Global / Debt Strategy

Emerging Markets

30 January 2004

Dresdner Kleinwort Wasserstein

Strategist	Jorge Amato	
Strategist	Frank Zheng	+44 20 7475 3914
Economics	Michael Hart	+44 20 7475 8708

Global head of EM research and strategy
Arnab Das +44 20 7475 3875

EM strategy focus

EMTA Winter Forum - London

Buy-side and sell-side presentations were very much in-line with our own views: (1) easy money would continue to search for yield, thereby enticing inflows, (2) buoyant commodity prices to remain, (3) weaker USD, and (4) improved fundamentals in EM credits supporting current valuations. Risks outlined were: (1) US Fed falling behind the curve and forced to hike rates precipitously, (2) China overheating.

The EMTA winter forum came and went without earth shattering comments or views. For the most part, investors, as well as the research community including DrKW, believe that the current environment remains conducive to a fairly decent performance for EM as a whole. Although forecasted EMBI+ returns ranged from –6% to 6%, most participants agreed that, if the actual performance fell within that range, this would be reasonable, considering the current global environment. There seems to be consensus that Local Markets, Corporates, Equities and Special Situations are the areas where investors should focus in order to outperform. Below, we outline the main issues discussed by both panels:

Sell-Side

- **Are we in a bubble?** Only 1 of the 5 sell-side panelists regarded the current market as a bubble. There was recognition that some elements of a typical bubble were beginning to appear: (1) rationale of valuations with momentum and technical arguments, (2) increased risk taking by moving down the credit curve – usually a late cycle signal, (3) higher leverage – although the level is still a far cry from that seen in 1997 when inflows into EM were mostly tactical rather than strategic, which was seen post the Russian crisis.
- **What about the Fed?** The biggest risk faced by the market is that the Fed pulls the liquidity rug from under its feet. The greatest highlighted concern was not focused on when and if the Fed would hike, but rather what if the Fed fell behind the curve and was forced to undergo an aggressive monetary tightening cycle like it did in 1994. The timing of Fed hike forecasts ranged from this August (+50bps) to as late as some point in 2005. In no case did the forecast hike rise above 1.5%. An interesting observation, however, is that 10yr rates are expected to rise beyond the maximum 50bp forecast hike, implying a severe steepening of the US Treasury (UST) curve. The highest forecast for the 10yr Treasury was a very high 5.5% from a house that expected unchanged Fed funds at 1% at least until 2005! This last issue on the steepness of the UST curve is where our house view differs. DrKW expects flattening pressure as we expect investors to prefer the pick up in yield vs the potential duration risk.
- **Is the latest sell-off a buying opportunity?** Three of the five participants responded yes. Two said not yet, arguing that recent new issuance had caused indigestion and this could take a few more weeks to unwind.

Buy-Side

- **Liquidity remains the main driver**. Easy money will continue to drive the search for yield. Inflows are, in general, expected to continue although not at the same pace seen last year.
- **Biggest risks for the market?** Same as the Sell-side panel: US rates and China overheating. EM political cycles not a significant risk for 2004, despite some major elections in minor countries or those in Russia. The year 2006, however, promises to be more interesting with presidential elections in Mexico and Brazil.
- **Best opportunities across EM asset classes:**
  - EM equities
  - Local markets: Brazil and Turkey followed by South Africa and Poland.
  - Exotics: Bosnia, Iraq, Sudan, Uruguay, Jamaica, Dominican Republic, NPLs in China.
  - External debt: Brazil, Venezuela
- **Argentina was a controversial topic.** Two of the panelists believed that defaulted external debt presented value as the government has increased incentives to offer a substantially better deal to creditors. The other three panelists argued that Argentina could very well go down the path of isolationism, not an unfamiliar path to this credit, and currently had little incentive to change its current hard line stance, rendering current external debt levels expensive. Current Bodens found better acceptance as a good off-index bet, although there was no consensus on this either.
- **EM client base has changed**. There was consensus that there has been a dramatic change in the composition of the investor base, and hence in the type of flows that EM has received. After the 1998 debacle, a volatile investor base, then dominated by hedge funds and macro funds, transformed into a much more stable one. Strategic rather than tactical inflows dominate today's market, as long-term investors, dedicated or crossovers, dictate the direction of the market. The positive aspect of this change is that these investors tend to bring more stability to the market. The negative side is that as these funds have grown in size, and as the sell-side has been increasingly reluctant to take increasing exposure, liquidity has suffered. Broker screen volumes today are roughly 1/3 of those seen in 1997-98. This higher concentration of more assets into fewer funds was also mentioned as a risk by the buy-side panel.
- **Will CDS market liquidity improve beyond that of cash?** This question had a unanimous answer: highly unlikely. While CDS market liquidity has been consistently improving since 1998, the sell-side continues to be the main user of this market. Real money dedicated fund managers reported to have little time and, in some cases, significant constraints to trade or analyze the CDS market.

Panelists

Sell-Side:

- Jonathan Bayliss – JP Morgan – Moderator
- Walter T. Molano – BCP Securities
- Tim Ash – Bear Stearns
- Richard Segal – Exotix
- Tulio P. Vera – Merrill Lynch

Buy-Side:

- Brett Diment – Deutsche Asset Management – Moderator
- Jerome Booth – Ashmore Investment Management
- Robin Hubbard – Foreign & Colonial Management
- Rob Drijkoningen – ING Investment Management
- Ingrid Iversen – Insight Investment