dollar from its bilateral trade with China. Stronger US payrolls push US treasury yields higher, while ECB's reluctance to ease briefly pushes EURUSD to its highest level since 2011.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	958	–	0.79%
MSCI EM Small Cap	1,030	–	1.72%
MSCI FM	611	–	0.82%
GBI-GD	7.00%	–	0.89%
ELMI+	3.57%	–	0.60%
EMBI GD	5.72%	309 bps	0.43%
EMBI GD IG	4.82%	202 bps	0.08%
EMBI GD HY	7.93%	562 bps	1.13%
CEMBI BD	5.52%	313 bps	-0.07%
CEMBI BD HG	4.61%	223 bps	-0.04%
CEMBI BD HY	7.40%	501 bps	0.48%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1878	1.80%
VIX Index	14.11	-11.81%
5 year UST	1.65%	19 bps
10 year UST	2.80%	19 bps
DAX	9347	-0.12%
10 year Bund	1.64%	9 bps
EURUSD	1.3872	0.98%
USDJPY	103.33	1.85%
Brent	107.75	-2.88%
Copper	321.52	0.58%
Gold	1336.79	-1.10%

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

Emerging Markets

EU/US discussions about Ukraine are aimed at managing the political fall-out from the Russian annexation of Crimea and avoiding another debt crisis in Europe. Politically, the problem facing Western governments is that they look (and are) impotent in the face of the actions of Russia, not just in Ukraine, but also in the recent past in Syria and Georgia. The challenge now is to snatch political victory from the jaws of defeat by turning (the rest of) Ukraine into a successful pro-Western state, like Poland. This strategy will only succeed if Ukraine becomes an economic success. After all, Ukraine's economic weakness is one of the main reasons why the country kept turning to Russia for money. To create an economic success in Ukraine, we expect strongly supportive Western rhetoric to be followed by emergency financial support from both the IMF and the EU/US. We believe a fully-fledged IMF standby arrangement will then follow after the elections scheduled for May. But turning Ukraine into an economic success cannot be achieved with public money and reforms alone. In particular, it is also essential for Ukraine's economic recovery that the country also attracts new private investment.

Past crises show unambiguously that the critical test in any adjustment program – that is, whether it succeeds or not – boils down to re-establishing a country's access to international markets. Uruguay during the 2001 financial crisis and the Argentina default is a classic case of a solvent country with a major liquidity problem where private buy-in set the country on a decade long path of sovereign improvement. New private money to Ukraine could be forthcoming if (a) official sector lenders would welcome private money and (b) Ukraine commits to the reforms required under an IMF agreement. The critical question for the official sector should be to establish whether Ukraine is technically insolvent or merely facing an illiquidity crisis. Given the country's 39.5% debt to GDP ratio (as of the end of 2013), it would seem that liquidity rather than solvency is the problem. If this is confirmed by the IMF then it would be a major policy mistake to demand debt restructuring (economic restructuring is a different matter – Ukraine needs plenty of that). A debt restructuring would be counter-productive by discouraging private investment and deepening the country's economic woes rather than fixing them. Ultimately, debt restructuring would also backfire politically by forcing Ukraine once more into the arms of Russia for financing.

The IMF mission in Kiev will likely address the key question of solvency versus illiquidity. The technical mission should be done with its work within the next few days; its report then goes to the IMF Board. One relevant fact to emerge last week was that as of last Friday Ukraine's FX reserves stood at USD 15.5bn, which was significantly higher than what had been expected by the market (USD 14.7bn). Positively, this suggests smaller than expected capital flight and/or less than expected FX intervention by the central bank.

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Russia's annexation of Crimea is a fact. Indeed, Crimea is set to hold a referendum on 16 March to formally join the Russian Federation after Crimea's parliament last week overwhelmingly approved the merger. There is no appetite for the severe confrontation that would be required to reverse this reality. Political logic demands visible punishment. Hence, we expect a lot of posturing against Russia from EU/US, but little fury – that is, actual economic damage. Germany relies on Russia for a third of its energy needs, while London's financial and property markets are flooded with Russian cash. The cacophony emanating from this surreal theatre of faux retribution is likely to cause volatility in Russian asset prices for some time, but should ultimately do little if anything to erode Russia's extremely strong ability to pay as well as its willingness to pay.

• China: In China, the announcement last week that Chaori Solar Energy, a CNY 1bn domestic Chinese corporate bond had defaulted is a pity for holders of the bond, but a major positive for investors in China more broadly. The absurdity that no domestic Chinese bond had ever defaulted is now a thing of the past. The default follows two recent failures of so-called trust loans. Why are these events happening now? Because the Chinese are allowing them to happen. The Chinese authorities recently announced the intention to allow market forces much greater sway in resource allocation. This will help Chinese bond markets – and credit markets more broadly – to move towards a fairer pricing of risk. In turn this should be seen as precursor for a wholesale shift away from exchange rate targeting to inflation targeting in China. Inflation targeting using interest rates as the main policy instrument requires a well-functioning bond market. But why the rotation toward inflation targeting and interest rate liberalisation? China is undertaking these draconian changes not because of major problems of resource misallocation at home (we do not think there is a systemic problem in China's credit markets), but in preparation for the major realignment of global currencies that will be unleashed once inflation returns to the heavily indebted/money printing economies of Europe and especially the US. Strong resulting appreciation of the CNY will render export-led growth less profitable and domestic demand the main driver of growth. And, unlike exports that are easily managed by exchange rate policies, domestic demand is best managed using interest rates. China's policies are far more forward looking that any other country on the planet.

• India: India's external balances continue to improve sharply on the back of last year's adjustment measures, underlining the profound difference between basic macroeconomic misalignments (which are easily and quickly fixed with simple demand management tools and currency measures) and crises (which require profound and sustained reforms). The current account deficit in the third quarter of India's fiscal year fell to a four-year low of 0.8% of GDP. This compares to a deficit of 4.9% of GDP just two quarters previously. India has rapidly made the transition from 'Fragile to Frugal', illustrating once again how sentiment about EM, especially in the media tends to be shrill, prone to exaggeration and often outright wrong. EM fundamentals are in most cases robust, even if economies can become imbalanced in a cyclical sense. Last week India's PMI index rose to a one-year high with strong gains in new orders and output forward indicators.

• Romania: Romania is on fire. Growth in Q4 reached 5.2% yoy, accelerating from the real GDP growth rate of 4.1% yoy achieved in Q3. Consumption was strong (3.2% yoy), but exports rose even more strongly (13.7% yoy). In the past week Romania's president signed off on a new coalition agreement for the government led by Prime Minister Ponta and Ioana Petrescu as Finance Minister. Romania has successfully implemented an aggressive fiscal adjustment since 2009, reducing its fiscal deficit from 7.2% of GDP to 2.5%. Romania's strong Q4 growth was achieved despite the collapse of its coalition government a few months ago, illustrating the point that political instability is not always a reason to turn bearish. After all, political noise is an entirely normal part of any country and 95% of political noise tends to be irrelevant for returns over the cycle. The establishment of a new government against a stronger fiscal backdrop bodes well for investment going forward and therefore a sustained upswing. Fitch, the ratings agency, last week affirmed Romania's investment grade sovereign debt rating (BBB- with stable outlook).

• Korea: The monetary policy committee of the Bank of Korea is considering settling bilateral trade with China in CNY and KRW rather than US Dollars. Cutting out the US Dollar as settlement currency would increase efficiency, ease upwards pressure on KRW (Korea runs a trade surplus vis-a-vis China), and both reduce risks and increase returns on cumulative surpluses, assuming they are invested in CNY. It is not just a question of higher returns on Chinese assets versus US assets; it is also that the US economy's massive debt mountain (totalling just under 400% of GDP excluding some 300% of GDP in unfunded liabilities) is likely to be eroded away through inflation with major negative ramifications for the purchasing power of the US Dollar over time.

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Emerging Markets

In other snippets of news, we would highlight the following:

- Turkey: Polls in Turkey showed the ruling AKP with a strong position ahead of municipal elections scheduled for late March. Despite its strong showing in the polls, the Erdogan administration imposed further restrictions on press freedoms last week in response to on-going disclosures of corruption in the administration.
- Brazil: Brazil's trade deficit halved from USD 4.1bn in January to USD 2.1bn in February. The trade balance is still widening on a year-on-year basis, however, but significant rate hikes and the currency adjustment of the last 12 months should soon turn year-on-year numbers to positive territory, in our view. Brazil's trade deficit is financed by solid FDI inflows. Minutes released from the central bank suggest that the hiking cycle is not yet over.
- Hungary: Both retail sale and industrial production in Hungary rose faster than expected. Retail sales rose 3.9% yoy in January versus 2.5% expected. Industrial production was up 6.1% in January versus 5.0% expected.
- China: HSBC's China services PMI rose to 51.4 in February, marginally higher than January's 51.1. Meanwhile, the official services PMI number rose more strongly to 55 in February from 53.4 in January. Numbers above 50 signal expansion. The National Party Congress set a growth target of 7.5% real GDP growth in 2014 and inflation of 3.5%, aided by a 0.1% of GDP expansion of the fiscal deficit (to 2.2% of GDP).

  Chinese inflation moderated to 2.5% yoy in February from 2.0% in January. Inflation pressures in China are likely to remain low as the economy restructures from export to domestic demand-led growth over the next few years.

  China's trade balance partly reversed January's outsized net export gain of USD 32bn. The volatility in net exports is due to the Chinese New Year. The reversal of net exports in February adds credence to the view – which we share – that recent deliberate weakening of the CNY fix by the central bank was done specifically to try to smooth FX flows around the volatility in net trade over the New Year period. By weakening the CNY, the PBOC created a more attractive entry point for fresh CNY longs to induce value-seeking inflows to off-set the decline in net export flows. We expect net exports to return to more stable positive numbers in the coming months.
- Panama: FDI flows in Panama increased by a whopping 61% in 2013 compared to 2012.
- Venezuela: Political tensions, including loss of life, continue in Venezuela.
- Argentina: The government in Argentina is considering reducing subsidies for energy. This would be highly credit positive if implemented. Energy subsidies account for several percentage points of GDP of the fiscal deficit.

Global backdrop

US treasury yields pushed higher last week on the back of a stronger than expected non-farm payroll print of 175K versus 149K expected, though the 3m rolling payroll number declined to 135K from 200K in December. But the unemployment rate also rose to 6.7% from 6.6% against the backdrop of an unchanged participation rate (63%). ADP payrolls were weaker than expected, but claims for unemployment were better. A mixed picture was also apparent in the manufacturing data. ISM services disappointed significantly, but the Markit PMI and ISM manufacturing numbers beat expectations. We think US companies are saddled with excess inventories after a strong build-up in H2 2013. These will fade as we approach summer, however, resulting in higher US treasury yields over the course of the year. We also think stronger data could prompt' bond vigilantes' to take on the Fed again as they did last summer, exacerbating any volatility in the Treasury market caused by economic data alone. But at the same time the US Fed is unlikely to welcome excessively high yields that can derail the recovery. An attack by the bond vigilantes would therefore likely be met with a change in the pace of tapering, in our view.

The ECB delivered no change in monetary policy in its monthly meeting, citing good recent activity numbers and higher than expected inflation. There are still rich seams of Euro pessimism and Dollar bullishness in the market place, but so far this year European data has outperformed US data and the EUR has surged to the highest level since 2011. In general, however, EURUSD has traded in a 1.20-1.50 range in the past 5-6 years, kept in range by the lack of growth, inflation, and low stable rates. Barring big surprises in the economic data in Europe and the US we think the most likely scenario is further range trading, and further easing by the ECB would require a substantial further rally in the EUR. Looking further ahead, we expect the debt crisis in Europe to return once global interest rates break out of their ranges, probably after US household deleveraging comes to an end. Even when this happens, however, a big fall in EURUSD is no certainty, because we expect US inflation to begin to erode the value of the US dollar roughly around the same time. What is more certain is that surplus countries that are not printing money will experience appreciation of their currencies. Investors are therefore better advised to allocate to EM currencies, whose purchasing power will not be eroded by unsustainable debt problems or by inflation.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.8%	-3.5%	-6.0%	-2.4%	17.8%
MSCI EM Small Cap	1.1%	2.9%	-0.5%	-0.4%	23.8%
MSCI FM	-0.4%	3.4%	21.1%	8.0%	15.1%
GBI-EM-GD	0.13%	-0.76%	-10.00%	0.96%	10.87%
ELMI+	0.27%	-0.54%	-2.67%	-0.94%	5.00%
EMBI GD	-0.14%	2.19%	-1.75%	6.79%	12.39%
EMBI GD IG	-0.21%	2.69%	-2.99%	5.53%	9.74%
EMBI GD HY	0.00%	1.22%	0.60%	8.92%	16.06%
CEMBI BD	-0.42%	1.57%	-0.49%	5.53%	12.66%
CEMBI BD HG	-0.10%	2.36%	0.51%	6.15%	10.71%
CEMBI BD HY	-0.05%	1.28%	0.11%	5.29%	20.14%

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