

# Emerging Market Debt in 2016: Turning the Corner?

## Executive Summary

- The anticipation of the mid-December Fed hike dissuaded us from publishing an Outlook piece until we've had a chance to see just how much of a yawn the much-feared tightening would produce. The well-telegraphed move barely raised an eyebrow in Emerging Markets ("EM").
- Instead, as we enter 2016, China concerns and oil prices have (rightly, in our view) occupied investors' minds. We believe those factors, combined with (geo) politics, will remain key drivers behind EM asset prices in coming months.
- Clouds continue to hang over EM, but we see little in the way of a crisis on the horizon. There may be disappointments in store, but of the priced-in, garden variety.
- We look for 2016 to be the year where EM growth and EM FX bottom out. We don't anticipate a rapid rebound or V-shaped recovery. Rather, we see EM turning the corner after three straight years of declining valuations and downward growth projections. Structural factors to justify optimism, ex-demographics, remain scarce, but whether it's overshoot or base effects – that spells a pick-up nonetheless!
- The risks include policy mistakes, populism, depletion of reserves and the impact on struggling EM economies should their Central Banks choose to follow the Fed and hike rates.

**EXHIBIT 1: THE MOST COMMON CONCERNS IN EMERGING MARKETS MAY NOT BE THE MOST PERTINENT**  
Our views on the most relevant factors in emerging markets versus what we think the markets are focused on

	Perceived Market/Investor Concerns in EM (prior ranking in parentheses)		What keeps GSAM EMD Team up at Night
1	Fed Tightening (1)	Tied	Oil Prices
2	China (1)		China
3	EM Corporate Crisis / Spillover (-)		(Geo)Politics
4	Liquidity (7)		USD Strength
5	Oil Prices (4)		Liquidity
6	USD Strength (3)		EM Corporate Crisis / Spillover
7	Flows (5)		Fed Tightening
8	(Geo)Politics (5)		Flows

Source: GSAM. As of Jan. 8, 2016

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## Review: What Happened in 2015?

### Chronicle of a hike foretold.

After spending a year fretting over the exact timing and impact of what may be the most anticipated Fed hike in history, investors awoke to a non-existent reaction from EM markets. Sovereign spreads closed the year within 1 basis point of where they traded on the day of the hike. The ELMI+ currency index also barely budged post-Fed. Chile, Colombia and Mexico followed the US Fed, upping rates by a quarter-point, largely in line with market expectations.

### Growth disappoints.

The IMF estimated that EM and Developing Economies would grow at 4% in 2015, down from 4.6% the previous year. GDP growth in major markets like Russia and Brazil continued to slide; in the latter, economists revised down their projections multiple times.

### Credit dispersion is key.

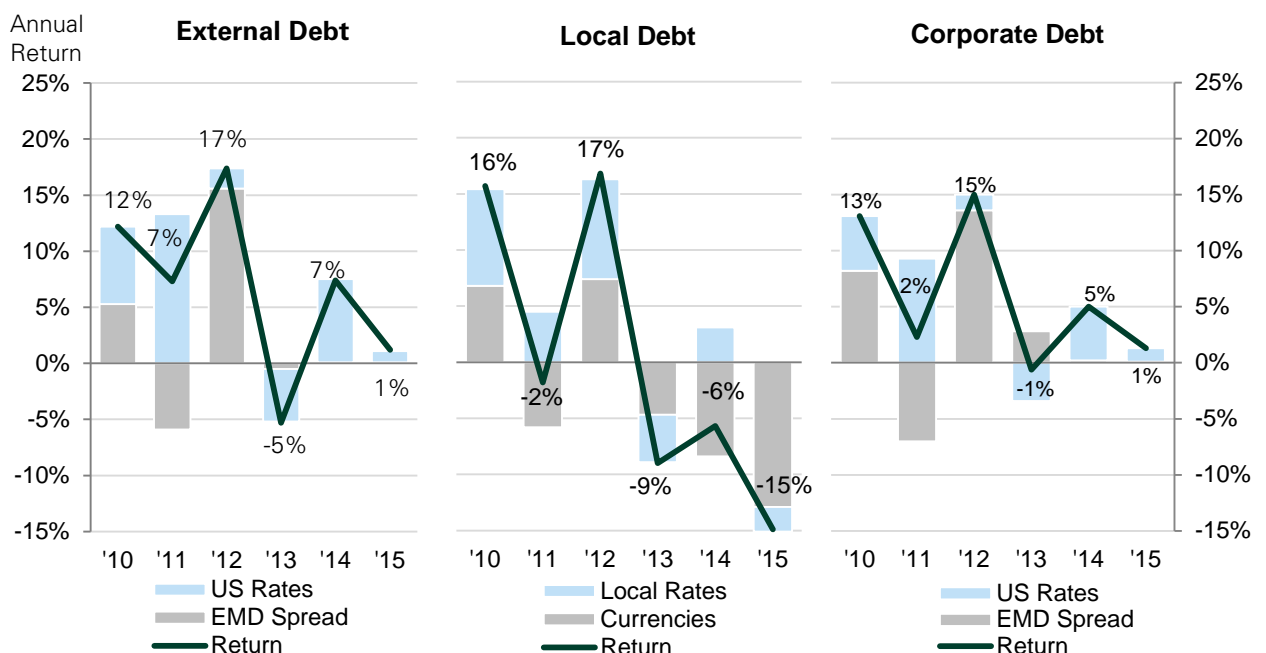
While overall returns for dollar sovereign and corporate bonds seemed moderately positive (~1-1.5%, slightly beating 10-year Treasuries), under the surface volatility reigned. Entering the year, one would have been tough pressed to predict that Russia's dollar sovereign debt would jump over 20% while Brazil's bonds would fall close to 14%. Argentina continued to rally, up ~27% on optimism around elections. Venezuela, despite weaker oil and emptier coffers, posted a ~17% gain (in part simply by paying coupons on time while its bonds traded in the 40s). And numerous African commodity producers sold off as their economies struggle to cope with the downturn, down 7-20%.

### The FX vortex.

EM currencies posted their third straight year of declines, with the FX component of the GBI-EM GD index down 15%. The resurgent greenback, tangled with weak EM growth and sliding commodity prices, stalled any recovery in EM FX.

## EXHIBIT 2: CURRENCY WEIGHED ON EM LOCAL DEBT RETURNS IN 2015

Emerging market annual returns and return components by asset class



Source: JP Morgan, GSAM. External debt is the JP Morgan Emerging Market Bond Index-Global Diversified. Local debt is the JP Morgan Global Bond Index-Emerging Markets Global Diversified. Corporate debt is the JP Morgan Corporate Emerging Market Bond Index Broad Diversified. As of Dec. 31, 2015

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## OUTLOOK FOR 2016

### '98 Problems?

Before discussing the outlook for the year, it's worth touching upon what we don't think is likely to happen. Specifically, we do not foresee a '98-style crisis. We do not foresee a wave of EM sovereign defaults. And we do not foresee myriad EM corporate defaults—not any time soon, at least, and in no major volume (although by number we may well see a pick-up in small issuers folding).

Most EM countries have switched to floating currencies or floating pegs (a discussion of Gulf nation pegs follows below). The majority of EM central banks introduced inflation targeting over a decade ago. Generally, central bank independence has held firm, although we list its gradual erosion in places like Turkey as a risk factor below. EM countries and policymakers have a number of crises under their belts in the span of just two decades – the “tequila” crisis in 1994-95, the Asian crisis in 1998-99 (triggered by Russia's default), previous Fed tightening in 2004-06, and of course the Global Financial Crisis (“GFC”). Memories of the latter are fresh in the collective policymaker memory.

As we have written before, we believe the currency depreciations per se are not life threatening for EM economies. The Aussie dollar, for example, has lost ~35% of its value since peaking in 2012, yet one barely hears forecasts of the country's imminent demise, unlike those regularly voiced on EM in the mainstream press. Unless a country has a large stock of foreign-denominated debt, which becomes burdensome to service, FX weakness can act as an escape valve to offset a terms-of-trade shock. The adjustment is far from painless as purchasing power erodes and imports shrink – we've seen a concomitant drop in world trade – but is far from endangering the solvency of the vast majority of countries in which we invest.

Furthermore, countries like Chile, Colombia and Paraguay have adopted fiscal responsibility laws. Those may translate into a structural fiscal balance requirement, a cap on allowed deficits, or a debt target limiting the cyclical deficits. Defaults, with the exception of Venezuela (~2.1% of EMBI GD index by market value as of December 31, 2015), seem remote. Clouds hang over oil producers like Ecuador (0.87% of EMBI GD) and some African economies like Ghana and Mozambique (0.54% and 0.17% of EMBI GD, respectively) have gone hat in hand to the IMF. Yet there are 64 countries in the index on last count, most of them in decent health. (Source: JP Morgan, as of December 31, 2015)

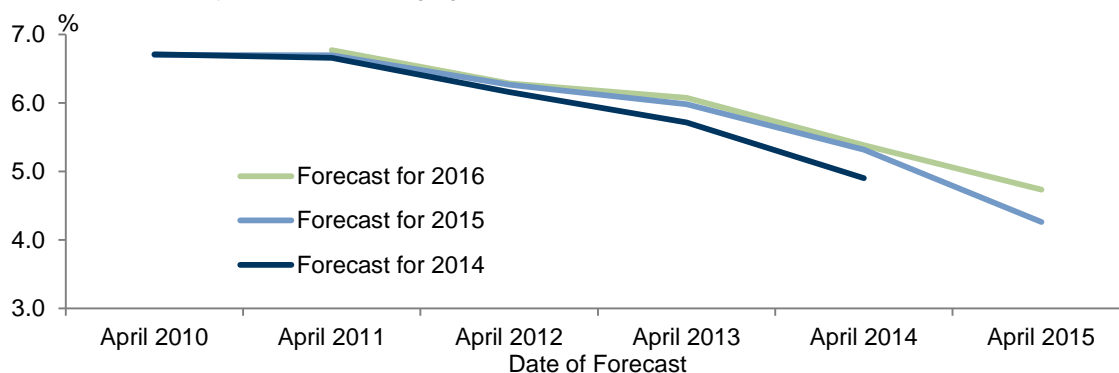
To summarize, EM countries may be knee-deep in problems, but not neck-deep in crisis.

### What's in store for EM in 2016?

EM growth projections have suffered multiple downward revisions (Exhibit 3). In coming years, various EM countries will have to adjust their business model in the absence of a “China put” to their commodity exports. Finding alternative sources of growth takes time and, as a result, a sea change in growth prospects is unlikely. Demographics are still supportive of many EM regions (notably Africa, some parts of Southeast Asia, and the Indian subcontinent). But a bigger workforce is no substitute for a decades-old EM model of digging black gold or precious metal out of the ground and shipping it to the Middle Kingdom.

#### EXHIBIT 3: EM GROWTH PROJECTIONS HAVE SUFFERED MULTIPLE DOWNWARD REVISIONS

International Monetary Fund (IMF) emerging market GDP forecasts



Source: IMF, GSAM. Forecasts are as of the April edition of the IMF World Economic Outlook 2010-2015.

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Yet there is a silver lining. We anticipate growth will bottom out in 2016 in places like Russia and Brazil. Base effects from insipid 2015 GDP figures will kick in. And after three years of declines, the overshoot in EM asset prices should begin to correct. These may not be the high quality growth drivers one hopes for, but they still reflect a potential turnaround. As the bearishness has become consensus, we see meaningful room for a snapback. We believe a near-term rally is unlikely as commodity prices remain a headwind, but we think EM sovereign credit offers valuable carry in a world of ongoing low rates. Given our outlook on sovereign defaults, the sector can offer attractive volatility-adjusted returns. Even if the overshoot in spreads doesn't correct itself immediately, it's difficult to dismiss the 6.5%+ yield in US-dollar terms.

#### Will the Fed tightening poison EM?

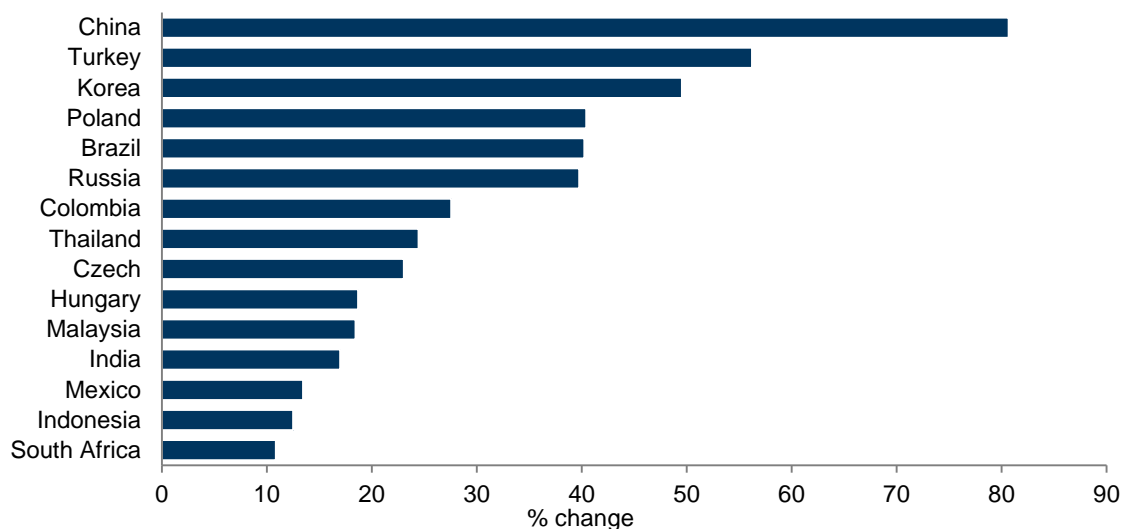
We have long held that widespread concerns of a kind of Pavlovian reaction to the Fed in EM – such as another leg down in EM currencies and leg wider in EM spreads – are misguided. The Fed has gone to great lengths to telegraph its intentions, while Emerging Markets have been in freefall ever since the May 2013 “taper tantrum”. We believe that EM currency, rate and spread moves already reflect an environment of tighter Fed policy. But we must not forget that most episodes of higher US rates prior to 2013 entailed an actual contraction in EM spreads. The pre-“taper tantrum” paradigm suggested higher Treasury yields, assuming they occurred due to expansion in the US, were net beneficial to EM, trade and broad macro stability. Furthermore, even if the Fed delivers the four hikes penciled in by our colleagues in Goldman Sachs's Global Investment Research (markets are baking in somewhere between two and three), that would put the upper-bound of 2016 year-end rates at 1.5% – hardly a mouth-watering yield.

#### Will EM corporate stress or quasi-sovereign debt envelop sovereigns?

A narrative that has taken hold in the press in recent months involves an imminent wave of corporate and quasi-sovereign defaults that spill onto the sovereign balance sheet and even threaten the sovereign's solvency. We beg to differ. While the amount of debt issued and outstanding by both types of institutions is significant (its post-crisis expansion in Exhibit 4 is disquieting), we do not see this becoming a systemic issue. The macro backdrop is already pushing up default rates, yet we don't anticipate a sharp spike or a GFC-style surge in contingent liabilities. And philosophically sovereigns should be willing to walk away from state-owned firms should there be a risk to the country's solvency.

### EXHIBIT 4: EM PRIVATE SECTOR CREDIT HAS EXPANDED OVER THE LAST 10 YEARS

Change in private non-financial debt/GDP ratio from 2005 to 2015

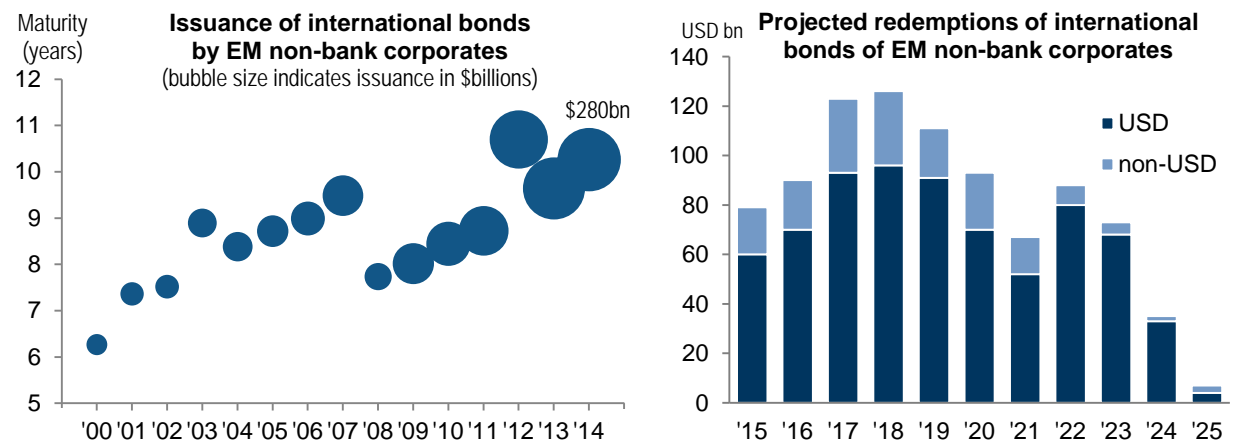


Source: Capital Economics. As of Q2 2015.

Exhibit 5 (left chart) recognizes the large volume of issuance, but also points to the terming-out (read: lengthening) of maturities. As Exhibit 5 also shows (right chart), no refinancing spike occurs before 2017. The volume maturing that year is circa 30% of what corporates borrowed annually around 2013-14. And while figures are not readily available, numerous sources suggest that a sizeable stock of hard currency exposure had been hedged. This also ignores the fact that ~1/3 of corporate issuance is related to commodity exporters, with hard-currency revenues, and another ~40% to banks, with better asset/liability matches. Having said that, the sharp drop in oil prices may cause stress among producers with high or foreign currency-denominated production costs and more levered balance sheets.

#### EXHIBIT 5: CREDIT ISSUANCE HAS ALLOWED EM CORPORATES TO EXTEND THE MATURITY OF DEBT

Issuance and projected redemptions of international bonds of EM non-bank corporates



Source: Citigroup. As of December 2015

We believe some countries will re-open the GFC “playbook”: helping national champions through the rough patch and indirectly aiding the private sector by injecting liquidity into the banking system. And while we are skeptical of the stand-alone valuations on various quasi-sovereigns (our cautious stance in that space is detailed below), a crisis seems remote. We anticipate pockets of distress in EM corporate land, hit by the business cycle as growth troughs in EM. And the on-going corruption scandals in Brazil make the local corporate sector vulnerable. Chinese issuers, on the other hand, have been busy repurchasing their hard-currency debt, rewarding holders by paying above-market. These companies are hedging against further yuan weakness and re-issuing at lower yields in local markets.

We are certainly concerned about the increased debt load faced by Chinese corporates, but not alarmist. The key mitigating factors are: 1) the debt is typically denominated in the local currency; 2) State-Owned Enterprises (“SOE”)s were responsible for part of the borrowing binge financed by State banks. As money went from one government pocket to the other, there is likely room to extend maturities should the need arise. To quote an old banking adage, “a rolling loan gathers no loss”. Nevertheless, this will create a headwind to growth. Non-performing loans have been on the rise and a new stimulus package does not appear forthcoming. The authorities are more likely to use RRR ratios and monetary policy to counter these trends. In the meantime, poor visibility into the dealings of the Chinese banking system will impair foreigners’ ability to follow developments as they unfold. The next section sets out our macro views on China in greater detail.

### What does China mean for EM?

China's 2016 opening salvo of FX and equity volatility was greeted by a worldwide mini-meltdown. So despite accounting for just ~2% of S&P 500 sales and 0.7% of US corporate profits (Source: Goldman Sachs Global Investment Research), China has graduated from being an EM bogeyman and gone global.

The two main concerns at the top of investors' minds are the path of Chinese growth and currency. The ~210%+ of GDP debt pile known as Total Social Financing ("TSF") and accumulated post-GFC further worries markets. The opacity of decision-making around the currency, plus mixed use of policy tools and sporadic intervention have made it increasingly difficult to forecast the path of the yuan this year. While the moves signal further yuan weakness, the authorities keep catching markets off-guard and the pace of decline remains an open question. Descriptions of recent policy actions have ranged from "micro-meddling" to "trial-and-error". Asked about Chinese FX moves, one EM Central Banker said politely, "we need to better understand their reaction function".

While markets obsess over whether Chinese GDP will register 7% or 6.5% growth, we are most concerned with the delta, or the rate of change. In fact, a famous 2007 cable by US Ambassador Randt, made public by WikiLeaks, describes his meeting with then-regional Party Secretary Li Keqiang (already considered "a front runner for elevation to the Politburo") and now China's Premier. It reveals Li's skepticism towards GDP figures, which he refers to as "man-made" and consequently unreliable, "for reference only".

The release also led to the creation of a so-called "Li Keqiang index", a type of GDP proxy, comprising electricity consumption, rail cargo volumes and loan disbursements – factors that Li cited he used in evaluating the state of the economy. As Services became an ever-greater percent of the economy in recent years (51.4% of GDP as of Sep-2015), overtaking Manufacturing and Construction (40.6% of GDP as of Sep-2015), the relevance of that particular index has waned. Various alternative GDP proxies seek to estimate true growth based on a panoply of production and expenditure-side indicators. All spell slowdown in excess of that suggested by the published figures (Exhibit 6).

#### EXHIBIT 6: ALTERNATIVE MEASURES SUGGEST CHINA'S GROWTH IS WEAKER THAN PUBLISHED GDP

Alternative indicators of China's economic growth

Firm	Proxy Name	GDP Proxy Latest Reading	Difference from Official GDP (PPT)
Bloomberg	Monthly GDP Tracker	6.7%	-0.3%
Oxford Economics	GDP Proxy	6.1%	-0.9%
Barclays	GDP Forecast	5.6%	-1.4%
Capital Economics	China Activity Proxy	4.3%	-2.7%
Lombard Street Research	Real GDP Estimate	3.4%	-3.6%
Bloomberg	Li Keqiang Index	2.4%	-4.6%

Sources: Bloomberg Intelligence, Barclays, Capital Economics, Lombard Street Research, Oxford Economics. As of January 2016

One commonly cited factor for the slowdown is the inefficiency of China's stimulus during the global financial crisis, which unleashed a flurry of fixed asset investment. This led to excess capacity, which in turn prompted a decline in productivity and fed into a strong deflationary impulse. The Producer Price Index dropped below zero in March 2012, and has stayed in negative territory for 45 consecutive months since then. The latest reading of -5.9% in December 2015 suggests the tide is not about to turn.

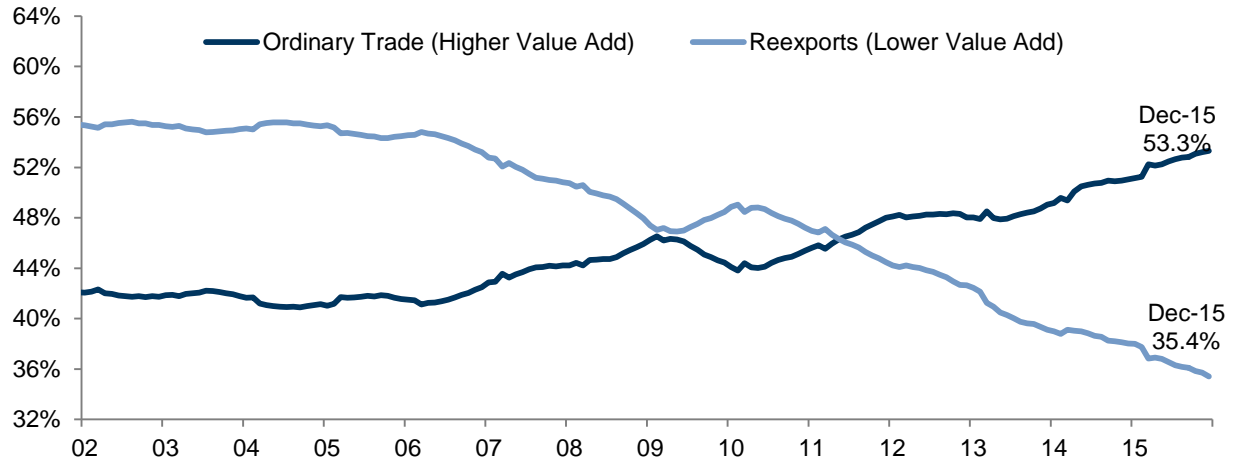
We believe the China slowdown, spare capacity and deflation will continue to feed into a vicious cycle of slower world trade and exported (or imported) dis-inflation. Numerous Southeast Asian countries, while tentatively more competitive as their currencies declined faster than the yuan, remain vulnerable. The open economies of South Korea and Taiwan, for example, continue to suffer from low demand for their exports and are further squeezed by China's advancement up the value chain (see Exhibit 7). Barclays researchers believe the model will evolve from "Made in China" to "Made by China" within a decade – whereby local firms go from making parts or components for re-export to producing the entire gadget or vehicle.

Some EM commodity exporters, on the other hand, built up spare capacity in anticipation of continued or greater Chinese demand, which has instead gone in reverse. And the competitive devaluation in EM minted few clear winners; instead, it resulted in a kind of competitive deflation. The prospects for a weaker yuan are further muddying

the waters. Will EM countries be subject to another round of currency declines as China devalues? As Nixon's Treasury Secretary Connally famously told a group of European finance ministers, "it's our currency but it's your problem". The yuan has become everyone's problem.

#### EXHIBIT 7: CHINA IS MOVING UP THE VALUE CHAIN

China re-exports versus ordinary trade as a percent of total exports



Source: Haver Analytics, KKR, GSAM. As of December 2015.

#### Will the Mid-East pegs break?

While most Middle Eastern countries do not fall into the EM indices we use – their gross national income (GNI) per capita is above the Index Income Ceiling, set by JP Morgan at \$19,403 in 2015 – many of their corporates issue debt that enters the CEMBI benchmark. As a result, we follow these countries closely, and are able to express our views either via the corporate market, or as off-benchmark bets in FX or rates. As oil is the dominant driver of their economies, numerous Gulf nations maintain currency pegs to the US dollar, in which their main export is denominated. Saudi Arabia's has been in place since 1986. With the collapse in oil prices, fixed Gulf currencies moved into the cross-hairs of macro investors. Will these countries be forced to devalue their currencies, creating a shock absorber for weaker oil?

Judging by media coverage, a devaluation is almost unavoidable. In the meantime, the September 2015 IMF Article IV Staff Report on Saudi Arabia actually remarked: "The authorities and the staff agreed that the exchange rate peg remains appropriate for the Saudi economy." (Source: IMF, JP Morgan) We think fears of Middle-Eastern pegs imminently breaking are reminiscent of the fear-mongering over Grexit in recent past. While both arguments have a reasonable economic underpinning, they ignore political and social considerations that often override the dismal science in the real world. In the world of ivory towers, currency unions break and pegs crumble. Reality often treads a different course. Saudi Arabia, for example, has embarked on a slew of reforms and spending cuts to deal with declining revenues and mushrooming deficits. Privatizations appear on the table (even if commentators may be getting ahead of themselves on the timing and size of Saudi IPOs). This may well serve as a potent alternative to changing FX policy – thus preserving stability while undertaking necessary reforms.

But as always, we like to take advantage of dislocations. In this instance, while we maintain the pegs are unlikely to break, some local currencies price in too low a probability of devaluation. For example, while currently suggesting a 1-in-10 chance of a 15% devaluation, the UAE currency was pricing in low single-digit probability some weeks back. For Oman, on the other hand, while implied yields translate into more than a 1-in-4 chance, the country's reserves are significantly lower as percent of GDP than the likes of Saudi Arabia. The Sovereign Wealth Fund ("SWF") assets could provide a boost, but those are often tied up in illiquid investments. Finally, having a short position in the likes of UAE and Oman currencies provides an attractive oil hedge, as further downside in commodities would raise the probability of devaluation (See Exhibit 8).

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**EXHIBIT 8: ESTIMATING THE PROBABILITY OF CURRENCY DEVALUATIONS**

Factors underlying GSAM estimates of currency devaluation probability

Country	UAE	Oman	Saudi Arabia	
Currency	AED	OMR	SAR	
Spot	3.673	0.385	3.752	A
Forward points	0.025	0.014	0.095	B
1yr Forward	3.698	0.399	3.847	C = A + B
Forward Cost	0.68%	3.51%	2.47%	D = B / C
Implied yield	1.49%	4.25%	3.35%	E
Probability of a 15% devaluation	9.9%	28.3%	22.3%	F = E / 15%
FX Reserves (\$ bn)	78.6	19.2	630	
FX Reserves + Estimated SWF Assets	853	32.2	630	
2015F GDP (\$ bn)	339.1	60.2	653	
Reserves / GDP	23.2%	31.9%	96.5%	
(Reserves + SWF Assets) / GDP	251.5%	53.5%	96.5%	

FX data as of January 12, 2016. Source: Bloomberg, GSAM.  
Reserves and SWF data as of November 2015. Source: BAML Research.  
2015F GDP sources: UAE, Saudi Arabia - BAML Research, Oman: IMF.

**What will happen in LatAm – Argentina, Brazil, Venezuela?**

A favorite joke in EM circles in 2014 was that Brazil was becoming Argentina, Argentina was becoming Venezuela, and Venezuela was, well, going somewhere in a handbasket. Fast forward to 2016, and Brazil hasn't changed course, Argentina delivered a positive surprise, and Venezuela's opposition clinched a key parliamentary majority that, alas, may not alter the country's course over the next 1-2 years.

Brazil is the key focus given its prominence in EM indices: 3.4% in EMBI GD, 10% in GBI-EM GD and 6% in CEMBI BD. For all the excitement, Argentina represents less than 2.5% of EMBI GD and ~1.4% of CEMBI BD by market value, and Venezuela just over 2% of EMBI GD. (Source: JP Morgan, as of December 31, 2015)

But if there's a common thread among these three countries it is politics.

- Argentina: The refusal of the previous administration to negotiate with the hold-outs in Argentina's restructuring prompted a technical default and locked the country out of global markets.
- Brazil: For all the talk of "fiscal dominance", political gridlock in Brazil is preventing any meaningful budgetary reform. This leaves few options but to tighten monetary policy again, a big pro-cyclical blow to a fragile economy, and has already cost Brazil its investment grade rating from S&P and Fitch.
- Venezuela: The country's future is further clouded by the roadblocks Maduro's administration is erecting to impede the newly-victorious opposition from enacting any legislation.

**The outlook is brightest for Argentina.** A decade ago a prominent journalist accused then-President Nestor Kirchner of corruption and mismanagement, comparing his policies to "chocar la calesita" or "crashing the merry-go-round". While an overly benign moniker for Argentina in the best of times, it remains to be seen whether Mauricio

Macri can reverse the damage. Argentina's debt in EMBI GD rallied by nearly 300 bps in 2015, closing the year at ~440 bps.

**Two uncertainties put pressure on Brazilian asset prices** in the past months: the political paralysis and its effect on Brazil's ability to meet the primary deficit targets, and the country's rating. As mentioned above, the political gridlock remains in place. The rating uncertainty has been eliminated, although the resolution was obviously negative. An issue with Brazil valuations is the lack of a catalyst. Impeachment remains unlikely, and politicians do not appear any closer to making Brasilia, the capital, a functional place.

The on-going corruption investigations have rocked the country and continue to weigh on Congress and the administration. On last count, there are 144 people charged with crimes, of which 34 are sitting congressmen (Source: *The Economist*). Judges have commented they barely scratched the surface among politicians, and more arrests are in store. While the economy remains in limbo, there is a bright side: this is likely the biggest round of anti-corruption investigations since Italy's famed *mani pulite* process in the 1990s. They should discourage graft in Brazilian business and politics, and can make the country a better, more transparent place to do business in years to come.

**Brazil's problems pale in comparison to those faced by Venezuela.** The opposition victory in parliamentary elections prompted the Maduro administration to harden its stance, rather than encourage a move to the center. The country's bonds trade in the high 30s in cash price terms, with 5-year CDS implying over 98% cumulative probability of default. The critical months for debt repayments this year – with \$1.5-3bn due in each – are February, October and November. We estimate a \$1 change in oil price is equivalent to 9% of the country's debt service. And at \$28 per barrel for the Venezuelan crude basket, which typically trades at ~15% discount to Brent, debt service represents ~42% of total exports. While a February payment seems likely, the Q4 maturities will be difficult to make under current circumstances. With oil prices in the low 30s and little political leeway, default may be a question of "when", rather than "if".

## What are the other key risks for EM in 2016?

We believe there are five key risks for 2016, in no particular order:

- **Policy mistakes**  
The stress experienced by many EM economies may prompt policymakers to adopt politically expedient measures that will have negative longer-term consequences. Examples include capital controls, import quotas, or excessive reserve depletion. The independence of Central Banks may come under greater pressure (Turkey is a prime suspect).
- **Populism**  
While some of the above policy mistakes may have roots in leaders unwilling to make difficult adjustments, another is fiscal tightening – political kryptonite, especially in recessionary times.
- **(Geo)Politics**  
Unfortunately, being short world peace may be the safest trade of 2016. With large parts of the Middle East and North Africa in conflict, terrorism and cyber-terrorism rife, international relations are strained across the globe. This leads to fluid alliances and can have knock-on effects on growth (tourism to countries experiencing terrorist attacks evaporates). A slew of elections in EM will further challenge the sector.
- **Pro-cyclical tightening**  
As highlighted by Goldman Sachs's Global Investment Research, the Fed tightening comes at a time when some EM economies may be unfit to follow its path, yet forced to comply to reduce the risk of capital flight. In Brazil's case, the inability to tighten its fiscal stance is prompting the country to embark on further hikes while GDP growth continues to fall.
- **FX intervention**  
The IMF prescribed reserve accumulation for EM countries after the Asian crisis, to be used for a rainy day. Many countries complied and are now using the funds to get past the stormy days in EM. So while intervention is common to curb currency volatility (reserves are there for a reason!), prolonged or excessive depletion of reserves raises red flags.

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## Portfolio Themes and Positioning

There are four broad themes in the portfolio, some still intact from early/mid-2015 and some more recent:

- **Bearish on China and Southeast Asia**

The persistent China risk is exacerbated by the limited set of hedging instruments. We remain partial to owning protection on the country via China CDS and staying short the renminbi. We reduced exposure to China quasi-sovereigns and corporates in EMBI GD and CEMBI BD benchmarked portfolios. In addition, we remain short a basket of Southeast Asian currencies.
- **Bearish on the Middle East**

We have owned zero in Lebanese bonds for a long period of time, concerned with its “bad neighborhood,” potential dollar shortages and concentrated holdings of sovereign debt in local bank books. With oil prices collapsing, we have trimmed exposure to Middle Eastern quasi-sovereigns and corporates in EMBI GD and CEMBI BD benchmarked accounts. In addition, even if ultimately the pegs hold, we think the currencies of Oman and UAE misprice the risk of a devaluation.
- **Overweight oil importers and selectively adding to oil exporter names**

We remain bullish on the Central American / Caribbean region (Dominican Republic, Costa Rica, Honduras, Guatemala), which imports oil and relies on American tourism. We have overweight positions in Colombia and Azerbaijan, countries we believe are appropriately handling the downturn in oil; we hold a position in Venezuela, where the near-term path is uncertain but ultimate recovery should be meaningful.
- **Underweight Quasi-sovereigns**

While we believe sovereigns will stand by their national champions, the business models of these companies (many in the oil and gas business) are suffering. Their stand-alone (ignoring sovereign ownership) credit quality is sliding, and at current levels spreads do not fully account for the deterioration.

## Conclusions and Relative Value Comparison

- With China fears having become a global phenomenon, adverse news flow from Beijing seems to produce a broad risk-off environment. Arguably, EM assets have repriced ahead of developed markets, capturing higher China vulnerability.
- Given our views on EM growth turning the corner, we think EM local debt will become an attractive investment in 2016. However, having an appropriate 2-3yr horizon will be key, as further noise and volatility can't be ruled out.
- As EM currencies continue to gyrate, investors can still get attractive yield pick-up without having direct exposure to FX by investing in the external sovereign or corporate bonds.
- We believe EM external sovereign credit remains cheap, both relative to the underlying risk of default and compared to other sectoral “options” in fixed income.
- But with no end to oil weakness in sight, we think 2016 will be about “carry over rally”, even if, in our view, sovereign fundamentals will eventually prompt tighter spreads.
- For EM corporates, the theme is “alpha over beta” – plentiful opportunity for credit selection given the index has over 550 names – but overall spreads on the sector do not seem to have repriced fully.

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