Drobny Guest Research

September 12, 2012

3701 Highland Ave, Suite 302, Manhattan Beach, CA 90266 andres@drobny.com *(310) 545-6996*

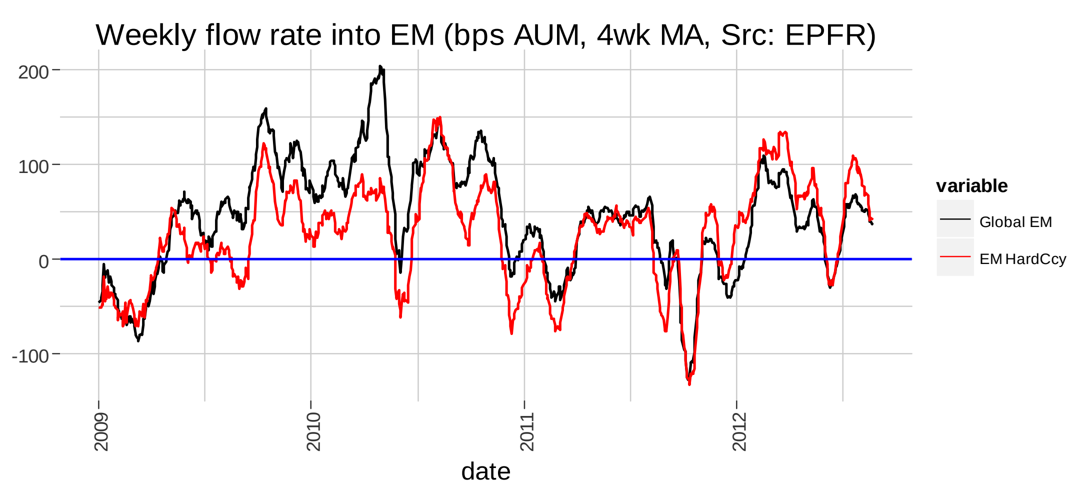
Several of you have expressed concern about the outlook for EMG, though the specific asset class and, importantly, the potential source of any turbulence has varied. In this piece, our friend Guilherme is concerned about the recent rise in Treasury yields which, if sustained, might create ripple effects on EMG bond markets. - *Andres Drobny*

Impact of Higher US Treasury Yields on Emerging Market Assets*

Guilherme Schmidt
Black River Asset Management

(*followed by an anonymous peer review)

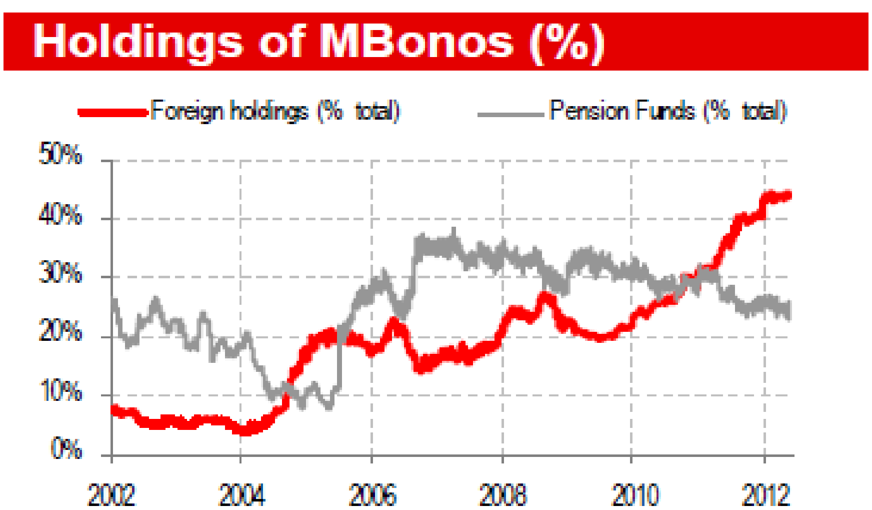
In this piece we endeavor to address the consequences of a prolonged and acute US Treasury selloff to the emerging markets fixed income space. We have seen that the deepening European crisis has pushed market participants to protect themselves from a potentially cataclysmic series of sovereign defaults. US Treasuries have rallied to historic lows as investors reallocated into traditional fixed income havens, and central banks have directly intervened as a matter of policy. These low yields have forced investors to seek returns in almost every other fixed income category. Emerging markets, in particular, have seen sustained and significant fund allocation from a variety of sources, including many with limited emerging markets experience. This investor demand has pulled EMBI+ index yields down to 4.9%, approximately 5.6% below their average since inception.



Historically, emerging markets fixed income performs well in a risk-on environment, but the compression of emerging markets yields has left external and local fixed income markets very exposed to a UST selloff. In a neutral or risk-on environment where there is less perceived risk out of periphery Europe and less chance of further easing in the US, we would expect investors to reallocate back into equities and away from Treasuries. A UST selloff could reverse emerging markets fixed income investor demand because we may see a reversal of preferences for fixed income over equities. In addition, the expectation of emerging markets assets outperforming in a risk-on, global growth environment will likely not play out and investors will be surprised by how much their total return is exposed to US rate risk. Therefore, outflows from the emerging markets fixed income asset class are a real risk in this scenario.

The tremendous inflows into emerging markets fixed income over the past five years have led to several distortions of relative value relationships. We highlight three examples of securities that have been mispriced relative to history and to equivalent risks, are exposed to US rates, and are most likely to revert to historical norms in a substantial UST selloff.

Mexico MBonos: Recent trends show real money accounts including insurance companies, pension funds, and dedicated bond funds searching for yield in the Mexican Mbono market. Mexico is an attractive market for international real money investors due to its low barriers to entry and openness to international flows. Macroeconomic data further supports MBonos based on fundamentals such as low debt to GDP, sound financial management, reasonable current account and fiscal balances, increasing currency reserves, and inclusion in global bond indices. The chart on the right illustrates the historic foreign fund allocation to the Mbono market:



Sources: Banco de Mexico and Santander.

The demand for the 10-year Mbono has pulled these cash instruments 75 basis points below the 10-year TIIE (Mexican Peso denominated interest rate swaps) versus a historic average of 30-40 basis points. This premium cannot be due to bank risk, since most TIIE counterparties are large money-center banks. Equivalent swap spread relationships in the US are near 20-year lows and bank CDS are near post-2008 lows. A reallocation away from “safe” fixed income instruments such as UST and highly correlated “go-go” EM bonds such as MBonos should happen together, and the anomalies in the spread relationships we have witnessed over the last 8-10 weeks could return to normal.

Colombia Global TES: Local currency securities are difficult to access, so foreign investors typically have a strong bias and preference for internationally-settled euroclearable bonds that can give them high yield and (for some) the added benefit of currency exposure. In the Colombian fixed income market, the Global Tes (Gtes), debt settled in US Dollar but are denominated in Colombian Peso, provides this accessibility. As sizeable foreign real money investors have demanded this EM local rate exposure, relative value distortions have been created between local and offshore assets. Through mid August, the 10-year Gtes trades at a yield of 4.25%, approximately 250 basis points inside the onshore Peso-denominated Colombian Tes, the onshore equivalent of the Gtes. Primarily invested by local real money, the onshore Tes is not as likely to lose investor support when global fixed income demand shifts. We reiterate our view that a reversal of the quest for yields to other fixed income markets, triggered by a UST selloff, would lead to a correction between onshore bonds, and their offshore equivalents that are preferred by foreign investors and reward investors who identify these relative value opportunities.

External Debt Bonds: External debt bonds have been the most direct way foreigners gain access to emerging fixed income markets. These securities are issued by emerging market sovereigns, but are denominated in hard currencies (usually US dollars), so the value of the securities is directly related to US Treasury yields and emerging markets credit spreads. Investors in emerging markets external debt have enjoyed strong total returns over the past 5 years as evidenced by the performance of the JPMorgan EMBI+, the most common benchmark index. Investment grade EMBI+ yields stand at 3.6%, with many countries trading through yields on US investment grade corporate indices. A UST selloff will immediately impact total returns and we foresee severe investor dissatisfaction with the absolute return of their portfolio, even in the presence of spread compression. Without the appropriate yield compensation for holding emerging markets credit, we believe investors will reallocate away from hard currency bonds, reversing the strong inflows that emerging markets external debt markets have enjoyed. If this were to occur, the current large spread between true expressions of credit risk (credit default swaps) and hard currency bonds would normalize. This would create a variety of trading opportunities between the two instruments (basis trades) since cash bonds are directly impacted by Treasury rate changes and CDS is not. Refer to the chart below for an illustration of absolute and relative returns of the EMBI+:

Year	EMBI+ Index Return	EMBI+ Spread Index Return [1]
Aug 2007 – Jul 2012 (Annualized)	10.61%	2.57%
2012 YTD	11.64%	7.90%
2011	9.20%	-4.93%
2010	11.83%	5.21%

For the time being, the UST selloff has not yet signaled a market shift out of emerging markets. However, in a more substantial UST selloff, we consider significant outflows out of emerging markets local and external fixed income markets to become a more likely scenario. In a world where risk taking becomes more comfortable and the likelihood of inflation increases, investments with better real return prospects recover, and safe havens such as US Treasuries and emerging markets bonds are no longer attractive. Historically, emerging markets fixed income would have done well in this type of environment, but low yields have made these instruments much more correlated to Treasury movements than to the equities markets. Investors accustomed to the strong return of EM fixed income will be disappointed and some will choose to reduce their exposure to long-only EM fixed income funds. In contrast, absolute return funds that can effectively hedge treasury risk and take advantage of relative value opportunities in an environment of rising Treasury yields will likely outperform.

Guilherme Schmidt
Guilherme.Schmidt@black-river.com

An Anonymous SG comments: I guess the question he is thinking about is if the fixed income bull market will end. I agree with his forecasts of what will happen but am not ready to say that it will end. I think EM debt works as long as investors seek yield, the USD stays in a range and we muddle through in the developed world. If China can show some cyclical bounce (not a hard landing) that could add further support to the perception of EM's strong balance sheet.

On the contrary, if US yields go up because of a bad outcome in the US, then all bets are off. The direction of the USD will be key as it will not only impact the total return of local currency denominated debt but will also impact the balance sheets of EM for the USD denominated debt.

If UST yields spike, due to a crisis of confidence in the US, then I can make a case for both sides. Ironically, a US default would probably be the worst possible thing for EM debt because investors would flock to US assets once the country had a clean balance sheet. But that is a provocation for another discussion…

Andres Drobny adds: I suspect the key for EMG FX and bonds is the outlook for the USD in the event of rising Treasury yields. In a traditional story, when US yields rise and that serves to pull up the USD, then that spells trouble for EMG FX and bonds. If, however, this new world of 'risk-on/off' prevails, and the USD goes down as Treasury yields rise, then the outlook for EMG FX and bonds won't be so bad. That's an environment where spreads to Treasuries would likely narrow.

Past reports can be accessed at www.drobny.com