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EMFI Monthly Outlook January 2012
A pause rather than a new start

MARKET REVIEW & OUTLOOK

After the holiday break, with a New Year starting, we all dig into the process of looking at what's new and figuring out strategic themes for the year ahead. A fellow money manager colleague qualified current trading environment as one in which the mechanism of transmission of liquidity are in a state of hypostasis (this term is used in mechanics and refers to the fact that one piece of an assembly retains at least a degree of mobility, creating instability and parasitic movements in the overall structure). Rather odd for a currency expert, but summarising well current low volumes and absence of risk taking. Usually the themes that prevailed during the last weeks of the year are pushed by market participants. This early January trading action follows this traditional pattern so far: sell Eastern Europe (all Europe related I shall say), and buy Latin America; be defensive because global growth is weak or expected to be weak. We do not differ from the consensus on regional macro views, but think there are more opportunities on cyclical assets than the consensus portrays. We have discussed extensively over the last quarter our rationale for investing and our scenario analysis, but it is worth highlighting our main conclusions: external debt to outperform; growth momentum not uniform with US and Latin America in a relatively strong position; market priced for a European recession and weak global growth.

In December, we outlined our view that the conditions are in place for a rally into year-end and into the first quarter, driven by investor defensive positions, the gloomy economic views priced into global assets, and improving economic momentum. Can real numbers outperform economists' expectations? The bar is not set very high thankfully. US numbers have been coming in not only better than expected but strong by absolute measures. The US rebound is a boost for our long Latin America against Eastern Europe trade, and we expect this trade to continue to perform well (mainly from the long Latin America leg). Mexico is enjoying the US growth lift, and Brazil activity bottomed around October. On this side of the Atlantic things look fine to rosy. On the other side of the world, Eastern Europe divergence increased between large domestic markets and small-open economies, but overall here as well economic numbers failed so far to catch-up with bearish economist views. Surely the European banks deleveraging process will be a huge drag on the region for the year and possibly next, but it seems that the transmission channels are taking longer to operate. Be wary on the bear market rally in European assets! Lastly, in China the monetary policy has now turned to be more supportive of domestic growth, limiting near term risks. The rally has been underwhelming so far to say the least, with equity and currencies being left out. The near term outlook continues to favour sovereign and corporate debt. Currencies will need a catalyst, the swap line rate cut last month did not prove enough, but EMFX is outperforming developed currencies.

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ALPHA STRATEGIES

Emerging markets external debt rallied in the last month of the year, helped by stable spreads and lower UST yields. The EMBI Global Diversified index was up 1.1% in December. We think the rally has more leg, driven by Latam high-yielders outperformance. Our main positions remain unchanged during December, seeing value in Argentina and Venezuela (primary elections in February), while remaining neutral in Eastern Europe. We remain long Russia (against Turkey and South Africa now), and do not see the upcoming presidential elections as a threat for the market: protesters want change not a revolution; they are asking for a strengthened democratic process but no radical change. In the medium term, this is likely to stimulate the democratic debate and the formation of a true and united opposition. In the near term, oil prices are high and the balance of payment will show a huge surplus in the first quarter. The sovereign debt primary market has been very active quite early in the year. We expect supply dynamics to be an important driver on top of macro views, the two of them having compounding effect in most individual cases. High-yielders have been outperforming high-grade names so far this month, and we expect this trend to continue.

Emerging markets corporate debt performance continued to improve at the end of last year, and is starting the New Year solidly. The CEMBI Broad Diversified rallied 0.8% in December. With liquidity drying up already mid-December, market action was reduced to a minimum during the holiday period. Money seems to have been put to work at the start of the year, and new issues are being absorbed well so far. Heavy cash flows and already high cash balances in funds are helping absorb the supply coming at a premium. We like cyclical assets exposed to strong EM domestic demand and buoyant commodity prices. We are underweight steel against iron ore producers. High-yield is outperforming high-grade by a wider margin than in sovereign debt, helped by technicals and attractive carry.

Emerging market local currency debt remains lost in limbo, struggling to find a direction since October. The GBIEM Global Diversified lost 1.5% in December. Latin American currencies versus Eastern European ones remain our favourite trade. We remain mainly exposed via relative value, but now with a tactical long bias. We like the BRL, COP and RUB are our favourite currencies to express a cyclical assets bias. Equity portfolio flows and strong balance of payments are better selection criteria for currencies than valuation in a poor liquidity environment. EMFX performance is best captured against a basket of developed currencies. We continue to diversify our funding away from the US Dollar. Demand for Dollar assets is strong, given the healthier state of the US economy and financial sector compared to other developed countries. Dollar demand is putting pressure on funding rates as well, although the pressures are mostly felt where home-grown problems have surfaced (Hungary policy drift, and Turkey inflation problem). Despite slower growth, we are not expecting much in terms of rate cuts. Dollar funding pressures, resilient growth in major EM countries and already flat curves, are all conspiring to push local rates higher and curves steeper. We are defensive on the long-ends and prefer to position in the 3 to 5 year sectors.

Michel Aubenas, CFA
Portfolio Manager & Macro Strategist
Tel: +44 (0) 20 7063 75 12
michel.aubenas@fftw.com

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