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EMFI Monthly Market Outlook

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EMFI Team, January 2016

MARKET OVERVIEW

2015 closed on a weak note for Emerging Markets and global risk assets more generally. Unfortunately for investors betting on a 'January Effect' turnaround, markets over the first week of the New Year have been similarly disappointing with renewed concerns about the three biggest drivers of emerging market (EM) risk last year: US Federal Reserve policy, oil and commodities pricing, and Chinese growth. While none of these factors seem particularly confidence-inspiring at the moment, the huge adjustment we have already seen in EM asset prices and currencies should provide a considerable cushion for the year ahead and be a limiting factor for expected volatility relative to 2015.

After a brief rally triggered by rising tensions between Saudi Arabia and Iran, oil prices have continued to fall on weak global demand and rising supply and inventories. The end of the ban on US exports should further contribute to the global glut and has already narrowed the spread between West Texas Intermediate (WTI) and Brent to near parity. We maintain a downside bias to our expectations for oil this year but not significantly so. For some producers such as Colombia, the worst of the pain is likely already behind, with oil revenues linked to producer company margins which have declined more than the actual commodity's price. FX weakness has also provided a significant offset in terms of local currency revenues and external balances.

In terms of the two biggest engines of global growth, United States and China, we are somewhat more optimistic and believe that an unexciting muddle-through scenario is most likely. For the US, this means that economic growth is not accelerating significantly, and the pace of Fed tightening is likely to remain very modest. However, there is enough momentum in employment and consumer spending to sustain investor risk appetite, particularly for higher quality assets. In China, weak manufacturing data triggered a rout followed by heavy government intervention in the stock market.

This is additional evidence that the economic transition from manufacturing and exports to domestic consumption is proceeding and not indicative of a breakdown in Chinese economic activity.

EMFI MARKETS

EMERGING MARKETS EXTERNAL DEBT

Hard currency sovereign bonds fell 139 basis points over the course of the month, while the high yield component gave up some of its recent outperformance relative to investment grade. The overriding theme for the month was rising spreads in oil exporting countries led by Africa and Latin America, as well as other primary commodity producers. Brazil, Iraq, Gabon and Zambia each lost in excess of 5% on a total return basis. Venezuela posted a smaller loss of 350 basis points in spite of the increasingly dire dollar liquidity crisis facing the country. Early in the month, National Assembly elections resulted in super-majority victory for the opposition and a sharp shift rightward in terms of the economic policy outlook. The range of options the government has to address the economic situation is however extremely limited, and some form of debt restructuring in the next 18 to 24 months seems likely.

EMERGING MARKETS LOCAL CURRENCY DEBT

EM sovereign debt issued in local currencies underperformed their dollar counterparts, losing 223 basis points over the month. Local rates fell 71 basis points with the remainder due to FX losses. On a regional basis, South Africa was the worst performer, losing more than 13% on a total return basis. The country continues to trade with extreme volatility in light of weakening fundamentals, rising probability of sovereign ratings downgrades and policy missteps by the government. Economic policy credibility was severely compromised by the appointment of David van Rooyen as Minister of Finance who only lasted a few days before being replaced by former Finance Minister Pravin Gordhan. While this quick capitulation was welcomed by investors, the country still faces a very challenging outlook.

EMERGING MARKETS CORPORATE DEBT

Corporate bonds traded broadly in line with sovereign, albeit with a more marked degree of underperformance by high yield. The broad index fell 154 basis points versus a loss of 265 basis points in the lower credit quality basket. Once again, the dominating trend was oil and commodities weakness, with producers in Africa and Latin America struggling.

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