

Emerging Markets Debt Update

Monthly Commentary

February 2012

Market review

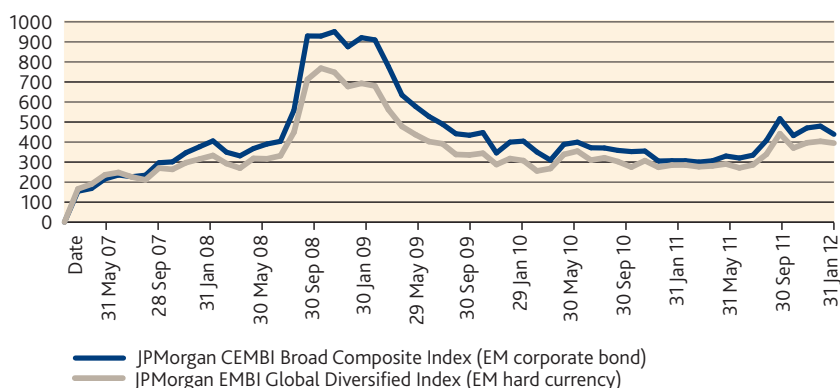
Emerging market debt posted strong gains in January on back of improved global risk appetite, which was triggered by the ECB's liquidity injection via the initial Long-Term Refinancing Operation (LTRO) and the US Federal Reserve's dovish interest rate outlook. On the month, the JP Morgan EMBI Global Diversified index (hard currency) gained 1.58%, while the benchmark spread narrowed 9 basis points (0.09 of a percentage point) to +395 over US Treasuries. Local currency debt outperformed hard currency debt, benefitting from strong currency gains, with the JP Morgan GBI-EM Global Diversified index surging 7.4%.

Sub-investment grade sovereigns were the notable outperformers in hard currency, with Ivory Coast up 15% while Argentina and Venezuela gained over 7%. Investment grade sovereigns generally lagged due to new supply, with Brazil, Mexico, Indonesia, Turkey and Lithuania all offering new issuances on the primary market. In local currency debt, Mexico and Hungary gained over 10% while Turkey, Poland, Russia, Brazil and Colombia also outperformed.

Performance of Emerging Market Debt (to 31 Jan 12)

Total Return %, USD	1 month	3 months	YTD	1 year	3 years	5 years
JPM EMBIGD (hard currency)	1.58	1.82	1.58	9.70	56.80	48.60
JPM GBI-EM GD (local currency)	7.42	2.22	7.42	7.19	58.36	68.04
JPM CEMBI Broad Diversified (corporate)	3.06	2.28	3.06	6.46	64.52	48.74

Spread over US Treasuries (basis points), USD



Note: A comparable spread is not available for the local currency (GBI-EM GD) index.

Source: JP Morgan, Bloomberg.

Past performance is not a guide to future performance.

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Sub-investment grade sovereigns were the notable outperformers in hard currency

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Aside from some profit taking and discussions over a 'haircut' for private sector investors in Greek debt, there appears to be little in the way of headwinds for risk assets

China

China's official December PMI came in above consensus, ending its declining trend of two consecutive months with a rise to 50.3. This resulted from healthy gains in new orders including exports. The trade data were more mixed, with exports modestly softer at 13.4% year-on-year while imports increased 11.8%, the lowest annual figure over the past two years. This resulted in a widening trade surplus, which increased by 13.7% month-on-month to US\$16.52bn, compared to US\$13.08bn one year ago. On a positive note, inflation continued to decline, albeit marginally in December to 4.1% year-on-year from 4.2% in November. Food prices rose 1.2% month-on-month and 9.1% year-on-year, reflecting seasonal supply shortages, especially in vegetables, while non-food consumer price inflation dropped 0.1% month-on-month and rose 1.9% year-on-year.

Brazil

Brazilian monetary policy remained dovish following the expected 50 basis points (0.5 of a percentage point) interest rate cut to 10.50%, with the post-meeting statement making it clear that the policy rate could fall to single digits. The Brazilian Monetary Policy Committee justified its decision by citing an unfavourable global macro outlook, the behaviour of commodity prices, and the opening of an output gap that would allow inflation to converge to its 4.5% target in 2012, remaining there in 2013. The market is pricing in further interest rate cut of 110 basis points this year but remains unconvinced on the inflation front, with expectations at 5.28% in 2012 and 5% in 2013.

Mexico

Mexican inflation surprised on the upside in December, rising 0.82% and to 3.82% year-on-year from 3.48% due to higher core processed food prices, and lingering energy tariff prices. Monetary authorities played down the recent inflation spike, citing the stability of core measures while maintaining the 4.5% policy rate. The post-meeting statement was viewed to be more dovish than the previous one, with the Monetary Policy Committee seemingly distancing itself from concerns expressed in the past about Mexican peso weakness. While we think there is scope for an interest rate cut in the coming months, supported by the recent peso recovery, which gained over 7% against US dollar in January, the window of opportunity for central bank to take action will be limited ahead of the presidential election in July.

Hungary

Hungary's monetary authorities surprised the market by keeping the policy rate unchanged at 7% following two consecutive 50 basis points interest rate increases. National Bank of Hungary Governor, Simor noted that the decision to keep rates on hold was a close call, with a 50 basis points rise also discussed. Monetary policy will remain hostage to progress on IMF/EU negotiations, which have provided a respite for Hungarian assets following a big selloff earlier in the month. Nonetheless, we believe talks with the IMF and EU on a financial support programme could become protracted as they will first require the reversal of several controversial laws passed by the Hungarian government in late 2011.

Ivory Coast

Ivory Coast Eurobonds posted robust gains ahead of, and following a meeting with commercial creditors in London. Ivorian officials provided clarity on the economic and financing outlook, and assured creditors they would meet the next coupon payment in June after missing the previous three payments due to the political crisis. Finance Minister Diby confirmed they would also make a 'good faith' payment on the missed coupon payments, and said they would present a restructuring plan on the outstanding amount once the country has reached its HIPC Completion point, which they expect in H2 2012. HIPC debt relief from public sector creditors should provide further support for Ivorian Eurobonds, along with confirmation of the June coupon payment.

South Africa

South African inflation surprisingly remained, unchanged in December from the previous month, at 6.1% year-on-year, while moderating in sequential terms to 0.4% month-on-month from 0.5%. Inflation remains above the South African Reserve Bank's 3-6% target range, and is at its highest rate for almost two years, but the SARB remains reluctant to tighten monetary policy given the sluggish growth outlook.

Outlook

Following a cautious start to the year, risk assets have been buoyed by the actions of the European Central Bank and the Federal Reserve. The ECB's €489bn Long-Term Refinancing Operation (LTRO) has addressed concerns about the financing outlook for the European banks, while the Fed surprised the market by extending the start of its interest rate normalisation process to the end of 2014. Expectations of the second LTRO operation at the end of February, which could double the size of the initial allocation, will provide further support for risk assets in the coming weeks. Aside from some profit taking and the Greek private sector involvement discussions, there appears to be little in the way of headwinds for risk assets.

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