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There's been considerable speculation on the outlook for rates this year, with little actual movement. This piece suggests something a bit different and raises the potential for an outsized move in EM spreads to Treasuries. A discussion of specific trade ideas that flow from this analysis will follow in a **DG Views** piece tomorrow. - *Andres Drobny*

Where Not to Invest in 2013!!

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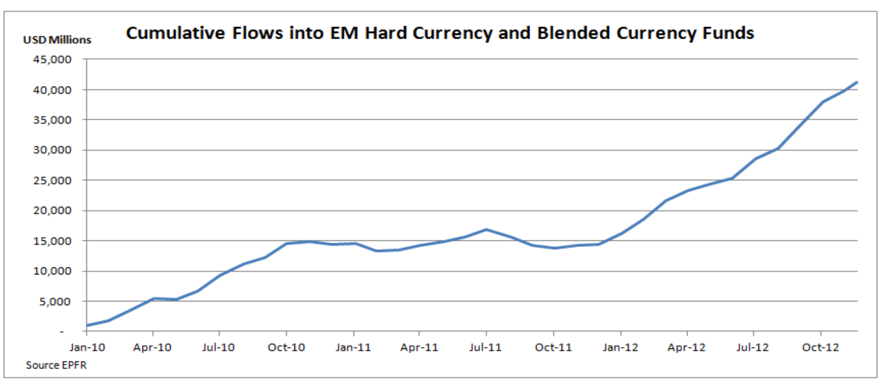
In 2012, investors displayed a remarkable preference for long only, dedicated investments in emerging markets. They have continued to pour money into long-only EM hard currency debt funds in apparent response to strong historical performance of the index, a lack of yield in developed fixed income and a comparatively positive growth outlook for emerging markets relative to developed markets. They are now investing in yields which have little chance of providing the return to which they have become accustomed.

Emerging markets were on a tear in 2012, with the JPMorgan EMBI+ returning 18.04%. 2012 retail flows into EM bond funds were $41 billion, with over $27 billion going to hard currency and blended currency funds (EPFR data). Institutional flows into the asset class were also sizeable.



There are misconceptions about this asset class, which may lead to investor disappointment. The historic returns of these bonds have been very impressive, but a disproportionate part of the performance of the asset class over a five year horizon has come from the rally in US Treasury bonds. The table below compares headline index returns with those obtained strictly from spread exposure.

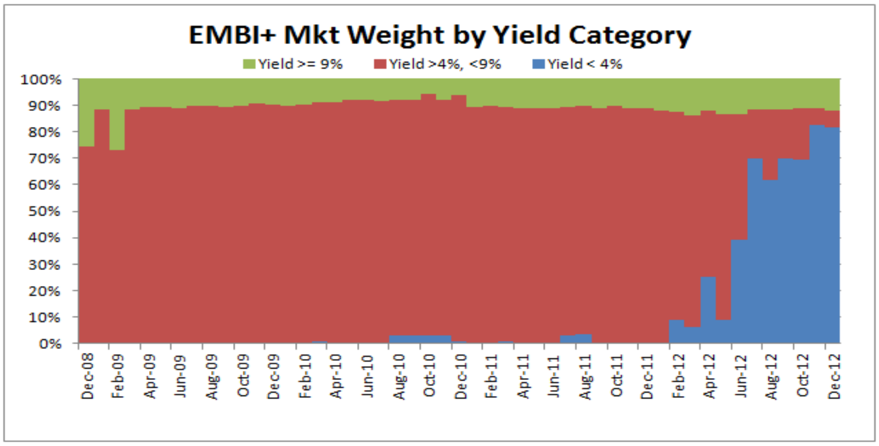
Historical EMBI+ Index Returns		
Year	EMBI+ Index Return	EMBI+ Spread Index Return [1]
Jan 2007-Dec 2012 (Annualized)	9.72%	2.97%
2012	18.04%	16.35%
2011	9.20%	-4.93%
2010	11.83%	5.21%

[1] Rates hedged index returns. Source: JP Morgan

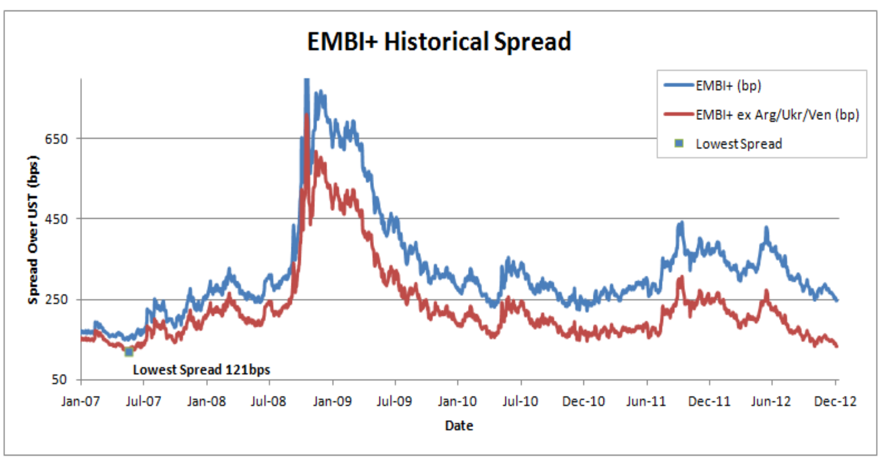
The JPM EMBI+ is an index that tracks the most liquid sovereign hard currency instruments. Its yield is now at historic lows with 82% of the index represented by bonds yielding less than 4%. Besides these low yielding countries (where future performance will be driven disproportionately by Treasury returns), only Argentina and Venezuela, which represent 12% of the index, have yields over 9%, and only 6% of the index have yields between 4% and 9%. So when an investor buys the EM Hard Currency Index, he/she is investing in a very bifurcated market where 8 out of 10 issuers offer very little premium over Treasuries and 1 out of 10 is distressed. The mid-yield credits that used to make up the majority of the hard currency universe no longer exist. The table below shows the weights, spreads and yields of the component countries in the EMBI+.

EMBI+ Components by Country (12/31/12)			
	EMBI+ 2012 Ave Wt	Current Spread	Current YTM
Argentina	2.18%	991	11.87
Brazil	12.45%	142	3.57
Bulgaria	0.47%	94	1.19
Colombia	5.46%	112	3.24
Croatia	1.52%	304	4.13
Ecuador	0.22%	826	8.59
Hungary	2.04%	349	5.24
Indonesia	7.02%	156	3.62
Mexico	13.03%	126	3.59
Panama	3.10%	129	3.44
Peru	4.00%	114	3.48
Philippines	9.25%	119	3.31
Russia	12.30%	128	2.97
South Africa	2.85%	139	3.06
Turkey	13.09%	176	3.78
Ukraine	1.64%	598	6.93
Venezuela	9.38%	773	9.42
EMBI+	100.00%	248	4.45

The graph on the following page shows how the proportion of the index in various yield buckets has changed over time. It is a dramatic change and as highlighted above, it is self- evident how the index is now comprised of very low yielders compared to recent history.



Investors may look at the spread of the EMBI+ (248 basis points) and think that the premium looks reasonable relative to history (historic spread lows of 149 in 2007); however, this spread is coming disproportionately from the most distressed issuers (Argentina, Ukraine and Venezuela) which account for 46% of the spread. The following graph shows that the historical spread over Treasuries for the EMBI+, and for the same EMBI+ with Argentina, Ukraine and Venezuela removed. With the high yielding credits removed, the spread of the EMBI+ drops to 132 basis points, just 11 basis points from its all-time low of 121 basis points in 2007.



Investors may think that the 10% historical average return over the last 5 years of the EMBI+ might continue. But in order to get returns anywhere close to 10% for 2013, Argentina and Venezuela need to rally tremendously. Effectively, an investor who is long EM debt at these levels either 1) has a very positive outlook on Treasuries or 2) believes that Argentina and Venezuela will recover from currently distressed levels. If Treasury rates do not rally at least 50 basis points, it is very difficult to get to a 10% return target for EM hard currency debt.

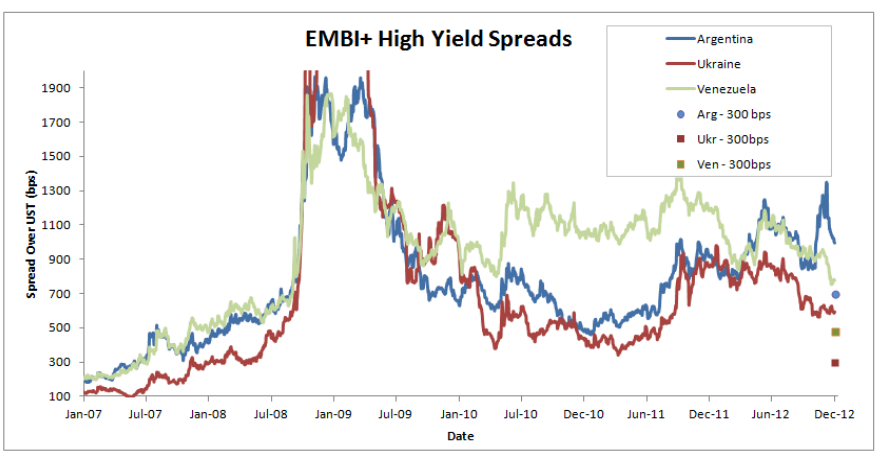
The following table illustrates what EM returns would be under different assumptions for US Treasuries and high yield sovereigns. If Treasury bonds were to remain around current levels, then high yield sovereign spreads (Venezuela, Argentina and Ukraine) would need to tighten by 500 bps to have a market return of 8.9%.

Scenarios from Moving US Rates and HY EM Spreads
other EM Spreads Unchanged

	Treasury Rates				
HY EM Spreads [1]	-50bps	-25bps	unch	+25bps	+50bps
+200 bps	6.9%	4.8%	2.7%	0.6%	-1.5%
+100bps	7.8%	5.7%	3.6%	1.5%	-0.6%
unch	8.7%	6.6%	4.5%	2.4%	0.3%
-100bps	9.5%	7.4%	5.3%	3.2%	1.1%
-200bps	10.4%	8.3%	6.2%	4.1%	2.0%
-300bps	11.3%	9.2%	7.1%	5.0%	2.9%
-400bps	12.2%	10.1%	8.0%	5.9%	3.8%
-500bps	13.1%	11.0%	8.9%	6.8%	4.7%

[1] Argentina, Ukraine and Venezuela

This would imply Venezuelan EMBI+ spreads tightening from 773 bps at year-end to less than 300bps by the end of 2013. Argentine assets that are in the EMBI+ would need to rally from 991bps to less than 500bps, which are levels last seen in early 2008. We show how a 300bps rally for each of these credits would be relative to their long-term histories.



Unfortunately for investors, last year's 18% EMBI+ return can only be seen in the rear view mirror. EM hard currency debt used to offer an attractive combination of high spreads that worked in market rallies and exposure to Treasuries that offered some protection in a risk selloff. The current combination of low spreads and low Treasury yields offer limited upside in most market environments. Buying EM now is an inefficient way of buying a combination of Treasuries, Venezuela and Argentina. At these low yield levels, returns of the higher quality EM bonds are much more sensitive to Treasury rates.

We do not think Treasuries will add to returns in the coming year, since we agree with most investment banks that Treasury rates are more likely to rise over the next year than remain at current levels. Replacing the Treasury scenarios in the table with scenarios for low beta sovereigns, which we remind you represent 82% of the index, shows that these low yielding sovereigns need to have their spreads decline by 50bps to generate an 8.0% return. That would require spreads to fall below the 2006/2007 lowest historical levels. In this scenario, spreads on 10-year bonds from Mexico and Brazil would yield just 30bps over US Treasuries.

Scenarios from Moving Low Yld and HY Spreads
UST Rates Unchanged

	EM Low Beta Spreads				
HY EM Spreads [1]	**-50bps**	**-25bps**	**unch**	**+25bps**	**+50bps**
+200 bps	6.2%	4.5%	2.7%	0.9%	-0.8%
+100bps	7.1%	5.3%	3.6%	1.8%	0.0%
unch	8.0%	6.2%	4.5%	2.7%	0.9%
-100bps	8.9%	7.1%	5.3%	3.6%	1.8%
-200bps	9.8%	8.0%	6.2%	4.5%	2.7%
-300bps	10.6%	8.9%	7.1%	5.3%	3.6%
-400bps	11.5%	9.8%	8.0%	6.2%	4.4%
-500bps	12.4%	10.6%	8.9%	7.1%	5.3%

[1] Argentina, Ukraine and Venezuela

Next year it will be vitally important for EM external debt investors to get the high yield component of the EMBI+ correct. Trading high beta countries is always a balance between the quality of the credit and how an investor is being compensated for the risk. Each of the high beta stories is complicated. Following is a brief synopsis of each credit including our strategy:

Venezuela: President Chavez was re-elected to another 6-year term in October, handily defeating opposition candidate Capriles. Chavez has been ill for the past 18 months with some sort of sarcoma in his abdomen. He has been treated exclusively in Cuba amidst much security and secrecy. He is rumored to be in a coma (as of early January), but has endorsed his Vice President Maduro as his surrogate in the event that he cannot begin (or fulfill) his term. While it looks unlikely that Chavez will be president 6 months from now, it is uncertain who would win a snap election between Maduro and opposition candidate Capriles. By law, a new election must be called within 30 days of death or incapacitation. In December, the opposition candidates were heartily trounced by the PSUV (Chavez's party) candidates in gubernatorial elections. This is casting doubt on the market thesis that we are looking at certain regime change in Venezuela. Even with a Maduro victory, we think that Venezuela spreads are too high given the default risks and we are focusing our risk in the short end of the Pdvsa curve where yields are close to 8%.

Argentina: The holdout saga reached a fever pitch in November when a NY judge ordered Argentina to pay \$1.3bln into an escrow account at the same time it made December coupon and warrant payments. He also lifted a stay from a prior ruling that had allowed Argentina to make external debt payments while litigation continued. Since it was unlikely that Argentina was going to make payments escrow and we speculate that they began to make arrangements to pay the coupons onshore. The US appeals court stepped in and re-instated the stay while lifting the escrow requirement. New arguments are due at the end of February, and a ruling expected in the spring. If Argentina loses this round, they have said they will appeal to the US Supreme court. The debt has rallied in the interim, but the fortunes of bond investors will ultimately be determined by US Courts. This will continue to be a volatile credit and we will continue to trade local markets FX and rates against bond positions. We prefer the local law dollar debt to international law debt.

Ukraine: This is the tightest of the high yielders, but could be the most problematic credit. In order to avoid a full blown balance of payments and currency crisis, Ukraine needs to join a customs union with Russia in a deal where Ukraine would have access to lower imported gas prices. If this doesn't happen, it is crucial for Ukraine to get an IMF agreement this year, and the market is assuming that this is close to a done deal. We think the IMF is more likely to play hardball due to Ukraine's checkered past of fulfilling IMF programs. The two main sticking points are gas subsidies and the FX policy. Both are on an unsustainable path. Ukraine is one of the most inefficient users of energy in the world and shows no signs of reforming. They import gas at a price of \$440 per 1,000 cubic meters and sell it at \$100 per 1,000 cubic meters. This costs Ukraine \$10 billion a year. On the FX side, the reluctance to devalue seems to stem from bank positioning. Banks carry \$24 billion of hard currency debt, and in addition are running a \$10 billion short dollar position. A devaluation would be very painful. The 2013 budget is another problem. The government is likely to be operating under an assumed budget deficit of 3.2% GDP, but this is assuming real GDP growth of 3.4%. This would make it the fastest growing country in Europe. The actual number is likely to be flat. We will be watching the IMF negotiations (if they start) carefully and are looking for levels to play Ukraine from the short side.

In summary, we think that passive investing in EM for 2013 is not going to return anywhere near the 5-year average of close to 10% that we have recently seen, let alone last year's 18% return. Investors who are chasing historic returns are in for a potential disappointment. We think the opportunities for active and total return investing in EM will reward those that can move between local and external EM swiftly. Black River has a long history of navigating turbulent and smooth waters in emerging markets, and has a broad and very knowledgeable team. We are excited about the opportunity set in EM, and believe that investors should be actively allocating to EM, but not through passive nor index outperformance long-only vehicles, chasing past returns that will be impossible to replicate.

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