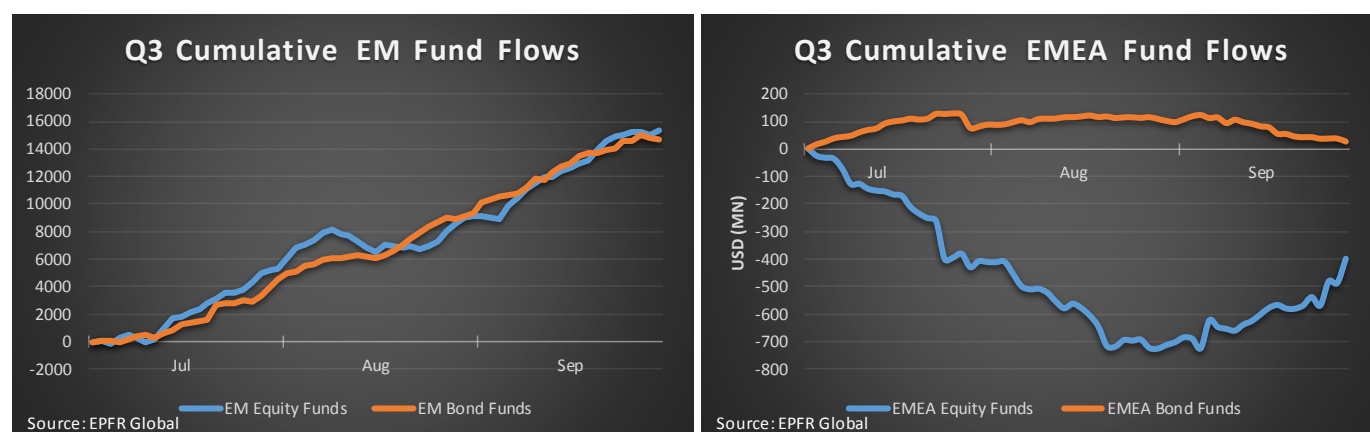


# CEEMEA MARKETS – Q4 OUTLOOK

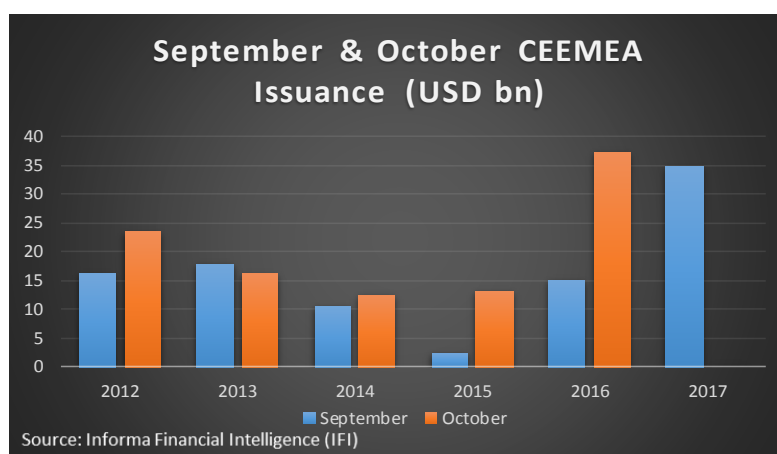
05 October 2017

The start of Q4 follows three weeks of losses for CEEMEA markets, as investors ratcheted up their bets on a December rate hike in the US. This after Fed Chief Yellen stuck to the gradual rate rise mantra, despite persistently weak inflation readings, and after the USD and UST yields were given a further boost by US President Trump's tax plans.

However, capital flows to emerging market funds since July, as illustrated by the following charts from EPFR Global, have not been reversed by these developments, although CEEMEA equity funds have seen net outflows.



There were no signs of stress either in the CEEMEA new issue market, where supply continued apace in September, headlined by junk rated sovereign issuers. In fact, this September was the best on record for issuance, at almost USD35bn. This compares to an average of USD14.8bn over the previous five years, excluding 2015. Our records also show that October tends to be an even busier month for EM supply and has in fact beaten September issuance volumes in four of the past five years.



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## CEEMEA MARKETS Q4 OUTLOOK

**Thus we examine the risks ahead in Q4, and whether CEEMEA markets and new bond issuers will be affected by the turn in global monetary policy and rising UST yields.**

**Key external risk events that may impact CEEMEA markets in Q4.**

- Global policy tightening
  - The Fed will put its massive USD4.5tn balance sheet on a diet starting in October, and is expected to again raise interest rates in December.
  - ECB President Draghi said tapering of the EUR2tn QE programme could be announced in “Autumn”, spotlighting their October 26 meeting, with the process probably starting from January 2018.
  - Higher interest rates could derail the global economic recovery, the Bank for International Settlements warned.
- Chinese Party Congress and credit concerns
  - Begins on October 18 and will see the Communist Party reshuffle leadership, which should allow President Jinping to further consolidate his power.
  - Investors will watch for any updates on the party’s “Belt and Road Initiative,” and a commitment to reduce risks from the continued surge in credit creation.
  - However, slowing Chinese credit growth, along with strengthening of the renminbi trade-weighted exchange rate, will likely hurt Chinese manufacturing activity in H2 2017.
- European Union leaders meeting
  - To gather on October 18-19 in Brussels and, of course, Brexit will be a hot topic.
- U.S. tax cuts, debt ceiling and government shutdown risk
  - Trump’s sweeping plan for tax reform has led to speculation that the much vaunted, but yet to materialise ‘reflation trade’, could be back on, feeding into USD strength and rising yields.
  - However, a long drawn out congressional battle lies ahead and these plans are likely to be changed before being approved.

**CEEMEA country specific risk events that may impact in Q4**

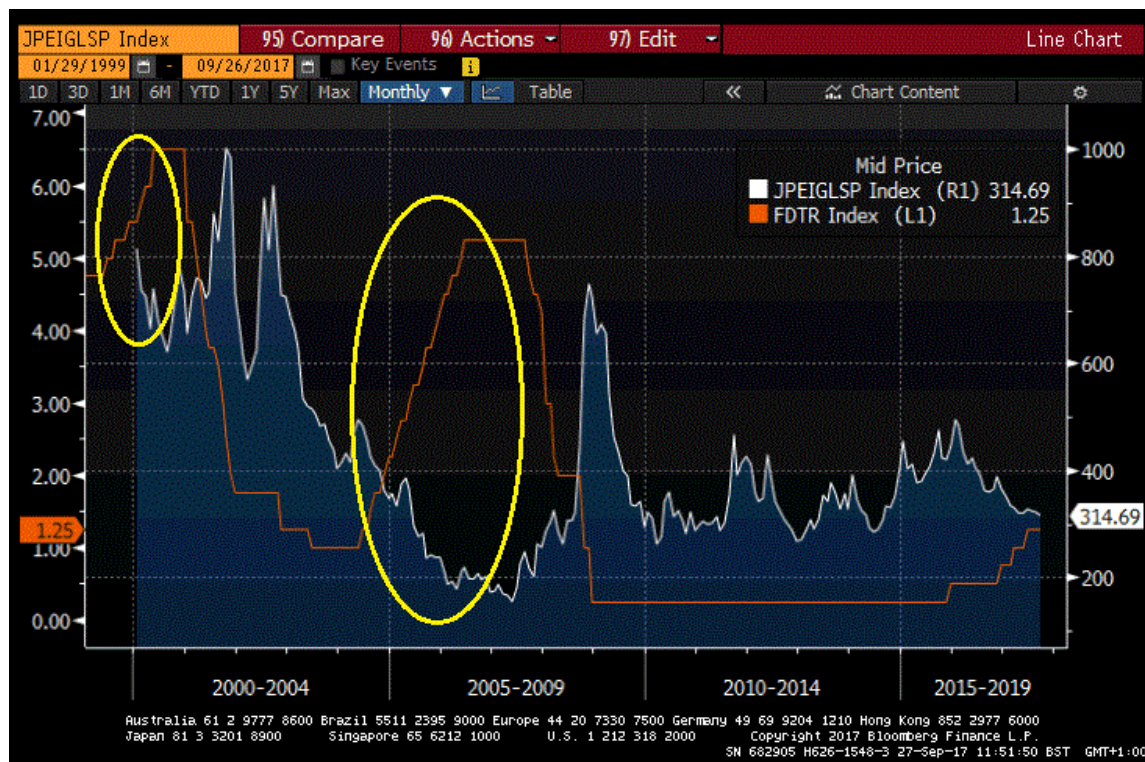
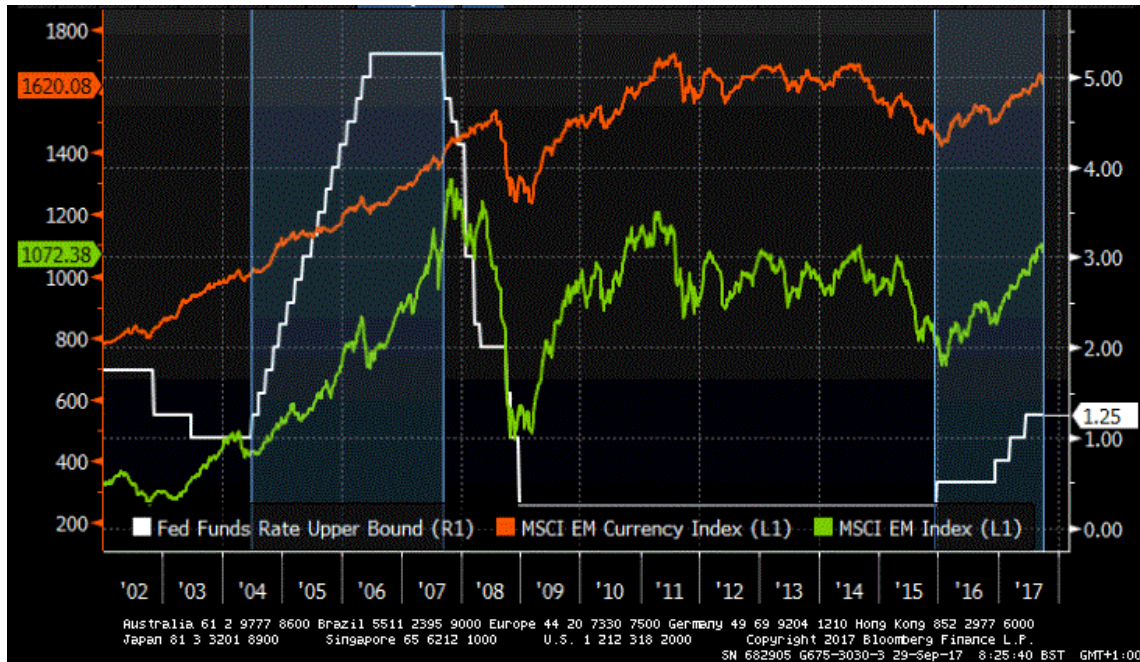
- Russia
  - There remains a risk that more dominoes will topple among Russia's privately owned banks.
  - The standoff with the US is also a lingering focus for investors, with the possibility of sanctions on Rouble government bonds.
- South Africa
  - Significant political risk as the battle for ANC leadership looks set to become even more fractious heading into the elective conference on December 16-20.
  - The contest to succeed President Zuma centres around Zuma's pick, Dlamini-Zuma and Deputy President Ramaphosa (latter seen as the more market friendly option).
  - Investors must also contend with the possibility of another rating downgrade if the government does not implement structural reforms. With Moody’s and S&P scheduled to review the sovereign on November 24.
  - Moody’s assessment the most crucial for sentiment as it is the only one of the big 3 to still assign an IG rating.
- Turkey
  - For the most part tensions in the Middle East are usually just background noise for Turkish investors. However, the recent Kurdish independence referendum in Iraq - deemed a ‘direct threat’ by the Turkish security council - has demonstrated that Turkish assets are still not immune to regional risk.
- Poland
  - Political risk is set to weigh as the erosion of judicial independence has brought the country into conflict with the EU, but for the moment it is little more than a noisy clash.
  - The EU’s Article 7 penalty would require a unanimous vote by member states, and Hungary would most likely reject it.

## CEEMEA MARKETS Q4 OUTLOOK

### How vulnerable are CEEMEA markets to rising US yields?

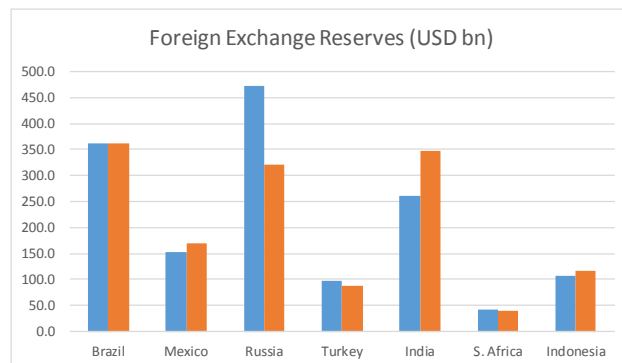
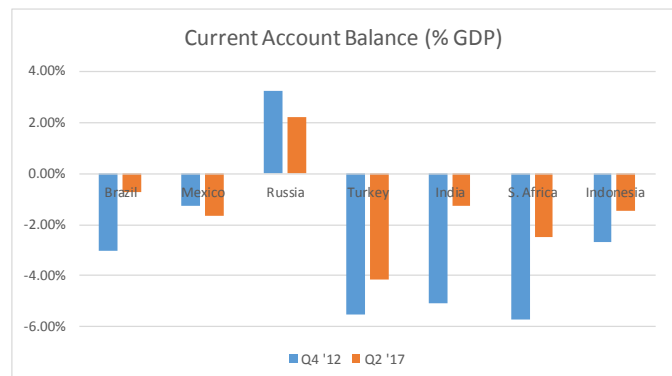
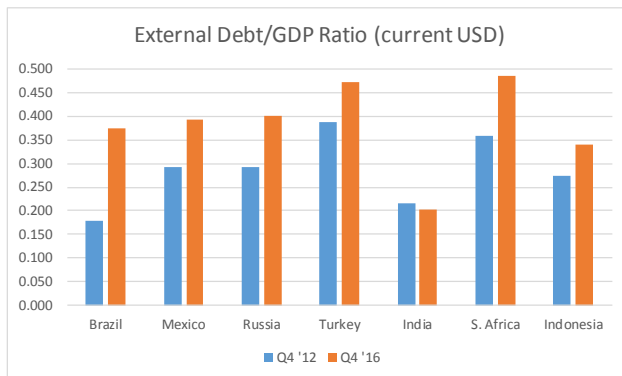
Emerging markets have not been negatively impacted during previous periods of Fed tightening, as the next two graphs demonstrate (source Bloomberg).

- During the last hiking cycle (2004-2006), and since rates began to rise at the end of 2015, the MSCI EM Currency Index and Equity Index have headed steadily higher (graph 1). This is also demonstrated by the JPM EMBI Index, which measures EM credit spreads, and has narrowed during periods of Fed rate rises (graphs 2).



## CEEMEA MARKETS Q4 OUTLOOK

Our own study of EM vulnerability (see graphs and table below – source Bloomberg) highlights how EM economies have strengthened since the 2013 taper tantrum.



|           | External Debt/GDP Ratio |        | FX Reserves (USD bn) |        | Current Account Balance (% GDP) |        |
|-----------|-------------------------|--------|----------------------|--------|---------------------------------|--------|
|           | Q4 '12                  | Q4 '16 | Q4 '12               | Q1 '17 | Q4 '12                          | Q2 '17 |
| Brazil    | 0.179                   | 0.373  | 362.1                | 361.7  | -3.04%                          | -0.71% |
| Mexico    | 0.292                   | 0.393  | 153.5                | 169.1  | -1.28%                          | -1.65% |
| Russia    | 0.293                   | 0.401  | 473.1                | 320.8  | 3.23%                           | 2.20%  |
| Turkey    | 0.389                   | 0.471  | 98.3                 | 87.1   | -5.50%                          | -4.13% |
| India     | 0.216                   | 0.202  | 261.7                | 346.3  | -5.08%                          | -1.24% |
| S. Africa | 0.359                   | 0.486  | 41.2                 | 38.9   | -5.70%                          | -2.48% |
| Indonesia | 0.275                   | 0.340  | 105.9                | 116.1  | -2.69%                          | -1.45% |

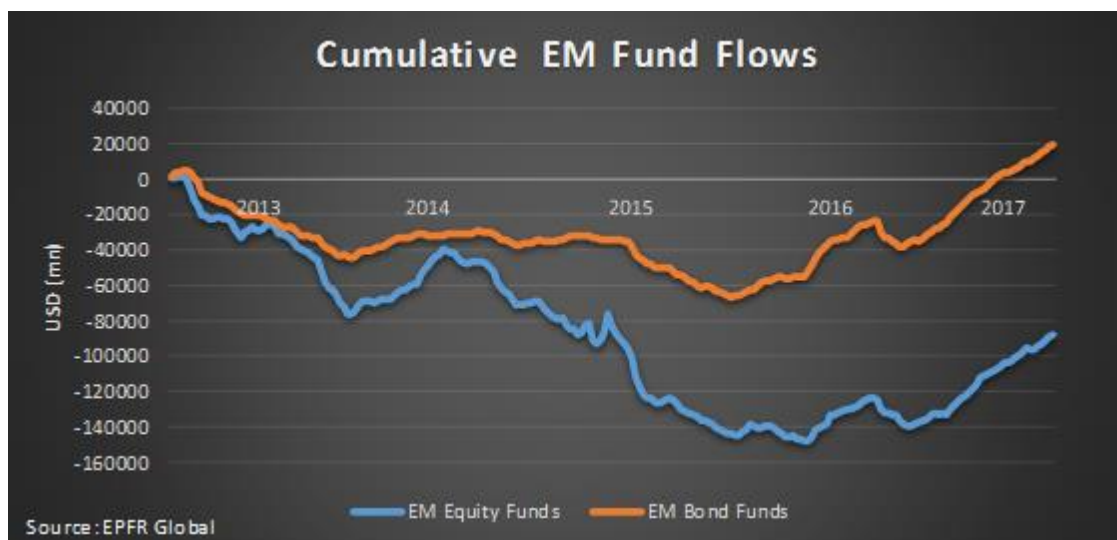
- EM economies are now much more insulated from the Fed's tightening shocks than in previous periods. As the data highlights, the key EMs (Brazil, Mexico, Russia, Turkey, India, South Africa & Indonesia) have seen massive improvements in their current balances from the end of 2012 to the end of 2016, with only Russia and Mexico showing deteriorating balances.
- However, the table also shows that external debt levels have surged in that period, (apart from India), and this is a concern for a number of EM watchers. At the same time, FX reserves for most remain at comfortable levels and have improved from 2012. So whilst higher US rates do lead to rising interest payments, countries are better positioned to deal with this.



## CEEMEA MARKETS Q4 OUTLOOK

### *Bullish Case for CEEMEA markets remains*

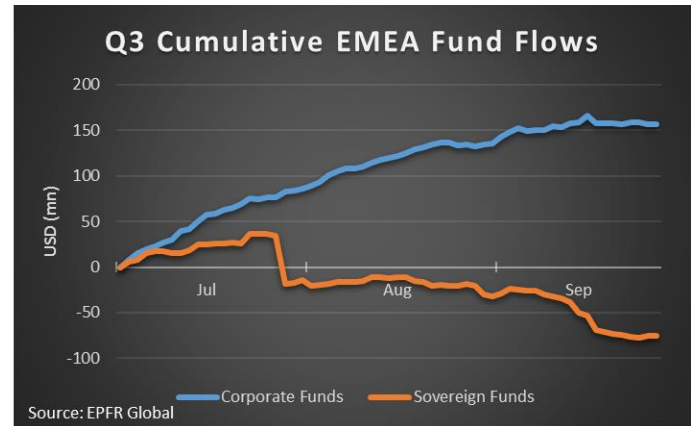
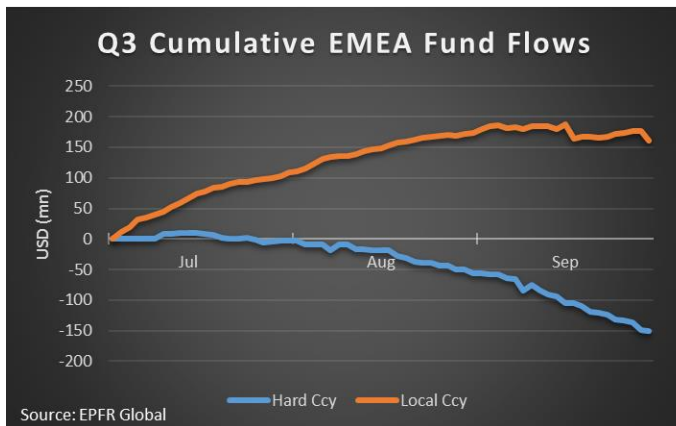
- Reverse gear QE argument
  - There is a rationale that as QE accelerated investors sold EM in size to chase capital returns in the US and Europe, thus the scaling back of QE is likely to push these trades into reverse gear as EM now offers both carry and potential capital gains.
- Global Policy Tightening to remain gradual
  - Despite Fed Fund Futures now pricing in 67% chance of a rate hike in December, we believe that the Fed and ECB will remain very cautious, as the process of deflating bubbles is by nature very risky, so the QE central banks are also likely to go easy on rate hikes for the foreseeable future. Our base case is that the Fed will only hike if markets have fully priced the hike.
- Positioning remains light
  - Inflows have yet to make up for the outflows from 2013 to 2016 (see graph below). This shows net flows into EM Bond and Equity funds since May 2013, just before the taper tantrum. It clearly shows that flows into equity funds are some way short of making up the mass outflows in the preceding three years, whilst flows into bonds have only just returned into positive territory.



## CEEMEA MARKETS Q4 OUTLOOK

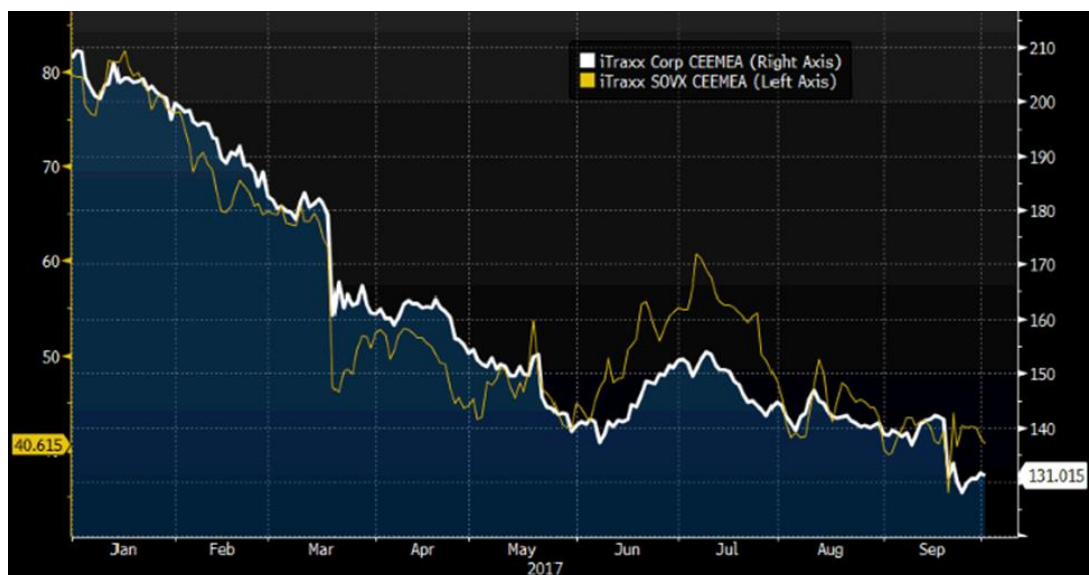
### Outlook for CEEMEA Eurobond Issuance

As discussed, flows data shows that fresh money continues to pile into CEEMEA Bond Funds and this should support new issuance. However, it is clear from the graphs below that it is local currency corporate bond exposure that is most in demand, given that these offer the highest yields.



A continued bullish signal also continues to come from the iTraxx CEEMEA Corp CDS index, which as we anticipated back in our February report has continued its steady decline under the 200 level that was previously flirted with in 2014.

- The index has shed more than 25% over the past six months to carve out fresh record lows under 130 in September. At the same time, the iTraxx CEEMEA Sovereign index has tightened further into uncharted territory, reaching almost 35 in September, marking a continuation of the recovery in investors' perception of EM risk since early 2015 (see graphs below for 2017 performance so far & 5 year performance, source Bloomberg).

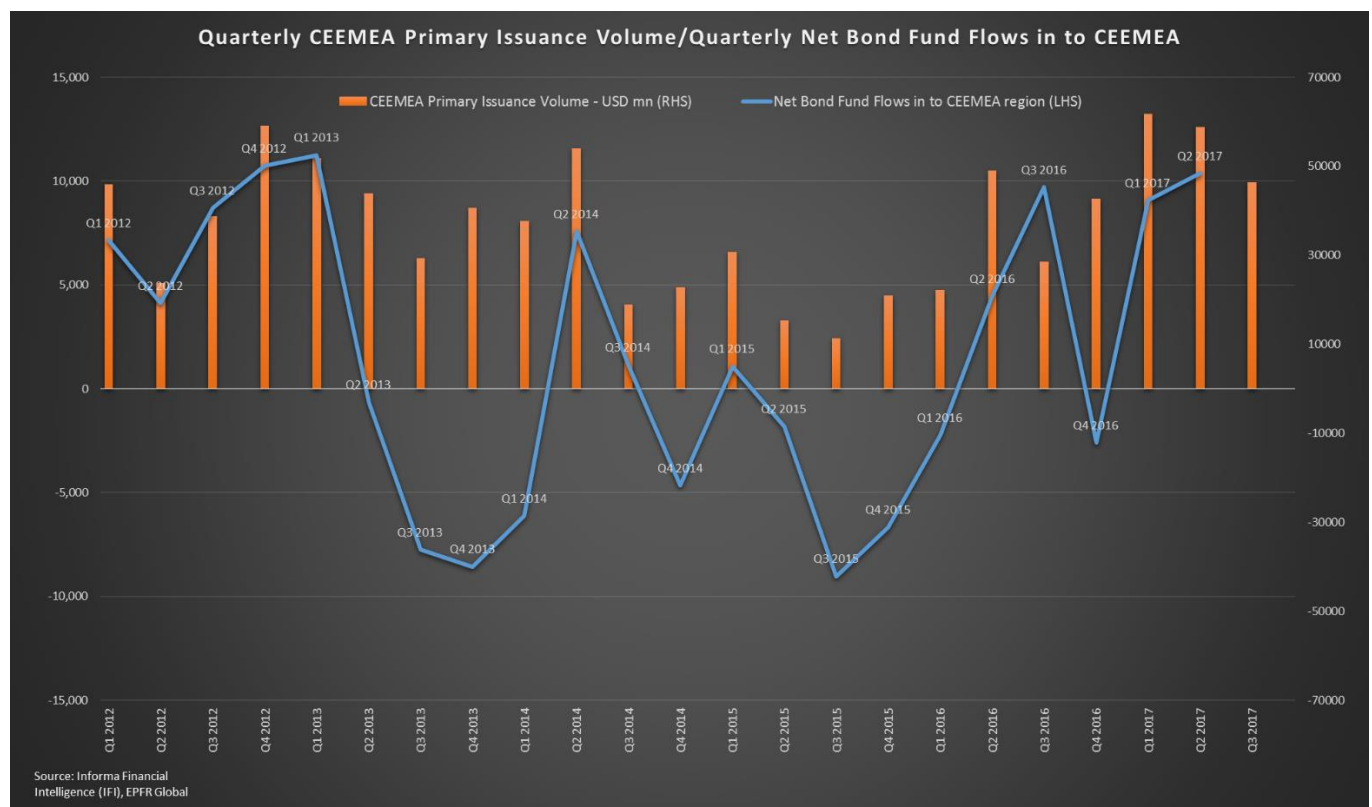


## CEEMEA MARKETS Q4 OUTLOOK



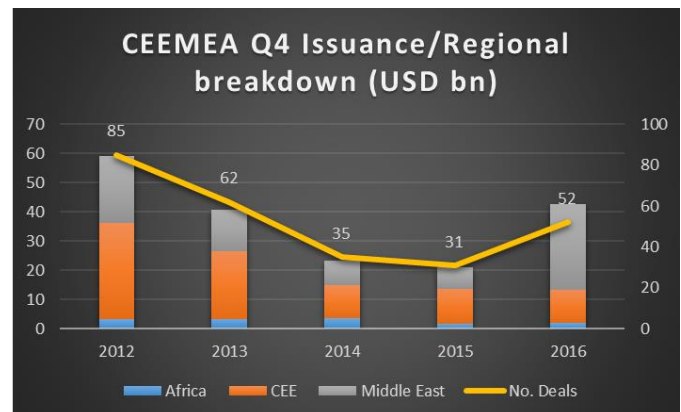
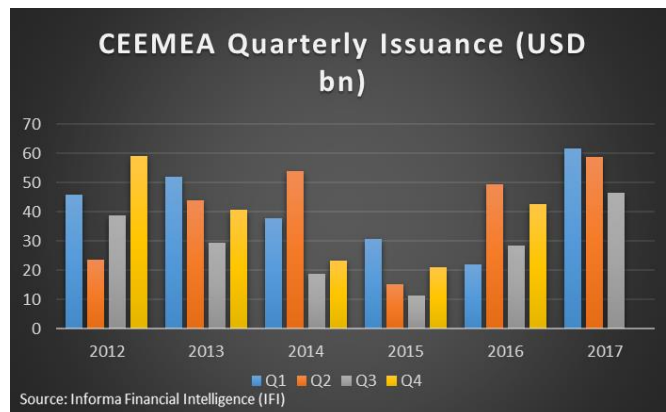
As the next graph shows, the performance of these indices appears relatively correlated with CEEMEA issuance.

- The blow-out of the iTraxx Corp CEEMEA Index and more modest move in the iTraxx SOV CEEMEA Index in late 2014-early 2015 was followed by a lull in issuance volumes out of the region – dipping below USD20bn in Q3 2014 for the first time since 2011, and again in Q2-Q3 2015. The subsequent recovery in these indices has coincided with a pick-up in CEEMEA issuance, with volumes in two quarters of 2017 exceeding USD50bn, which has only been achieved a handful of times in the past, when the indices previously flirted with the 200 level. Furthermore, Q1 issuance reached a record USD62bn.



## CEEMEA MARKETS Q4 OUTLOOK

A strong October tends to be a prelude to a busier run into year-end for primary issuance, as typically robust Q4 issuance volumes outlined in the following chart illustrate (a look back at the past five years shows Q4 issuance has consistently exceeded Q3).



As the graphs demonstrate it is the CEE and Middle East regions that tend to carry the weight for CEEMEA in terms of Q4 issuance. However, these two regions saw a notable decline in the 2013-15 period.

- The Middle East staged a rebound in Q4 last year – aided by Saudi Arabia's EM-record beating, USD17.5bn debut conventional offering – which helped to lift the Q4 issuance volume to levels last seen back in 2012.
- The Middle East may well lead the way again in Q4 this year as GCC sovereigns look to take advantage of current oil prices (Brent at five month highs) and lower borrowing costs to fund budget deficits.
- Typically, UAE corporates and financials are regular Middle Eastern issuers in Q4, having raised a combined USD15bn over the past five years via 27 deals (13% of the total Middle Eastern issuance).
- Turkish banks are also key players within the region - 23 deals for a total of USD11bn over the same period (9% of the total Middle Eastern issuance).
- Russia has issued just one new Eurobond so far this year, defying sanctions with a two-part USD deal in June, and conducted a tap in September, but does not traditionally return to the market in the final three months of the year.
- By contrast, Russian corporates and financials tend to be fairly frequent issuers in Q4 and make up 30% of the total, circa USD90bn Q4 issuance from the CEE region over the past five years.

***We stick to our outlook that the recent Emerging Market sell-off is likely to be temporary since the Fed itself has repeatedly said any further monetary tightening would be at a gradual pace.***

***Positive carry, improving global growth, near-term stability in Chinese growth, solid fundamentals, and cheap valuations - all remain reasons to be bullish.***

***The evidence suggests that EM assets perform well during periods of Fed tightening and that investor flows into EM funds remain robust. This should ensure that fresh capital continues to be pushed towards new bond issues as investors look to gain exposure to improving credit stories and accelerating global growth.***



## CEEMEA MARKETS Q4 OUTLOOK

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