GRANT'S
INTEREST RATE OBSERVER®

Vol. 33, No. 17b Two Wall Street, New York, New York 10005 • www.grantspub.com SEPTEMBER 4, 2015

Almighty ringgit?

Just how investors can "take" their money from a particular market—as investors, en masse, are reported to have done from emerging markets—is, to us, an enigma. Someone sells, another buys. Money exiting meets money entering. To whom do the sellers sell? Not to nobody.

Which will serve to introduce another enigma, the fancy prices assigned to the dollar-denominated bonds of emerging-market governments. You look at the low yields quoted on the dollar debts of Russia, Turkey, Brazil et al. and you wonder if people have stopped reading the newspapers. The countries are down, their debts are up.

In preview, we're bearish on what's overpriced, notably the iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB on the Big Board's Arca market). We're open-minded toward—not bullish on, but interested and curious about—what may just be underpriced.

An "emerging market" is what 21st century Wall Street calls a financially speculative country. It's what 20th century Wall Street called, at various junctures, a less developed nation, a Third World nation, a developing country, a backward country and a waste place. Names change, but cycles remain the same.

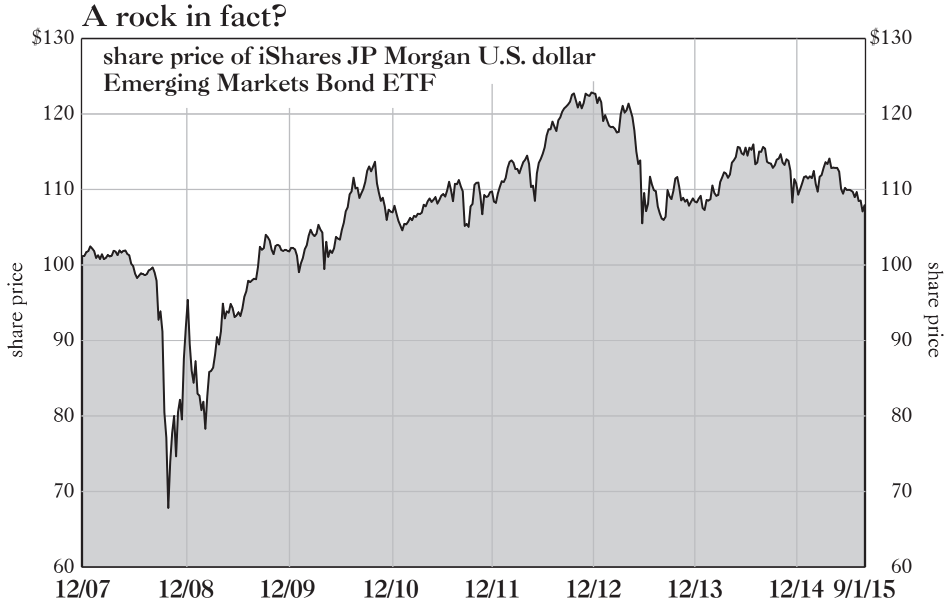
Maybe "waste place" will get another spin. The Bloomberg Commodity Index sits at its lowest level since 1999. Political crises have rocked Brazil, Malaysia and Turkey. The Indonesian rupiah and the Malaysian ringgit have depreciated to levels unseen since the Asian crisis. China's renminbi, once that supposed anchor to an alleged second coming of the Bretton Woods post-World War II monetary order, is today no anchor but a loose cannon. On Aug. 24, the Russian ruble traded at 70.9 to the dollar, an all-time low. Whether or not investors have "yanked," "pulled" or otherwise extricated $1 trillion from emerging markets, it's clear that dollar bills have temporarily lost their zest for foreign travel.

"Knowing this," as colleague Evan Lorenz observes, "you would expect EM assets, stocks and bonds alike to trade at fire-sale prices. They do not. The Russian MICEX Index, which changes hands at 10 times' trailing earnings, only looks screamingly cheap in comparison to the Jakarta Stock Exchange Composite Index, at 23 times, or the FTSE Bursa Malaysia KLCI Index, at 16 times. An investor in Kuala Lumpur may rationalize the purchase of domestic stocks at full multiples in the midst of mass street protests as a way to hedge the sinking ringgit. An investor in Chicago can't."

Value is notably meager in the dollar wing of the EM sovereign debt market. Over the past 12 months, the price of Brent crude oil has plunged by 52%, eclipsing even the fall in the ruble/dollar exchange rate. Yet the Russian government is actually paying less today than it did in August 2014 to borrow in dollars. One year ago, Russia's U.S. dollar 7 1/2s of 2030 were quoted at a price to yield 5.1%. Now they trade at 3.6%. Over the same 12 months, the yield on the ruble-pay Russian 4.673s of 2029 jumped to 11.9% from 9.5%.

Brazil makes another case study in paradox. The crisis of the corrupted government of the Dilma Rousseff regime, the bear market in oil and a decelera-

A rock in fact?



source: The Bloomberg

tion in Brazilian economic growth have served to drop the real by 39% against the dollar over the past year. In response to which, the Rousseff government has ordered state-owned lenders Banco do Brasil SA and Caixa Economica Federal to pass around the bank credit more liberally. The QE-sedated bond market has protested this policy affront in the mildest manner. In comparison to the 3.8% yield prevailing a year ago, the dollar-pay government of Brazil 4 1/4s of 2025 are quoted today at 5.4%. For comparison, the yield on the real-denominated 10s of 2025 lenders has popped to 14.5% from 11.1% over the same 12 months.

Then there's that powder keg by the Bosporus. Turkey, which our friend Russell Napier identified as the country most likely to tilt the EM world into a bear market (*Grant's*, Aug. 7), is borrowing dollars at the quoted yield of 5.1%, up just 70 basis points from a year ago. Here, too, one observes a disconnect between the economic and political fundamentals, on the one hand, and the quoted value of government debt on the other. Facts on the ground feature business stagnation (or worse), plunging exports, currency depreciation, external debt equivalent to 52% of GDP and, of course, the regal person of Recep Tayyip Erdogan, the once and (aspirationally) future Turkish autocrat who some months ago called the central bank governor a "traitor" for refusing to cut interest rates as fast as Erdogan desired. Mr. Market seems to stifle a yawn. The dollar-pay Turkey 7 3/8s of 2025 change hands at 117 to yield the afore-noted 5.1%. The lira-denominated 9s of 2024 fetch 10.1%, up from 8.9% a year ago.

By comparison, the Philippines—a democracy boasting a 5.6% rate of GDP growth and also, not unimportantly, relatively few panic-prone foreigners in its financial midst—has been largely unscathed. The local peso is down by 7% against the dollar over the past year. The yield on the dollar-pay Philippine 9 1/2s of 2030 has actually fallen to 3.8% from 4.1%. The peso-denominated 12 1/2s of 2030 trade a hair's breadth wider to yield 3.9%; one year ago, they were quoted at 4.8%.

Which brings us to EMB, the previously cited exchange-traded fund in dollar-pay EM sovereign debt. With a market cap of $4.2 billion and a price per share of $107.63, the fund is priced to deliver a yield of 4.5%, 280 basis points lower than average American junk-grade bond yield. It's quoted at a discount to net asset value of 0.3%.

Top 10 credits of iShares J.P. Morgan USD Emerging Markets Bond ETF

	weight in EMB	2015 est. GDP ($ billions)	foreign currency reserves (%GDP)	external debt (%GDP
Turkey	5.4%	$752.5	13%	52%
Philippines	5.0	308.0	23	24
Russia	4.4	1,176.0	26	51
Hungary	4.2	126.7	30	144
Colombia	4.1	332.4	13	30
Indonesia	3.7	895.7	11	33
Poland	3.7	491.2	20	72
Brazil	3.5	1,903.9	19	29
Lebanon	3.1	54.7	74	57
Peru	3.0	190.3	31	32

sources: BlackRock, the Bloomberg, IMF

EMB fills its portfolio according to the composition of the referenced Morgan emerging market index. Top constituents include Turkey (5.4% of overall holdings), the Philippines (5%), Russia (4.4%), Hungary (4.2%), Colombia (4.1%). The component securities show an average weighted maturity of 11.5 years and average duration of 7.12 years (that is, a 100 basis-point rise in yields would mean a 7.12% loss in average price).

EMB is, in the main, an investment-grade index, though triple-B, the last full ratings stop before speculative grade, is the dominant rating; 47.1% of the portfolio is so appraised. Just how much risk does the investor shoulder? It depends on whom you ask. For any who equate risk with volatility, EMB is a port in a storm. For BlackRock's money, the ETF is among the least risky of the funds it ranks, "[b]ased on the one-year standard deviation of the [share price]." Can you guess which fund the BlackRock volatility assessors judge to be the riskiest? That would be the iShares MSCI Global Gold Miners ETF (RING on the NYSE Arca). Well, it certainly *has been a dog*.

Besides the unjittery price action, BlackRock enumerates three reasons to own EMB. Thus:

Exposure to U.S. dollar-denominated government bonds issued by emerging market countries;

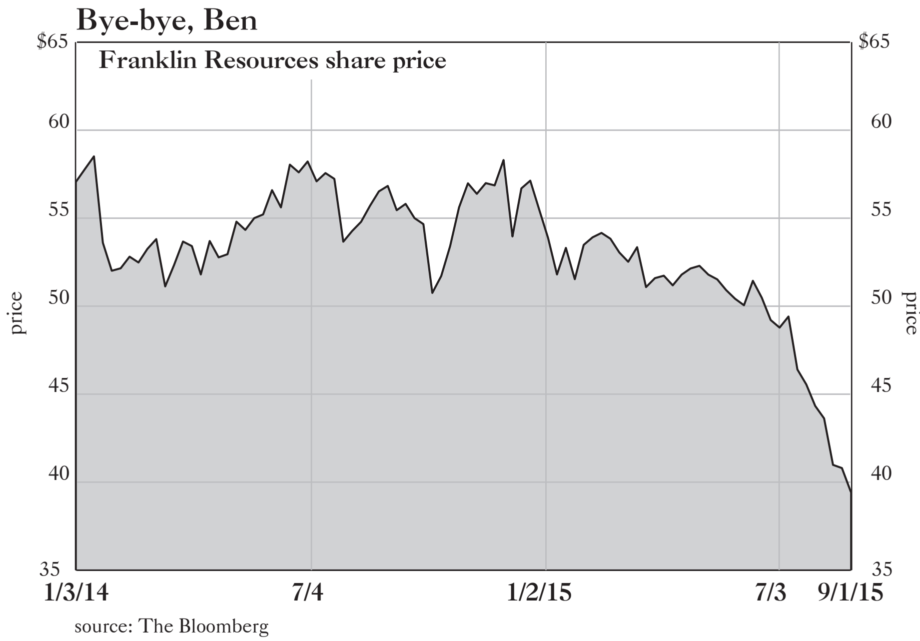
Access the sovereign debt of 30+ emerging market countries in a single fund;

Use to seek higher yield and customize your emerging market allocation.

Nobody holds the authors of advertising copy, even of high-toned financial advertising copy, to the literal, disinterested truth. Still and all, a word on price and value would not have been amiss. Then, again, price and value are not the EMB's best features. The bear market in American corporate credit is starting to put the bruited "higher yield" in the shade. If it's a BBB-rated, dollar pay credit you want, the Verizon senior unsecured 5.15s of 2023 pay 3.8%, up from 3% on April 8. While EMB is weighted to investment-grade issuers, fully 37.3% of the portfolio is rated junk.

The principal selling point of dollar-denominated emerging markets debt is, after all, the dollar itself. The dollar is up and is widely expected to go higher. Emerging market currencies are down and are widely expected to go lower. Momentum may indeed carry the respective monetary units in just these indicated directions. Possibly—we are just imagining—the Fed will lift the funds rate not once but twice in what remains of 2015. So doing, it will stoke a new dollar boom and a reciprocal emerging markets' bust. Commodity prices will continue to plunge as a deflationary chasm opens in China (the Fed will say that the problems are "contained").

Or—we continue to imagine—the Fed will lift once, afterwards declaring that it will do nothing more of the kind till it sees the whites of the eyes of inflation. Fear will thereupon give way to greed, the dollar exchange rate will weaken and EM currencies will rally, an



updraft predicated partly on relief, partly on positioning and partly on value.

Scenarios are free for the imagining; anybody can dream one up. At least, we judge, it's not too early to begin thinking about a dollar/EM reversal and how the doughty speculator might prepare for it.

Since EMB came into the world at the end of 2007, the share price has been up, down and—lately—sideways. In the year to date, it has fallen by 1.9%. It plunged by 36% in 2008. It rallied by 12% between 2011 and 2012. It pulled back by 15% at the time of the 2013 taper tantrum.

You scratch your head. The Lehman-centered horrors of seven years ago did not exact anything like so steep a toll on EM investment flows (as those flows are measured and reported) as have the cumulative EM disappointments of the past 12 or 13 months. The 2013 downdraft in the EMB share price was provoked by fears that the Bank of Bernanke would throttle back on the rate at which it materialized new dollars, not at any threat to stop the magic, let alone to raise an interest rate.

We've all been reading how credit supposedly "leads" equities—how the bond market has a better line of sight into the future than the stock market. The EM branch of the bond market would hardly seem to support that proposition. It stood stock still as the 1997 Asia crisis broke.

The Thai government, its foreign exchange reserves run dry, floated the baht in July 1997; that was the crack of the Asia-crisis starting pistol. By Sept. 30, the Thai currency showed a year-over-year decline against the dollar of 30%. The ringgit and the rupiah had registered losses of 23% and 29%. The dollar-denominated debt of the three afflicted countries hardly shuddered.

"On Sept. 30," Lorenz relates, "the Thai dollar-pay 8 1/4s of 2002 changed hands at 103 to yield 7.4%, 130 basis points more than the 10-year Treasury was paying. By Nov. 18, 1997, someone had apparently picked up a loose copy of *The Wall Street Journal* because the Thai dollar 8 1/4s were trading at 93 to yield 10.3%. So it was in spades with the Indonesian dollar 7 3/4s of 2006: Quoted at a 7.7% yield on Sept. 30, 1997, they plunged to a 22.8% yield by October 1998. The bear market was worse than even the spurt in yield suggests. On many a day, the aforementioned securities were untradable. A friend of ours remembers that seemingly no piece of paper connected with the Asian troubles was easily negotiable. 'At the time,' she relates, 'Freeport McMoRan was an Indonesian pure play. They had bonds that traded 30 bid-50 offer and nothing would trade. A multibillion dollar company! In fact, Merrill Lynch had an emerging market bond index at the time and things were so bad that they stopped printing the index.'"

Things will be different next time—they always are. Not forgetting 1997, EM governments have piled up immense dollar reserves; whether those war chests will prove adequate to the next occasion is a question that only the occasion will answer. Another change in the financial scenery from that day till this concerns the nature of EM borrowings. Bank debt predominated in 1997. Now marketable securities are the favorite flavor. As the hammer fell in 1997, U.S. dollar credit to foreign, non-bank borrowers footed to $2 trillion, of which two-thirds took the form of bank loans. Today, U.S. dollar credit to foreign, non-bank borrowers totals more than $9 trillion, of which only half takes the form of bank loans. Mutual funds and ETFs hold much of the balance.

Managers of emerging-markets ETFs and mutual funds know full well how thin is the line they walk. They promise their shareholders instant liquidity. They do not qualify that promise with the self-protective codicil that the assets they hold will prove least liquid when the public most ardently wants its cash. How does a conscientious fiduciary deal with the inherent conflict between instant liquidity on the liability side of the balance sheet vs. not instant liquidity on the asset side? Why, that steward starts selling when the public comes redeeming. An August working paper issued by the Bank for International Settlements concludes that professional EM bond managers sell securities to the tune of 110% of what the public redeems. Which is to say that selling begets selling (along with the necessary reciprocal buying, of course).

So it has proved at Franklin Resources (BEN on the Big Board) and the Templeton Global Bond Fund. The management company and the fund—the flagship fund—were featured subjects in the issue of *Grant's* dated July 11, 2014. Sell short the management company and steer clear of the fund, were our investment conclusions.

Our principal complaint with BEN, and with the Michael Hasenstab-managed Templeton Global Bond Fund (TPINX), was that illiquidity posed an underpriced risk. As of one year ago, investments in the sovereign debts of Hungary, Poland, Indonesia, Ukraine, Malaysia, Brazil and Russia accounted for 36.8% of the portfolio. A good number of these investments were denominated not in dollars but in forint, zloty, hryvnia, etc.

In the past year, TPINX has suffered a drop in assets to $65.3 billion from

Select World Bank bonds—a sampler

currency	coupon	maturity	bond price	bond yield	y/y change in currency vs. U.S. dollar
Russian ruble	11.6	2/10/20	106.7	9.7%	-44%
Indian rupee	4.2	1/30/20	92.6	6.1	-9
South African rand	0.5	2/20/20	70.5	8.8	-21
Colombian peso	8.0	3/2/20	108.0	5.9	-38
Mexican peso	7.5	3/5/20	110.9	4.7	-23
Turkish lira	8.58	6/30/20	90.0	11.3	-26
Brazilian real	0.5	12/20/19	60.9	12.6	-39
Polish zloty	3.25	1/31/19	104.2	2.0	-15

source: The Bloomberg

$72 billion, owing in part to redemptions, in part to a mark-to-market loss of 7%. How has Hasenstab responded to these difficulties? Exactly as the authors of the afore-cited BIS paper would have expected him to, namely, by getting liquid. At the end of July, 28% of Templeton Global was in cash, up from 19% in July 2014.

Last week, Hasenstab stood in front of the Franklin-Templeton corporate video camera to reassure his stockholders that they faced not ruin but opportunity. He said that the markets were panicking, that China posed no existential threat to world finances, that the devaluation of the Chinese renminbi was relatively small beer and that—convinced of the health of the U.S. economy—he would continue to sell short U.S. Treasurys.

Hasenstab also addressed the selloff in EM currencies. He said that it was unearthing terrific value. "In Asia," he said, "many of the currencies are approaching or [are] at levels that we didn't see in the Asian financial crisis, when Asia was the source of the crisis. Today fundamentals are very different than they were back in the late '90s that caused that crisis. In fact, most countries have significantly higher reserves from large current account surpluses, growth is on much stronger footing than it was back in that period where there was an investment bubble, huge macro imbalances that led to a collapse. We're seeing tremendous value in that region."

Latin America, too, is on sale, said Hasenstab: "The Mexican peso went above 17 to the dollar; it's never traded there before. It's had a bigger depreciation than we have seen during the Tequila crisis in the mid-1990s when the economy was living day-to-day on very short-term capital, and any disruption to that led to a complete implosion of their economy. Mexico today has very little debt, strong reserves, good leverage to the U.S. economic recovery—again, a once-in-a-decade, if not several decades, opportunity that we're seeing in some of these currencies."

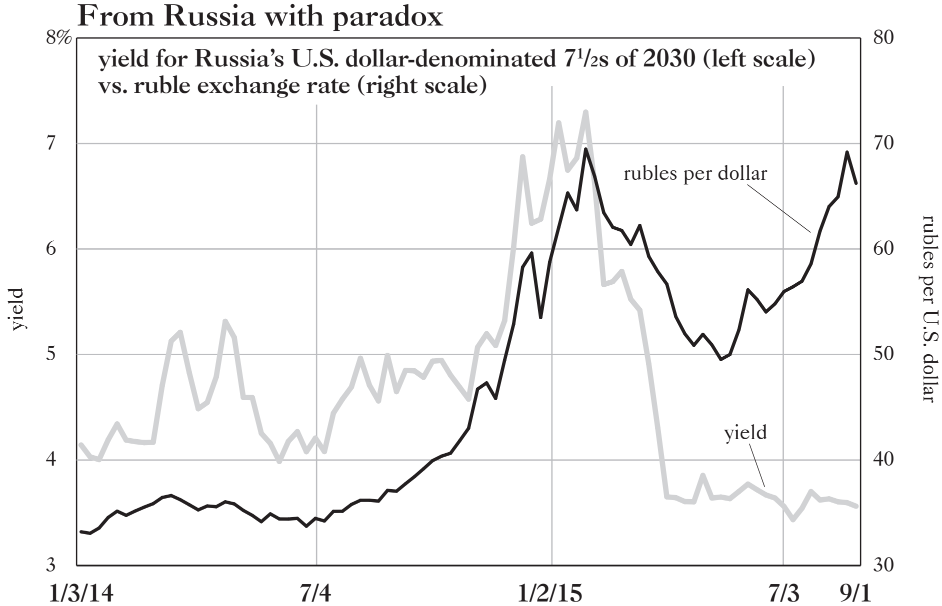
We happen to disagree with Hasenstab on China: Stock market, currency or business prospects, things are just as bad as they seem, if not worse. Neither are we so sanguine as the Franklin Templeton portfolio manager appears to be concerning American prospects—suppress interest rates for the better part of a decade, as the Fed has done, and you pay some price. However, concerning the opportunities being surfaced by the rout in the EM currencies, we believe that Hasenstab is on to something.

No 21st-century currency is intrinsically sounder than any other. All owe their value to the say-so of a government. No such unit of scrip is anything more than a piece of paper or a line of digital code. Value is a function of yield, purchasing power, political stability (or the appearance of same) and speculative positioning.

Today, the world wants dollars rather than rupiah, pesos, ringgits, rubles. Let us imagine a scenario in which Donald Trump cops the Republican nomination for president, or in which the Fed implements QE-4 (or 5 or 6). On some future day that nobody knows, the world may want rupiah, pesos, ringgits, rubles. How to invest in some future EM/dollar reversal?

EMB has a local-currency doppelganger. It's the iShares Emerging Markets Local Currency Bond ETF (LEMB on the NYSE Arca). Holding assets of just $530 million, LEMB is a shadow of its dollar-bond counterpart. It stocks its portfolio in accordance with the Barclays Emerging Markets Broad Local Currency Bond Index. "While triple-B-rated bonds account for 42% and 47.1% of the assets in LEMB and EMB, respectively," Lorenz observes, "just 3.75% of LEMB's holdings is either unrated or rated speculative grade; 37.3% of EMB's portfolio is so designated. Like EMB, LEMB trades very nearly at net asset value (the discount is just 0.3%). Unlike EMB, LEMB has traded down this year to the tune of 10.7%. As for the yield, you will not be blown away at its generosity. The relatively short-dated portfolio (average maturity is 6.7

From Russia with paradox



source: The Bloomberg

years) delivers 5%. Somehow, in exchange for the risk—even the risk of some of the more respectable emerging names such as South Korea and the Philippines—one had expected more."

There are, as well, closed-end funds that focus on emerging market debt. Three have market caps in excess of $400 million: Morgan Stanley Emerging Markets Domestic Debt Fund Inc. (EDD on the NYSE) with a $513 million market cap; Templeton Emerging Markets Income Fund (TEI in the NYSE) with a $475 million market cap; and Western Asset Emerging Markets Debt Fund Inc. (ESD on the Big Board) with a $421 million market cap. The three trade at an average 18.6% discount to net asset value. EDD, at a 19.2% discount, uses leverage to enhance returns—it boasts a 12% dividend yield vs. 8.1% and 9.3% for TEI and ESD. While all three funds invest in emerging markets, only EDD offers exposure to the movements of local currencies. TEI consigns 85% of assets to U.S. dollars; ESD is 97% dollar-invested. Of course, leverage and exposure to local currencies cut both ways: over the past 12 months, EDD's share price has dropped by 43% vs. a 26% decline for TEI and ESD. Morgan Stanley, alert to the yawning EDD discount, has repurchased 859,160 shares this year out of 69.8 million outstanding.

Or perhaps the World Bank's monetary and interest-rate smorgasbord might be of service. The International Bank for Reconstruction and Development, appraised triple-A by three ratings agencies, issues bonds in 21 currencies. Buying them, an investor gets interest-rate risk and currency risk without the associated credit risk.

It would be analytically convenient if the local-currency World Bank issues were easily comparable to the EMB's dollar issues. They are not. The weighted average maturity of the EMB, as mentioned, is 11.5 years, the weighted average maturity of the World Bank issues (at least of the ones that interest us) is closer to 4.4 years. The nearby table compares eight currencies by yield and depth of depreciation against the dollar. You will see, for instance, that World Bank 8s of 2020, denominated in the plunging Colombian peso, changes hands at 108 to yield 5.9%; over the past year, the peso has given up no less than 38% of its value against the dollar, one percentage point shy of the Brazilian real. As for the World Bank's real denominated 0.5s of 2019, they are quoted at 60.9, a price to yield 12.6%. On average, the eight under-achievers featured in our table have slumped by 27% since the summer of 2014.

Currencies are made to depreciate—the modern central banker insists on it. Even at the ostensibly benign and necessary 2% annual rate of debasement, they lose their value within two generations. We ourselves furnished a painfully vivid demonstration of this truism in the Nov. 28 issue of *Grant's*.

"With the ruble at 46 to the dollar," we said in reference to the ruble-denominated World Bank 6 1/4s of 2017, "a move to 50.29 at maturity would cause a 9.34% loss and thus erase the investor's projected dollar return. But should peace and capital return to Russia within the next three years, an investor could earn an equity-style return for assuming equity-style risk."

Neither peace nor capital having returned to Russia, the dollar price of the ruble 6 1/4s has subsequently declined by 26%. In the monetary race to the bottom, some currencies lead and others lag. The point we wish to make is that the lead does periodically change hands.

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