

# HEDGEYE

## **#EMERGINGOUTFLOWS ROUND II**

**DARIUS DALE: MACRO TEAM**

MARCH 12, 2015 UPDATE

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# TOP THREE REASONS TO BE BEARISH ON EM

1

## A [DEFLATIONARY] BREAKOUT IN THE U.S. DOLLAR

*In the context of our expectations for European and Japanese monetary policy, we think the rally in the U.S. dollar – which, now more than ever, has a profoundly negative impact on EM asset prices and economic growth – has legs.*

2

## ANOTHER LEG DOWN IN CHINESE DEMAND GROWTH

*Over the next three years, we see probable downside to +6% YoY as the bull case for [reported] Chinese real GDP growth and the “real” impact of this deceleration is set to weigh heavily upon the BoP dynamics of EM exporters.*

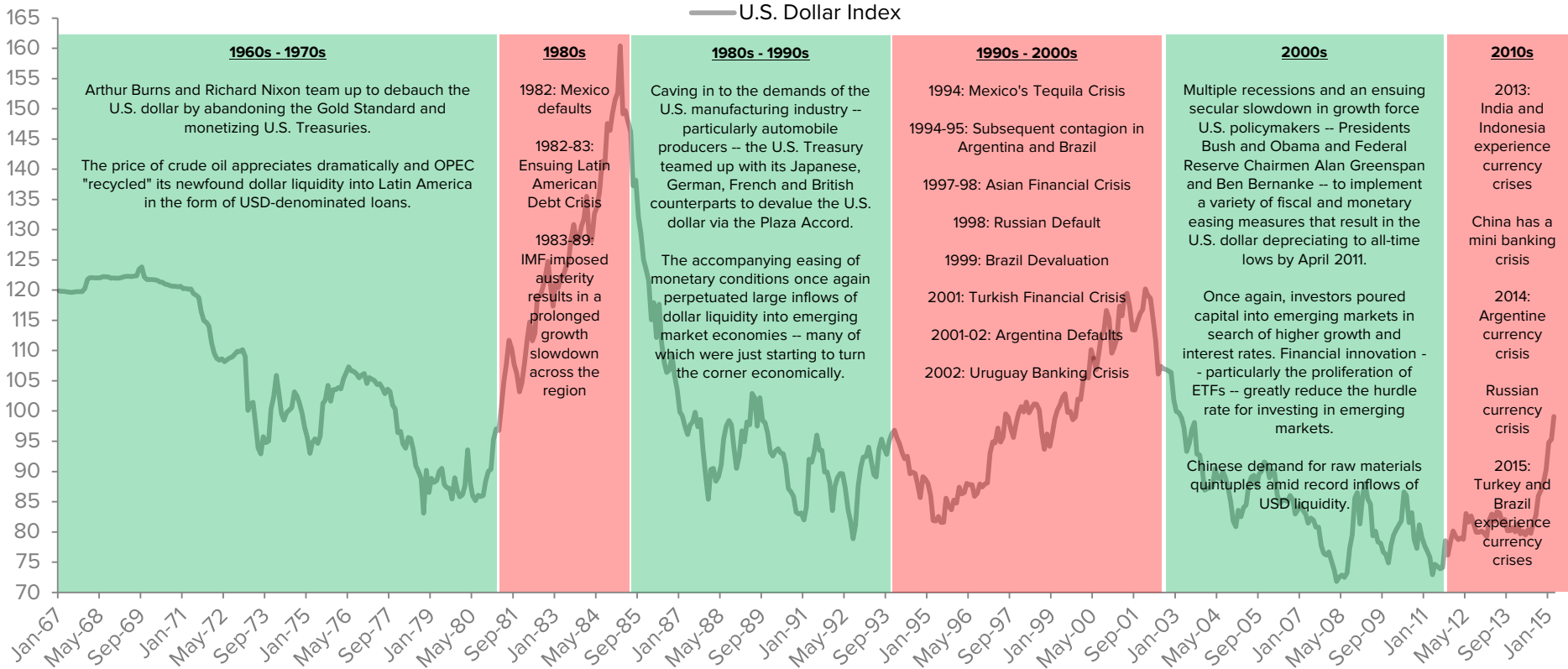
3

## BOND MARKET ILLIQUIDITY PERPETUATING A NEGATIVE FEEDBACK LOOP

*Gaps down in EM asset prices have a tendency to perpetuate incremental selling as asset managers seeking monthly and quarterly returns are forced to de-risk their portfolios amid thin secondary market liquidity and dramatic concentration risk.*

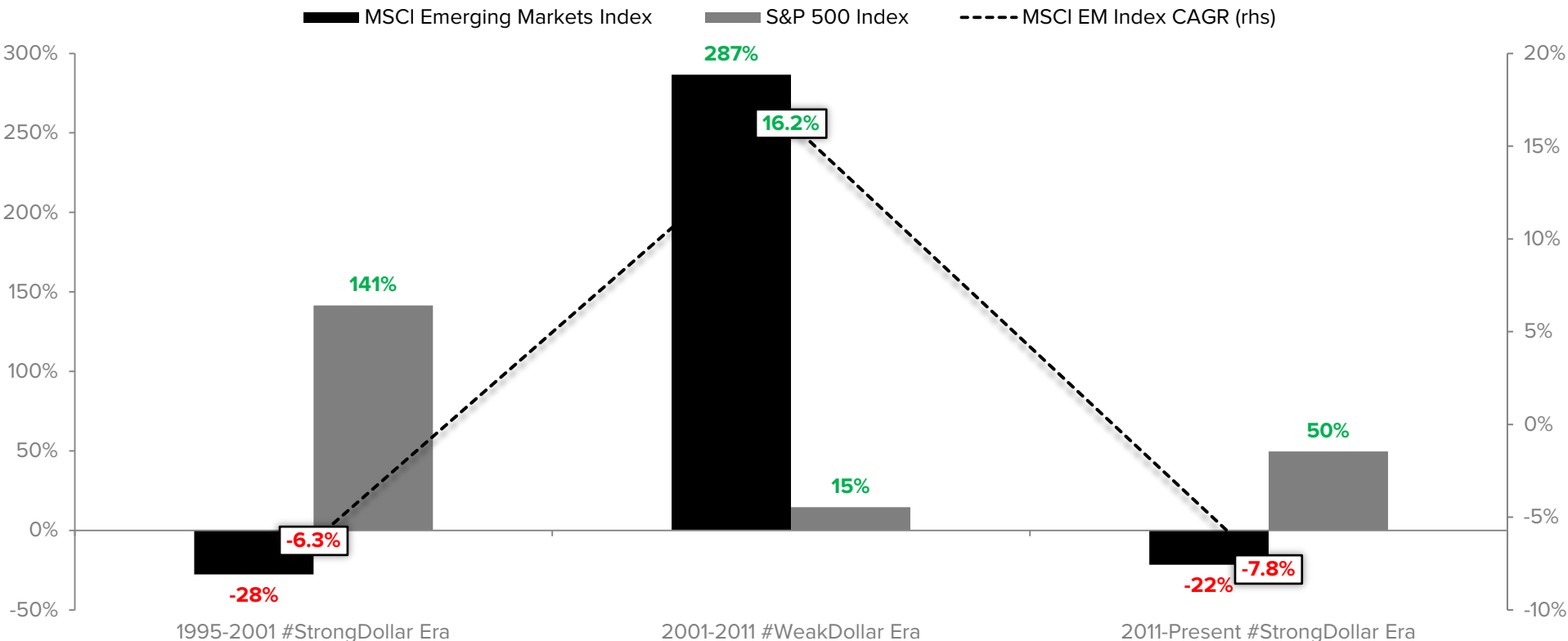
# THE #1 RISK: A RISING U.S. DOLLAR

**SECULAR U.S. DOLLAR APPRECIATION HAS HISTORICALLY EXPOSED VULNERABILITIES AND PERPETUATED CRISES ACROSS EMERGING MARKET ECONOMIES... CONTRARY TO POPULAR OPINION, THIS TIME IS NOT DIFFERENT**



# THAT IS CERTAINLY THE CASE IN THE CURRENT CYCLE

## #STRONGDOLLAR IS PERPETUATING EMERGING MARKET ASSET PRICE DEFLATION



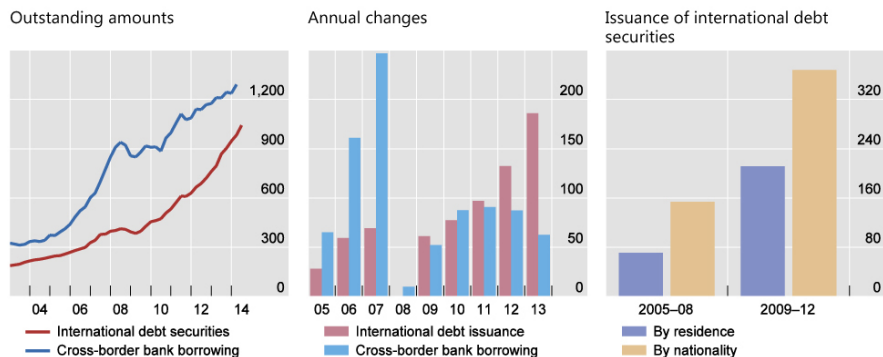
# EM BORROWERS ARE INCREASINGLY SHORT OF U.S. DOLLARS

## THE PACE OF INTERNATIONAL DEBT ISSUANCE HAS DOUBLED

EME private cross-border bank borrowing and international debt issuance<sup>1</sup>

In billions of US dollars

Graph 1



<sup>1</sup> Private non-bank sector. Cross-border bank borrowing (by residence) also includes claims on the household sector and claims on portfolio debt investment (implying a degree of double-counting), while international debt issuance (by nationality) includes securities issued by non-bank financials and non-financial corporations; and these securities could be denominated in local or foreign currency.

Source: BIS consolidated banking statistics and international debt securities statistics.

© Bank for International Settlements

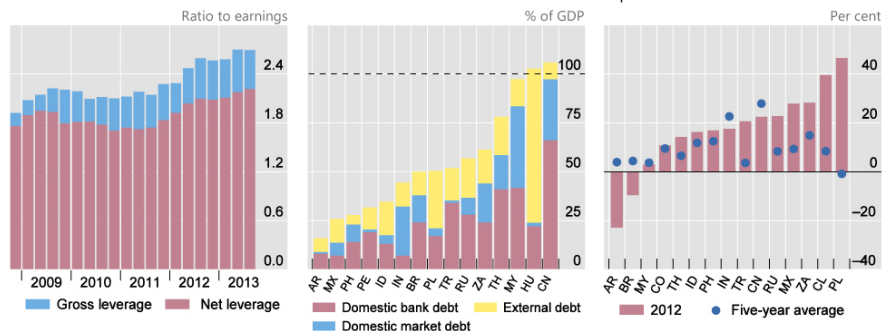
*“Issuance data based on issuer nationality (including issuance by the overseas subsidiaries of the corporations headquartered in a given country) indicate that private sector borrowers (other than banks) in major EMEs issued international debt securities worth almost \$375 billion in 2009-12, more than double their issuance in the four-year period prior to the crisis.”*

## SUPPORTING A STEADY INCREASE IN LEVERAGE RATIOS AND DEBT SERVICE COSTS

Leverage ratio of EME corporations<sup>1</sup>

Corporate sector debt in 2013<sup>2</sup>

Annual growth rates of interest expenses



AR = Argentina; BR = Brazil; CL = Chile; CN = China; CO = Colombia; HU = Hungary; ID = Indonesia; IN = India; MX = Mexico; MY = Malaysia; PE = Peru; PH = Philippines; PL = Poland; RU = Russia; TH = Thailand; TR = Turkey; ZA = South Africa.

<sup>1</sup> Firm-level data from S&P Capital IQ for 900 companies in seven EMEs; simple average across countries; gross leverage = total debt/earnings; net leverage = (total debt – cash)/earnings. <sup>2</sup> External debt includes liabilities from affiliates, direct investments and other sources.

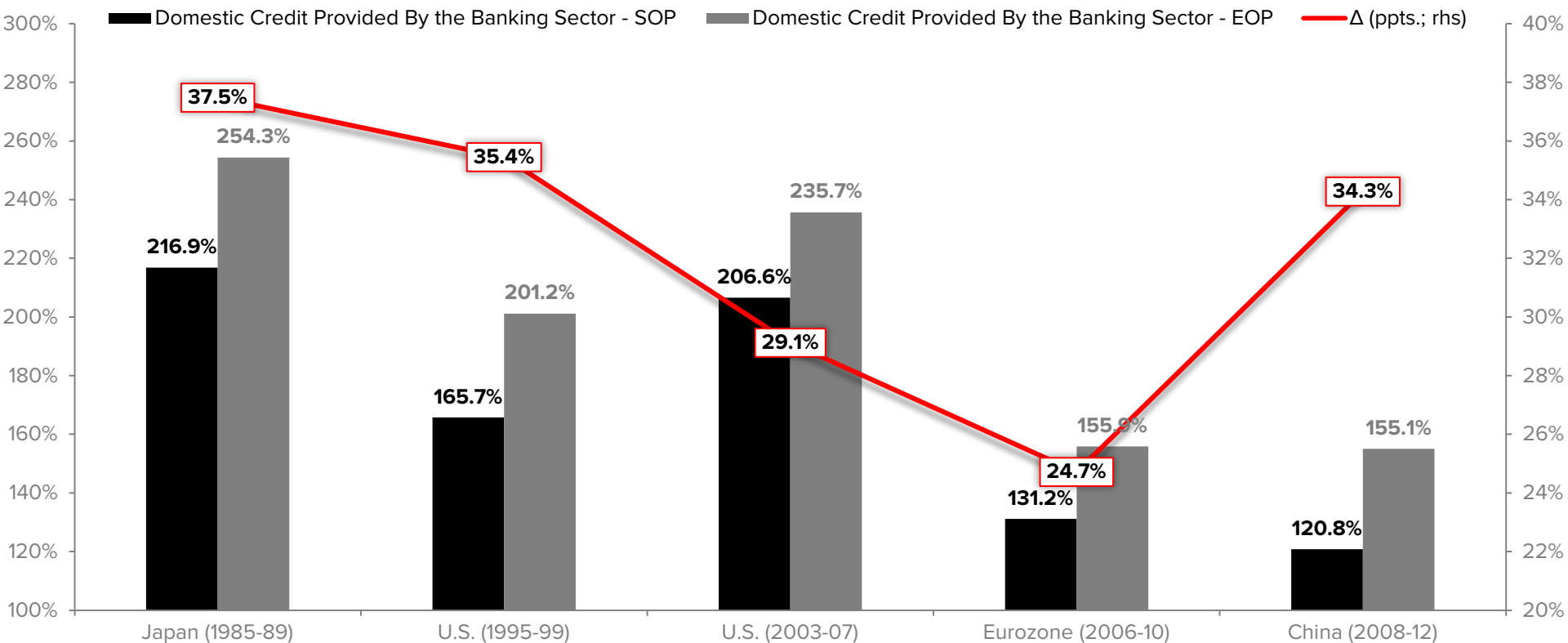
Sources: IMF, *Global Financial Stability Report*, April 2014; Morgan Stanley; BIS calculations.

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*“According to this metric, corporate indebtedness now hovers at around 100% of GDP for some EMEs. Yet, despite recent trend growth, levels vary considerably between countries and remain modest by international standards.”*

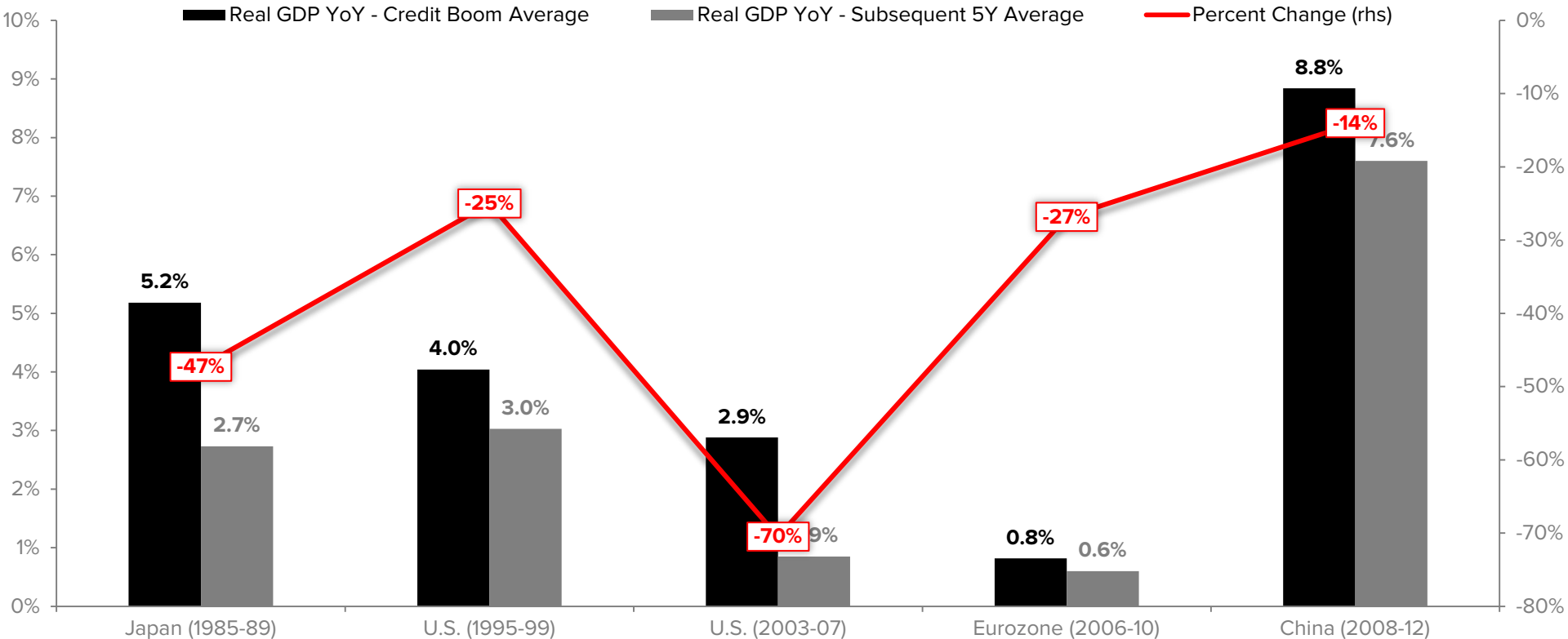
# APPLYING THE “5-30 RULE” TO CHINA...

A CREDIT BOOM IS TYPICALLY DEFINED BY A ~30-POINT INCREASE IN THE BANK CREDIT/GDP RATIO...



# ... SUGGESTS CHINESE GROWTH WILL CONTINUE TO SLOW

... WHICH IS TYPICALLY FOLLOWED BY A STRUCTURAL DOWNSHIFT IN GDP GROWTH



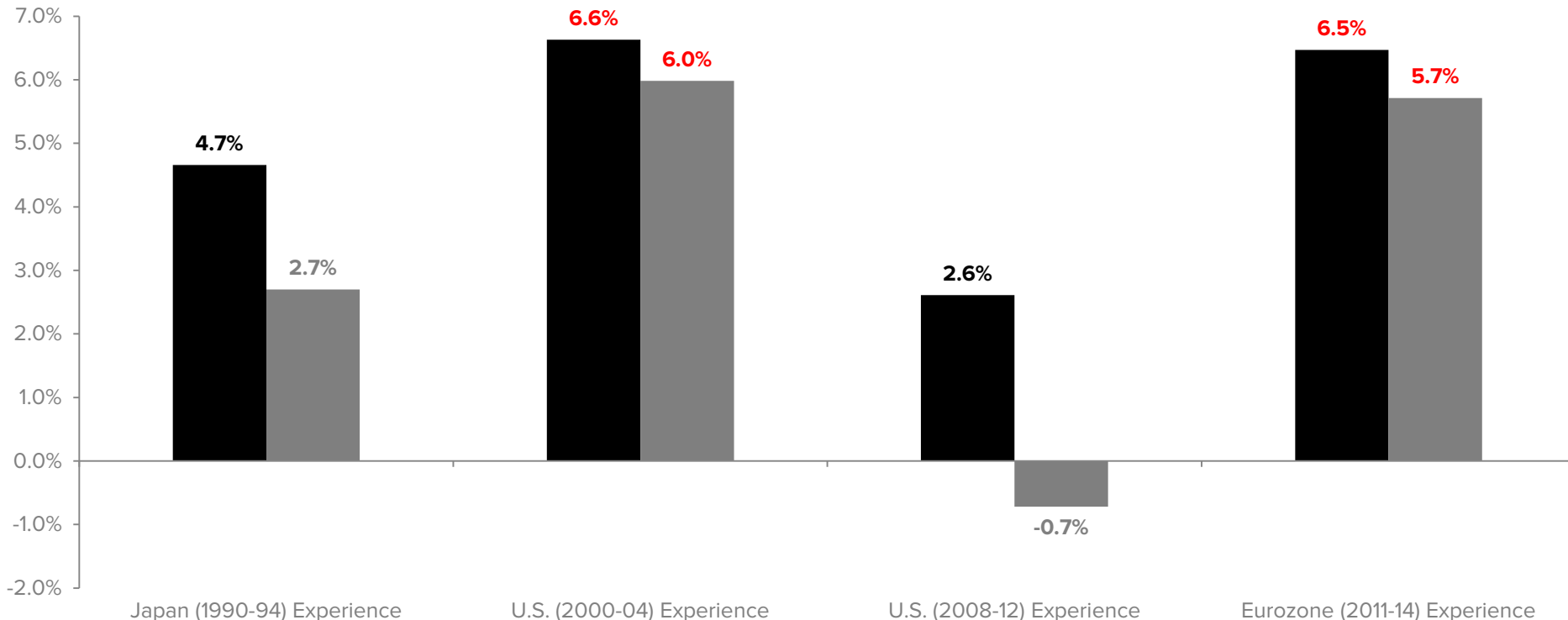


# CHINESE GDP GROWTH: ON THE WAY TO 6% Y/Y?

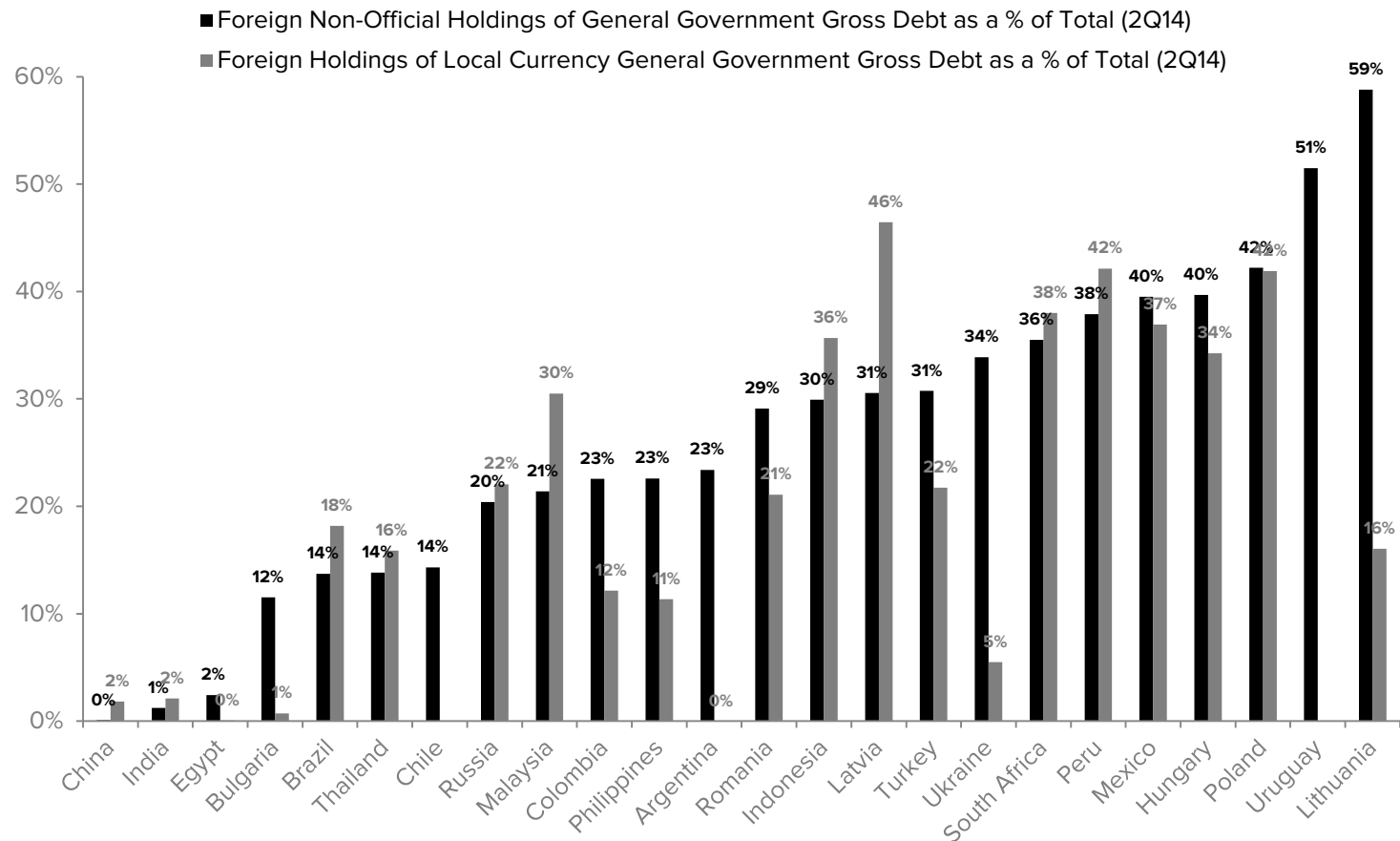
THUS FAR, CHINA'S TRENDING GROWTH RATE HASN'T DECELERATED THAT MUCH – EFFECTIVELY LEAVING AMPLE ROOM FOR A DOWNSIDE SURPRISE OVER THE NEXT THREE YEARS

■ Est. China 2013-2017 Average Annual Real GDP Growth

■ Est. China 2015-17 Average Annual Real GDP Growth



# EMERGING MARKETS RELY HEAVILY ON FOREIGN PRIVATE PORTFOLIO FLOWS

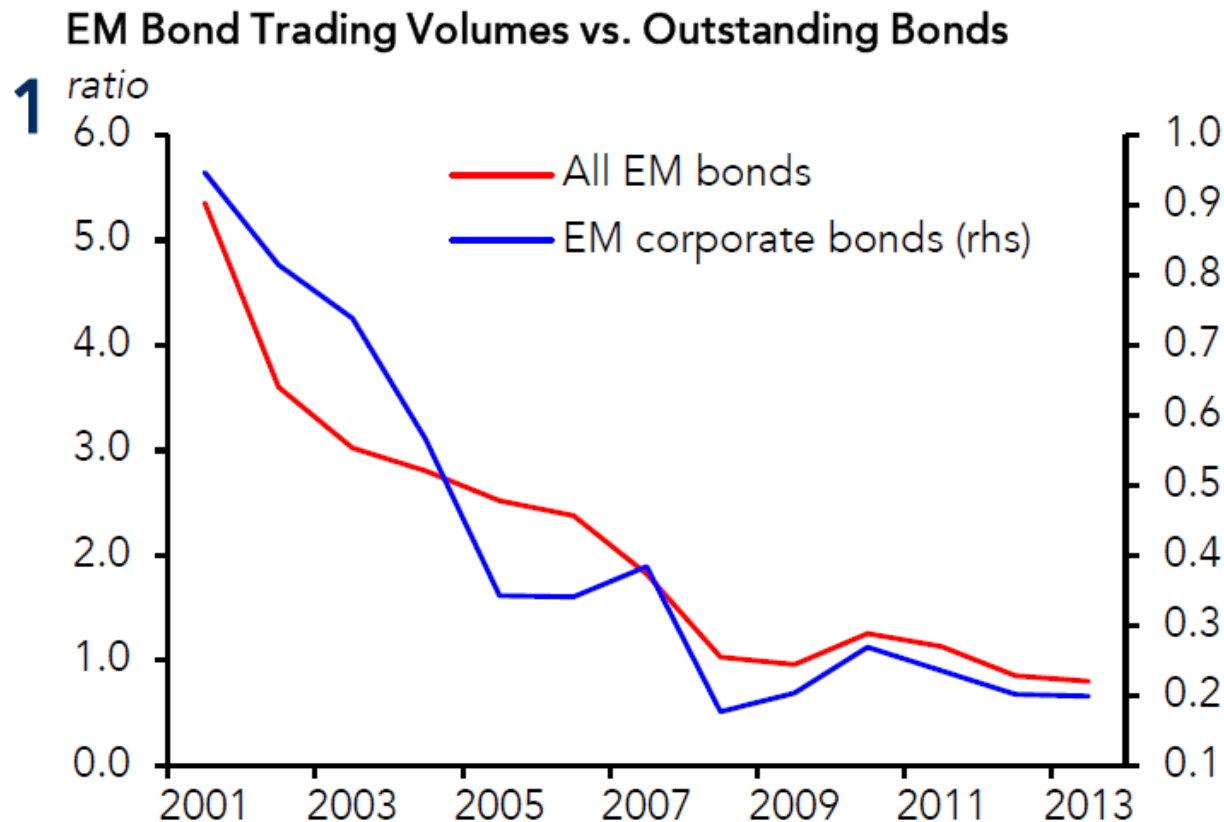


*"We estimate that total foreign investors held about US\$1 trillion of EM government debt (excluding foreign official loans) at end-2012. About half of these holdings were accumulated during the three years from 2010 to 2012. As of end-2012, we estimate that foreign nonbanks (i.e. foreign asset managers) held about US\$800 billion of EM government debt, or about 80 percent of total foreign holdings (excluding foreign official loans). In addition, as discussed in the previous section, we estimate that foreign central banks held about US\$40-80 billion of EM government debt, with a concentration in a seven countries (Brazil, China, Indonesia, Poland, Malaysia, Mexico, and South Africa)..."*

*Regardless of the reason (country-specific or global) a rising share of foreign investors in the investor base can increase the exposure of a sovereign to external funding risks... market concerns about sovereign risk could undermined confidence in banks, and thus threaten domestic financial stability, if banks hold large amounts of government debt or their funding costs are closely tied to sovereign yields..."*

*Due to these negative feedback loops, a large concentration of government bond holdings in domestic banks is a potential risk to domestic financial stability."*

# EM DEBT IS A DANGEROUSLY ILLIQUID ASSET CLASS



Source: EMTA, BIS , IIF.

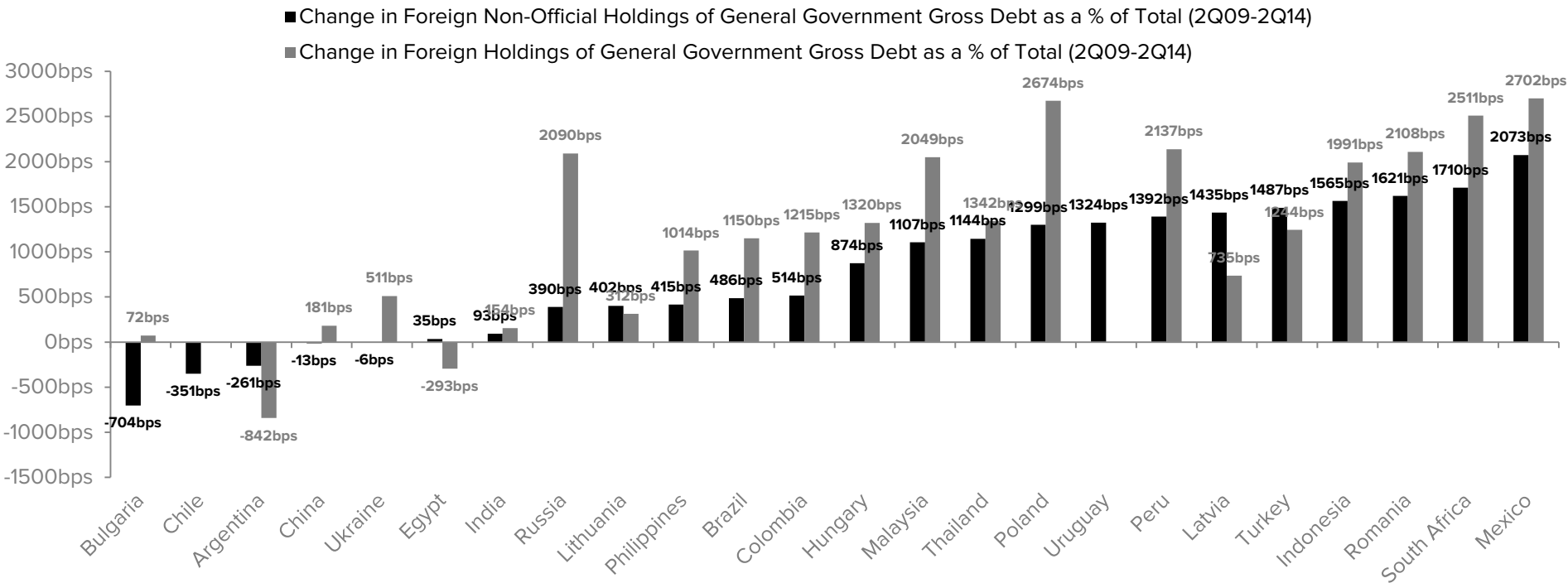
SOURCE: IIF (ELIF AKSOY, GIBBS, NGUYEN, TICU, TIFTIK AND TRAN, JULY-AUGUST 2014, PAGES 6-7)

*"Trading volumes in EM secondary bond markets have been relatively stable according to EMTA, with \$5.9 trillion traded in 1997 and \$5.6 trillion traded in 2013. However, trading activity has not kept up with the growing size of the EM debt market: turnover—measured as the dollar trading volume divided by total bonds outstanding has been declining steadily since 2001..."*

*Another key measure seems to support the secondary market liquidity concern: the average bid-ask spread of 10yr EM local bonds for 26 countries has approximately tripled since 2010... spreads retreated subsequently in tandem with volatility, but did not re-turn to prior levels. Instead these have stayed elevated during a time of record low global volatility..."*

*A fourth key measure is adding to this evidence: the average trade size in U.S. secondary bond markets has been steadily declining as the proportion of larger trades (> \$100,000) is lower by 10% with respect to 2008 per MarketAxess. According to a 2013 presentation to the U.S. Treasury Borrowing Advisory Committee, there are fewer block trades (> \$5 million) and even those have been getting smaller, with average block trade size declining from \$28 million in 2005 to \$14 million in 2013."*

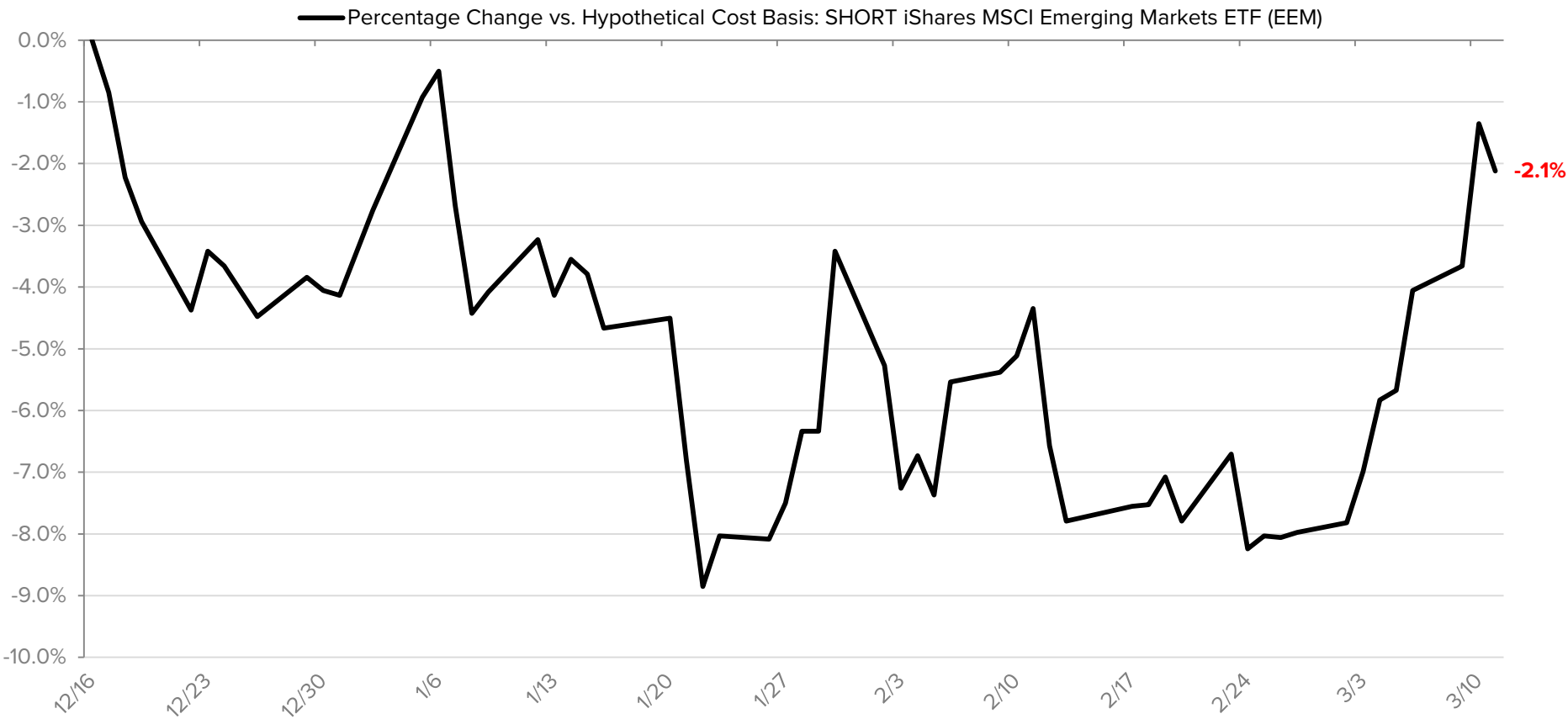
# WHAT HAPPENS WHEN THOSE POSITIONS ARE FORCIBLY UNWOUND?



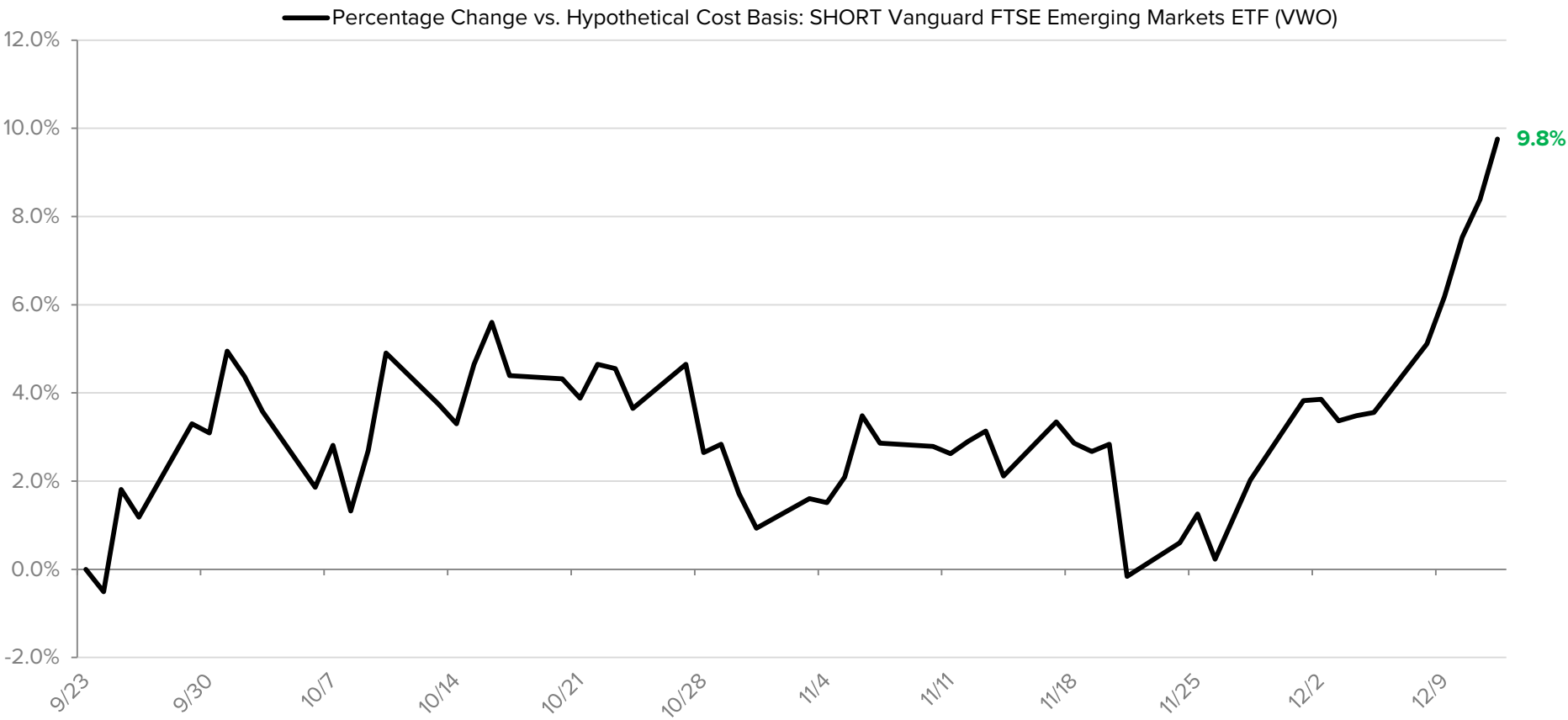
## THE RISK OF CAPITAL OUTFLOWS IS LARGELY A FUNCTION OF TRAILING INFLOWS... DUH!

*“The [2008-09 global financial] crisis episode suggests that foreign inflows to EM government debt markets could be highly cyclical. Across our sample, countries experiencing the greatest foreign inflows before the crisis typically experienced the greatest outflows during the crisis.”*

# SHORT EMERGING MARKET EQUITIES

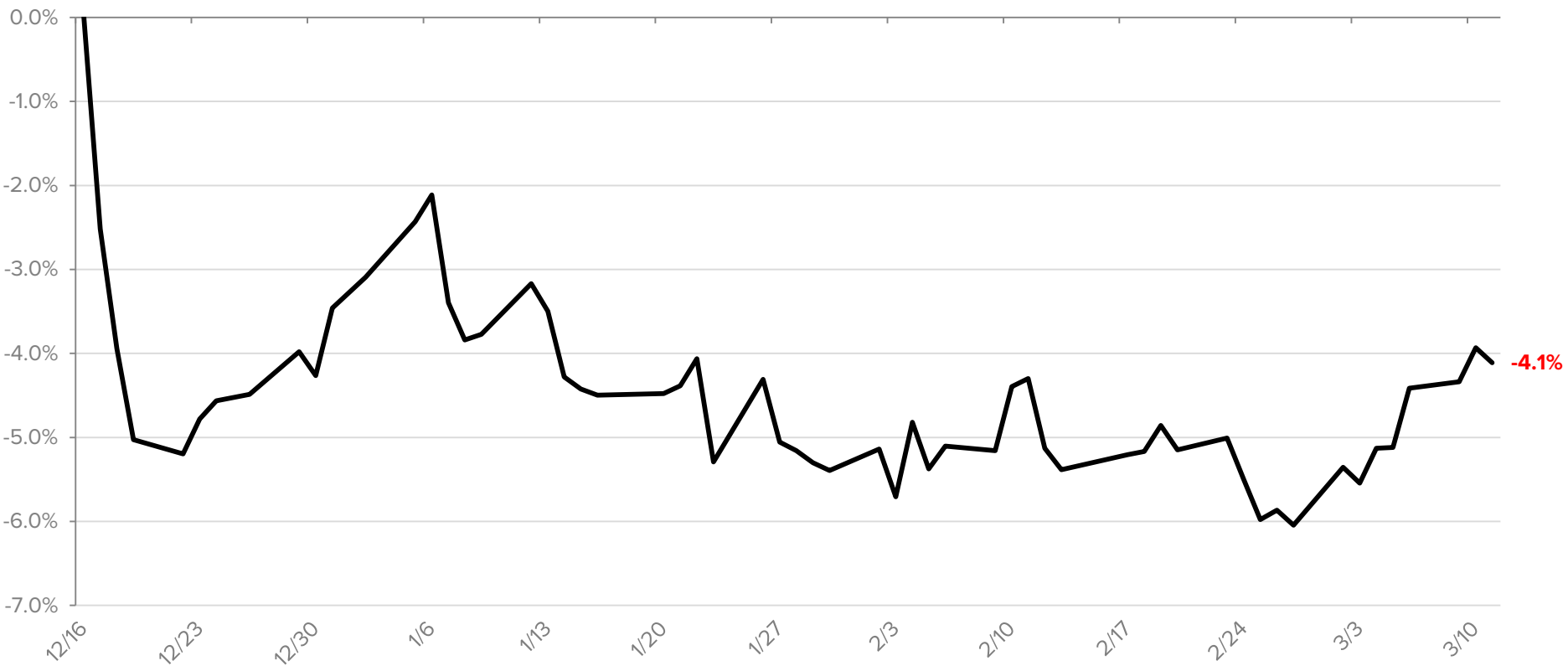


# SHORT EMERGING MARKET EQUITIES



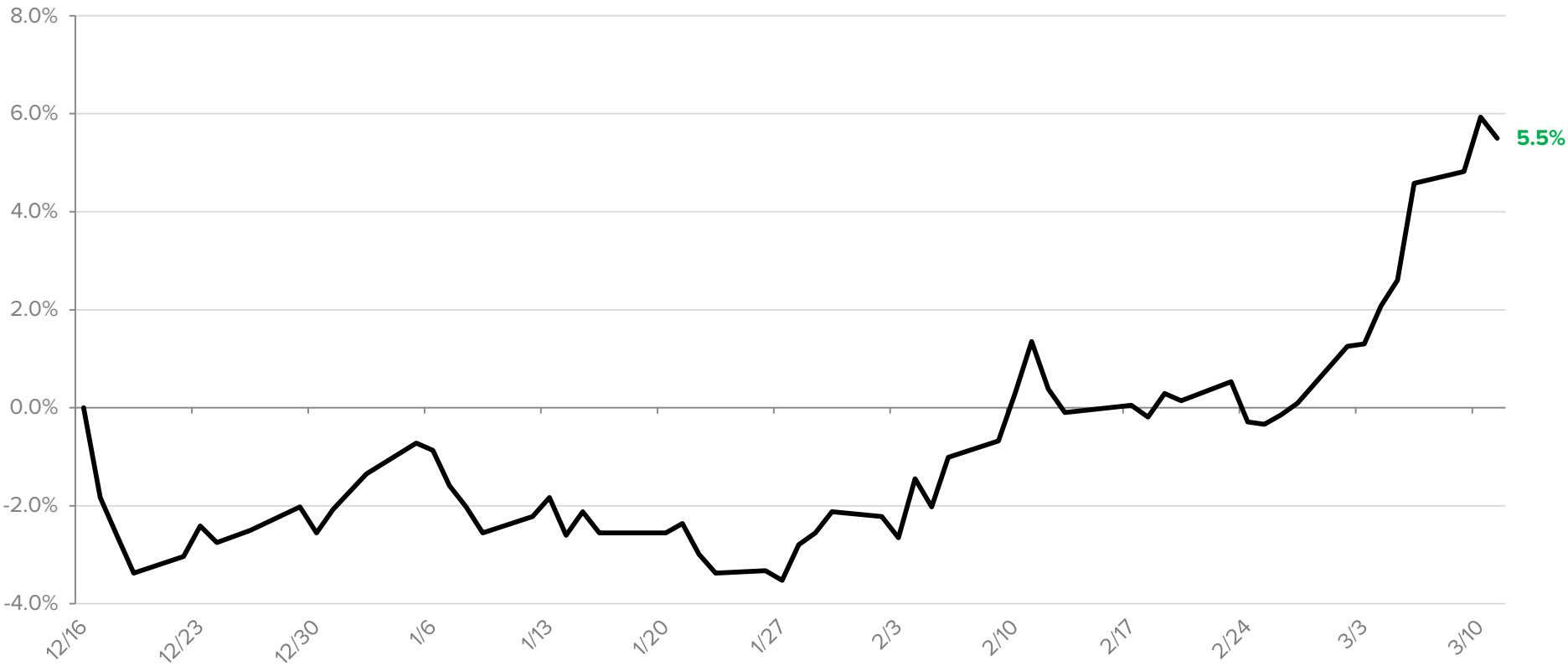
# SHORT EMERGING MARKET USD DEBT

— Percentage Change vs. Hypothetical Cost Basis: SHORT iShares JP Morgan USD Emerging Markets Bond ETF (EMB)



# SHORT EM LOCAL CURRENCY DEBT

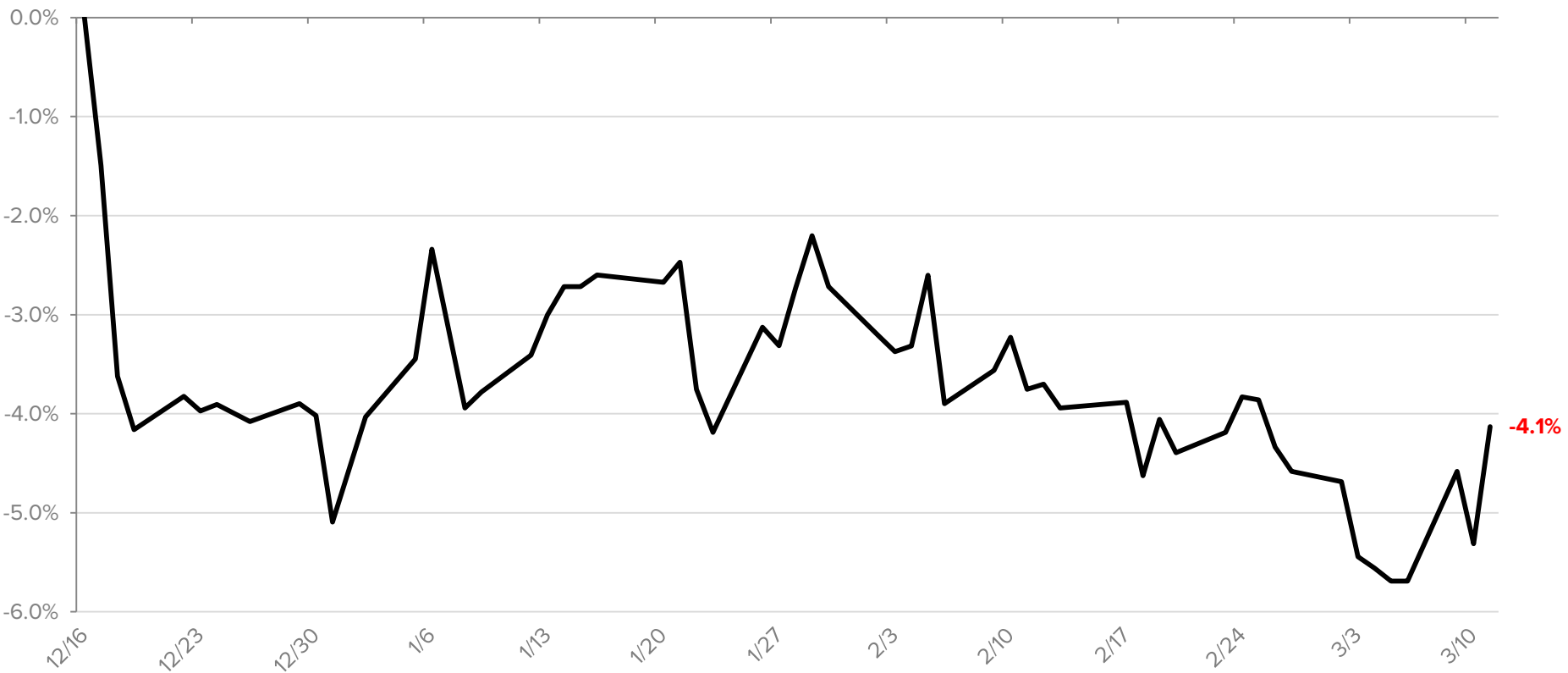
— Percentage Change vs. Hypothetical Cost Basis: SHORT Market Vectors Emerging Markets Local Currency Bond ETF (EMLC)





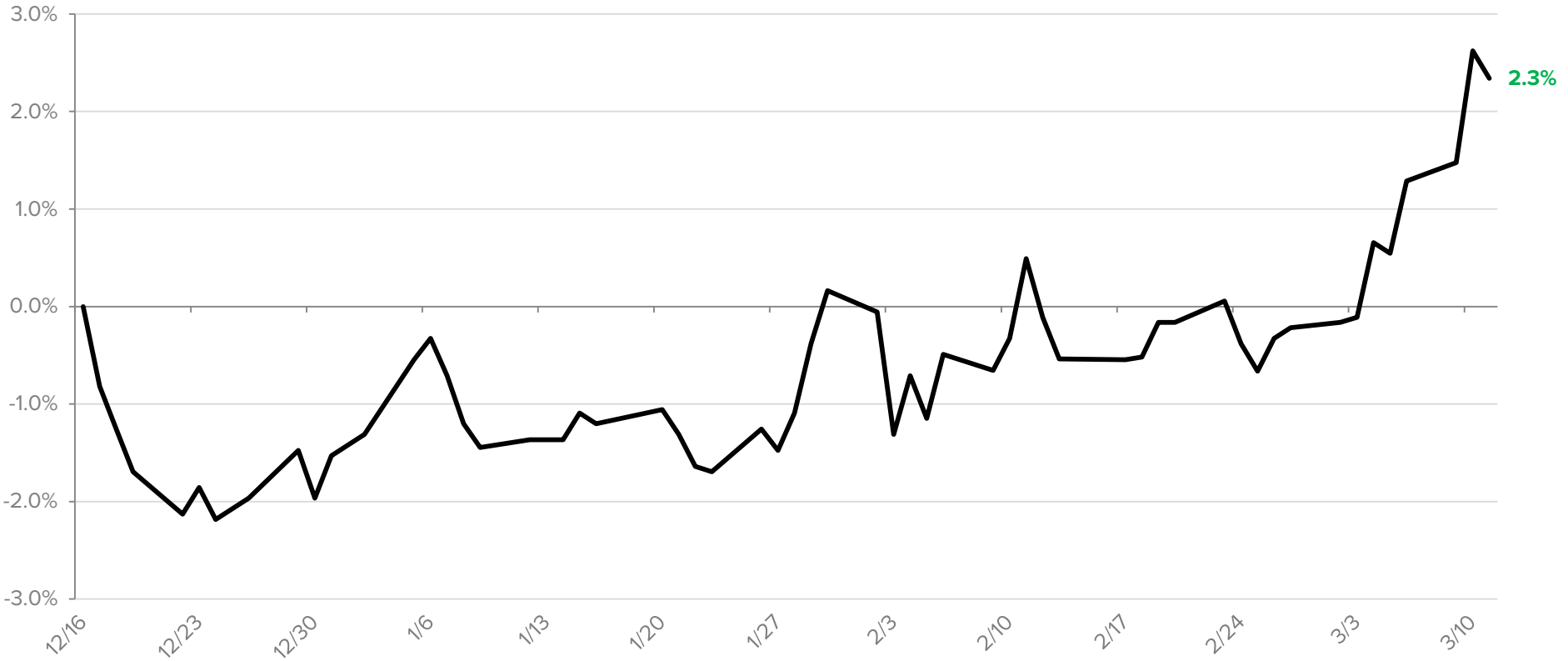
# SHORT EM CORPORATE DEBT

— Percentage Change vs. Hypothetical Cost Basis: SHORT WisdomTree Emerging Markets Corporate Bond Fund (EMCB)



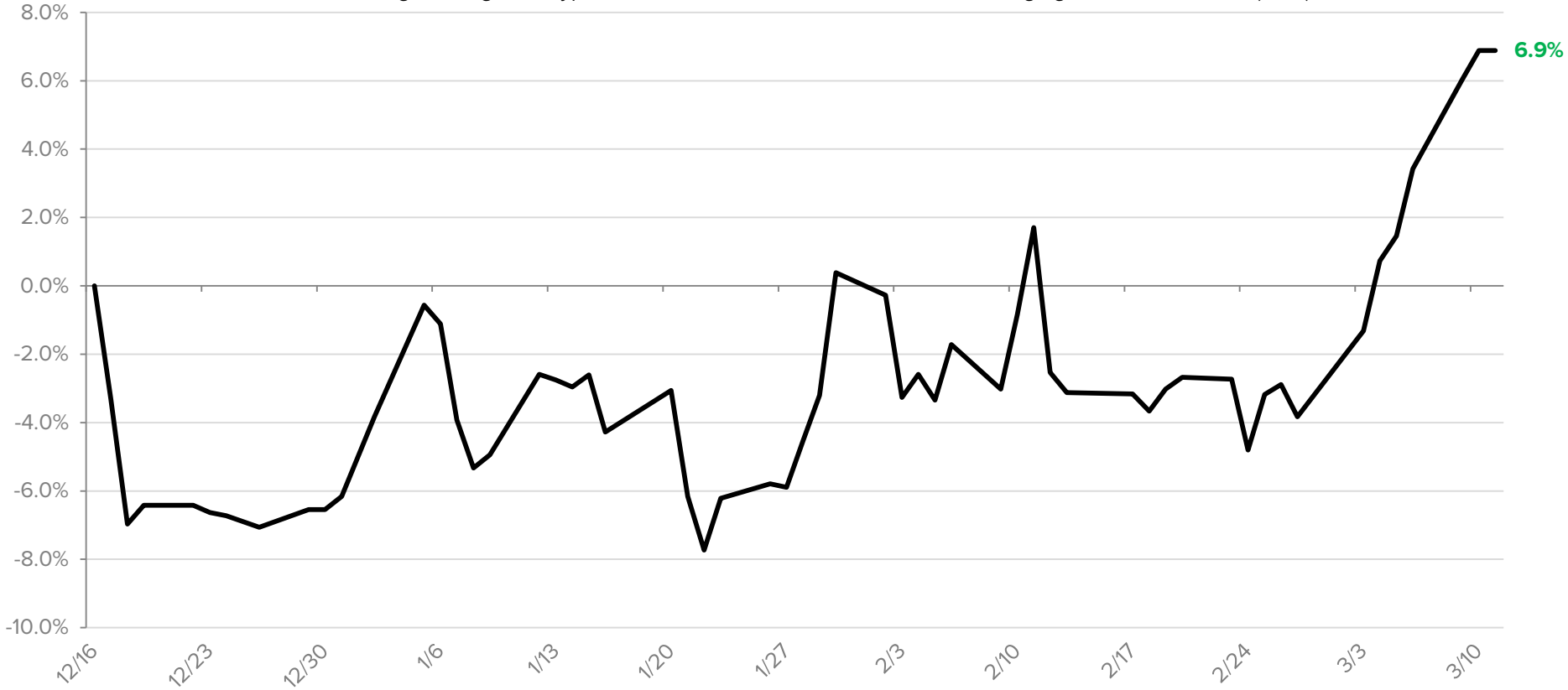
# SHORT EM CURRENCIES

— Percentage Change vs. Hypothetical Cost Basis: SHORT WisdomTree Emerging Currency Strategy Fund (CEW)

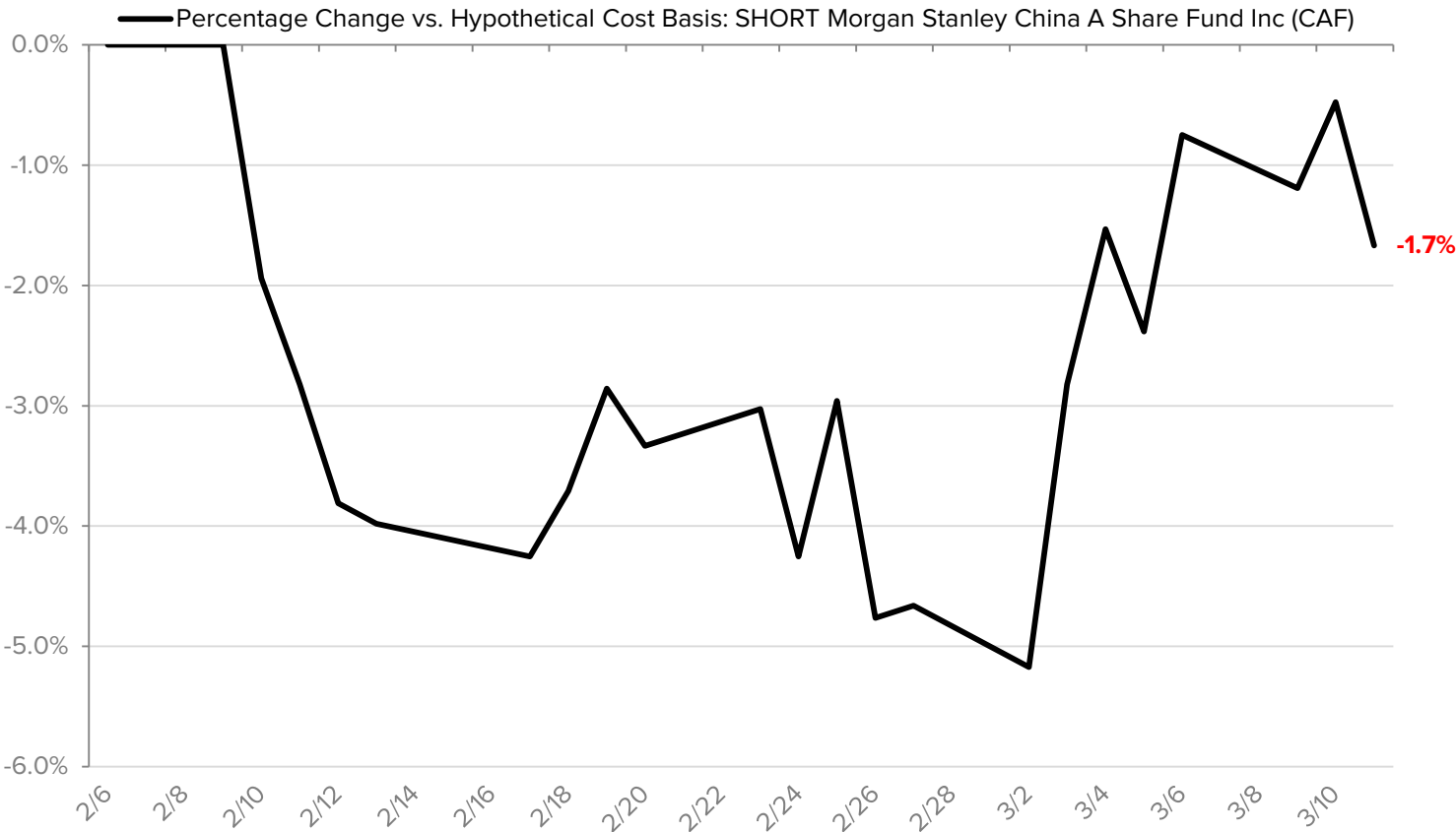


# SHORT LATIN AMERICA

— Percentage Change vs. Hypothetical Cost Basis: SHORT SPDR S&P Emerging Latin America ETF (GML)



# SHORT CHINA



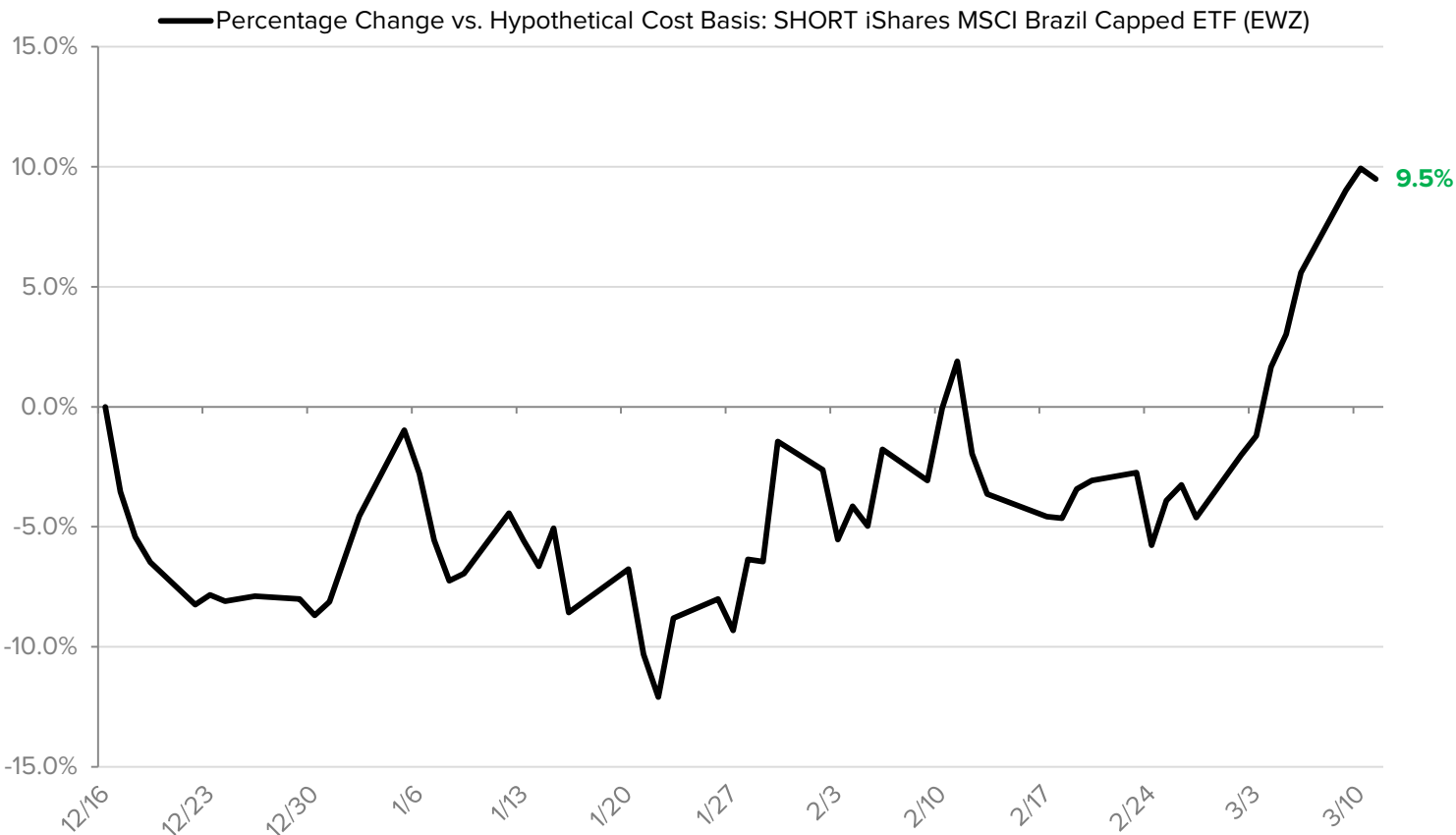
Recent developments:

Growth data taking another leg down in the YTD (-)

Increased willingness to ease among policymakers (+)

An acceleration in capital outflows and CNY selling pressure (-)

# SHORT BRAZIL



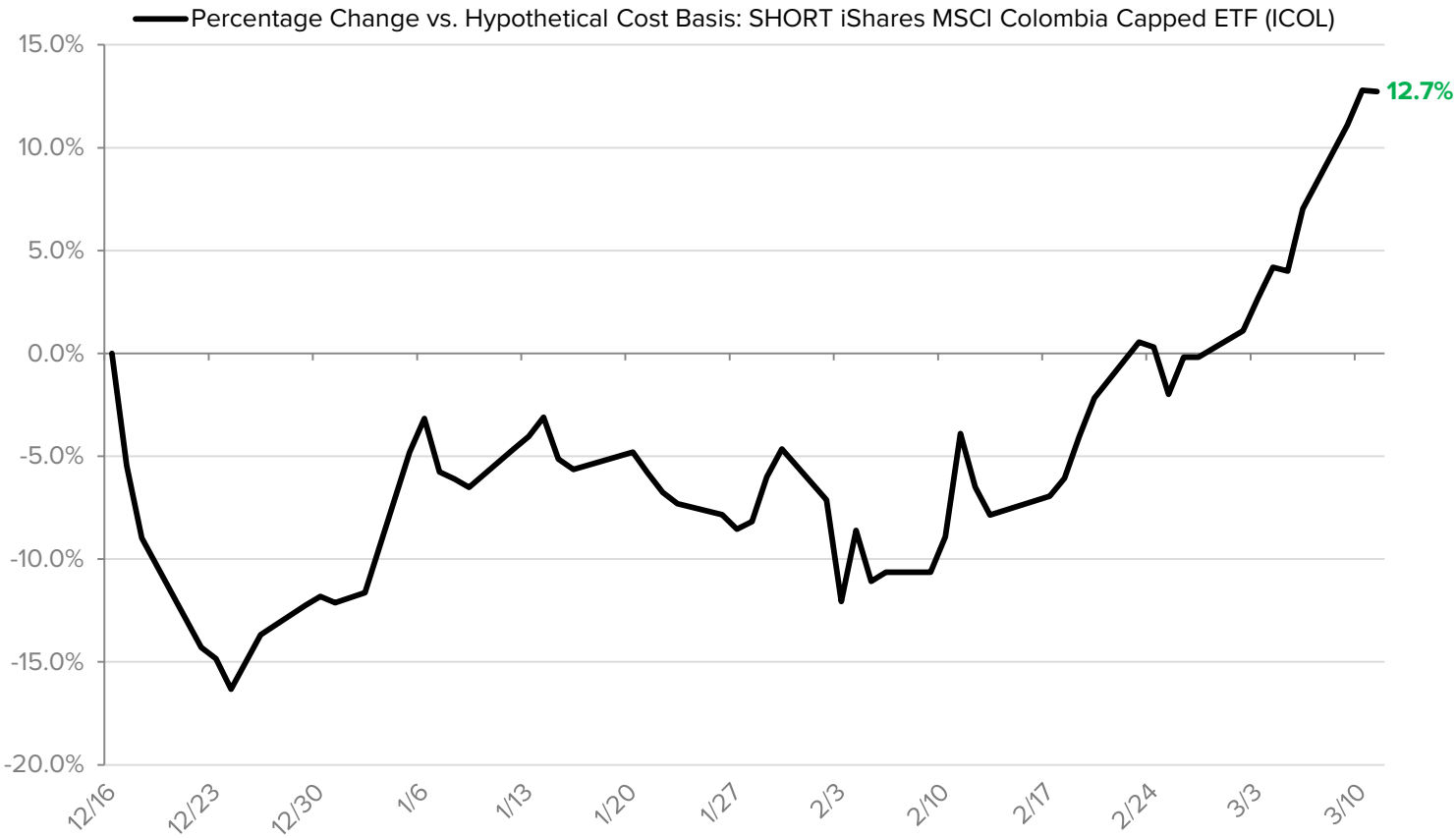
Recent developments:

Political risk accelerating with  
PBR corruption scandal (-)

Rate hikes as Congress pushes  
back on fiscal retrenchment (-)

Inflation accelerating (-)

# SHORT COLOMBIA

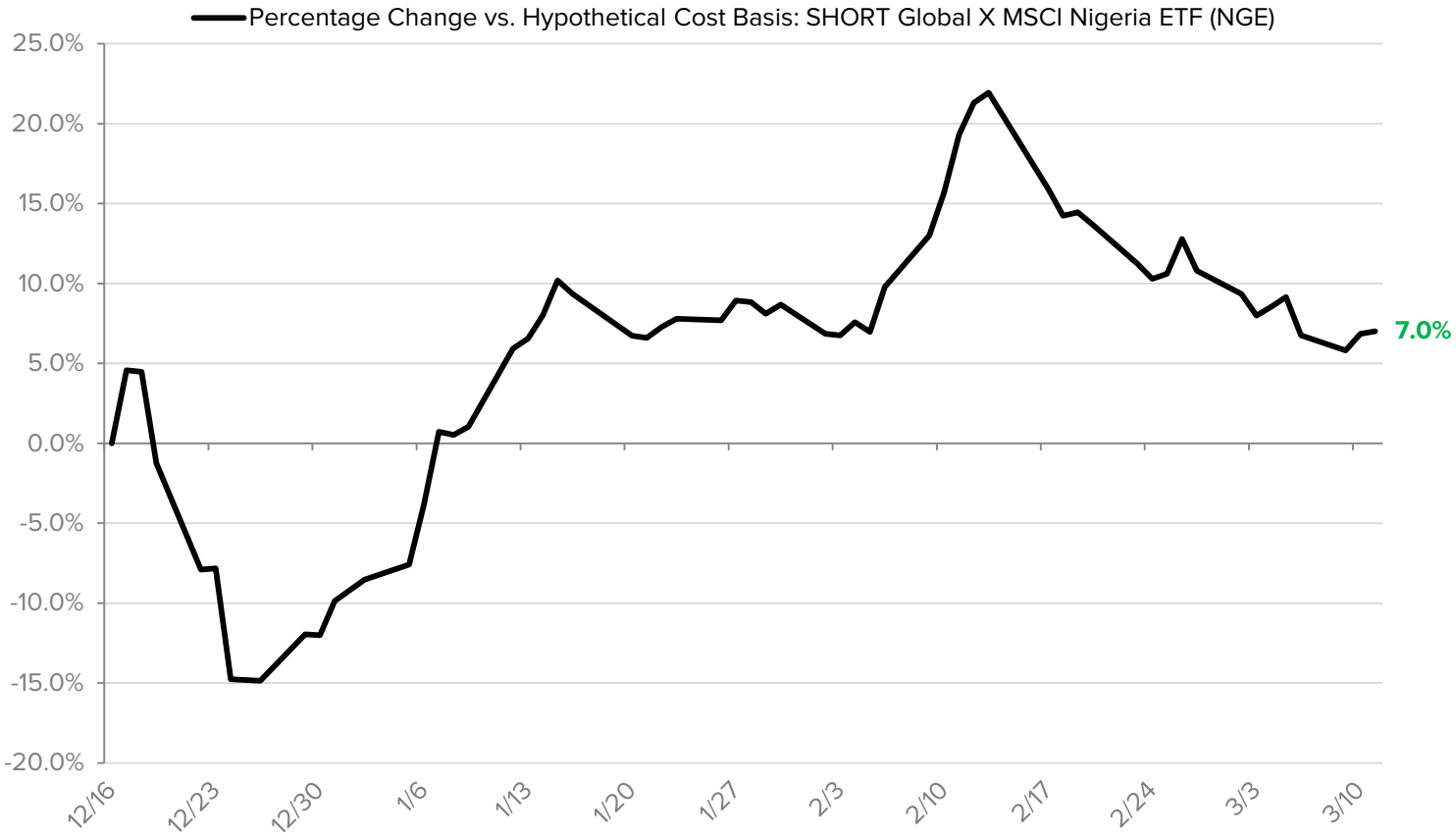


Recent developments:

Current account deficit widening to levels not seen since 1998 (-)

Inflation accelerating (-)

# SHORT NIGERIA

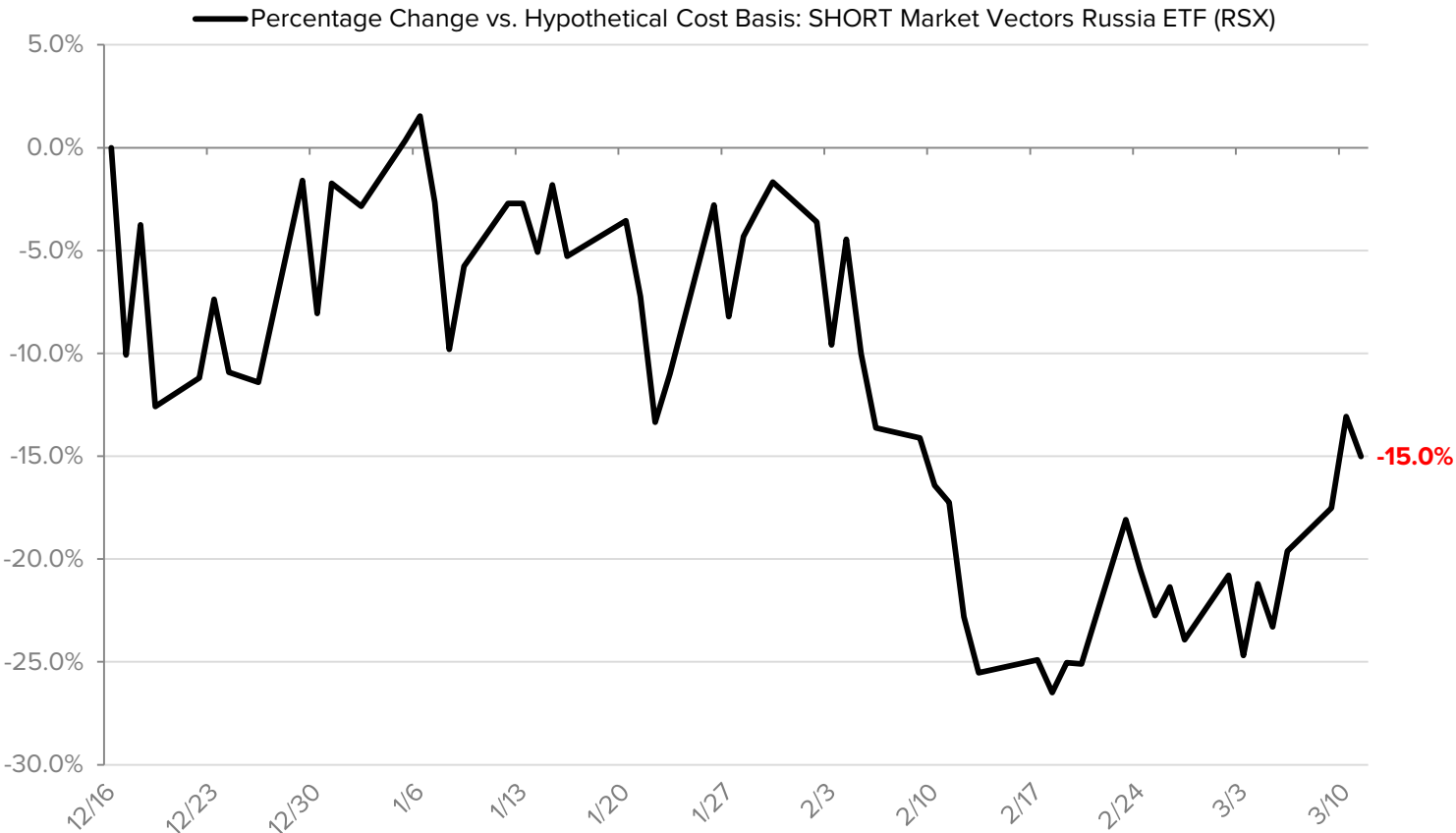


Recent developments:

Inflation accelerating (-)

Monetary tightening (-)

# SHORT RUSSIA



Recent developments:

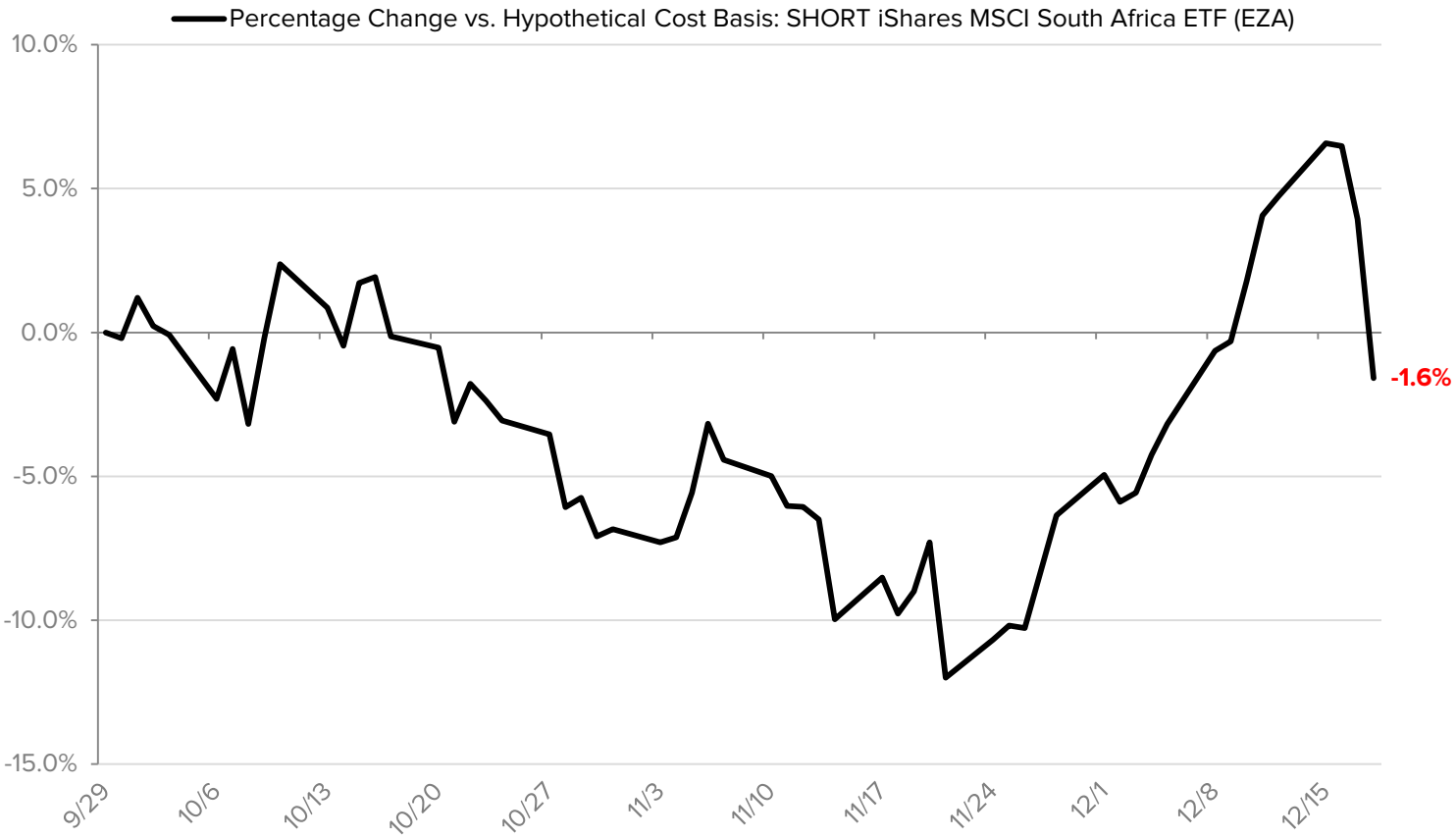
Cut to junk by two of the big three ratings agencies (-)

Forced tax repatriation to shore up the RUB (+)

Accelerated growth slowdown as the country enters recession (-)



# SHORT SOUTH AFRICA

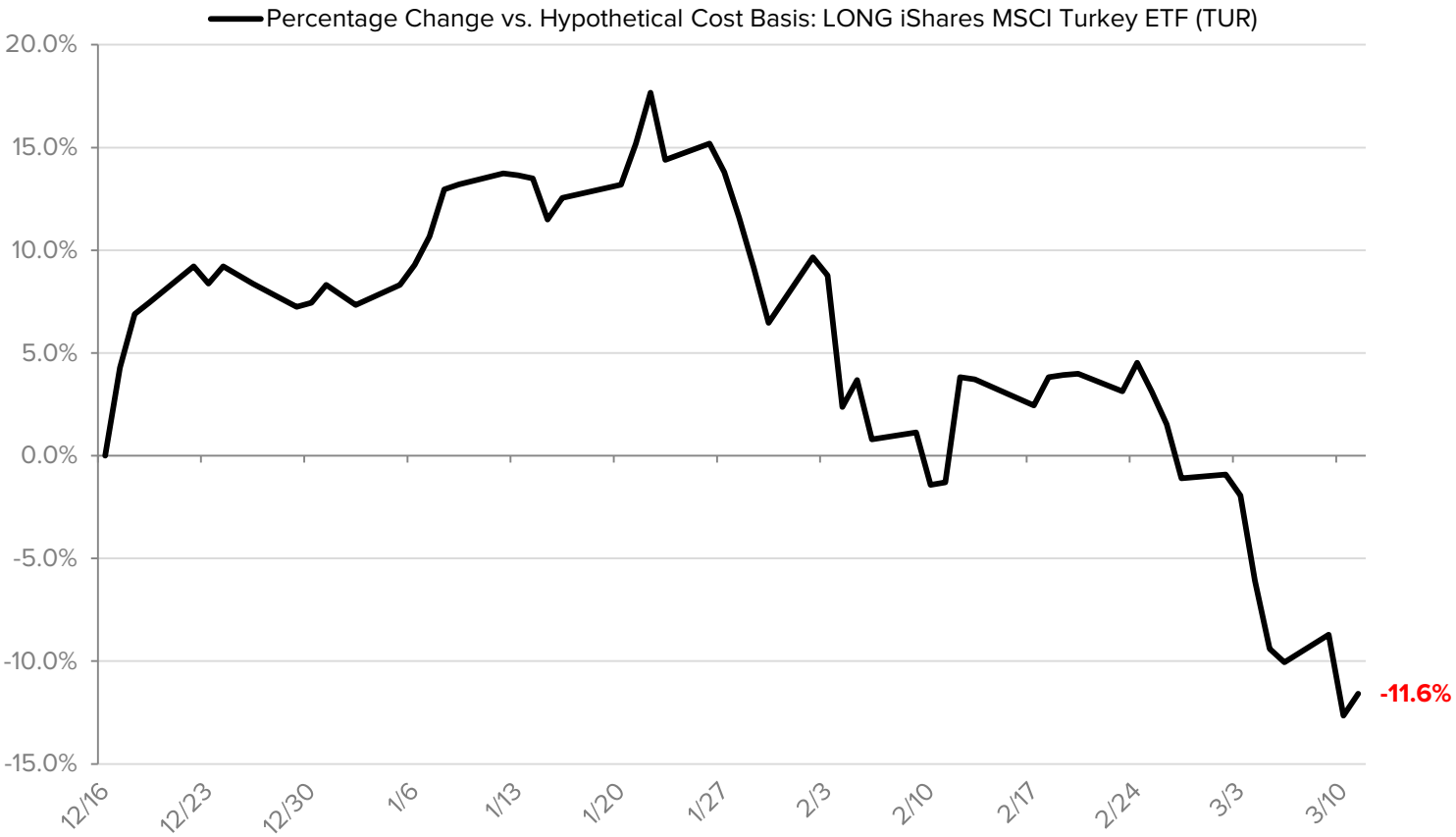


Recent developments:

Rolling blackouts (-)

Tighter monetary policy (-)

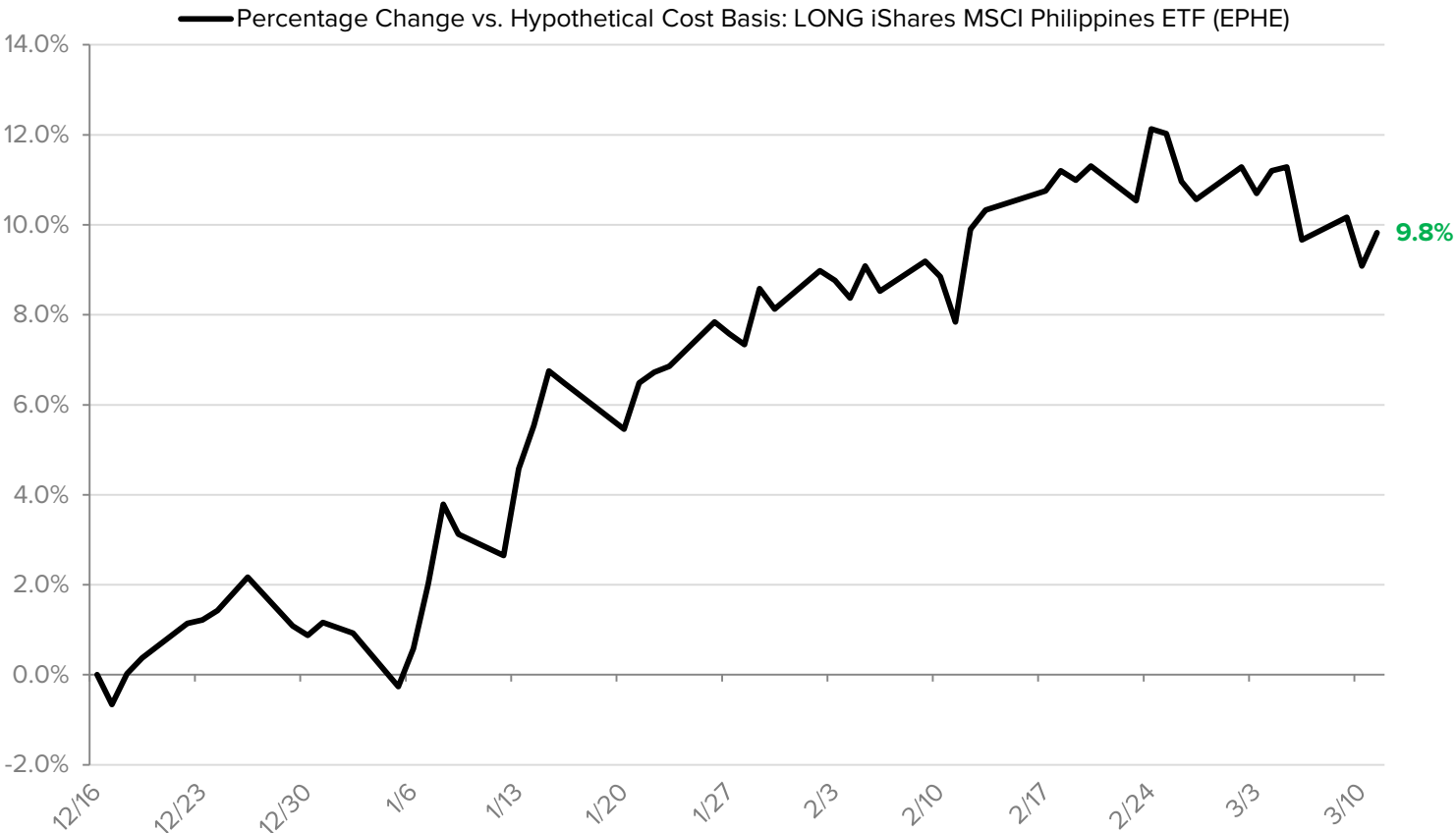
# LONG TURKEY



Recent developments:

Persistent criticism of the central bank's monetary policy stance contributing to a crisis of confidence in the TRY (-)

# LONG PHILIPPINES



Recent developments:

Current account surplus widening  
(+)

Inflation decelerating (+)

# REVISED EM INVESTMENT STRATEGY

## LONGS

- India (EPI)
- Philippines (EPHE)
- BOOKING:
  - Turkey (TUR)

## SHORTS

- Emerging Market Currencies (CEW)
- EM Local Currency Debt (EMLC)
- Brazil (EWZ)
- Colombia (ICOL)
- Nigeria (NGE)
- Russia (RSX)
- Turkey (TUR)
- BOOKING:
  - Emerging Market Equities (EEM, VWO)
  - Emerging Market USD Debt (EMB)
  - EM Corporate Debt (EMCB)
  - Latin American Equities (GML)
  - China (CAF)
  - South Africa (EZA)

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