EM Special

EM Outlook 2016 - Deeper into the vortex

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- After a disappointing 2015, some local currency and bond markets are arguably cheaper than they were a year ago; many hard currency sovereign and corporate bonds are too. Yet EM assets may still not be cheap enough.
- Weaker Chinese growth, further falls in commodity prices, corporate defaults, and the impending Fed tightening cycle are possible threats, and there may be other factors that may drag EM into a vortex.
- We expect EM assets to weaken further in H1, but though this weakness may extend into H2, it will eventually create some interesting buying opportunities.

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TRADE RECOMMENDATIONS

1. Short select EM currencies through a cheap basket

A set of bearish EM outcomes (Fed tightening, Chinese growth, yuan depreciation and a rise in EM corporate defaults) suggests that correlations in the EM space will stay elevated and could rise further in 2016. Taiwan and Chile have the biggest export exposure to China. In G10, our bullish USD/JPY view is moderate, but a disorderly CNY fall would revive fears of an Asian currency war and support a larger move. Markets are still pricing these joint macro risks as diversified, offering the opportunity of a cheap worst-of option. **Buy 6M worst-of CNH, JPY, TWD, CLP ATMS puts / USD calls.**

2. Regional EM: Short Asia against EMEA and LATAM

Against the backdrop of growing concerns about EM corporate credit quality and higher US rates, downside risks to Chinese growth (SGe 6.0% vs consensus 6.5%) coupled with RMB depreciation (USD/CNY moving at 6.80 by year end) will see Asia underperform EMEA and LATAM on a total return basis. **Buy RUB, BRL vs sell KRW, MYR.**

3. Short EM exposure: Long USD vs TWD & KRW

Korea and Taiwan are both highly exposed to weaker Chinese growth through the direct export channel and from RMB depreciation through the indirect channel by having relatively high export similarity. Both currencies could be increasingly used as proxy trades for the China story given more favourable carry characteristics.

4. Long EM exposure (against EUR): Short EUR vs PLN and CZK

Despite a challenging environment for EM FX, the CEE currencies will do well against the EUR on strong basic balances, robust domestically generated growth dynamics, and suppressed inflation. The CNB is expected to abandon the floor in EUR-CZK in Q3, though the risks of a later exit have increased.

5. Long EM exposure (against USD): Short USD vs RUB and INR

The RUB is expected to do well next year as domestic factors coupled with modestly higher oil prices proves beneficial. For a second year in a row, the INR is attractive on a carry-adjusted basis due to improvement in external balances, higher FII limits and the RBI limiting large movements in either direction.

6. EM relative value: Short TWD-INR, long RUB-MYR

Two positive carry structures with appealing qualities related to China and commodity exposure. India has the lowest direct export exposure to China in the region, while Taiwan has the highest, and for the sizeable positive carry (6.5%) to be eroded, it would probably require a sustained risk-on rally. Stable to higher oil prices would be beneficial for long RUB-MYR, and if oil prices fall, further the positive carry (approximately 9% per annum) provides a significant downside buffer.

7. Bearish China trade I: Long USD-CNH call spread

A gradual and controlled depreciation in USD-CNY toward 6.80 is our baseline scenario, but there are risks of a larger move if trade-weighted appreciation is too much for policymakers to bear relative to growth and employment objectives. Substantial negative carry (-3.8% over 12M) and unfavourable breakeven levels in plain vanilla call options leaves a USD-CNH call spread as the most attractive structure to position for either orderly or disorderly depreciation.

8. Bearish China trade II: Long CNH vs TWD and KRW

Given the unfavourable risk-return characteristics of being long USD-CNH, relative value structures against regional low yielders has some appealing qualities. First, long CNH against KRW and TWD has decent positive carry (+3.7% on an equally weighted basket). Second, these crosses have been positively correlated to higher USD-EM. Third, investors are likely to seek proxy trades for gaining exposure to the RMB depreciation story, and as such, KRW and TWD depreciation should at least match, or more likely exceed, that of CNH at different points throughout the year.

EM FX AND RATES FORECASTS

	3-Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
EUR/PLN	4.31	4.15	4.12	4.08	4.08
EUR/HUF	312.26	310	312	315	316
EUR/CZK	27.07	27.05	27.02	26.00	26.00
EUR/RON	4.47	4.42	4.42	4.43	4.42
EUR/RSD	121.42	120	121	121	121
EUR/RUB	73.89	66.15	64.14	61.28	59.80
RUB/BASK	70.72	64.42	63.79	61.62	59.80
USD/RUB	68.11	63.00	63.50	61.90	59.80
USD/TRY	2.89	2.95	3.02	3.05	3.10
USD/ZAR	14.38	14.50	14.80	15.10	15.45
USD/ILS	3.85	3.85	3.80	3.75	3.75
USD/BRL	3.78	3.95	4.00	4.05	4.10
USD/MXN	16.72	16.90	16.90	16.95	17.00
USD/CLP	701.38	717.00	720.00	722.00	725.00
USD/COP	3152	3000	2800	2750	2600
USD/CNY	6.40	6.60	6.65	6.70	6.80
USD/HKD	7.75	7.75	7.75	7.75	7.75
USD/INR	66.66	67.20	67.50	68.00	68.20
USD/IDR	13845	14400	14700	14900	15300
USD/KRW	1164.55	1200	1210	1220	1230
USD/TWD	32.78	33.50	33.80	34.10	34.40
USD/THB	35.88	36.60	36.80	37.00	37.10

Key policy rates

	9-Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Poland	1.50	1.50	1.50	1.50	1.50
Hungary	1.35	1.35	1.35	1.35	1.35
Czech Rep.	0.05	0.05	0.05	0.05	0.05
Romania	1.75	1.75	1.75	1.75	1.75
Turkey	7.50	7.75	8.00	8.00	8.25
Russia	11.00	9.00	8.50	8.00	7.50
South Africa	6.25	6.50	6.50	6.75	7.00
Israel	0.10	0.10	0.10	0.10	0.25
Brazil	14.25	14.25	14.25	14.25	14.25
Mexico	3.00	3.50	4.00	4.50	5.00
Chile	3.25	3.75	4.00	4.00	4.00
China	1.50	1.50	1.50	1.25	1.25
Indonesia	7.50	7.25	7.25	7.00	7.00
South Korea	1.50	1.50	1.50	1.50	1.50
Taiwan	1.75	1.75	1.75	1.75	1.75
India	6.75	6.75	6.75	6.75	6.75

EM GOES DEEPER INTO THE VORTEX

Still under pressure

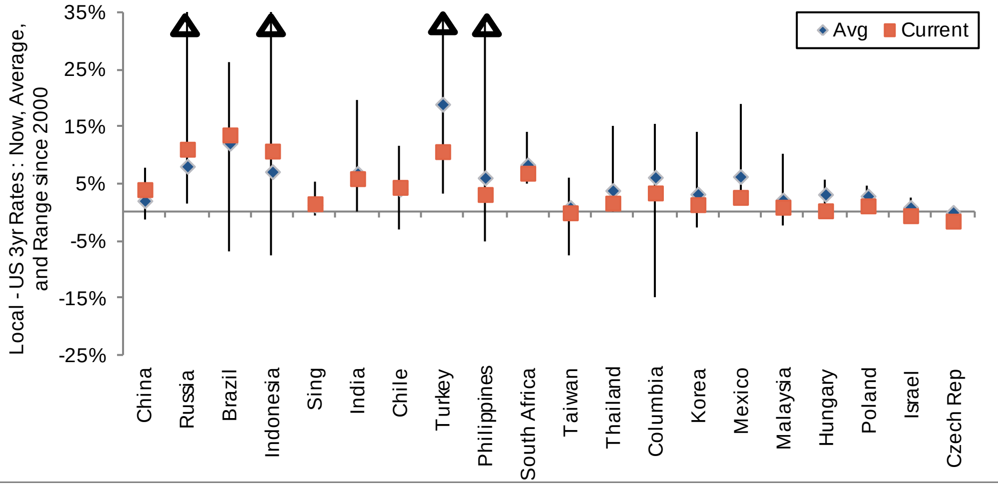
A year ago in "Keep calm and carry bonds," we argued that EM markets would spend the first half of 2015 waiting for the Fed to hike interest rates, but would rally once that rate hike came. Twelve months later, we are still waiting for that first US rate hike, though our economists expect it to come on 16 December, after this EM 2016 Outlook has gone to press.

However, the debate in emerging markets has moved on. After a disappointing 2015, some (but certainly not all) local currency and bond markets are cheaper than they were a year ago; many hard currency sovereign and corporate bonds are too. Yet EM assets may still not be cheap enough. Weaker Chinese growth, further falls in commodity prices, corporate defaults, and the impending Fed tightening cycle are possible threats; these risks are well understood, but if they worsen next year then EM assets could continue to sucked deeper into the vortex of negative returns. We expect further EM weakness in H1, but though this weakness may extend into H2, it will eventually create some interesting buying opportunities.

Carry to disappoint again

In "Will the carry trade ever come back in vogue", we note that carry has been an unrewarding strategy for EM FX investors since at least 2010. Returns worsened significantly from the middle of 2014 as high yielding EM currencies weakened by much more than forward levels had implied. Even then carry strategies worked in 2000-2007, mostly due to interest rate differentials rather than currency gains, and even after a weak eighteen months, spreads between EM and US rates are not particularly high. The chart below compares the current 3m implied yield on a range of EM currency forwards (the orange dot) with fifteen year averages (in blue). Brazil, Indonesia and Russian spreads are well above historical levels, but in most markets the carry at the short end of the curve is in line or lower than the historical averages.

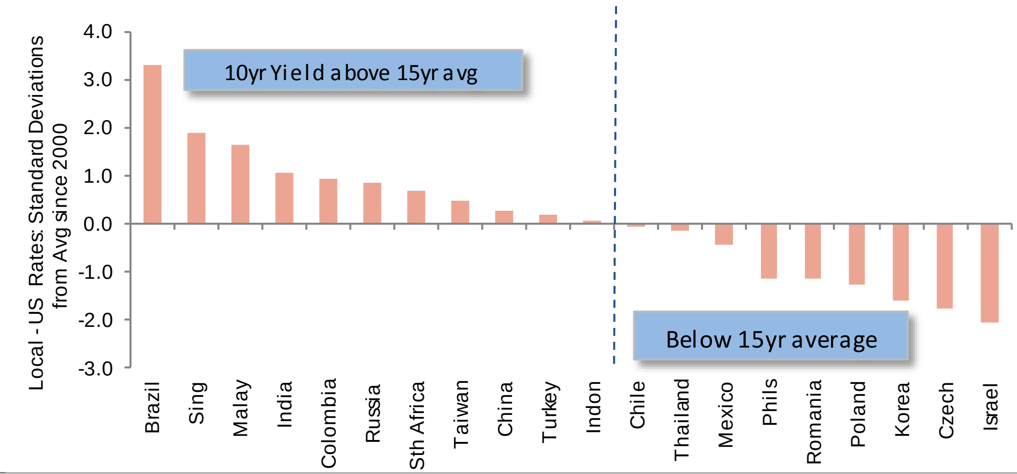
EM short rates not much higher vs US in comparison to history



Source: SG Cross Asset Research

Bond yield differentials are only slightly more compelling at the long end of the curve. The chart overleaf shows spreads between EM and US yields in the 10yr area of the curve relative to their historical averages, with the spread shown in standard deviations of the fifteen year distribution. In slightly more than half of the EM universe, 10yr yields are below the averages since the start of the century. Even where they are not, there are only a few situations – like Brazil or perhaps Malaysia – where the bond yield differential relative to the US is high vs the fifteen year average.

Only in some cases is carry much better than historical averages



Source: SG Cross Asset Research

Financial stress could get worse

So despite the weakness in currency markets, local rate and bond yield spreads to the US remain low relative to the history of the past fifteen years. In “Stress Indicators: Liquidity well protected; sovereign credits comfortable; FX the weakest link,” we look at this relationship in more detail. Forex markets have borne the brunt of weakness, as seen by EMP (exchange market pressure) indicators which show how much local currencies weakened and/or how much reserves have been used to defend local currencies. By contrast, the relative spreads between EM bond yields and the US versus their historical wides could reflect the fact that in some markets, local government issues now represent a safe haven against equities, just as they would do in developed markets.

And portfolio flows unlikely to pick up soon

In “Assessing EM capital outflow risks,” we note that capital flows drive currency moves, and that the deceleration in both foreign direct investment (FDI) and portfolio investment and ongoing outflows related to cross-border banking activity has weighed on EM currencies over the past eighteen months. FDI depends on growth prospects, which is a topic we will return to, but portfolio investment depends on rate differentials and on the relative appeal of equity markets. Above, we show that rate spread differentials are only well above historic valuations in a handful of countries. Are EM equity market valuations more compelling?

Not necessarily. EM P/E and price to book ratios of 13x and 1.4x, respectively, are well below their DM equivalents of 20x and 2.2x, but much of this is due to a difference in the weights of various sectors in the indices. As the table below shows, if we recalculate the EM P/E and P/B levels using EM sector ratios but multiplying them by DM sector weights, the ratios rise to 18x and 1.9x, respectively.

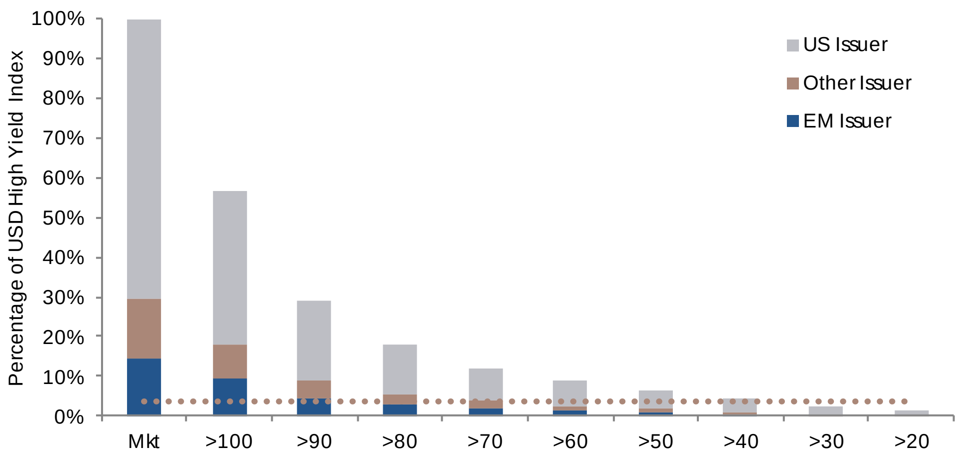
EM equities cheap only in some sectors

	EM Wts	DM Wts	EM P/E	DM P/E	Spread P/E	EM P/B	DM P/B	Spread P/B
Index Avg	$3.9trl	$32.3trl	*13x*	*20x*	*-7x*	*1.4x*	*2.2x*	*-0.7x*
Avg Using DM Wts			18x	20x	-2x	1.9x	2.7x	-0.8x
Finance	27.7%	20.9%	8x	15x	-7x	0.7x	1.2x	-0.5x
Tech	20.7%	14.4%	13x	20x	-7x	2.0x	3.8x	-1.8x
Consumer Staples	8.4%	10.1%	24x	22x	2x	3.6x	4.0x	-0.4x
Telecoms	6.9%	3.3%	16x	19x	-3x	2.0x	2.2x	-0.3x
Consumer Discretionary	10.1%	13.3%	16x	19x	-4x	1.8x	3.1x	-1.2x
Energy	7.3%	6.6%	14x	46x	-32x	0.7x	1.4x	-0.7x
Industrials	7.1%	10.7%	15x	18x	-3x	1.4x	2.6x	-1.2x
Materials	6.0%	4.4%	53x	21x	32x	1.0x	1.7x	-0.7x
Utilities	3.1%	3.1%	9x	21x	-12x	1.0x	1.5x	-0.4x
Healthcare	2.9%	13.1%	29x	22x	7x	4.2x	3.8x	0.3x

Source: SG Cross Asset Research

Much of the rest of the gap can be explained by the cheapness of the EM finance and tech sectors. Given our economists concerns about rising non-performing loans in Asia and other emerging markets, the gap between financial valuations in DM and EM markets may persist. The tech valuation gap looks more likely to narrow, even though there are some important differences between the DM tech sector (driven by US names) and the EM tech sector (which comprises mostly Korean, Chinese and Taiwanese companies). But since tech is only a fifth of the EM indices, this by itself is unlikely to lead to huge portfolio flows.

Despite the risks, few EM high yield USD bond trades at distressed levels



Source: www.Markit.com, SG Cross Asset Research/EM

As noted above, we fear that non-performing loans are likely to rise in the emerging markets. In “Corporate Leverage: the key EM risk in 2016?” we show how EM corporate leverage has ballooned since 2009. Nonetheless, hard currency EM corporate markets have generated small positive returns this year, outperforming local rates markets and hard currency sovereigns. Yet the markets may be far too sanguine. Non-performing loans peaked in previous EM crises between 50% (in Indonesia in 1998) and just under 10% (in Singapore in 2001), but while more than 6% of US high yield bonds trade under 50 (implying a good chance of default), almost none of the bonds from EM issuers in the USD high yield indices are this distressed.

Of course, this hard-currency universe is a rather specialised sub-sector of the whole EM debt market. Yet the relatively high prices the EM bonds above contrasts with the evidence of accelerating Chinese defaults in 2015, pressures on EBIT margins in energy companies from Indonesia to Latin America, nervousness about Brazilian retailers and fears of rising non-performing loans in the Indian banking system. We do expect these pressures to eventually drive prices lower on EM USD-denominated corporate bonds as well.

Not much hope from growth either

So if valuations, carry, and portfolio flows are not going to help emerging markets, we will have to count on more fundamental improvements. In "EM Macro Vulnerabilities – Slimmer buffers to cushion global headwinds," we update our EM macro vulnerability index, and find that although the aggregate external position is quite benign, there are worries about both the macroeconomic performance and financial stability. Macroeconomic performance roughly translates into economic growth, and the outlook here is poor. In their Global Economic Outlook our economists see emerging market GDP growth accelerating from 4% in 2015 to 4.5% in 2016 and 4.8% in 2017, but these good headline figures hide some worrying individual cases. Our economists expect Brazil to contract by 3.2% in 2016, though this should set the stage for a bounce in 2017. In "EM Growth: Renewed Hopes for a Turnaround in 2016," we highlight the sensitivity of the Latam economies in particular to China, and show the imbrications between the macro-economic outlook of the whole sector.

A challenging H1

In sum, the outlook for emerging markets remains challenging, at least in H1. With weak economic growth, with the threat of bankruptcies hanging over the corporate and banking sectors, and with carry still not that compelling, local markets may remain under pressure in the near term. In "Sovereign Credit: The resilient asset class," we argue that the hard currency corporate markets should prove a relative haven, especially in comparison to the hard currency corporate credit markets. Another relative haven should be Asian local rates, where we expect increases in front-end rates to be checked by still accommodative monetary policies in H1, though this will be less true in the second half of the year.

Below we offer some highlights from each of the asset classes covered in this report:

EM FX – Collisions; momentum and butterflies

Emerging market currencies face another challenging year, though the pace of depreciation will be significantly less than 2015. Until a sufficient catalyst emerges to extinguish the well entrenched trend dating back to 2011, the path of least resistance is for additional dollar strength. Trading strategies will need to be more nimble than last year and timing will be critical. Our current bias is to be long dollars (or flat) or seek relative value structures, but selective tactical short-term opportunities to get long EM will arise as risk sentiment oscillates between the bullish and bearish camps.

The cocktail of Fed tightening, below consensus Chinese GDP, RMB depreciation, and rising corporate defaults, is a bitter and potent one. Volatility will stay elevated and risk taking restrained, while there is no end in sight to the moribund capital inflow dynamics plaguing EM FX. Although these macro risks are well known, they are not individually, and especially not the combination of all four, fully priced into markets. Investors should be particularly worried about the butterfly effect as the confluence of macro developments introduces significant asymmetric downside tail risks.

While spot rates should remain relatively well correlated, there is some scope for differentiation relative to the forwards. On a regional basis, Asian currencies are expected to underperform, while the EMEA dollar bloc will be the leading outperformer, followed by the EMEA EU bloc and LATAM. We are most bullish on the RUB, PLN, and INR – and most bearish on CNH, KRW, and MYR.

Long term FX ideas – six to twelve months

Regional: Short Asia against EMEA and LATAM

Short EM exposure: Long USD-KRW, USD-TWD

Long EM exposure: Short EUR-PLN, short EUR-CZK, short USD-RUB, short USD-INR

Relative value: Short TWD-INR, long RUB-MYR

China trades: USD-CNH (call spread), long CNH vs TWD & KRW

Option structure: Worst-of CNH, JPY, TWD, CLP ATMS puts / USD calls

EM local rates – Potential Fed Hike Leaves Limited Space

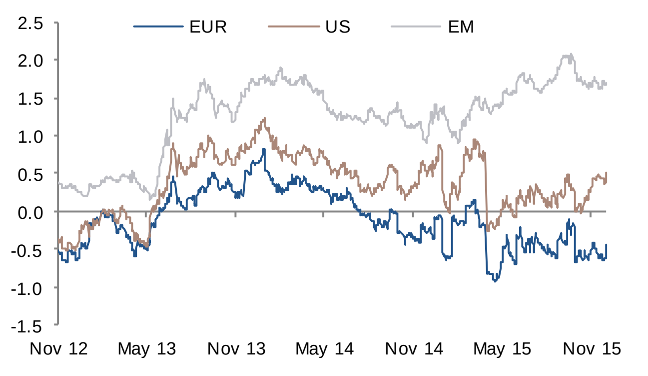
With potentially higher USD real rates on rising US yields and EM central banks largely done with monetary easing, there appears to be little space for EM real rates to move lower. Most EM nominal yields rose in 2015 on nervousness about credit quality and on measures adopted by some central banks to defend their currencies. Higher USD and EUR nominal yields will push US and EUR real yields higher leading to higher EM real rates on average. EMEA rates are lower, but are likely to stay that way due to continued ECB QE and perhaps further monetary easing. Asian and Latam real rates spreads suggest that some countries with high nominal interest rates such as Brazil, India, Indonesia and South Africa are attractive if credit quality does not worsen, even if impending US rate hikes make the markets more volatile. Although some Asian rates, i.e. in China, Korea, Taiwan, appear rich relative to lasty year's levels, they benefit from safe-haven flows within Asia.

The US rate shock in the summer of 2013 offers a yardstick as to how markets might move if US yields climb sharply. During this period, India and Turkey were forced into emergency rate hikes following sharp currency sell-offs. MXN, HKD and SGD yields followed USD yields most closely, while CNY and HUF yields were least affected by higher nominal US yields. This time around the move might be sharpest in Brazil, Indonesia, Turkey and South Africa yields if: 1) lower current correlations move higher towards higher historical averages, and 2) markets take a cue from the summer-2013 US rate hike episode.

Sovereign credit – the resilient asset class

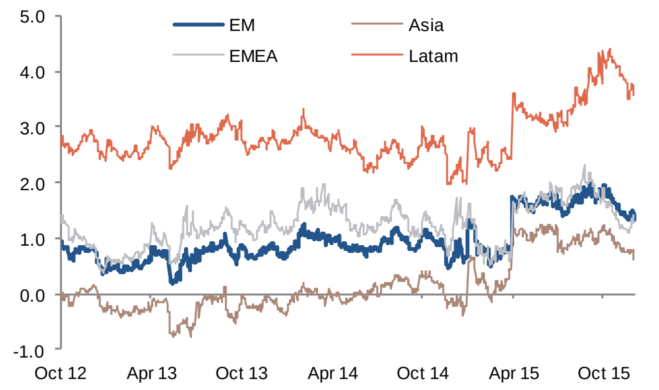
Sovereign spreads do not yet fully reflect the fall in commodity prices, and should therefore widen further through the first half of 2016. More sovereign downgrades are expected, and this should also be a factor which weighs on the asset class. However, low sovereign debt levels in EM and high FX reserves should act as a buffer, even if investors are concerned about contagion from corporate credit markets. High bond redemptions in 2016 should mitigate the impact of potential asset reallocation out of the asset class. On balance, we expect the EMBID spread index to trade at 420bp by the end of 2016. We also see the growing importance of EUR-denominated bonds, which we believe could represent 40% of total sovereign issuance in 2016.

Higher EM real yields; lower US and EUR real yields



Source: Bloomberg, SG Cross Asset Research/EM, levels for EM real rates, US real yields and EUR real yields. Real rates calculated as 10y yield – 4 quarters ahead CPI forecasts. EM real yield – average of 10y Govt yield for CNY, INR, KRW,IDR,MYR,SGD,TWD,THB,HKD, MXN, PLN, HUF and CZK . 5Y IRS for BRL,RUB, ZAR, TRY and CLP

Real rates spreads adjusted higher in Latam and Asia



Source: Bloomberg, SG Cross Asset Research/EM, levels for EM real rates above US real rates. Real rates calculated as yield – CPI 12m forward forecasts, Core CEE country (PLN, CZK, HUF) real yields adjusted for EUR real yields

In our latest EM Credit Hawk (Russian bonds expensive, Brazil still offering value), we highlight our top picks in the sector. Across all markets Kenya is now the cheapest credit, followed by El Salvador, but amongst the bigger names Brazil offers good value, and Kazakh bonds are also attractive. The Philippines and Vietnam are both very expensive relative to their fundamentals, and amongst the larger markets Russia has now turned expensive. We recommend increasing exposure to Brazil relative to Russia as a result.

In the sovereign bond market, Indonesia offers the best potential for capital gains on a cross-currency basis. Turkey and South Africa EUR-denominated issues are also both attractive relative to their USD-denominated equivalents.

Our fair value model also highlights possible ratings changes. Hungary is seen as having the highest chance to be upgraded in coming months, followed by the Philippines (where bonds nonetheless remain pricey). Cheap Kazakhstan and Brazil have the potential for downgrades (and the bonds are attractive nonetheless). South Africa and, to a small extent, Turkey also face possible negative ratings actions.

Corporate credit – The worst is yet to come

Bonds from emerging market issuers were surprising outperformers relative to the rest of the corporate bond world in 2015; as the table below shows, both high yield and investment grade EM bonds outperformed their US or euro-denominated equivalents.

Table 2: Emerging market bonds outperform other corporates – but not for long

	Excess Return	Total Return
US ex EM (IG)	-0.5%	-0.3%
Euro (IG)	-0.8%	-0.4%
GBP (IG)	0.0%	1.4%
EM in USD (IG)	**-0.1%**	**0.5%**
US incl EM (HY)	-1.8%	-2.5%
Euro HY (HY)	3.3%	2.6%
EM in USD (HY)	**5.2%**	**5.8%**

Source: SG Cross Asset Research

We do not expect this outperformance to continue in 2016 – indeed we think the market has become very complacent. As we note above, there are a lot of US high yield energy bonds trading at distressed levels, but almost no EM corporates. This may reflect the fact that EM investors consider these companies too big – or too important – to fail. But EM investors can't have it both ways. As we note above, EM sovereign indebtedness as a percentage of GDP looks reasonable compared to DM indebtedness, but it looks a lot less reasonable when corporates are folded into the figures. With Chinese defaults increasing already in 2015, defaults are likely to be a theme which impacts all EM markets in 2016, and makes hard currency corporate bonds underperform not only sovereigns, but also potentially local markets (local currency rates?) as well.

Our top picks are in the defensive sector of central and Eastern Europe, where companies run more defensive balance sheets since the euro crisis and have tilted their financing towards the cheaper euro. Investors looking for more spread should move east to Russia, where reviving economic growth means that the spread compression seen through 2015 can continue, back towards the levels of early 2014. Another attractive opportunity still is India, where short-dated bank debt still offers quite wide spreads.

By contrast Latin American credit spreads still seem too low relative to the risk, and the sector is one we would continue to underweight, despite the attractive carry. We would also still underweight South East Asian credit markets, where we think the risks are still underestimated. Another area which is likely to prove much more challenging in 2016 is the Middle East, where banks in particular are likely to tap the capital markets for financing after a long absence.

China is the biggest part of the EM corporate bond markets, and here we recommend a strategy based more on sector selection. Property has had a good run but is now looking fully valued, especially given the deceleration in property prices in the past two months. As this sector begins to falter, the banking sector will too, and we recommend underweighting financials as a result. Instead, we think the consumer sector should perform better as consumer demand picks up, though we would definitely position at the short end of the curve because we fear investment grade curves will steepen as default concerns pick up. In this context, we would avoid the Chinese high yield market next year.

WILL EM GROWTH ACCELERATE?

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Expectations for a broad-based rebound in EM growth have been disappointed again this year after already disappointing in 2014. In fact growth in emerging markets this year has not only missed the IMF's initial forecast of 5.00% but embarked on a protracted slowdown that can be traced back to 2011. After rising above 7.5% in 2010 after the global financial crisis, EM growth has since then continuously decreased, and the gap between advanced nation growth rates and EM growth continues to narrow. Having stood at around 6.30% in 2011, growth in emerging markets dropped to 4.6% in 2014 and is expected to fall towards 4.00% in 2015. This will mark a fifth straight year of slowing growth in the emerging markets.

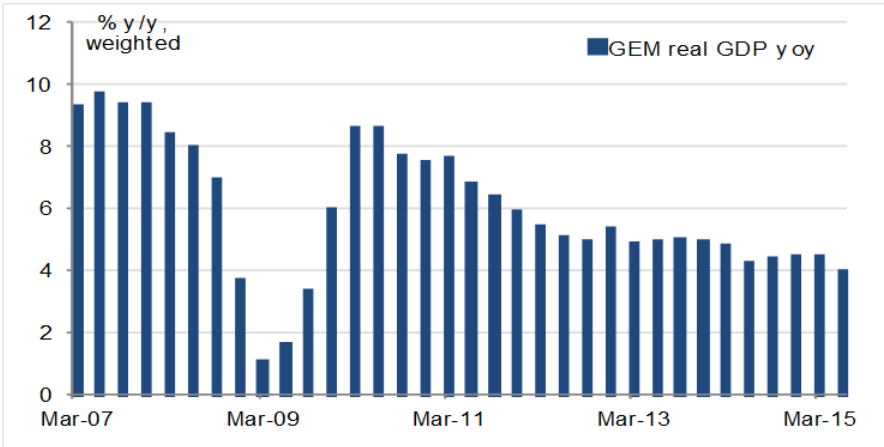
The reasons for the EM growth slowdown are a larger than expected slowdown in China, weaker growth in commodity-exporting countries and especially oil-exporting countries, adjustments in the aftermath of credit and investment booms in many EM countries, geopolitical tensions and worsening structural fundamentals in some bigger EM countries like Brazil and challenging external conditions with the prospect for higher US rates triggering higher financing costs for corporations that have boosted their USD borrowings significantly on the back of almost a decade-long period of ultra-low interest rates in the US.

EM growth: Expect a gradual recovery from a low base, but downside risks could undermine positive 2016 growth outlook

The IMF expects EM growth to reach a bottom at the end of 2015 before rebounding in 2016. It projects growth in emerging markets to rise to 4.5% in 2016 from 4.0% in 2015. Meanwhile, with growth rates in advanced economies predicted to rise to 3.6% in 2016 from 3.1% in 2015, the gap between EM growth and advanced nation growth should remain at a multi-year low of 0.9% next year. The expected recovery in emerging market countries does not reflect a general recovery but more a partial normalization of conditions in countries that experienced deep recessions in 2015, namely Brazil, Russia and the countries in Latin America that suffered a significant growth slowdown in 2015 due to the steep fall of commodity prices.

While growth in emerging markets is also expected to get a boost from stronger activity in advanced nations, downside risks to the current more positive outlook for EM growth in 2016 exist and seem to be more material than in previous years. These downside risks include disruptive asset price shifts and higher volatility triggered by monetary policy tightening in the US later in the year which could trigger a reversal of capital flows out of emerging markets, and a higher USD which could in tandem pose balance sheet and funding risks for corporations and countries where USD debt has risen substantially in recent years due to ultra-low interest rates in the US. The biggest downside risk to the current positive outlook for a rebound in EM growth is posed by a stronger-than-expected slowdown in China and a corresponding drop in global commodity prices.

EM growth has dropped to 4% in 2015

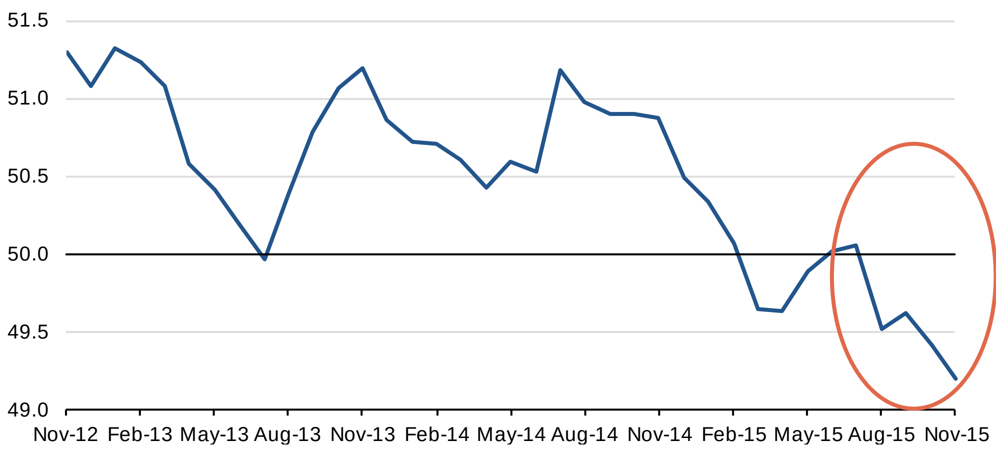


Source: SG Cross Asset Research/EM

EM PMIs: Latin America currently looking very weak

Purchasing Manager Indices (PMIs) have on average declined further in 2015. After the cyclical trough reached in the summer and autumn of 2015, PMIs are expected to stabilize at a low level. While growth prospects vary across countries and regions the Chinese slowdown and the decline in commodity prices is currently weighing very negatively on growth prospects in Latin America where PMIs continue to contract, especially in Brazil. In 2016 growth is again likely to show sharp divergences between EM regions, but country-specific divergences will also remain high due to structural problems in big BRIC countries like Brazil and Russia.

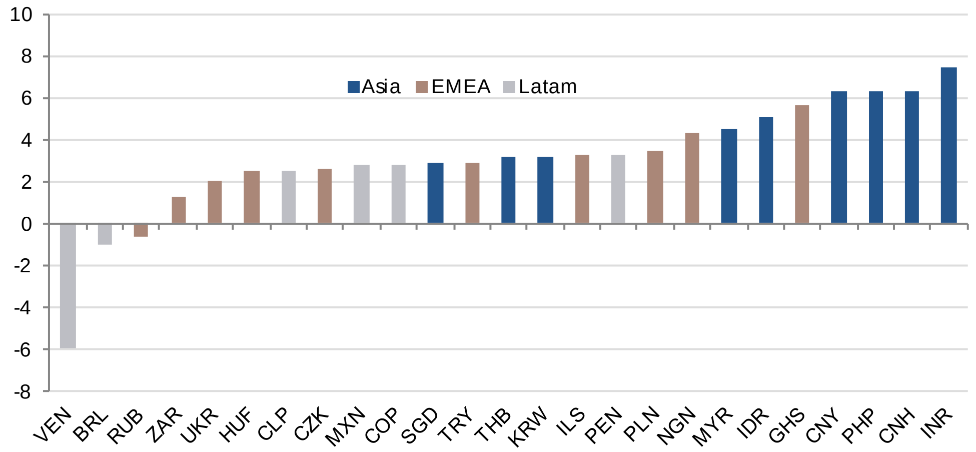
EM PMIs currently show no sign of a growth pick up



Source: SG Cross Asset Research/EM; based on GDP-weighted average

Growth rates in Eastern Europe have outperformed the rest of EMEA on a relative basis in 2015, a trend that we expect to continue in 2016 due to the positive impact of ECB easing on euro zone growth and sub-potential growth compared to previous years in other EMEA countries, namely South Africa and Turkey. Overall, developing Europe should continue to benefit from lower oil prices, domestically-generated growth and the gradual recovery in the euro zone. Asia should again outperform EMEA and Latam in terms of growth, despite a continued slowdown in China where we expect growth rates to drop to 6.0% in 2016. Overall the IMF expects growth in Asia to stabilize at around 6.4% next year. One shining light is India where growth is poised to jump back to 7.50% next year thanks to recent policy reforms, a pickup in investment and lower commodity prices. Latin America will be the weakest of all regions. Due to base effects, average growth in the region is expected to rise back to 0.8% based on current IMF projections after seeing a steep contraction of economic activity in 2015 due to the China slowdown and the drop in commodity prices. Brazil is set to experience its worst back-to-back recession since the 1930s, Peru, Colombia and Mexico are projected to post the highest growth rates in Latam of around 3.0% while Chile is on the path to post growth of 2.5% in 2016.

Expected GDP growth rates in 2016

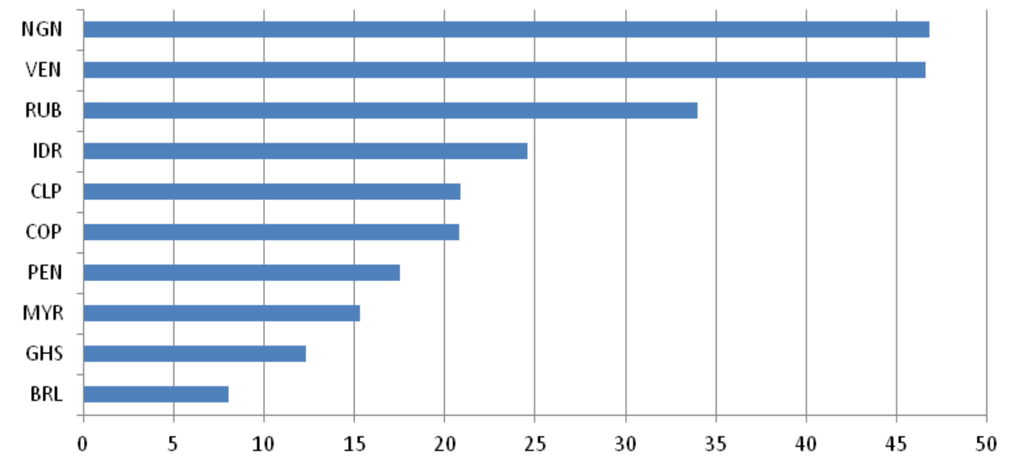


Source: SG Cross Asset Research/EM; IMF

Hard landing in China biggest risk for 2016 EM growth outlook

A hard landing in China represents the main downside risk factor for emerging market growth in 2016. A much steeper-than-expected slowdown in China would trigger another leg down in commodity prices and hit emerging market countries that rely heavily on commodity exports or have significant trade links with China particularly heavily. The Latin American region in particular would be likely to face another perfect storm in an environment of Fed tightening and a hard landing in China as most Latam countries have high trade exposure to commodities and China. In a list of countries with high net commodity exports to GDP, five Latin American countries rank among the top 10. Of these five countries, Venezuela has the highest exposure, with net commodity exports accounting for 46% of GDP which at a global level is only topped by Nigeria on 46.8%. Meanwhile Chile, with 20.9%, and Colombia, with 20.8%, also look very vulnerable on this account. Another drop in commodity prices would also be very negative for Africa, as several African countries rank among the highest by percentage of net commodity exports. After Nigeria, Ghana is heavily exposed to commodity exports. In EMEA, Russia is most vulnerable to a slowdown in commodity prices triggered by a Chinese hard landing; in Asia, Indonesia has a high share of commodity exports with 24.9%.

Net exports of commodities in percentage of GDP



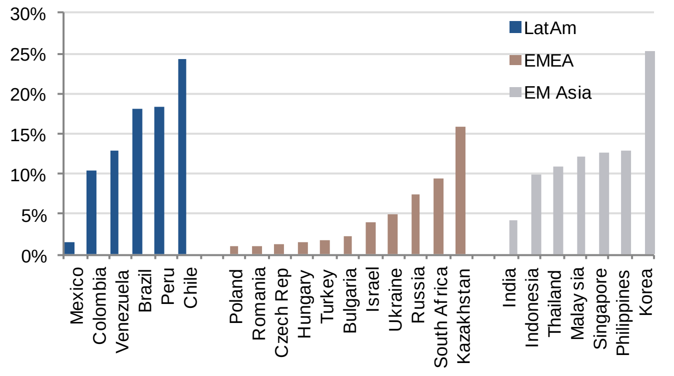
Source: SG Cross Asset Research/EM; IMF

According to our calculations a 10% fall in commodity prices would lead to a nearly 5.2% fall in Latam exports and reduce overall GDP by 0.9% in 2016, compared to current expectations. Another risk factor is the trade dependence on China as China is the single most important export destination for Latam exports. In Chile, exports to China have skyrocketed from 4% in 2000 to almost 25% in 2014; also Brazil has increased its total share of exports to China by around 15% since 2000 while Peru's share has increased by 11%. The estimated impact of a 1% drop in Chinese nominal growth on exports to China works out at -11.9% in Colombia, -4.5% in Brazil and -3.9% in Chile.

Sensitivity of emerging markets to a Chinese slowdown

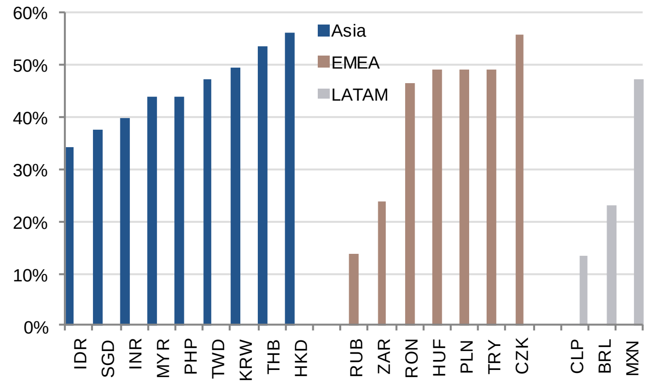
As highlighted in our publication "Cyclical growth undulations affect EM assets", changes in global growth matter significantly for the EM FX and interest rate markets. While we and the IMF expect a rebound in global and emerging market growth it is essential to measure the impact of a Chinese slowdown on world growth and EM growth. Emerging markets are exposed to global and Chinese growth through export channels and capital flows. Useful analyses in this context are the UN Similarity Index (similarity of the export structure with China) and the exposure of individual countries to China. The following charts show that of all regions, Asia and Latam would be by far the most vulnerable to a bigger-than-anticipated slowdown in China as they export a high proportion of their goods to China. By contrast, EMEA has a relatively low export exposure to China, especially the CEE3 countries, and Turkey would be least impacted by a Chinese slowdown and could even profit from falling energy prices. In Latin America it is no surprise that in 2015 the currencies of countries with the highest exposure to China have been hit hardest. This list includes Chile, Peru, Brazil and Colombia whereas Mexico exports relatively little to China. In Asia, Korea has by far the highest exposure to China and the KRW would be most sensitive to a negative surprise in China in the upcoming year.

Export exposure of individual EM countries to China



Source: SG Cross Asset Research/EM, UN

Export structure with China (UN similarity index)



Source: SG Cross Asset Research/EM, UN

Regional outlook: Brazil and Russia remain in recession

In *EMEA* Russia is expected to have passed the lowest point of its recession in 2015 as its GDP is expected to contract by "only" -0.6% next year. Overall, lower oil prices for longer and the impact of the sanctions are still weighing negatively on the economy. Eastern European economies are expected to grow strongly on the back of a gradual recovery in the eurozone and resilient domestic demand, especially Poland which we expect to show 3.5% growth in 2016. At the same time, growth in Hungary is expected slow down to 2.5% after reaching more than 3.0% in 2015. South Africa continues to disappoint and is expected to post only 1.3% in 2016 on the back of a slowdown in investment, energy problems, lower commodity prices and ongoing union protests. Turkey will be one of the beneficiaries of lower oil prices and is also profiting from stable exports into Europe. As the political risks subside, Turkey could see more foreign direct investment inflows in 2016, which could result in an upside surprise to the current growth projection of 3.0%.

In *Latin America*, Brazil is experiencing a back-to-back recession. Business and consumer confidence continue to fall and the unemployment rate is rising further towards 10%. The economy is set to remain in stagflation for a second year in a row. While inflation is currently rising towards 10%, economic growth looks set to sink to around 3.5% in 2015 and is expected to contract by another 1.00% or more next year. Structural domestic problems and a political stalemate are holding back growth. In Mexico the economy is forecast to recover from its soft patch in 2015 and grow by 2.8% in 2016 driven by relatively strong US growth rates and further implementation of the domestic structural reforms that are poised to improve longer-term growth prospects for Mexico. A downside risk remains the Fed interest rate hike as the central bank expects significant turbulence in the domestic bond markets. In Chile and Colombia growth should recover from a relatively low base in 2015 when falling oil and copper prices took a big toll on both economies. Overall Peru and Colombia continue to outperform other economies in the Latin American region.

In *Asia* we expect India to overtake China in terms of GDP growth rates. While we expect China's GDP growth rate to hit 6.0%, India is expected to grow with 7.3% next year. South Korea will post positive growth of 3.2% hence recover from the relatively low growth rates of 2.5% in 2015. Also Indonesia will post decent growth rates of 5.2% based on our current assumptions.

EM MACRO VULNERABILITIES – SLIMMER BUFFERS TO CUSHION GLOBAL HEADWINDS

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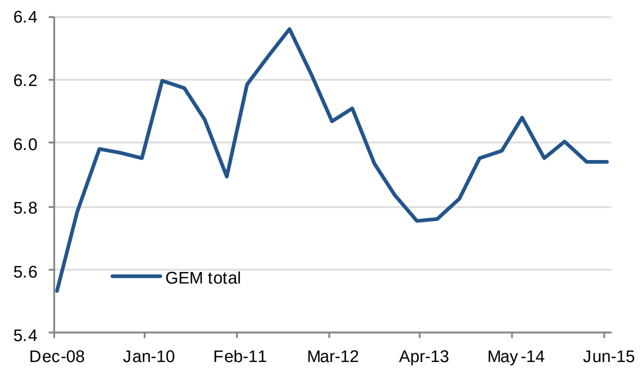
We have updated our EM macro vulnerability index and overall, we find that the fundamental picture across emerging markets has deteriorated over the past year. The weaker macro performance and worsening domestic financial stability variables have exacted a toll on the aggregate vulnerability profile of EM, outweighing a still-benign aggregate external position. LatAm countries predictably suffered the most on the back of a sharp deterioration in key domestic vulnerability variables, while EM Asia continues to tread water. At a country level, the Philippines and Thailand ranked highest in our beauty pageant. The Czech Republic stands out as best performer in EMEA, while the rest of the CEE countries have reversed some of last years' improvements. In terms of policy room (fiscal space, FX reserves, real rate compared to 5-year average), Thailand, the Philippines and Romania retain the widest room for manoeuvre. At the other end of the spectrum, Colombia and Chile are bound by limited remaining headroom.

A fresh look at the EM vulnerability profile

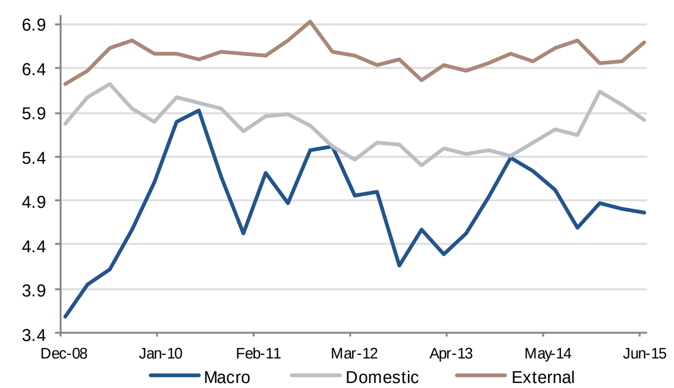
The EM complex has operated under strong pressure this past year, due to a corrosive cocktail of Fed-related uncertainties and rising concerns about the global slowdown. As markets prepare for the first step in the Federal Reserve monetary policy normalisation cycle, we take a fresh look at the recent developments of the macro landscape in order to assess the fundamental support for EM assets. For this purpose, we revisit our EM vulnerability index, aggregating data for the 24 countries in our sample.

Global EM vulnerability profile has deteriorated



Notes: The higher the score, the lower the vulnerability; The indicator is constructed using macro variables with a quarterly frequency. The choice of the timeframe (December 2008-June 2015) is dictated by the limited availability of the data across the 24 EMs and for the analysed variables.
Source: SG Cross Asset Research/EM

Weaker macro performance and worsening domestic variables have exacted a toll on the GEM vulnerability index

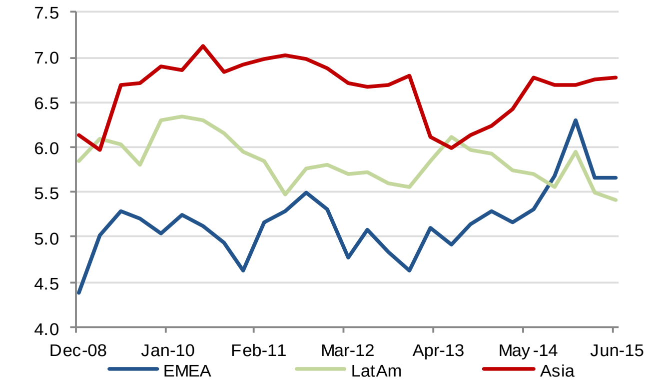


Note: The higher the score, the lower the vulnerability
Source: SG Cross Asset Research/EM;

As a reminder, our EM vulnerability indicator covers 16 equally-weighted variables grouped in three major risk components, namely macroeconomic performance, domestic financial stability and external vulnerability. For the aggregated GEM index, we have elected to weigh the individual countries according to their respective market size across three EM asset classes, using a combination of their FX market turnover (BIS), and their weight in the flagship sovereign debt (EMBI) and local debt indices. In order to produce an aggregate measure of vulnerability and observe its evolution over the past years, we define a 'normal' range for each indicator (ranging from 0 to 10). High, close to 10 values imply very strong performances.

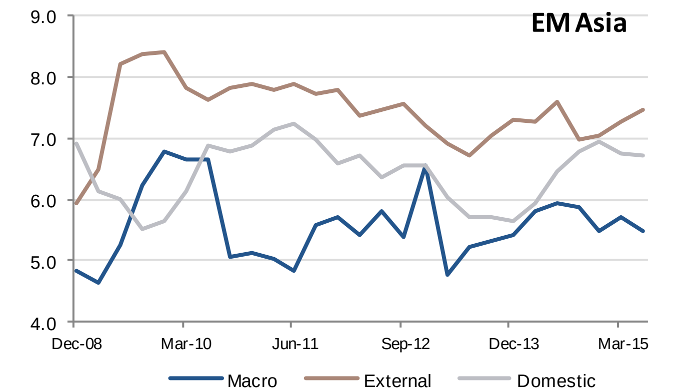
EM vulnerabilities are once again on the rise. Our assessment currently yields an aggregate score of 5.9 for GEM, reversing last years' gains and reflecting a turnaround to September 2013 levels. Indeed, the widespread deceleration in domestic activity and persistent FX weakness have supported, in aggregate, a relative resilience of external variables (6.7). In fact, zooming in on underlying indicators, the weighted average current account balance has crossed into positive territory (+0.03% vs -1% of GDP, a year ago), while weighted REER sits 10% lower compared to a 5y average. Meanwhile, the gauge for macro economic performance (4.8) has reversed course, reflecting growth slowdown (-13% yoy) and diminishing disinflationary pressures (-3.6% yoy decline in CPI indicator). The domestic financial stability profile across EM (scored 5.8) has seen very modest improvement compared to a year ago (5.7), but some of last quarter's additional gains have swiftly disappeared. The only silver lining on the domestic front is the relatively stable snapshot of non-performing loans across the board, despite widespread CHF loans issue, as well as receding real house prices. At the other end of the spectrum, commodity market woes and pro-cyclical spending have started to erode EM budget balances, with an inherent knock-on effect on public indebtedness.

The cross regional breakdown reflects an asynchronous evolution of the vulnerability profile



Note: The higher the score, the lower the vulnerability;
Source: SG Cross Asset Research/EM

Emerging signs of weakness in EM Asia dominance



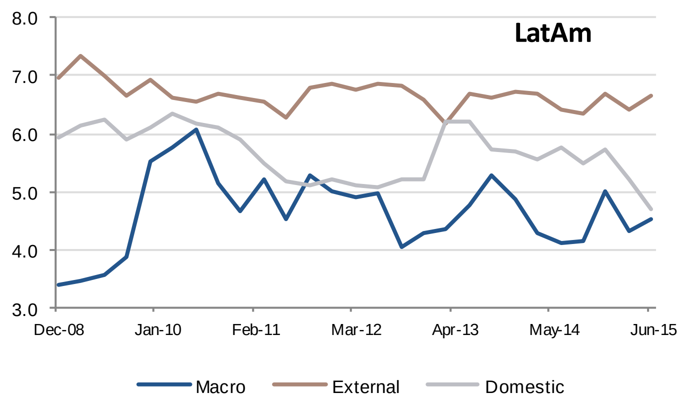
Note: The higher the score, the lower the vulnerability;
Source: SG Cross Asset Research/EM

EM Asia's still-low nominal vulnerability risk continues to trump other regions. Among our three large EM regions under consideration, Asia continues to display the lowest nominal vulnerability risk (scoring 6.7), although momentum is stalling. In essence, a strictly fundamental assessment limits the scope for relative scrutiny on EM Asia going into 2016. Asian countries still outshine LatAm and EMEA across all chapters (i.e. external, domestic and macro performance). That said, the oversized gravity effects connected to China and tail risks connected to the Chinese economy (as recently discussed by SG economists) may dent the resilience of the region's assets. Indeed, weaker CPI and growth scores have resulted in a 7.6% yoy erosion in macro performance across the Asian countries in our sample. Most sovereigns in the group fare particularly well on the topic of external vulnerability (22%

stronger than the laggard - EMEA, on aggregate), displaying a current account surplus and a modest external debt burden. The first cracks in Asia's domestic vulnerability profile were engendered by modest rises in NPL (China) and declining capital adequacy (Thailand, Philippines).

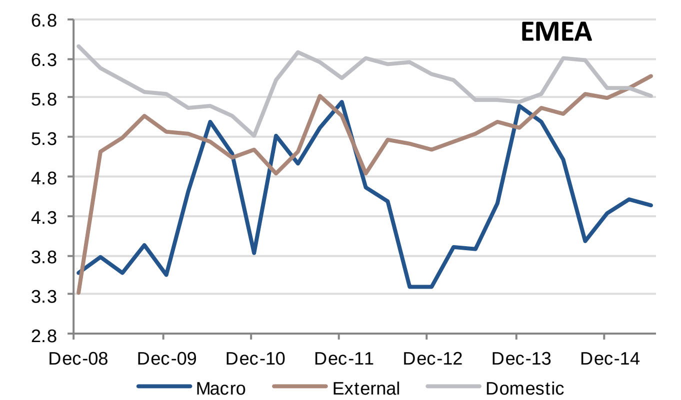
No signs of a turnaround in LatAm. In aggregate, LatAm (including Venezuela) scored worst both in absolute terms (5.4) and also relative to its year-ago snapshot (-5% yoy). The downturn in commodity prices, lower import demand from China and disruptive political woes have had a taxing effect on the region. Green shoots across external vulnerability indicators (REER, current account) were trumped by the sharply plummeting gauge for domestic vulnerability (-18% yoy). The regional heavyweights, Mexico and Brazil, have seen a widening of their fiscal balances over the past year, resulting in rising public indebtedness. The aggregate macro performance reflects a mixed picture. Flagging growth momentum (Chile) or outright contraction (Brazil) overshadows a broad-based improvement in labour market competitiveness. In addition, the sharp FX sell-off has produced nascent signs of increasing pass-though effects onto headline inflation (Chile, Colombia).

LatAm suffered on the back of a sharp deterioration in its aggregate domestic vulnerability profile



Note: The higher the score, the lower the vulnerability;
Source: SG Cross Asset Research/EM;

EMEA's vulnerability profile is once again at risk



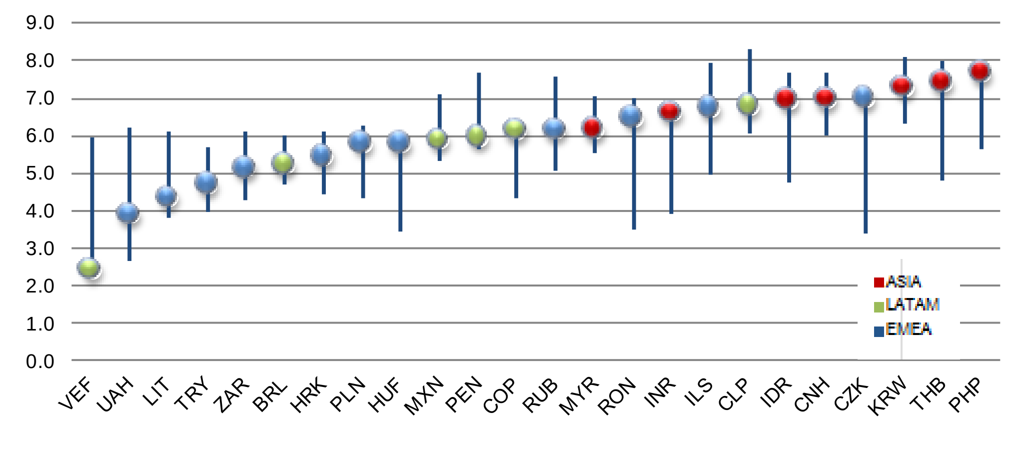
Note: The higher the score, the lower the vulnerability;
Source: SG Cross Asset Research/EM

EMEA's vulnerability profile was hindered by uninspiring macro performance. Collectively, EMEA remains the most dynamic region, as reflected by a 7% yoy improvement in its vulnerability gauge compared to last year (currently, 5.7). However, the underlying picture is quite mixed. Macro performance has suffered a 12% hit on the back of a widespread growth slowdown (Hungary, Turkey, Israel, Russia) and rising real unit labour costs (CEE4). The aggregate domestic vulnerability profile (5.8, -8% yoy lower) captures, to some extent, the rising tide of budget balance deterioration (Russia, South Africa) and climbing public indebtedness, but has yet to reflect ongoing pro-cyclical fiscal easing initiatives (Poland, Romania). The region continues to show good momentum on the external vulnerability chapter (+8% yoy), not least due to a stellar improvement in REER valuations and improving basic balance (defined as CAD+FDI) in key countries such as Turkey and Russia. Even so, EMEA remains a laggard in this department, as a testimony of a lower and declining reserve war chest (though supplemented by IMF financing lines) and higher average external indebtedness.

War-torn Ukraine, India and the Czech Republic saw the biggest leaps in score compared to a year ago. Once again, three Asian countries (the Philippines, Thailand and Korea) dominate our EM vulnerability ranking. The strong stride in their respective vulnerability profiles are a testament of recent improvements in external variables, i.e. better REER valuation on the heels of the PBoC's moves, increasing current account balances, as well as strong fiscal performances. Over the past year, all these developments have successfully offset the weaker growth dynamic (particularly in Thailand), strong credit growth and real advances in residential prices. China moves left by two spots compared to last year, undermined by the deterioration in (headline and primary) balance, the slight increase in non-performing loans and rising public indebtedness.

Cross-country comparison – EMEA countries dominate the bottom ranks

(current score vs 6y minimum-maximum score range value)



Notes: The bar indicates the maximum and minimum score recorded for each country since Dec-2008. The higher the score, the lower the vulnerability.

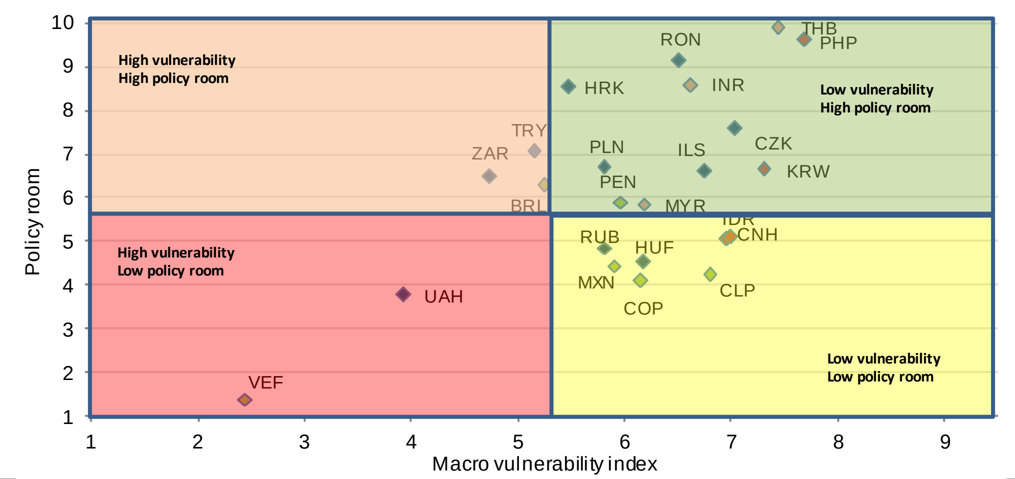
Source: SG Cross Asset Research/EM

At the other end of our scoring spectrum, Venezuela and Ukraine are once again at the lowest spots. Venezuela's frugal disclosure of real economic indicators remains a significant obstacle to assessing the true deterioration of its vulnerability profile, but, even so, the country maintains the worst score in our sample. In contrast, the predictable second-worst candidate, Ukraine, saw a commendable 25% yoy jump in its score, as a reflection of IMF-orchestrated adjustment fiscal efforts, sharp improvements in competitiveness (ULC and REER) and the resulting current account rebalancing. While they have yet to reach the highest ranking, the vulnerability profiles of both India and the Czech Republic show similar improvements in their scores. The Czech Republic stands out as the highest ranking EMEA in our latest vulnerability snapshot, largely drawing on stellar growth dynamics, a growing positive current account balance and improving CZK valuations. Although we foresee some deterioration in macro performance, as a consequence of the declining contribution of EU funds in 2016, rising political noise in the region leave it well positioned to withstand potential headwinds from EM. Excluding qualitative nuances that might deflect some of the optimism surrounding India (as detailed here), the undeniable net improvement in the vulnerability profile (25% yoy) draws on a steady advance in fiscal balance, declining public debt and narrowing current account balance (drawing on soft commodity prices).

Dissecting strategy implications of the current vulnerability snapshot

Our gauge for policy room for manoeuvre assesses Thailand, Romania and India at the top of the ranking. These countries benefit from a combination of still-strong primary balances, relatively low public debt and, in the case of Romania and India, high positive real interest rates (compared to a 5-year historic). Persistent headwinds across commodity markets have dented LatAm countries' room for manoeuvre, with most sovereigns in the region marching south in our current snapshot. Even excluding the clear underperformer (Venezuela), LatAm fared the worst according our assessment (4.4 vs 5.6 last year), as a result of deteriorating primary balances, squeezed real interest rates and climbing public debt. Unsurprisingly, EM Asia outclasses the other regions (6.7 vs 6.2 last year), bolstered by abundant FX coffers (China, Thailand), coupled with strong fiscal accounts. Nominal improvements in Ukraine's metrics and still-high disinflationary pressures across CEE successfully reflect a sharp rise in the aggregate score for EMEA (6.2 vs 5.4 last year). Both Turkey and South Africa remain in the high vulnerability-high policy room quadrant, as a result of resilient fiscal positions and higher real interest rate when compared to a 5-year average historic outcome.

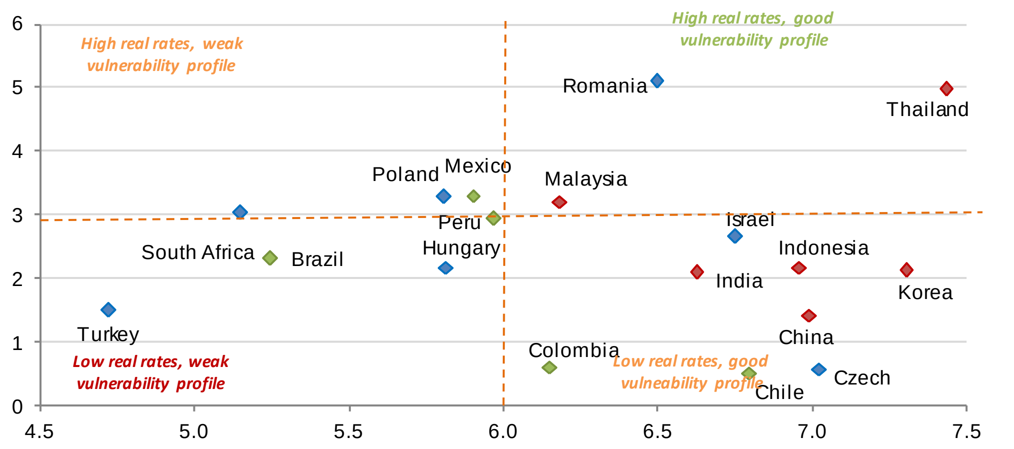
LatAm countries constrained by limited remaining policy room for manoeuvre



Source: SG Cross Asset Research

Asia less dominant in local rate valuations. As an additional nuance to our vulnerability assessment, we cross check individual scores with current valuations of local rates to determine relative value across the EM space. Our comparative analysis sets the raw output from our vulnerability indicator against volatility-adjusted real 5-year rates (discounted by realised CPI) using the standard deviation of 1-week changes. We conclude that the 'optimal' fundamental features – high vulnerability, high volatility-adjusted value - are displayed by a handful of countries, i.e. Thailand, Romania and Malaysia. Israel sits nearly on the border, and, despite still negative inflation, the prolonged regime of monetary policy accommodation has gone a long way in compressing real yields. Romania stands out as EMEA's best-placed candidate, although admittedly helped by the hefty amount of suppressed inflation pressure following an impactful two-staged VAT cut. Among the traditional high yielders, the attractiveness of pre-DI rates in Brazil fades when adjusting for their unmatched volatility. The picture in Mexico is clearly more benign, advocating for tactical opportunities over the coming year. Turkey fares considerably worse than South Africa in this assessment, as elevated volatility and high inflation pressures trump the attractiveness of nominal returns. In line with our portfolio positioning, Poland remains a good contender for receiving rates. Indeed, disregarding qualitative factors (political noise in Poland, discount IRS facilities in Hungary) which tilt the balance sideways, Poland appears better positioned in this simplified analysis.

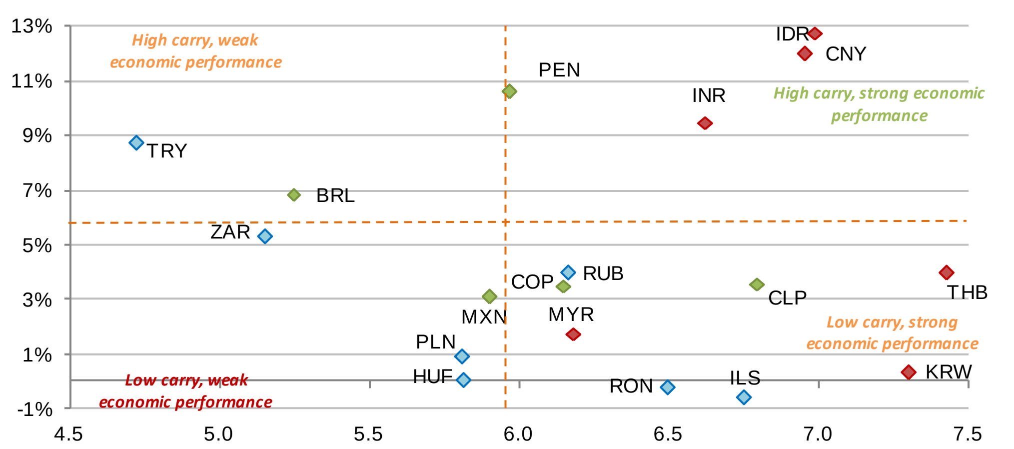
EM vulnerability indicator vs vol-adjusted real interest rates



Source: SG Cross Asset Research; Note The chart purposefully excludes Russia (as the clear outlier in terms of real vol-adjusted 5y rates) for the sake of a more balanced graphical representation; Figures used swap rates, adjusted for headline inflation and standard deviation of 1-week changes in nominal 5-year rates.

Fundamentals make a dent in the carry trade glow. As an extension of our analysis on carry trades, we set the results of the vulnerability assessment against the current snapshot in FX carry (volatility-adjusted). The combination of high return and still low-volatility, compounded by sound vulnerability metrics, preserves the attractiveness of CNY, IDR and INR. PEN also yields a good result based on simple metrics, although the relative size of the market curtails the investment attractiveness. The BRL fares well as a tactical opportunity in LatAm, although qualitative considerations (related to political uncertainties) certainly complicate the assessment. The ZAR, and even more so, the TRY stand as the traditional 'best' options for carry trades in EMEA, while the RUB is a casualty of this past year's spike in volatility. At the bottom of the spectrum, the RON and HUF see the least compelling valuations in terms of carry.

Fundamentals dent into the carry trade glow



Source: SG Cross Asset Research; FX carry is calculated against USD. Figures are adjusted by average 3-month implied volatility.

EM VULNERABILITY INDEX: METHODOLOGY

We compute the Vulnerability Index using 16 macroeconomic criteria, clustered under three categories:

* *Macroeconomic performance*: We assess current yoy dynamics and changes in GDP, gauge inflation pressures as well as the change in CPI dynamics and the evolution of unit labour costs.

* *External vulnerability*: Valuation of real effective exchange rate, current account balance, foreign direct investment, gross international reserves (relative to G&S imports and relative to short-term external liabilities) and level of external debt.

* *Domestic financial stability*: Net lending/borrowing, the primary balance and the level of public debt relative to GDP, financial stability indicators (credit growth, NPL, capital adequacy ratio)

The index is based on quarterly data with a start date of December 2008.

ASSESSING CAPITAL OUTFLOW RISKS

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The performance of EM currencies is inextricably linked to capital flows. The persistent deterioration in net capital flowing into Emerging Markets could extend further into 2016 unless macro conditions improve, uncertainty around Fed policy, Chinese growth, and RMB depreciation is eliminated, or central banks are able to revive economic growth.

A further worsening in global EM capital flows will disproportionately hurt those currencies that are still experiencing robust inflows, have attracted risky inflows in the past, have low FX market liquidity compared to previous inflows, and whose buffers through basic balances and reserve adequacy are inferior relative to other countries.

The capital outflows experienced in Q3 could be just a trial run for a more pernicious period ahead, and underscores the asymmetric tail risks facing EM currencies. Deterioration in reserve adequacy might point toward central banks permitting more FX depreciation than otherwise.

Based on our assessment of capital outflow risks and offsetting buffers, the IDR, TRY, and MXN are particularly susceptible to further deterioration in the capital inflow cycle.

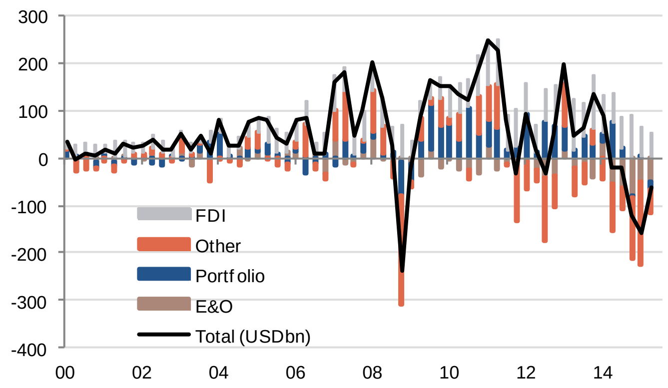
Capital has stopped flowing into EM

Net capital inflows to emerging markets experienced two cycles over the past 15 years.

- The first cycle was a gradual acceleration from 2002-2006 culminating in a boom in 2007 followed by a bust in 2008-09.
- The second cycle was a boom in 2010-2011 followed by a gradual but persistent deterioration that is still ongoing.

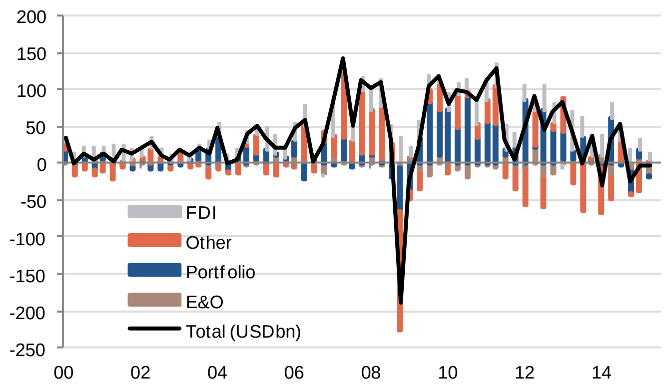
Despite the slowdown since 2011, the amount of capital that flowed into EM over the past five years is substantial. Whether investor appetite stagnates, improves, or in the worst-case scenario a large exodus occurs, is critical in assessing the evolution of currency markets.

Net capital flows into EM



Source: SG Cross Asset Research/EM. Countries included (CNY, KRW, MYR, INR, IDR, TWD, THB, BRL, CLP, MXN, TRY, ZAR, RUB, PLN, CZK, HUF). Data up to Q2 2015

Net capital flows into EM (ex-China)



Source: SG Cross Asset Research/EM. Countries included (KRW, MYR, INR, IDR, TWD, THB, BRL, CLP, MXN, TRY, ZAR, RUB, PLN, CZK, HUF). Data up to Q2 2015

Across major EM countries[1], net capital inflows (and E&O) have turned sharply negative. Portfolio flows have slowed, banking flows are sharply negative, E&O is in deep outflow territory and FDI has moderated. However, a large portion of the deterioration is related to China. In the past five quarters, China's capital flow picture has deteriorated sharply, led by a surge in outflows from local residents. Excluding China from the EM aggregate measure shows a less alarming, but a hardly encouraging picture.

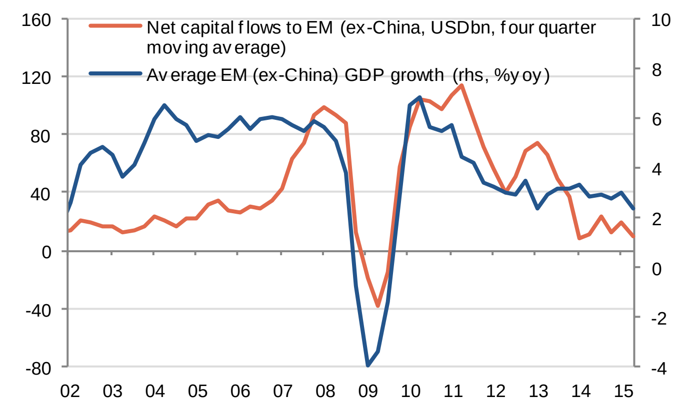
The FX, capital flow, and growth triangle

The importance of EM growth to capital flows, and capital flows to EM FX cannot be understated. Over the past 15 years the general undulations in EM growth have corresponded to the capital flow cycle. And the capital flow cycle is highly correlated to the movements in EM currencies. Unless the gradual growth slowdown in EM countries can be reversed, the stagnation of growth does not bode well for the capital flow outlook. If capital flows cannot recover, EM currencies should remain susceptible to depreciation pressures.

Over the past 15 years, the only period when EM currencies were able to stage a sustained appreciation phase was in 2003-07 and 2010-11. The former period was characterised by a weak dollar environment, a positive narrative around the long-term growth prospects of EM, and a commodity price boom. The rally in 2010-11 was a temporary recovery as capital flowed into EM en masse as the Fed embarked on aggressive quantitative easing.

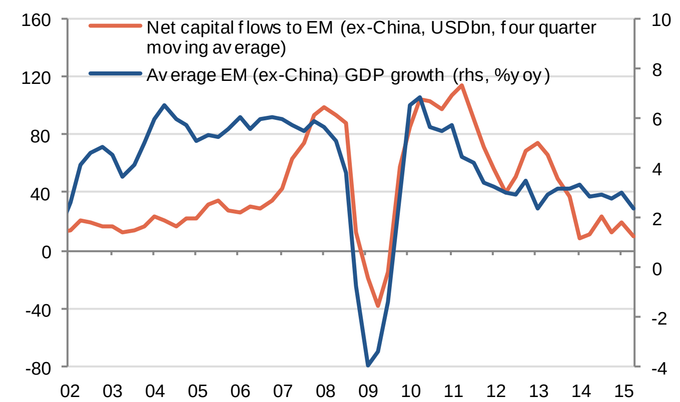
The prevailing backdrop for EM is a lot less friendly. Heading into 2016, the debate on the speed and magnitude of Fed tightening, the magnitude of the Chinese growth slowdown, and RMB depreciation fears, is unlikely to promote a positive risk backdrop that is conducive for EM capital flows to accelerate.

EM growth vs capital flows



Source: SG Cross Asset Research/EM. EM growth and capital flows include (KRW, MYR, INR, IDR, TWD, THB, BRL, CLP, MXN, TRY, ZAR, RUB, PLN, CZK, HUF)

EM FX vs capital flows



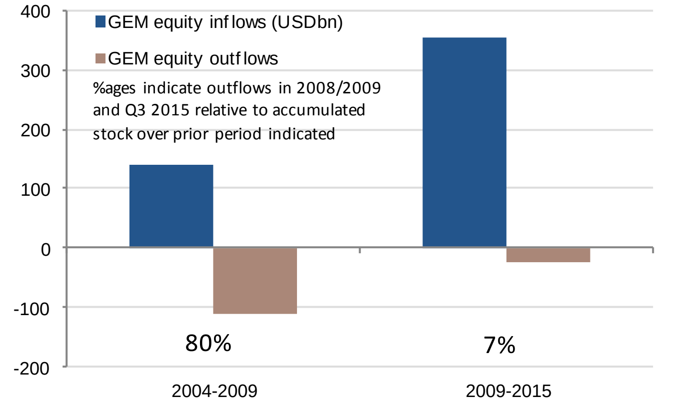
Source: SG Cross Asset Research/EM. Countries included (KRW, MYR, INR, IDR, TWD, THB, BRL, CLP, MXN, TRY, ZAR, RUB, PLN, CZK, HUF). Data up to Q2 2015

[1] For the purpose of analysing capital flows we define the EM universe as China, India, Indonesia, Thailand, Singapore, Malaysia, Taiwan, , Korea, Brazil, Chile, Mexico, Turkey, South Africa, Russia, Poland, Czech Republic, Hungary, and Romania. Data is up to Q2 2015.

Assessing susceptibility to capital flow reversals

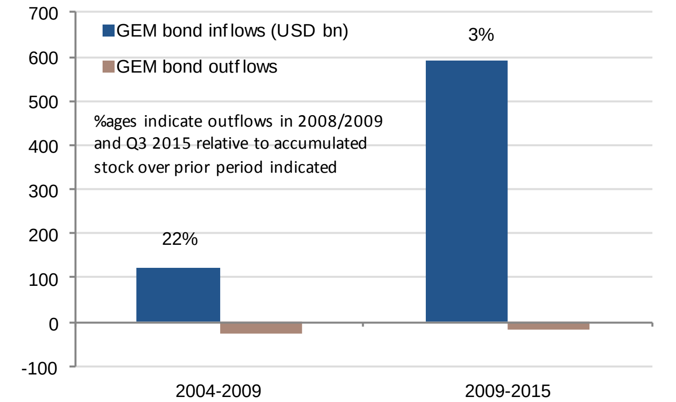
The disruptive outflows witnessed in Q3 this year could serve as a useful trial run for a more acute period of stress in the future. Foreign selling of local assets in Q3 was substantial in absolute terms but small compared to the accumulated stock of foreign purchases since 2009.

Foreign equity selling in Q3 small vs accumulated stock



Source: SG Cross Asset Research. Foreign purchases of EM equity (INR, IDR, KRW, TWD, THB, PHP, BRL, CZK, PLN, ZAR, TRY)

Foreign bond selling in Q3 small vs accumulated stock

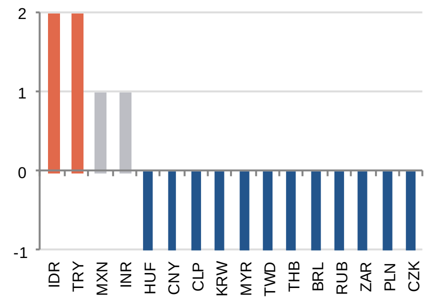


Source: SG Cross Asset Research. Foreign purchases of EM bonds (INR, IDR, KRW, THB, PHP,MYR, MXN, CZK, PLN, ZAR, TRY)

In Beware of surges & reversals in GEM capital flows we devised three scorecards to assess the vulnerability of countries to capital flow reversals.

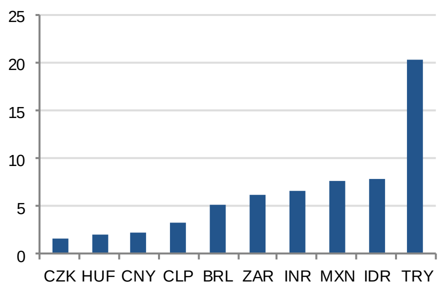
- **Capital Flow Surge Scorecard**: Countries experiencing rapid inflows relative to their historical average are more prone to a reversal of outflows. Indonesia and Turkey continue to be in the surge category, while Mexico has dropped out of the list.
- **Capital Flow Riskiness Scorecard**: Countries that have experienced cumulative net capital inflows over the past two years from more risky sources are more susceptible to underperformance. The top five currencies at risk due to dependence on more volatile capital inflows remain unchanged from last year (TRY, MXN, ZAR, INR, and IDR).
- **Capital Flow Liquidity Scorecard**: Countries that have experienced cumulative net capital inflows over the past two years that are large relative to respective FX market liquidity are at risk. The BRL, INR and especially the IDR are the most at risk.

Capital flow surge scorecard



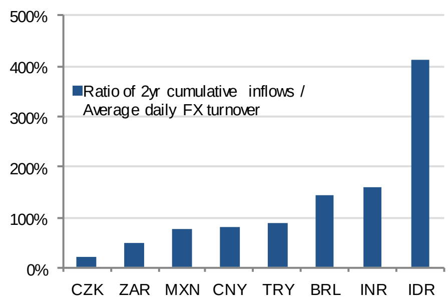
Source: SG Cross Asset Research/EM. Countries currently in a surge receive a value of '2', those that were in a surge over the past year receive a value '1", and the remainder receive a value of "-1"

Riskiness of flows scorecard



Source: SG Cross Asset Research/EM. Shows countries that have experienced net inflows into portfolio or other investment in the past two years and weights by volatility. Higher number = more at risk of capital outflows

Capital flow liquidity scorecard



Source: SG Cross Asset Research/EM. Higher figure means a currency is more susceptible to outflows

Currencies most at risk –summary of GEM capital flow scorecards

Surge Scorecard	Riskiness Scorecard	Liquidity Scorecard
IDR	ZAR	IDR
TRY	TRY	INR
	MXN	TRY
	CLP	RUB
	IDR	CNY

Source: SG Cross Asset Research/EM

Usefulness of the scorecards

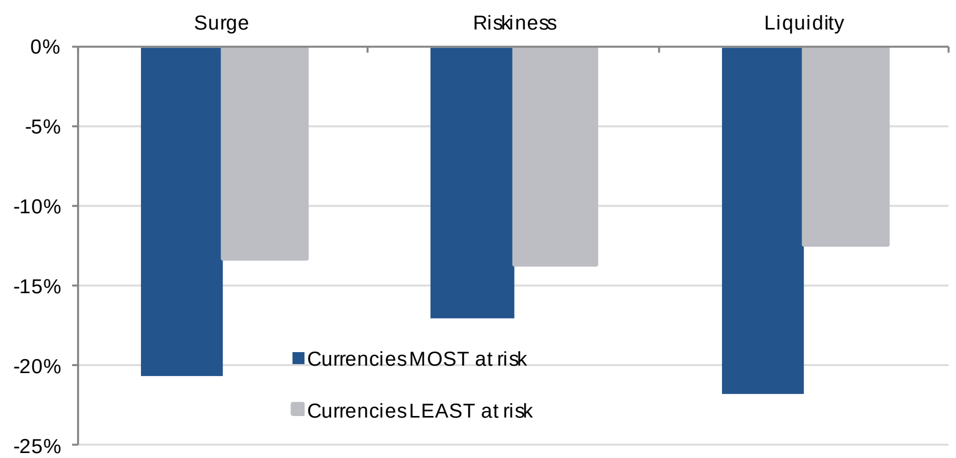
Last year we presented analysis that showed that currencies in a capital inflow surge underperformed those that were not in a surge when disturbances in global financial markets occurred (2008 crisis, 2013 taper tantrum). We update the analysis to include the current period of EM FX depreciation and also provide information on the performance of the riskiness of flows and FX market liquidity scorecards.

From 1 January 2015 to the peak in USD-EM (29 September 2015), the currencies that were classified as most susceptible to underperforming because they were experiencing a surge in inflows (IDR, TRY, MXN) underperformed those currencies that were not in a surge by a fairly wide margin (8%).

Currencies identified as susceptible to deterioration in EM sentiment based on the riskiness of inflows underperformed the less risky currencies, but only by a small degree (3%). The liquidity scorecard was the best performing metric, showing that countries with large inflows relative to FX market liquidity (-22% depreciation) significantly underperformed those with a less alarming ratio, or those that experienced net outflows over the past two years (-12%).

One limitation of our framework is that it will not capture every worst performing currency at each point in time, as country-specific factors (policy credibility, exposure to commodity prices, sensitivity to China, or political uncertainty etc) can have overriding influences.

Capital flow scorecards to identify FX underperformance



Source: SG Cross Asset Research/EM. january 1 2015 to the peak in USD-EM (September 29 2015)

Assessing buffers to capital outflow risks

To gauge vulnerability to capital outflows it is important to asses mitigating factors, such as basic balance of payment (current account surplus plus FDI) positions and reserve adequacy.

Basic balances

A basic balance of payments surplus is widely regarded as a fundamental factor that should reduce a currency's susceptibility to depreciation. Dividing the sample of EM countries into those that registered a basic balance surplus and those with a deficit leading up to the end of last year shows that those with a favourable buffer (i.e. surplus) significantly outperformed the deficit currencies. There are currently only five countries in EM with a basic balance deficit (ZAR, TRY, BRL, MXN, and IDR) and each of these scores highly as currencies susceptible to capital flight on at least one of our scorecards.

Reserve adequacy

As part of the IMF's external balance assessment, a broad range of indicators are used to assess a country's ability to withstand balance of payment shocks. In ARA (2014), the IMF notes that a composite metric outperformed traditional metrics at predicting market pressure events – as well as at explaining consumption-smoothing behaviour during stress events.

The IMF's extensive work on reserve adequacy[2] contains four specific elements reflecting potential drains on the balance of payments:

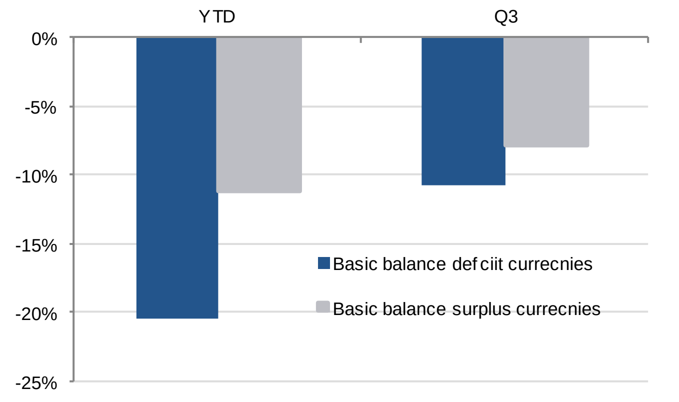
(i) export income to reflect the potential loss from a drop in external demand or a terms of trade shock;

(ii) broad money to capture potential residents' capital flight through the liquidation of their highly liquid domestic assets;

(iii) short-term debt to reflect debt rollover risks; and,

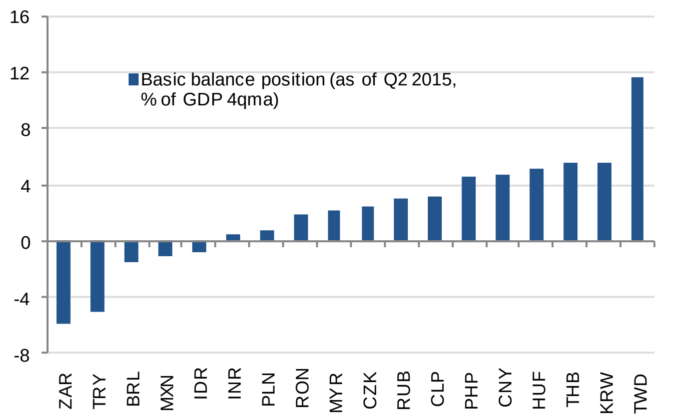
(iv) other liabilities to reflect other portfolio outflows.

Basic balance surplus/deficit and FX performance



Source: SG Cross Asset Research/EM. Haver. As of end-2014 surplus currencies (MYR, CZK, RUB, CLP, HUF, THB, KRW, and TWD) and deficit currencies (ZAR, TRY, BRL, MXN, IDR, INR, PLN)

Basic balance of payments positions



Source: SG Cross Asset Research/EM. Haver

[2] "Assessing Reserve Adequacy", IMF February 14 2011, "Assessing Reserve Adequacy, further considerations", IMF Policy Paper, November 2013, and "Assessing Reserve Adequacy – specific proposals", April 2015

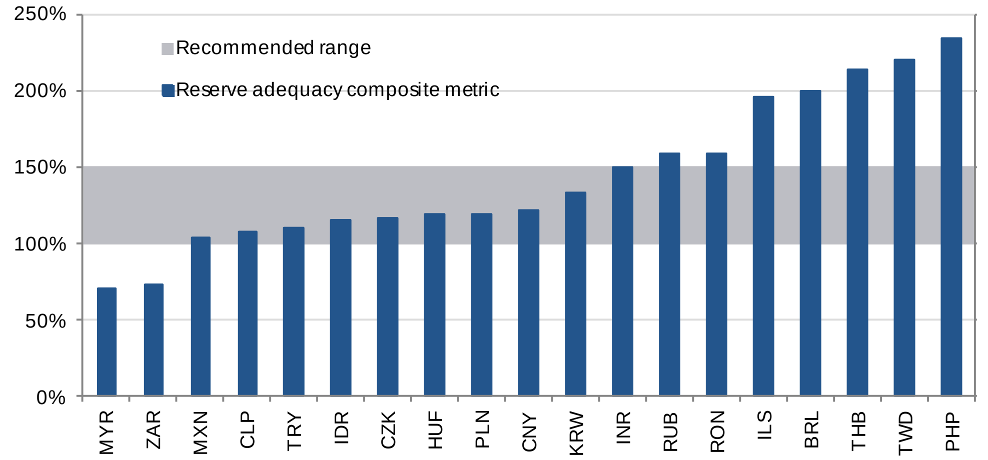
Weights vary depending on the classification of fixed versus floating exchange rates and the degree of capital account openness. Flexible exchange rates are those defined as being freely floating or floating as defined in the IMF's Annual Report on Exchange Rate Arrangements and Exchange Restrictions (2014). For capital account openness, we use the median of the Chinn-Ito[3] index to separate countries into ones with open and closed capital accounts.

The IMF recommends reserves to be 100-150% of the weighted average of the metrics mentioned above. However, the IMF notes that country-specific considerations can be important and the threshold levels are meant only as a guide. For example, an assessment of net drains on reserves from swap/forward books and availability of contingent financing lines and borrowing facilities might be necessary for some countries. Additionally, the IMF cites countries with high commodity export exposure as possibly requiring a higher level of precautionary reserves. Turkey stands out as a special case; around two-thirds of gross reserves are represented by minimum reserve requirements from domestic banks under the reserve option mechanism (ROM), and banks could, in a tail scenario, withdraw this FX liquidity from CBRT to repay their own FX debt.

Assuming the level of short-term external debt at remaining maturity was unchanged compared to end-2014, and updating the other relevant data up to current values, our calculations indicate that every EM country in our sample, with the exception of South Africa and Malaysia, has an adequate level of reserves.

However, reserve adequacy has deteriorated in most countries since end-2013. China has experienced the largest and most consistent deterioration over the past two years. Malaysia's reserve adequacy has fallen to 71% from 100% due in large part to the $36bn decline in reserves over that period. Other notable declines have been evident in Romania (due to FX reserves falling) and Philippines, but in both cases the level of reserves is above the upper end of the recommended threshold.

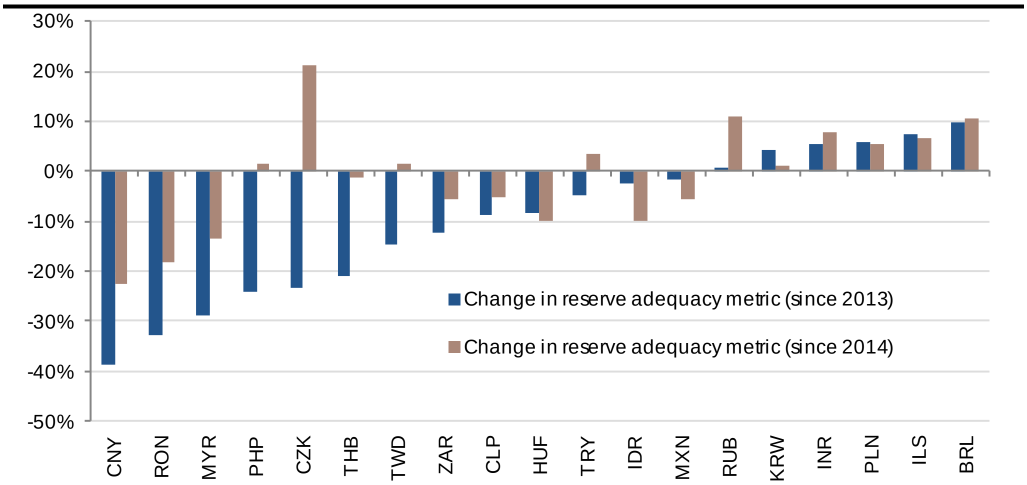
Reserve adequacy



Source: SG Cross Asset Research/EM. The IMF recommends reserves to be 100-150% of the weighted average of various metrics (exports, M2, short term debt at residual maturity, other liabilities). SG estimates differ slightly from IMF calculations

[3] Chinn, Menzie D. and Hiro Ito (2006). "What Matters for Financial Development? Capital Controls, Institutions, and Interactions," Journal of Development Economics, Volume 81, Issue 1, Pages 163-192 (October)

Change in reserve adequacy (end-2013 to Q2 2014)



Source: SG Cross Asset Research/EM

Asymmetric capital flow risks

Even though a cumulative $525bn of net capital has flowed into EM (ex-China) since Q1 2012, emerging market currencies have sharply depreciated (30% on average). What has been critical over this period is the trend – as less and less capital has flowed into EM each quarter, pressure on currencies has intensified. In the past four quarters (up to Q2 2015), emerging markets attracted a paltry $63bn of inflows and a meagre $83bn since Q1 2014.

A pick up in capital inflows to $200-300bn over the next year could prove to be a bullish scenario for EM currencies, especially on a carry-adjusted basis, if history is any guide. However, it might be a tall order for favourable conditions to be in place for investors to actively deploy capital into emerging markets. Recall that the previous capital inflow booms were associated with rising commodity prices, an ultra bullish outlook on EM growth, or in response to ample liquidity post Federal Reserve quantitative easing that spurred a global hunt for yield.

Based on recent experience, capital inflows in the range of $50-100bn is unlikely to alleviate the underlying depreciation pressure on EM currencies. Meanwhile, a repeat of the outflows in Q3, or a more sustained or gradual exodus of capital, presents significant tail risks for EM FX. Overall, the risks to EM FX appear asymmetric from the capital flow channel and more heavily skewed to weaker rather than stronger currencies over the next year.

WILL THE CARRY TRADE EVER COME BACK IN VOGUE?

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The heyday of the EM FX carry trade peaked in 2007 and since then it has generally been a painful strategy for buy-and-hold investors – and an unrewarding one since 2010 even for dynamic quantitative strategies. But the sharp depreciation in EM currencies coupled with some pockets of undervaluation and the ongoing global low yield environment, is starting to stoke some renewed interest in carry. While there might be some selective carry opportunities in 2016, especially if the interest rate channel gains more prominence due to some EM central banks raising interest rates, tail risks are still significant and the macroeconomic and financial markets conditions may not be favourable for a full revival of the carry trade.

Capturing risk premium

The forward rate bias is a well documented anomaly in currency markets, whereby there is a general propensity for currencies to depreciate by less than what interest rate differentials suggest over long time horizons. The strategy of buying high yielders and selling low yielders gained significant prominence in the early and mid-2000s as it produced spectacular returns. And even though the performance of the past five years has been less than impressive, carry considerations remain an integral part of investment decisions and trading strategies. At a psychological level, negative carry is difficult for investors to stomach so there is generally an inherent bias toward seeking positive carry strategies.

Long-term investors can attempt to capture the embedded risk premium by always being long high yielders and short low yielders. Shorter-term investors can capture carry in the same way, but usually applying a quantitative or qualitative filter in an attempt to minimise draw downs and enhance the return profile over time. Indeed, the SG EM quantitative carry strategy is such a strategy that applies quantitative rules to improve the risk-return characteristics of yield-based strategies.

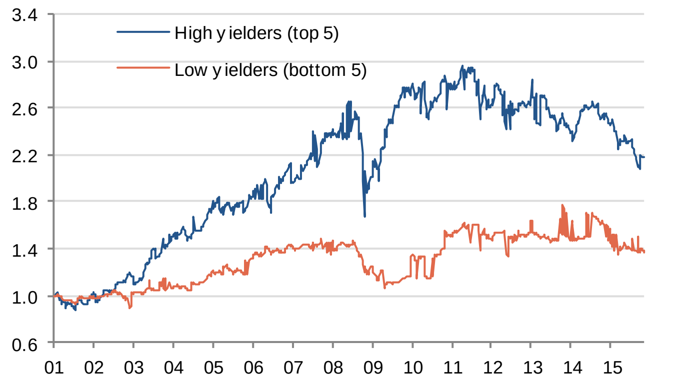
Recap of the past 15 years – passive strategies

Between 2001 and 2007 the carry trade produced massive returns. For example, being short USD against the top five highest yielders in EM (dynamically rebalanced each week based on yields) turned $100 into $260 in just six years, impressive returns for any asset class but especially foreign exchange. Back in the early 2000s, the high yielding currencies entailed the likes of PHP, IDR, PLN, TRY, BRL, ZAR and MXN with yields in the 10-25% area, and in the case of TRY, around 50-60% in 2001-2002.

Over this six-year period, the currencies in the high yielder basket were broadly stable (weakness in 2001-2002 followed by a shallow recovery, so the bulk of total returns came from the interest rate channel, not spot appreciation). After some ups and downs between 2008 and 2010, **a passive carry trade strategy of long the highest five yielders against the USD has consistently lost money since 2011**. Emerging market yields have compressed over time, but have still have averaged 5-10% since 2011, which is pretty decent in a world of zero yields in G3. However, the carry has been insufficient to compensate for spot FX depreciation.

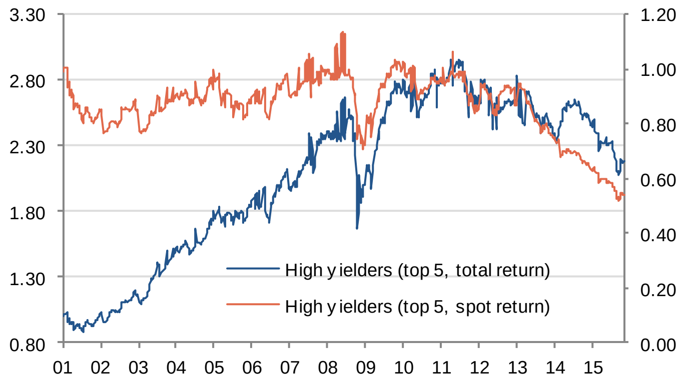
A passive inter-EM strategy of long the top seven highest yielders and short the seven lowest yielders has not fared much better than a dollar-funded strategy. An inter-EM pair strategy produced fairly consistent returns from 2001-11, but the underperformance of EM high yielders has caused a steady deterioration in performance since 2001 (-23% from the peak).

EM carry performance vs USD



Source: SG Cross Asset Research/EM. Basket is dynamically rebalanced based on interest rates. Currencies selected from the universe of SGD, PHP, TWD, INR, THB, IDR, KRW, CZK, HUF, PLN, TRY, ZAR, BRL, MXN, CLP

Rates vs spot: decomposition of carry returns

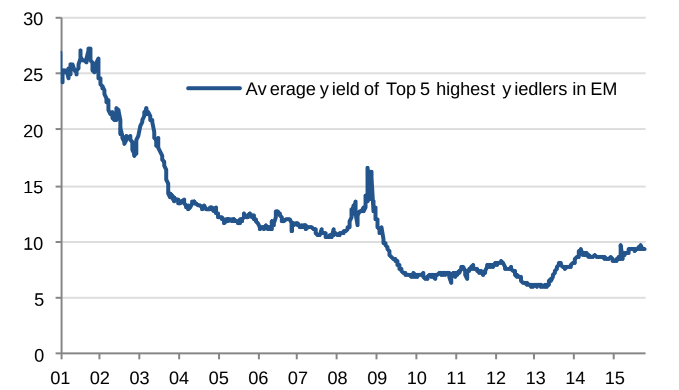


Source: SG Cross Asset Research/EM. Basket is dynamically rebalanced based on interest rates. Currencies selected from the universe of SGD, PHP, TWD, INR, THB, IDR, KRW, CZK, HUF, PLN, TRY, ZAR, BRL, MXN, CLP

SG quantitative carry strategy – significant improvement over a passive strategy

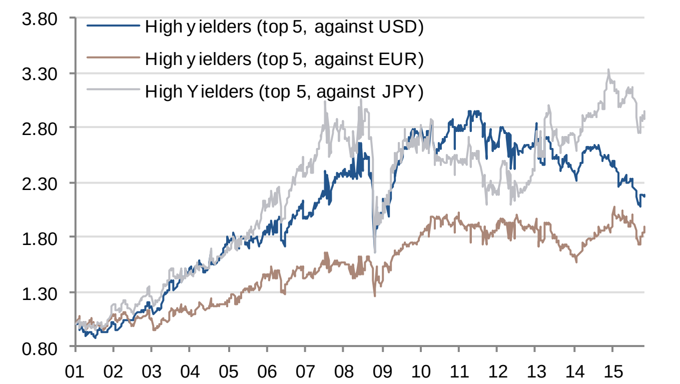
Given the inherent drawbacks of passive buy-and-hold carry strategies, the SG quantitative carry strategies (EM ex-Asia and Asia) was designed to minimise draw downs and improve risk-adjusted returns (link). The composition of the carry basket is optimised by explicitly taking into account the correlations and the volatilities between their constituents in addition to carry component. Also, carry income from the basket is maximised by limiting the yearly volatility of the basket to 10%. In addition, exposure to every individual currency is capped and the net beta exposure to the moves in the DXY index and total net USD exposure are constrained as well.

Average yield of top five highest yielding EM currencies



Source: SG Cross Asset Research/EM. Top 5 basket is dynamically adjusted each week based on relative yields

Choice of funding leg

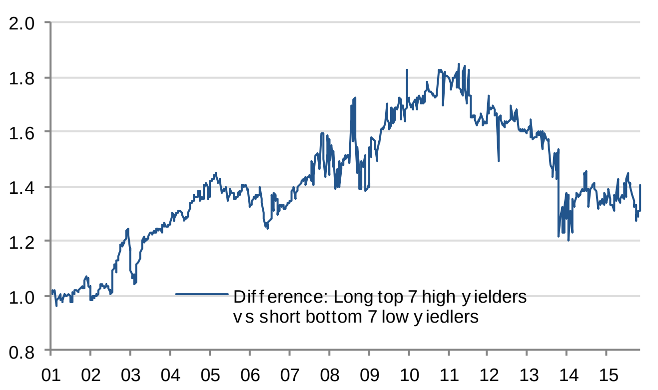


Source: SG Cross Asset Research/EM. Bloomberg

The adaptive version of our in-house SG risk sentiment indicator is used as a tool to manage the entry and the exit in the carry strategy (i.e. positive risk sentiment environment means higher exposure to the carry basket, while a risk-averse signal means exiting the carry strategy and marginally short the carry basket). A momentum signal is derived by considering the price dynamics of the carry basket and used as an additional overlay.

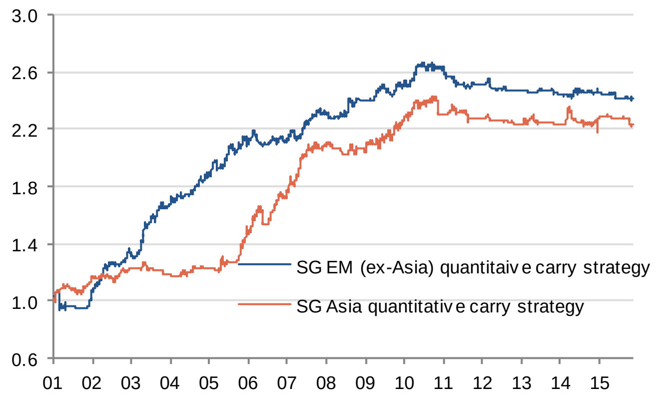
While the SG EM quantitative carry strategy has significantly outperformed a passive buy-and-hold strategy, its performance has also suffered since 2011 relative to the previous ten years. Aside from the general performance of the funding currencies, carry trades have typically done well when EM rates were high, the USD was generally on weakening path, and macroeconomic conditions were supportive.

Inter-EM carry trade basket – passive



Source: SG Cross Asset Research/EM. Basket is dynamically rebalanced based on interest rates. Currencies selected from the universe of SGD, PHP, TWD, INR, THB, IDR, KRW, CZK, HUF, PLN, TRY, ZAR, BRL, MXN, CLP

SG carry trade strategies



Source: SG Cross Asset Research/EM. Basket applies signals and filters to optimise returns. EM (ex-Asia) strategy selects high and low yielders from BRL, MXN, ZAR, HUF, CZK, TRY, PLN, RUB and ILS. Asia carry strategy selects high and low yielders from INR, KRW, IDR, TWD, PHP, SGD, THB, JPY

Will the EM carry trade be revived as a viable strategy in 2016?

The choice of the funding leg for passive EM carry strategies influences performance. Using the EUR as the funding leg against the top five highest yielding EM currencies produced lower returns compared to the USD through to 2007, but had lower draw downs during the financial crisis and has performed better since 2011. The move higher in EUR-EM pairs during periods of market stress is a reflection that the EUR has taken over as a prominent funding and safe haven currency. Since the peak of USD based carry trade in 2011, the USD strategy is down -26% while the EUR strategy is flat. This contrasts with a JPY-based funding strategy that outperformed the USD strategy through to 2007, but underperformed in the crisis, and since then has posted strong return (since 2011 +13%).

Examining the past macroeconomic and financial market conditions when the carry trade performed well is instructive in understanding whether yield-based strategies will be viable in 2016. The 2001-07 carry trade performance was assisted by a) a recovery from distressed levels in some currencies after the 1998 crisis and b) other currency crises in 2001/2002 such as BRL and TRY, very high yields across a wide swathe of countries, a positive narrative on EM growth expectations, booming commodity prices, an equity bull market, declining FX volatility, and accelerating capital inflows. In the post crisis period (2010-11) carry continued to do well as EM growth accelerated, capital inflows to EM surged, and as quantitative easing pushed investors into a massive hunt for yield.

Of the top five highest yielders in EM – BRL, TRY, ZAR, IDR – all have been beaten down significantly against the USD and on a trade weighted basis in the past 18 months, while the INR has fared better. And all five currencies appear cheap on a real effective rate (REER) basis versus their ten-year averages. This has stoked optimism that the carry trade might do well in 2016. **While we cannot rule out selective carry trade opportunities in specific currencies at various points over the next 12 months, the macro conditions and rising volatility might not cooperate to promote a true revival of the carry trade as a viable strategy.**

For example, weak commodity prices, stagnation in equities (MSCI World) since mid-2014, uncertainly about the speed and magnitude of Fed tightening coupled with the first notable global liquidity withdrawal in ten years, Chinese growth slowdown fears, and possible weakness in RMB, could restrain investor appetite for deploying capital into the carry trade.

TRADING CONVERGING EM PATHS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A set of bearish EM outcomes (Fed tightening, Chinese growth, yuan depreciation and a rise in EM corporate defaults) suggests that correlations in the EM space will stay elevated and could rise further in 2016. In G10, the yen remains threatened by Fed/BoJ divergence and Asian currency wars. Markets are still pricing these joint macro risks as diversified, offering the opportunity to take advantage of a cheap worst-of option.

Buy 6M worst-of CNH, JPY, TWD, CLP ATMS puts / USD calls

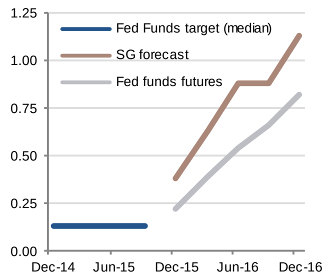
Risks: EM FX or the yen outperforming the dollar

Investors buying a worst-of option cannot lose more than the premium initially invested. The option will expire in the money only if all of the four underlying currencies have depreciated against the dollar in six months. In that case, the payoff will deliver the smallest of the four dollar outperformances.

Colliding bearish EM outcomes

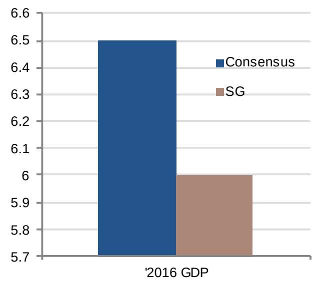
The bearish trend in EM currencies that began in 2011 will be reinforced next year by a number of macroeconomic and financial shocks – Fed tightening, slower Chinese growth, RMB depreciation, and rising corporate defaults. While these are widely recognized risks, it might be an insurmountable achievement for EM currencies to digest so many negative developments and come out unscathed.

Graph 1a. Faster tightening



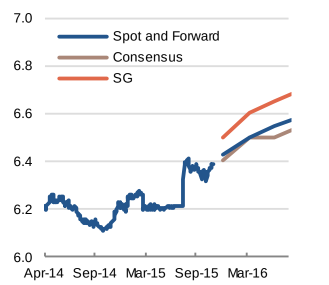
Source: SG Cross Asset Research/EM

Graph 1b. Weaker Chinese GDP



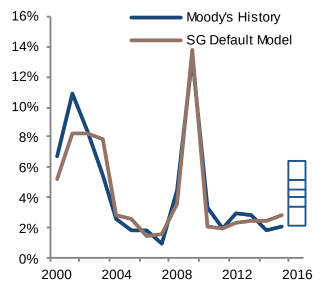
Source: SG Cross Asset Research/EM

Graph 1c. More RMB depreciation



Source: SG Cross Asset Research/EM

Graph 1d. EM corporate defaults



Source: SG Cross Asset Research/EM

Fed tightening

Rolling policy uncertainty will keep risk appetite depressed. After the initial Fed hike, there might be a small but unsustainable relief rally, but this is less certain than earlier in the year – a "dovish" hike is now the consensus (Graph 1a), and positioning is close to neutral. Market attention will increasingly shift to the speed, magnitude, and duration of the tightening cycle, and if expectations gravitate toward the SG view (100bp of hikes over 12 months and a terminal rate of 2.75%), **downward pressure on EM could intensify**. As long as policy uncertainty remains at the forefront, rallies will be temporary, shallow, and prone to reversals.

Chinese growth

A large downside surprise in Chinese growth would cause bearish sentiment to permeate across the EM complex. **Korea and Taiwan are the most sensitive to the direct export channel in Asia, while Brazil and Chile are most susceptible in LatAm, with EMEA being well insulated**. SG economics expects Chinese GDP to grow 6.0% in 2016, versus the consensus of 6.5% (Graph 1b), implying a marked slowdown from the pace seen in 2015. As the year progresses and downside risks become evident, there will be a revival of hard-landing fears.

RMB depreciation

Further yuan depreciation (Graph 1c) could pull the entire EM universe, especially Asia, down with it. To maintain competitiveness, **EM policymakers might endorse more currency weakness, especially in those economies with the export structures that are most similar to China's** – Taiwan, Korea, Thailand, Poland, Turkey, the Czech Republic and Mexico. Depreciation is necessary to delink from the USD trend, and this can happen in a gradual and controlled manner (USD/CNY 6.80 by end-2016). Larger moves are possible if regional currencies depreciate more than the yuan and the associated trade-weighted appreciation is too much for policymakers to bear relative to growth and employment objectives.

Corporate defaults

The breakneck growth of the EM corporate hard-currency markets since 2009 has been driven by rising corporate leverage. Yet earnings remain volatile, which suggests that **defaults could rise** (Graph 1d). Hard-currency corporate bonds have so far performed less poorly than EM currencies and no worse than hard-currency sovereign bonds, perhaps due to the illiquidity of the asset class. However, primary issuance – fuelled by redemptions – could see the market reprice in the coming quarters (link).

Buy a worst-of EM puts/USD call

Markets are not fully priced for individual (never mind joint) macro risks in 2016, which leaves us sceptical of pursuing a contrarian strategy. Over time, the general patterns in regional aggregates and the majority of individual currencies should remain closely linked. Underthese conditions, **a worst-of EM puts is discounted by soft correlations, while we expect correlated outcomes.**

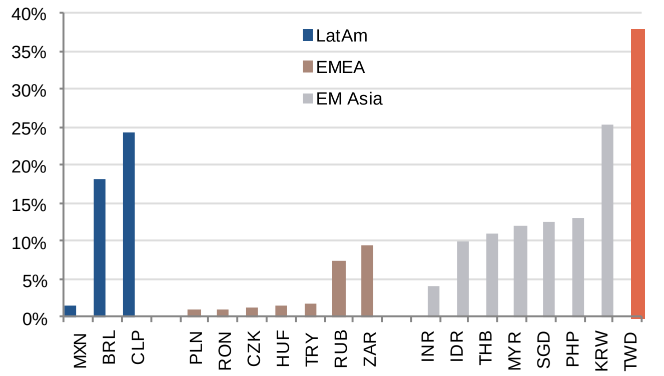
Building an effective short-list of shorts

Our collision scenario prompts us to contemplate the following shorts candidates against the USD: **CNH, KRW, TWD, BRL, CLP, JPY and AUD.**

More currency flexibility, volatility, and the continuation of yuan weakness are likely forthcoming, as depreciation will be required to delink from the USD and provide a cushion to the growth slowdown. This will most hurt China's neighbours Korea and Taiwan, noticeably via the trade channel (Graph 2). Taiwan's direct exposure to China, by far the highest in EM, introduces significant downside potential to the TWD if Chinese growth disappoints. In addition, if the opposition party wins both the general and parliamentary elections, the TWD could suffer. Similarly, Korea will be impacted by the weaker yuan, but also via its export structure, similar to China. More downside risks would arise from the eruption of a currency war in the region.

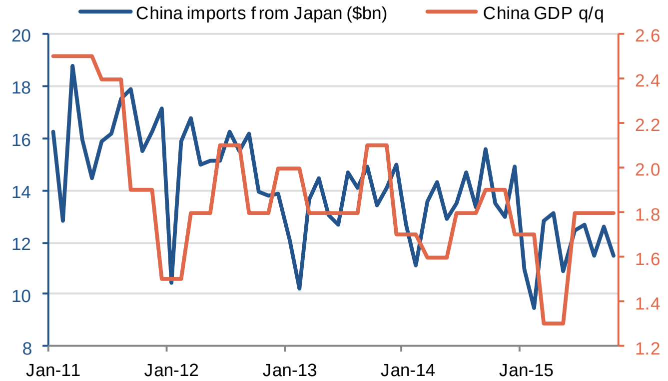
LatAm will also feel the pain, with Brazil and Chile at the top of the list (Graph 2). Chile produces more than one-third of the world's copper and its trade exposure to China is twice that of the US. Similarly, in the G10, the Australian dollar remains the most directly exposed to China's woes, given the reliance of the local economy on the mining sector.

Graph 2. Taiwan, Korea and Chile have the biggest export exposure to China in EM world



Source: SG Cross Asset Research/EM

Graph 3. Chinese slowdown continues to threaten Japanese trade



Source: Bloomberg/Customs General Administration PRC, SG Cross Asset Research/Forex

Yen depreciation is still needed to support the movement of the Japanese economy towards exiting deflation. The BoJ is expected to maintain its easy monetary policy, and real long-term bond yields remain negative, while the Fed is set to tighten. Against this backdrop, USD/JPY should continue rising along with US yields. In addition, the pace of Japanese exports to China follows the path of Chinese growth (Graph 3), suggesting that a downside scenario would require a boost in Japan's competitiveness.

Minimising the volatility of a not too small FX basket

The volatility of an FX basket adds individual volatility risks, but also includes correlation risks. If correlations are high and positive, this increases the volatility of the basket and makes the worst-of option more likely to expire in the money, since all currencies are expected to move in the same direction. This option pays the smallest individual performance within a basket, so it needs all components to deliver to still generate a gain. It is therefore buying intra correlations. **In minimising the portfolio volatility, the cost of the worst-of option is lowered** because it penalises the expected amplitude of the moves (via individual volatility) and the likelihood that they will occur in the same direction (via correlations). In the same fashion, considering a larger number of currencies increases the probability of an underperforming outlier and thus of a zero payoff. So all things being equal, **a larger basket also lowers the price**.

However, the collision of bearish EM outcomes detailed above should eventually guarantee that the realised correlations will be globally high, while **the market underestimates both the potential future EM volatility and EM intra correlations.**

The optimal basket: short CNH, JPY, TWD, CLP against USD

We computed the 'implied volatility' of the 35 portfolios of four currencies among our seven candidates (Graph 4). This metric is defined from both market volatilities and correlations. In the ten least volatile portfolios, the most represented currencies are the JPY (38%), the CNH (33%), the TWD (29%) and the CLP (25%). Unsurprisingly, the BRL is almost not used as it is by far the most volatile. This is also the composition of the minimal volatility portfolio and we therefore elect these four currencies for our worst-of option recommendation.

➔ **We recommend buying a 6M worst-of CNH, JPY, TWD, CLP ATMS puts / USD calls.**

Graph 4. The ten four-currency baskets having the lowest volatility (JPY: 38%, CNH: 33%, TWD: 29%, CLP: 25%)

	Curency 1	Curency 2	Curency 3	Curency 4	6M volatility
1	TWD	JPY	CNH	CLP	**5.7**
2	TWD	JPY	CNH	AUD	**6.0**
3	TWD	KRW	JPY	CNH	**6.3**
4	KRW	JPY	CNH	CLP	**6.6**
5	TWD	JPY	CNH	BRL	**6.6**
6	JPY	CNH	CLP	AUD	**6.7**
7	KRW	JPY	CNH	AUD	**7.0**
8	TWD	KRW	JPY	CLP	**7.0**
9	TWD	JPY	CLP	AUD	**7.0**
10	TWD	CNH	CLP	AUD	**7.1**

The 6M volatilities of four-currency equi-weighted baskets are computed from 6M implied correlations and volatilities.

Source: Bloomberg, SG Cross Asset Research/Forex

Graph 5. The JPY is offering diversification potential to EM shorts

6M implied correlations

	AUD	BRL	CLP	CNH	JPY	KRW	TWD	Average
AUD		27%	56%	32%	38%	51%	49%	42%
BRL	27%		27%	-5%	19%	39%	6%	19%
CLP	56%	27%		31%	11%	49%	62%	39%
CNH	32%	-5%	31%		10%	55%	63%	31%
JPY	38%	19%	11%	10%		31%	11%	20%
KRW	51%	39%	49%	55%	31%		83%	51%
TWD	49%	6%	62%	63%	11%	83%		46%
Average	42%	19%	39%	31%	20%	51%	46%	

Source: Bloomberg computations, SG Cross Asset Research/Forex

Correlation analysis

The JPY is the most represented currency because it offers a maximal average diversification to the basket (Graph 5). This is really the cheapening component of our trade and an appealing opportunity, since **the market underestimates the chances of a joint weakening of the yen and EM currencies.** The BRL offers a similar degree of diversification but is much less affordable in volatility terms. The CNH offers the second best diversification potential and is also the second most represented currency among our ten cheapest baskets (Graph 4).

Including the KRW would be somewhat redundant given its 83% correlation with the TWD. In the same fashion, the including both the AUD and the CLP is not useful. **Incidentally, it turns out that our optimisation process picked both the TWD and the CLP** (Graph 4)**, which have the highest regional exposures to China** (Graph 2).

STRESS INDICATORS: LIQUIDITY WELL PROTECTED; SOVEREIGN CREDITS COMFORTABLE; FX THE WEAKEST LINK

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We look at four stress indicators: basis swaps on liquidity risk; sovereign yield differentials on sovereign credit risk; EMP (exchange market pressure) on foreign exchange risk; 3M spreads on counterparty risk in the banking sector. Most EMs are well protected from previous crisis levels in terms of liquidity and counterparty risks – these are attributable to a number of factors such as macro-prudential policies for liquidity management in both foreign and domestic currencies. Many EMs see their government bond yield differentials at a comfortable margin from the previous widest points, although there are also quite a few markets nearer these points and the structural shifts in the EM bond space may require setting higher bars for defining stress levels for EM sovereign credits. The weakest link appears to be on the FX side, where quite a few EMs have been under relatively high depreciation pressure, as reflected by actual exchange rate movement or changes in FX reserves – or both. However, cumulative weakness does not automatically translate into continued weakness, or a recovery.

Choice of stress indicators

The literature on the measurement of financial stress has been well explored by academics, international organisations and central banks. Among the indicators that are most adopted by researchers, we choose those that more appropriately reflect the situation in the fixed income and currency (FIC) markets – which are the asset classes we primarily cover. Long-end sovereign yield spreads and EMPI (exchange market pressure index) have always been frequently used and are highly relevant to the FIC markets. Basis swaps started to be monitored much more closely after the liquidity squeezes during the 2007-09 period. In terms of the risk in relation to the banking sector, we tend to focus on counterparty risk as reflected by bill/interbank rates rather than equity market risk such as beta given our focus on money markets rather than equities.

We observe historical patterns of these indicators for EM, to confirm if they have been able to suggest past periods of heightened stress, in particular during the 2007-09 period characterised by the US subprime problem which was later on extended to a broader liquidity squeeze across markets, and the European debt problem in 2011. The four indicators we pick were able to reflect heightened stress in most EM for past episodes – but less so with sovereign yield spreads which may have undergone structural shifts in the past few years. We consider the four indicators that we choose to use to cover the main areas of potential concern: namely liquidity, sovereign credit, foreign exchange, and counterparty risks as perceived by the banking sector.

We compare the current levels of these indicators to previous peaks or troughs, using data starting from January 2007 subject to data availability. We calculate z-scores to illustrate how far away these indicators are from crisis levels.

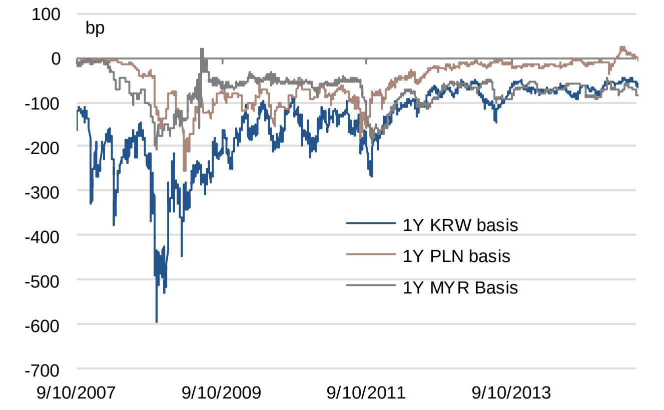
Basis swaps: USD/EUR liquidity versus LCY liquidity

EM can be broadly classified into two groups in terms of the reaction in basis swaps during times of liquidity squeezes. The first group saw squeezes in USD (or EUR) liquidity and very negative basis swaps, as there was generally a shortage of foreign currencies when financial institutions became more reluctant to lend, forcing investors to source liquidity from the CCS and FX swap markets. The second group saw high risks of capital outflows and bearish local currencies, and thus spikes in LCY implied rates and higher basis swaps. Regardless of the direction, the timing of these spikes coincided, making it feasible for us to do an analysis across these markets. Where the basis swap market is not liquid, we use proxies such as implied USD rates.

We take the absolute deviation from previous peaks or troughs in basis swaps/proxies and make adjustments in case there is a different quotation method (for example, basis swap being quoted as spreads over a USD rate rather than LCY rate). This gives an easy reference in that the higher its z-score, the further the market is away from its previous crisis level. This measure suggests that most EMs are at a comfortable distance from crisis levels.

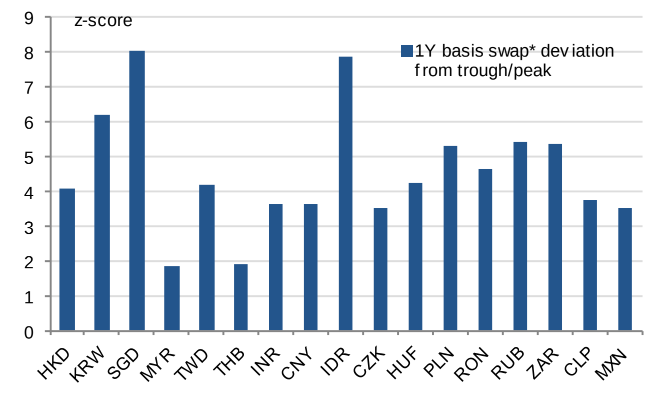
This situation is attributable to improvements in regulatory and market infrastructure where provision of USD (or EUR and the CHF) liquidity when needed is more adequate – while LCY liquidity is also better managed with various tools adopted. After the onset of the 2007/09 financial crisis many EMs drew on their FX swap lines with the Fed and the ECB, and/or used their own FX reserves (doing FX swaps) to provide USD liquidity. The existence of swap networks can continue to provide buffers. The establishment of swap lines between the PBoC and other countries was also partly motivated by the crisis – as a way to promote currencies other than the USD for trading and investment purposes.

An illustration of the signal from basis swaps



Source: SG Cross Asset Research, Bloomberg.

Distance away from previous crisis levels



Source: SG Cross Asset Research, Bloomberg. * implied USD rate for China; offshore rates for IDR; changed quotation method for MXN.

Sovereign yield differentials: a structural shift

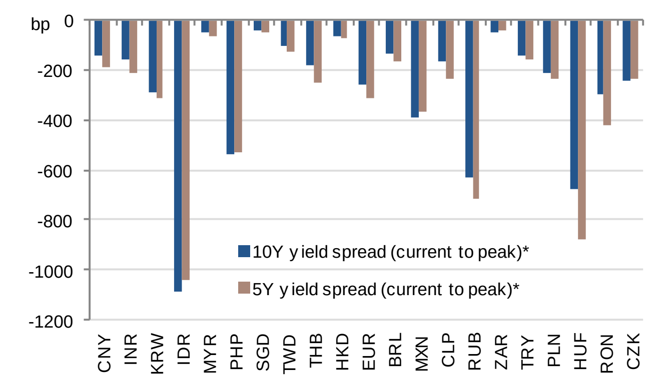
We look at nominal LCY government bond yield differentials of EM over the US at the 5Y and the 10Y tenors. This is a commonly used indicator to gauge sovereign credit risk. However, in some other studies when we look at valuation (such as "EM Rates Valuation: Potential Fed Hike Leaves Limited Space", in this publication), we compare real yields (yields adjusted by domestic inflation) and pick-up from asset swap trades (noting that the currency denominations are different, which leads to FX hedging needs). These may have quite different results or interpretations regarding where markets stand in terms of spreads and/or yield levels.

While many EMs see their government bond yield differentials at a comfortable margin from the previous widest points, there are quite a few markets which are nearer these points. These include the MYR and SGD markets where yield differentials are less than one standard deviation away from their respective widest levels; and the BRL, ZAR, INR, TWD, TRY and CNY markets are less than two standard deviations away.

Interpretation of the results must be carried out with particular care, especially given the high degree of variation across individual EM in terms of absolute yield differentials and of price actions over the years. For example, yield differentials between SUNs in Indonesia and USTs once spiked to more than 1700bp (SUN yields higher), which makes the current 600-plus level look comfortable. At the other end of the spectrum, TGB yields in Taiwan were very much below USTs, which renders the current 90-110bp differentials (TGB yields are still lower) as somewhat less spectacular.

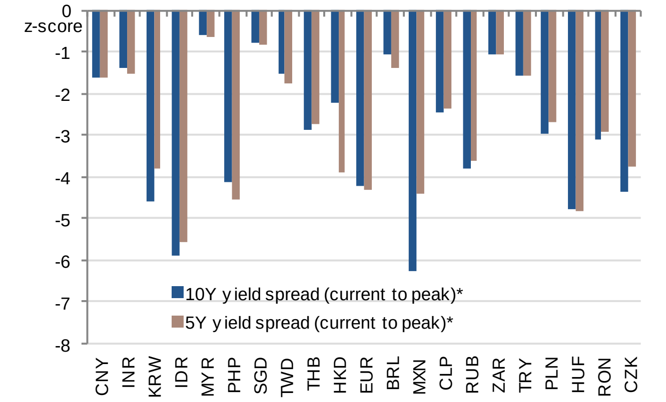
Still, we appreciate using z-scores as a standardised method for a historical comparison across different markets and should keep an eye on those markets which are nearer to stress levels using the measure of this indicator. We may yet have to set the bars higher for defining stress levels, especially given the structural shift in the performances of LCY bonds in some EMs, which have behaved more like safe-haven assets[4]. In other words, yield differentials may only need to widen to a fraction of their previous widest points to trigger caution among investors.

Mostly compressed yield spreads



Source: SG Cross Asset Research, Bloomnberg * spread over UST; over Bunds for PLN, HUF, RON and CZK

Some are less than one standard deviation away



Source: SG Cross Asset Research, Bloomnberg * spread over UST; over Bunds for PLN, HUF, RON and CZK

EMP: a higher degree of variation across markets

We adopt the definition of EMP (exchange market pressure) as the month-on-month percentage change in exchange rates (USD-EM) minus the month-on-month changes in the FX reserve/M2 ratio. We rebased it to 100 for January 2007 to form an index (EMPI) for comparative purposes. A higher EMPI for an EM points to depreciation pressure on that particular EM currency.

[4] Miyajima Ken, M S Mohanty and Tracy Chan (2012), "Emerging market local currency bonds: diversification and stability", *BIS Working Papers No 391.*

While researchers use various methods to decide on the weightings of the exchange rate and the FX reserve components, under certain assumptions EMP in an equal-weight framework is a proxy for the growth of the monetary base (or money supply) minus the growth of money demand[5]. Another interpretation is that EMPI captures both the major exchange rate movement – reflecting the point of pressure on a currency that results in actual FX movement, and the major changes in reserves – reflecting the pressure on a currency that has to be absorbed by the reserves.

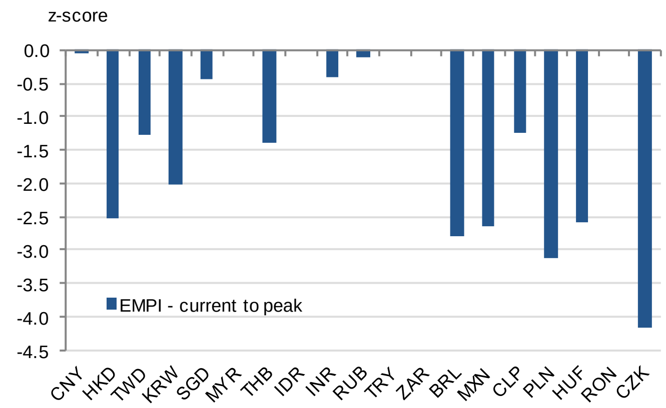
This is a useful indicator. To illustrate, for example, in the CZK case, where movements in nominal exchange rate are constrained by the EUR/CZK floor, the appreciation pressure on the CZK is reflected in increasing FX reserves, hence resulting in a lower calculated EMPI.

There is a high degree of variation in terms of how far one market is away from its peak EMPI. The CNY, SGD, MYR, IDR, INR, RUB, TRY, ZAR and RON have been under relatively high depreciation pressures judging by their EMPI. Compared with the various spread indictors we look at in this paper, foreign exchange is the weakest link in EMs.

We do not capture the impact of predetermined (mainly central banks' "forward book") or contingent (arising from positions on options, for example) net drain on foreign currency assets when calculating the EMPI, due to poor data availability. But if these components have a material impact on the EMPI, it looks fair to assume that the impact is for higher EMPI, given more incentives for operations using forwards when the aim is to prevent a currency from weakening too much.

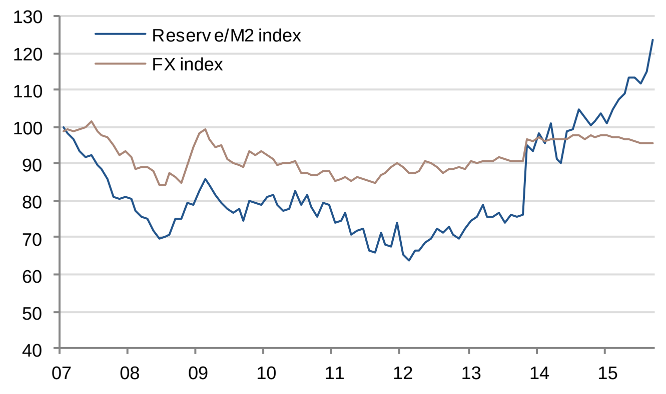
It is worth noting that the nature of EMPI is slightly different from other spread indictors in the sense that EMPI measures cumulative changes while spreads measure position at a point in time. Cumulative weakness, for example, does not automatically translate into either continued weakness or a recovery.

More variation across EMs in terms of FX pressure



Source: SG Cross Asset Research, Bloomberg * against EUR for PLN, HUF, RON and CZK

Illustration of the two components: CZK



Source: SG Cross Asset Research, Bloomberg *against the EUR

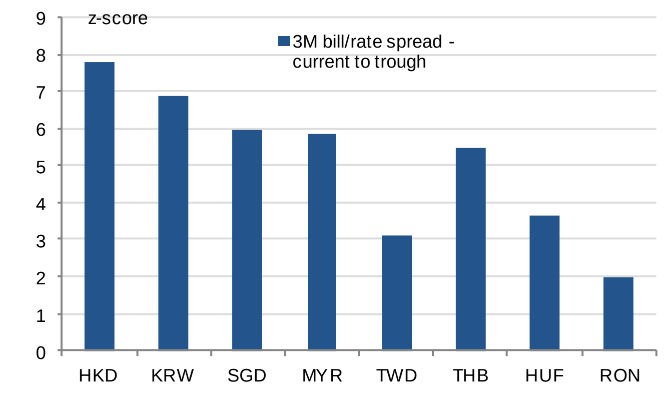
[5] Tanner, Evan (2001), "Exchange Market Pressure and Monetary Policy: Asia and Latin America in the 1990s", *IMF Staff Papers, Vol. 47 No. 3*

3M spread – for selected markets

Due to the under-development of the money markets, we construct this set of 3M spread indicators for selected emerging markets only – those with more liquid short-term instruments. During previous crisis episodes, interbank rates (or other money market benchmark rates) shot up far above bill yields. Heightened counterparty risks prevented market participants – banks in most cases – from lending to each other, while at the same time money was parked at safe-haven bills.

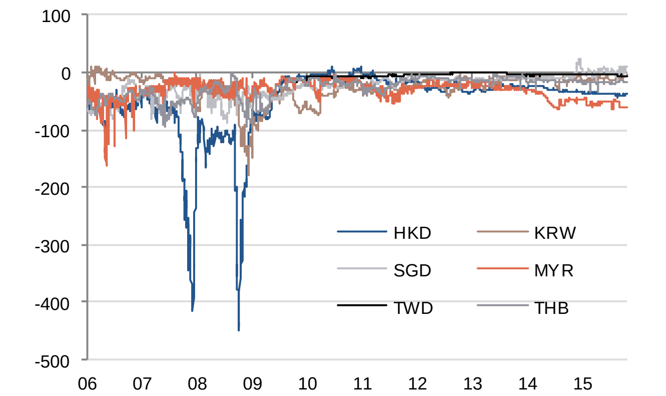
This 3M spread as an indicator for stress is more obvious where the money markets are more liquid. A case in point is the 3M HKD EFB/HIBOR spread, a mirror image of the TED spreads in advanced markets, which underwent spikes during 2007/09, but has since returned to a much more normal level and remained there. There are no heightened counterparty risks seen across EMs, and in particular the HKD, KRW, SGD, MYR and THB markets look well protected at the present time.

Perceived counterparty risks are low



Source: SG Cross Asset Research, Bloomberg

More obvious cases



Source: SG Cross Asset Research, Bloomberg

Implications of our views

The indicators in this paper are meant to be tools for monitoring various aspects of stress that EMs face via a historical comparison. They generally do not measure or compare performances across asset classes, although to a certain extent some indicators, in particular sovereign yield differentials and EMPI, reflect past performances.

Past cumulative pressures – as reflected by the EMPI or cheap valuations – are not sufficient reasons to buy EM FX. We remain bearish in EM currencies in 2016 amid Fed tightening, slower Chinese growth, RMB depreciation and rising corporate defaults.

In the EM LCY government bond space, narrow yield spreads vis-à-vis UST may suggest rather precisely that valuation is relatively rich – in addition to the situation where EMs do not face sovereign credit strain. The valuation aspect may be especially relevant to Asian and EMEA dollar-bloc LCY government bonds. As USD rates rise modestly in 2016, there is upside to these EM rates as well.

EM RATES VALUATION: POTENTIAL FED HIKE LEAVES LIMITED SPACE

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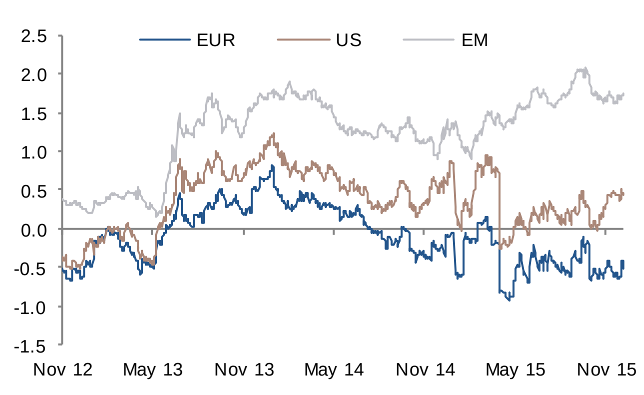
With potentially higher USD real rates on rising US yields and EM central banks largely done with monetary easing, there appears to be little room for EM real rates to move lower. Most EM nominal yields have moved higher in 2015 on the EM macro weakness premium and measures adopted by some central banks following the large currency sell-off. Higher USD and EUR nominal yields will push US and EUR real yields higher leading to higher EM real rates on average. EMEA rates do not suggest much downside on rich valuations as most of the EMEA rates are discounting ECB QE and monetary easing at the moment. In Asia and Latam, the real rates spreads suggest that some of the countries with high nominal interest rates, i.e. Brazil, India, Indonesia and South Africa, are attractive if the macro-vulnerability issues are kept at bay from volatility arising from impending US rate hikes. Although some of the Asian rates, such as those in China, Korea and Taiwan, appear rich on valuations vis-a-vis last year's valuations, they benefit from safe-haven flows within Asia.

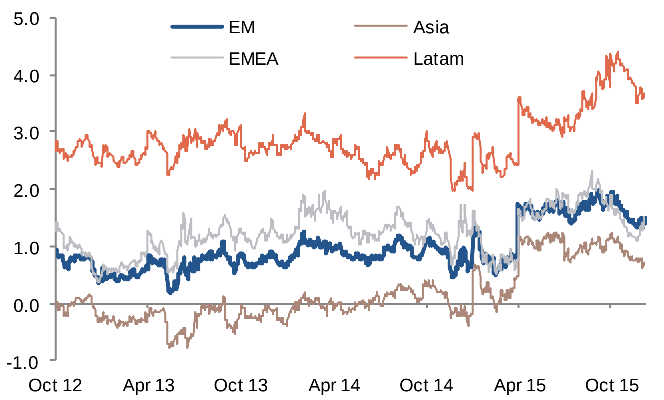
We look at EM rates correlation to USD rates on data starting in 2007, and the US rate shock during summer-2013 (previous studies here and here). EM rates moved higher in unison during the US rate shock, with yields in some markets, i.e. India and Turkey, caught higher on emergency rate hikes following a sharp currency sell-off. Based on correlations and the reactions to the summer-2013 shock, CNY and HUF yields appear the least affected by higher nominal US yields, while MXN, HKD and SGD yields follow USD yields most closely. A multiplied (upward) reaction could be seen in yields in Brazil, Indonesia, Turkey and South Africa if: 1) the subdued correlations move higher towards average historical correlation, and 2) markets take a cue from the summer-2013 US rate hike episode.

Higher EM real yields; lower US and EUR real yields



Source: Bloomberg, SG Cross Asset Research/EM, levels for EM real rates, US real yields and EUR real yields. Real rates calculated as 10y yield – 4 quarters ahead CPI forecasts. EM real yield – average of 10y Govt yield for CNY, INR, KRW,IDR,MYR,SGD,TWD,THB,HKD, MXN, PLN, HUF and CZK . 5Y IRS for BRL,RUB, ZAR, TRY and CLP

Real rates spreads adjusted higher in Latam and Asia



Source: Bloomberg, SG Cross Asset Research/EM, levels for EM real rates above US real rates. Real rates calculated as yield – CPI 12m forward forecasts, Core CEE country (PLN, CZK, HUF) real yields adjusted for EUR real yields

EM yields: Value in some pockets

Higher US and EUR real rates keep upward pressure on EM rates. Over the past few years, USD and EUR real rates have been broadly falling, while EM real rates have moved higher, based on CPI expectations. The expected pick up in US and EUR real rates on higher nominal yields (see: Rates 2016 outlook) would exert upward pressure on EM real rates, pushing EM yields higher while average CPI would likely pick up by 0.34%, according to current Bloomberg median CPI forecasts.

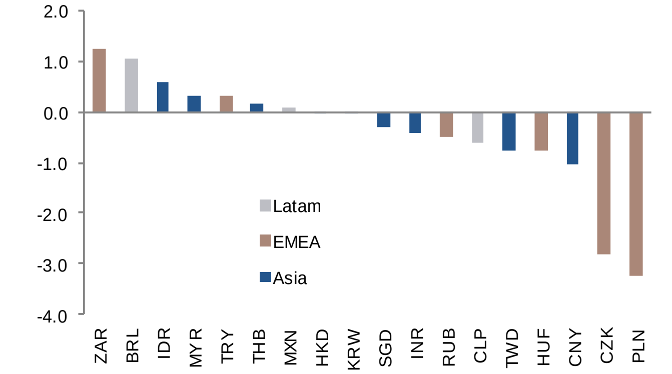
EM real rate spreads average 1.49% currently, up from 1.24% at the start of 2015. While most of the EM countries are done with monetary easing in 2015, some markets are still pricing in small rate cuts, e.g. India, Indonesia, Russia and Poland. If USD and EUR real rates move up towards their medium-term averages, EM rates will also move up on average.

EM rates' valuations diverge. The divergence in yields was more evident in 2015 as rates moved higher in some countries, such as Brazil and Russia, as the central banks resorted to rate hikes in order to counter macro-economic vulnerabilities on the EM FX sell-off, while other countries benefited from the hunt for yield and lower CPI expectations on the commodity price sell-off. Valuations look less compelling compared to the start of 2015 as the average EM yield spread (ex-Brazil) moved marginally higher from 0.98% to 1.07% while the potential Fed rate hike poses risks.

Based on the distance of current real rates from the past one year average and standard deviation moves above the past one year average, some pockets in Asia and Latam real rates valuations are attractive and average EMEA rates valuations are rich. The differentiation and entry timing remains the key within EM rates ahead of potential US rate hike and volatility.

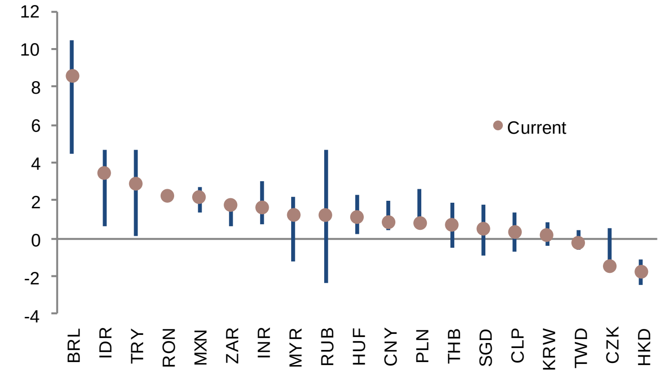
Asia rates: INR, HKD offer value. The average Asia real yield spread moved higher to 0.73% from 0.49% at start of 2015 led by wider real rates spreads in Indonesia and India. INR and HKD rates appear cheap compared to the last one year valuations, although the HKD real rate spreads are the lowest at -1.76% within EM rates. CNY, KRW and TWD real rates appear rich compared to last year's valuations, although they benefit from safe haven flows within the region. Indonesia and Malaysia real rate spreads cheapened as markets priced in a higher premium on vulnerabilities to lower commodity prices, high foreign holdings of local currency bonds and politics.

Asian rate spreads show value



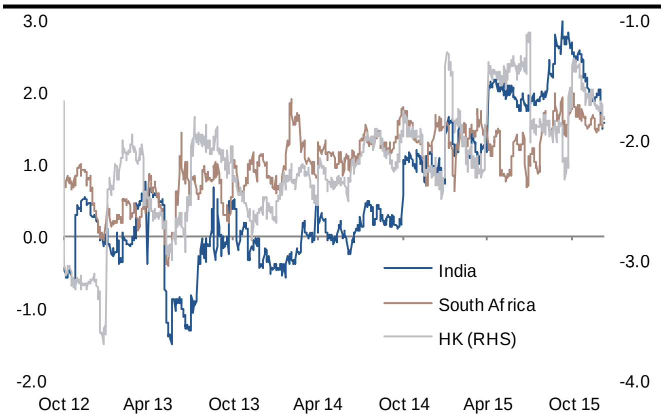
Source: SG Cross Asset Research/EM, Bloomberg, Standard Deviation move for last one year real yield data

BRL and ZAR spreads close to one year highs



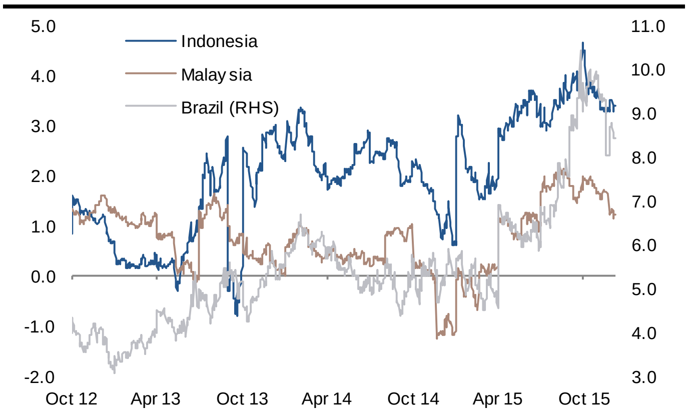
Source: SG Cross Asset Research/EM, Bloomberg , RON – historical inflation forecast not available

Real rates spreads – INR, ZAR and HKD cheaper



Source: SG Cross Asset Research/EM, Bloomberg

IDR, MYR and BRL spreads higher on commodities

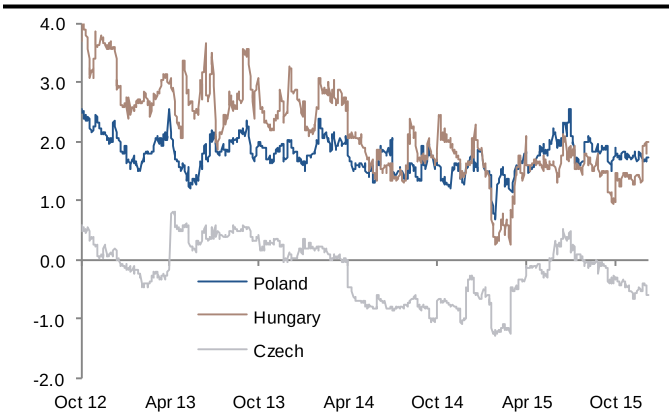


Source: SG Cross Asset Research/EM, Bloomberg

EMEA rates: PLN real rates more resilient vs peers. EMEA real rates spreads were unchanged at 1.53% from the start of 2015. CEE real rate spreads continue to compress over the last three years and in all the countries in our analysis, i.e. Poland, Hungary and the Czech Republic, real yields appear rich on an absolute and relative basis within EM rates. However, ECB QE and monetary easing expectations might continue to keep valuations rich in CEE. Within the EMEA dollar bloc countries, South Africa's real rate spread moved higher over the past year, while Russia and Turkey real rate spreads have been more volatile on macro-economic worries. South Africa real rates are cheap if the volatility regime remains supportive.

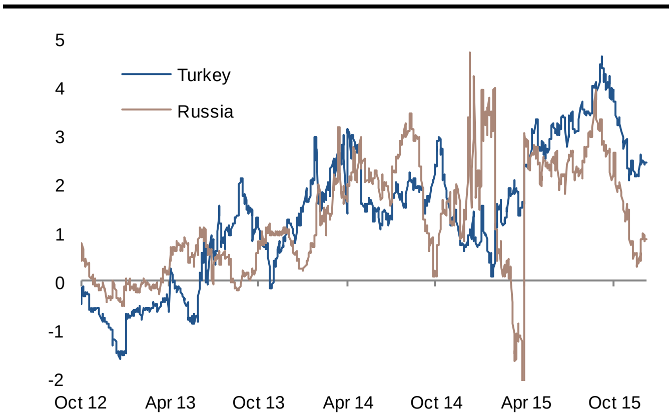
Latam rates: Brazil valuations cheap but vulnerabilities remain. Latam real rates spreads moved higher this year from 2.89% to 3.69%, mainly driven by higher Brazil real rate spreads. Brazil real rates spread continued to move higher from 5.7% to 8.6% this year on a deteriorating fiscal deficit, high inflation and political worries. While Brazil rates appear cheapest within EM on our valuation criterion, fast-deteriorating fundamentals and elevated political risks might justify the cheapness. Chile real rates have been volatile this year on commodity woes and the valuations look rich compared to historical levels. Mexico real rates valuations are rich vis-a-vis the rest of Latam and Asia, based on standard deviation.

Diminishing value in CEE real rate spreads



Source: SG Cross Asset Research/EM, Bloomberg

RUB, TRY cheaper on macro before recent rally



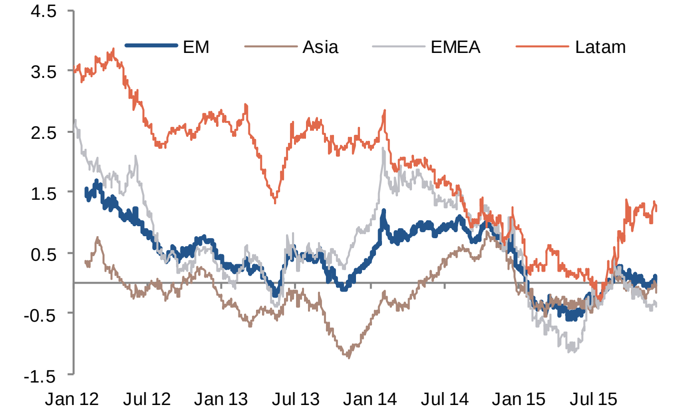
Source: SG Cross Asset Research/EM, Bloomberg

Nominal Interest Rate = Estimated Real Interest Rate + Inflationary Expectations

Case for choosing CPI four quarter forward forecasts. We also take a look at EM real yield spreads over US real yields based on official CPI data (discussed here and here) and compare the differences in approach. Methods to use CPI forecasts will likely avoid transitory and base effects of the actual CPI. While the median CPI forecasts might miss the actual CPI data release, the forecasts will likely also adjust to the change in CPI trajectory in a short span of time. While the actual CPI prints are important, the markets will also look at the forward CPI expectations for the relative valuation of yields. We can also take historical data for assessment, since the bonds would likely be priced based on available CPI data, CPI expectations and the real rates expectations in history (see - footnote).

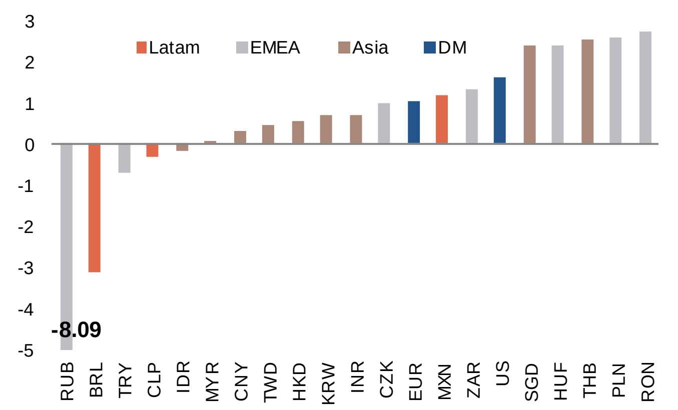
US and EUR four quarter forward CPI forecasts are higher by 1.63% and 1.06% than the last printed CPI, respectively, while EM CPI will adjust higher modestly by 0.34%, according to median Bloomberg forecasts in our sample of EM countries. Therefore, the EM real yield spreads over US or EUR will differ in CPI forecast vs actual CPI real rates methods. CEE countries' CPI are likely to move higher by maximum amount, while CPI for Russia, Brazil and Indonesia are expected to move lower over the next four quarters.

Real yields spread compressed (based on official CPI)



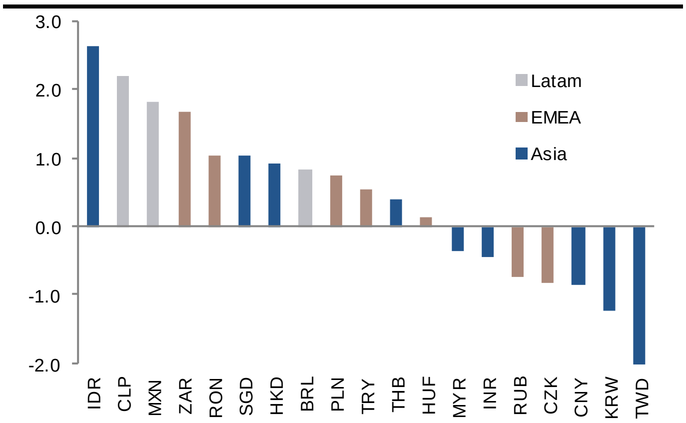
Source: SG Cross Asset Research/EM, Bloomberg

4 quarter forward CPI forecasts vs last CPI print



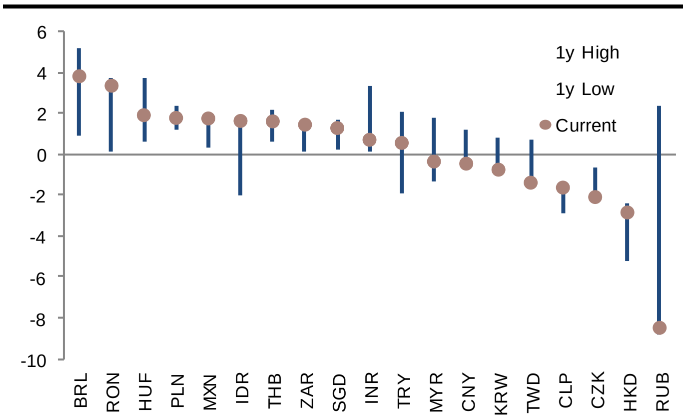
Source: SG Cross Asset Research/EM, Bloomberg

Valuation sign largely similar to CPI forecast method



Source: SG Cross Asset Research/EM, Bloomberg

EM real yield spreads over the past year (CPI)



Source: SG Cross Asset Research/EM, Bloomberg

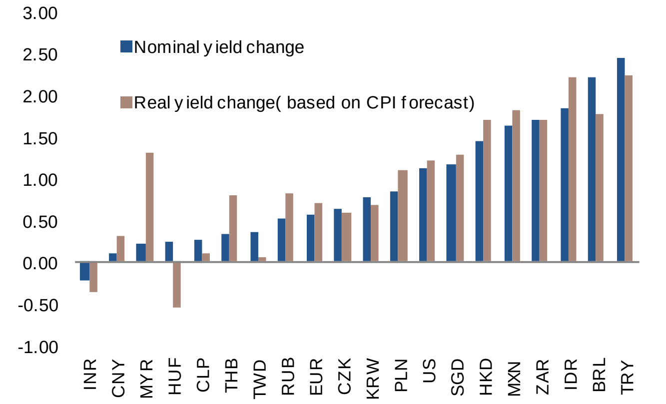
Links
1. Philly Fed – How much does expected inflation matter
2. SF Fed – How would change in inflationary expectations affect nominal interest rates and the yield curve

EM rates vulnerability to higher US yields

During the periods of higher US yields, EM rates generally move higher and average correlations move up. Based on correlations, the markets least affected by higher US yields are CNY, HUF and TRY rates along with high-yielders RUB and IDR, while HKD, SGD, MXN and KRW yields are the most correlated to US yields.

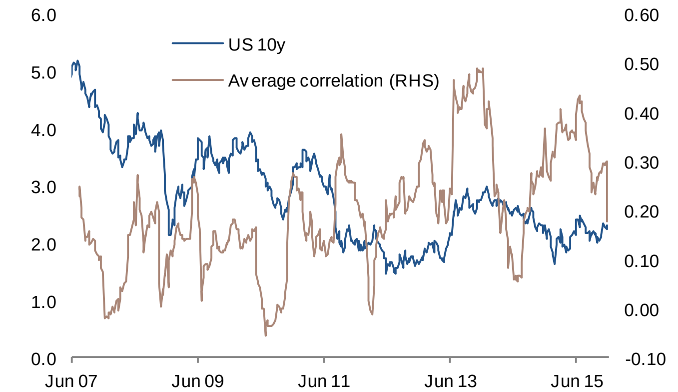
We also analyzed the impact of US rate rises on EM rates (here and here) and looked at the US rate rise shock during summer-2013. Rates moved higher in India, Turkey, Indonesia and Brazil later, as well as on an emergency response to a large FX selloff. EM yields in Turkey, Brazil, Indonesia and Taiwan are most exposed to higher US rates if correlations with US rates pick up to average (or even higher) historical levels, while the rates in highly correlated markets in Hong Kong, Singapore, Mexico and Korea will also move higher. Among EM rates, CNY rates will likely remain most insulated to higher US rates.

Higher US yields in summer 2013



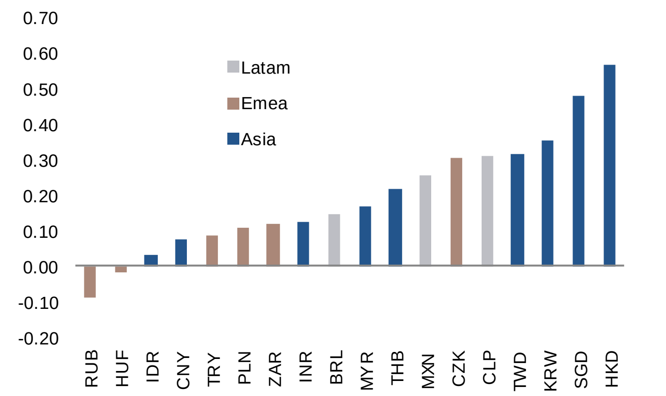
Source: SG Cross Asset Research/EM, Nominal yield change from 2-May-2013 to 5-Jul-2013, real yield changes based on 4 quarter forward Bloomberg median CPI forecasts, Bloomberg

EM – US rates correlation spikes during US rate rise



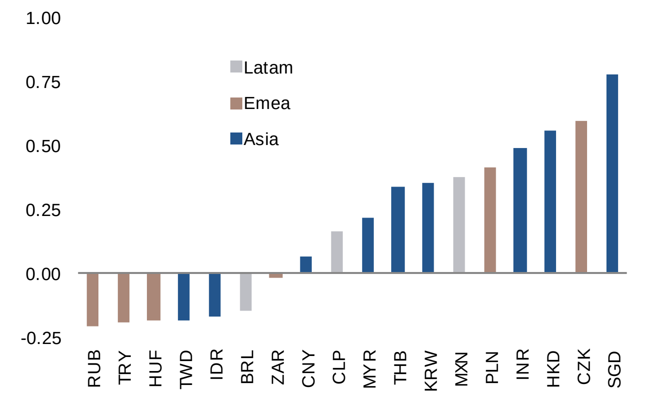
Source: SG Cross Asset Research/EM, Average rolling correlation of US 10y and EM rates weekly closing on half year data, Bloomberg

Average correlation with US yields high in Asia



Source: SG Cross Asset Research/EM, Average correlation since 2007 on weekly data, Bloomberg

EM yields' correlation with US 10y, over last 6m



Source: SG Cross Asset Research/EM, On weekly data, Bloomberg

SOVEREIGN CREDIT: THE RESILIENT ASSETS CLASS

EM Sovereign Credit Strategy

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EM fundamentals should continue to deteriorate in 2016, and sovereign spreads may widen to better reflect the fall in commodities. However, we think the downward pressure on sovereign credit will be relatively moderate, as debt levels are much lower in EM than in developed markets, FX reserves also acting as important buffers against external shocks. The upcoming Fed hike cycle will also adversely affect bond returns, but this scenario is much better factored in than the downturn in commodities. Bond redemptions are rather elevated this year, which should mitigate the impact of potential outflows. On balance, hard-currency-denominated bonds should continue to outperform other EM asset classes in 2016, especially in a context of a rising US dollar. On balance, we expect the EMBID spread index to trade at around 420bp by end 2016. We also see the growing importance of euro-denominated bonds, which could represent 40% of total sovereign issuance in 2016, we believe.

Wider credit spreads, but still outperforming

Last year, we were anticipating a major divergence between commodity exporters and importers (see EM Sovereign Credit in 2015: Sticking to EM Values, 30 January 2015). This prediction has largely materialised: oil producers, as well as metals & mining and soft commodity exporters have seen their growth performance plummeting, while the impact has been dearly felt in current accounts and/or in their fiscal balances. On the other hand, the fall in commodities has been beneficial for CEE countries, the region being a net importer of commodities.

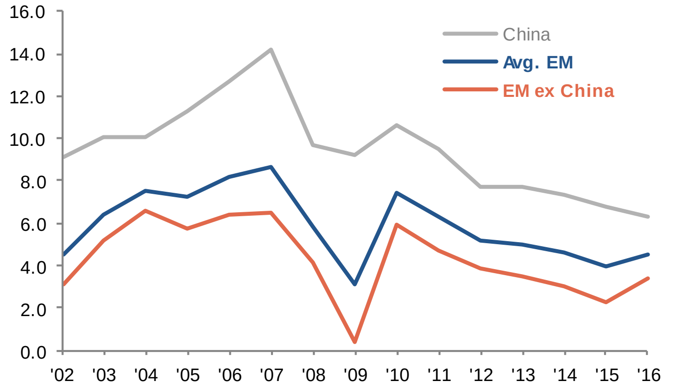
We believe that 2016 will see a continuation of this trend, as the impact of lower commodities has not been fully reflected in sovereign spreads, in our view. At the same time, we think EM sovereign credit will remain more resilient to the downside than other asset classes, EM fundamentals still comparing quite well in several aspects versus developed markets. In fact, our main concerns are for the corporate sector rather than for sovereigns (see EM corporate section). We also think that the divergence between the Fed and the ECB monetary policies will prompt a rebalancing in favour of euro-denominated bonds, a shift that should be very tangible in the primary market.

EM credit fundamentals should continue to deteriorate in 2016. The IMF expects EM growth (ex-China) to rebound next year to 3.4% (versus 2.2% for 2015), but given the strong correlation between fundamentals and commodity prices, the forecast already looks too optimistic: if we assume that China will grow 6.3% in 2016, then growth in the rest of EM should be closer to 3%, in our view.

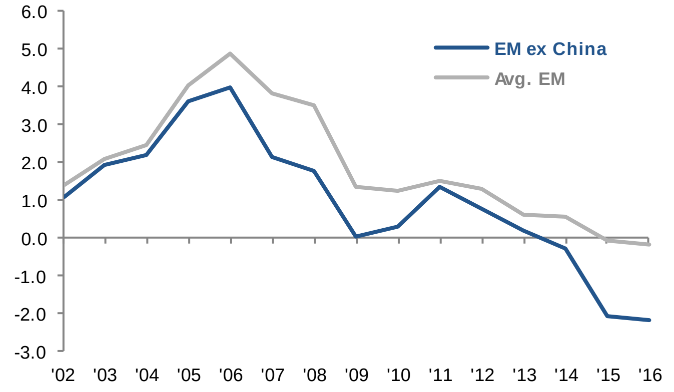
The plunge in commodities is benefitting CEE countries, but the external position of the majority of EM countries will continue to deteriorate: according to the IMF, EM countries (ex-China) should print an aggregate current account deficit of 2.2% of GDP in 2016, versus an estimated deficit of 0.3% in 2015. We are also seeing substantial erosion in public finances: the weighted-average EM fiscal deficit should widen to 4.3% of GDP this year, and the situation is expected to marginally improve in 2016 (for details, see EM Credit Hawk: Weaker fundamentals, benign market prospects, 16 October 2015).

Debt levels should significantly rise for commodity exporters. The rise in public debt should remain relatively contained for the majority of EM countries: based on IMF forecasts, the public debt/GDP ratio should be around 47% in the coming two years, versus 44.5% at present. However, the public debt of commodity-reliant countries such like Argentina, Chile, Peru and South Africa should rise by 1.5-3.0pp of GDP in 2016. The Brazilian public debt/GDP should jump nearly 5pp, as the government is trying to counteract the effect of the recession by maintaining high levels of public expenditures. For Venezuela, the situation is critical and may lead to a default in the course of 2016, in our view. Lastly in the Middle East, the level of public debt could surge by more than 10pp in the case of Bahrain and Saudi Arabia. In fact, Middle Eastern countries are likely to tap the primary market in large sizes to fill their financing gaps.

EM (ex-China) is expected to grow 3.0-3.4% in 2016

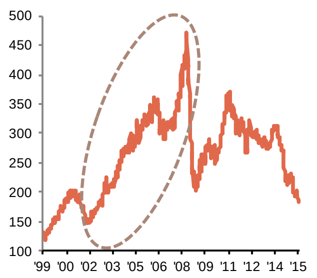


EM (ex-China) current account sharply deteriorating (% GDP)



Source: IMF, SG EM Research

CRB commodity index



Source: Bloomberg

More downgrades and wider credit spreads. The fall in commodities has not been fully reflected in credit ratings, and wider spreads may be inevitable. Based on our econometric model, and assuming that commodity prices will remain around their current levels (our base case), we find that EM fundamentals should then be rated somewhere between BB and BB+, which means a potential 0.8-notch downgrade from the current EM weighted-average rating (see EM Credit Hawk: Further downgrades and wider spreads inevitable, 24 September 2015).

Current EM spreads are implicitly pricing a downgrade of 0.3 notches, which is clearly not enough: given the high correlation between EM balance of payments and commodities, we estimate that the necessary downgrade is closer to 0.8 notches, which implies a fair value spread for the EMBID index of around 480bp. In other words, and assuming that commodity prices continue to trade at current levels, the market is not fully pricing in the new commodity prices just yet.

EMBID spread index

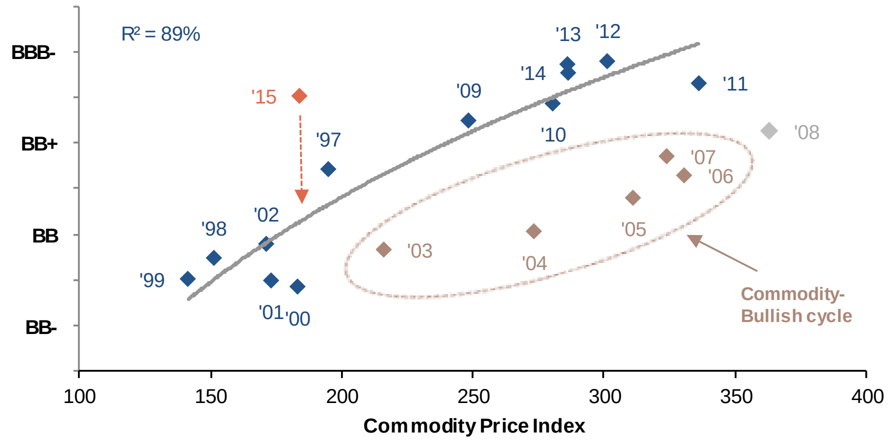
Source: Bloomberg

However, EM fundamentals still compare relatively well versus developed markets. We think that the EMBID index might not reach the 480bp level by end 2016. Instead, the adjustment may happen progressively over the coming two to three years, as EM fundamentals still compare relatively favourably versus developed markets (DM). Total EM public debt/GDP is nearly half that in DM, and external debt/GDP is a third of DM. Emerging markets have also accumulated large FX reserves, and although they have been depleting to defend their currencies, they are still mitigating the pressure from external deficits.

Sovereign credit, the safest asset class among EM. Moreover, the fact that the sovereign global bonds are by definition denominated in hard currencies (and more specifically in dollars for 80% of them), further weakness in EM currencies in 2016 will incentivise EM-dedicated investors to switch into hard-currency bonds, which still offer high carry without incurring the risk of currency depreciation. In the current global environment, sovereign credit acts as the "safe EM asset class" compared with local-currency-denominated assets.

For these reasons, we believe that wider spreads are inevitable, but the adjustment will be progressive without triggering credit events – with the notable exception of Venezuela.

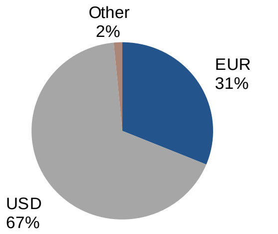
The fall in commodity prices has not been fully reflected in EM ratings
Average rating* versus CRB commodity index



* Based on EMBID index weights, using Mood´s, S&P and Fitch sovereign ratings.
Source: SG EM Research, Bloomberg

Fed hikes versus ECB quantitative easing. Potential Fed hikes will remain major drivers for EM credit: 75% of the sovereign bonds are denominated in dollars. Therefore, a scenario considering a steady series of hikes would inevitably put downward pressure on the asset class. Nevertheless, we believe that the market is relatively well prepared to absorb a hawkish cycle, as this scenario has been factored in by investors for more than two years, and even more so since the publication of the last two nonfarm payroll numbers.

Sovereign bond issuance by currency (YTD 2015, % total volume)



Source: SG EM Research

On the other hand, the ECB has announced that it will extend its quantitative easing measures, which should mitigate the impact of the Fed hikes on EM, at least to some degree. The extension of these measures might not trigger a significant rally for euro-denominated bonds, simply because euro spreads are already trading at very tight levels. However, we think that the Balkans and Romania could still benefit from further spread compression, as these bonds are trading cheap to the USD curve (see EM Credit Hawk, 20 November 2015).

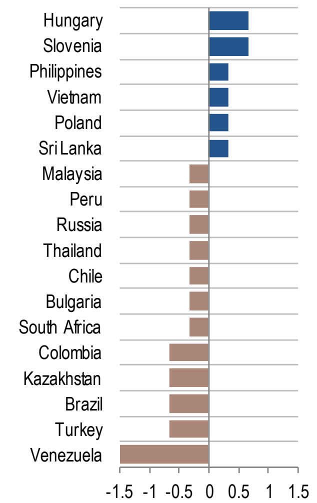
The extension of QE should provide a powerful backstop against the downside, however, and may continue to fuel the euro primary market. The euro-denominated bonds suffered several months of uncertainties related to Greece this year, but the bond supply has gathered pace since this summer, with several countries issuing in euro, including Lithuania, Romania, Poland, Latvia, Slovenia and Albania, while we expect Hungary to resume issuing euro bonds. Non-European countries have tapped the euro market, including Indonesia and Peru, following the path of Chile and Mexico earlier this year. As the ECB pursues its QE programme, more euro bonds are likely to be issued in the coming months. In fact, we expect the euro market to represent at least 40% of global sovereign issuance in 2016 (see EM Special: Position for the ECB imprint on EMEA assets, 29 October 2015).

Risk of outflows mitigated by elevated bond payments*. Technical factors should be* relatively benign for the market in 2016. In a context of US rate hikes, the asset class could face some outflows. However, bond payments are relatively high in 2016, which should largely offset this risk (see page Technicals section page 39).

On balance, we expect the EMBID spread index to trade in the 420bp area by end 2016, which is 25bp wider than the current level.

More downgrades in 2016

Select expected rating actions
Change in average* rating (notches)



* Based on S&P, Moody's and Fitch avg. rating
Source: SG EM Research

In 2015, 36 EM countries have been downgraded by at least one of the three major rating agencies, versus 23 upgrades. As a result, we calculate that the EMBID composite index has been implicitly downgraded by 0.36 notches since the beginning of the year. This contrasts with developed markets, where the situation has been more balanced, seven DM countries being upgraded against seven downgrades over the same period. The downgrade of the last few months is part of a trend initiated in 2012, and although we expect to see fewer rating actions in the coming months, they will still be significant. In aggregate, we anticipate the EMBID index to be implicitly downgraded by another 0.2 notches by end 2016.

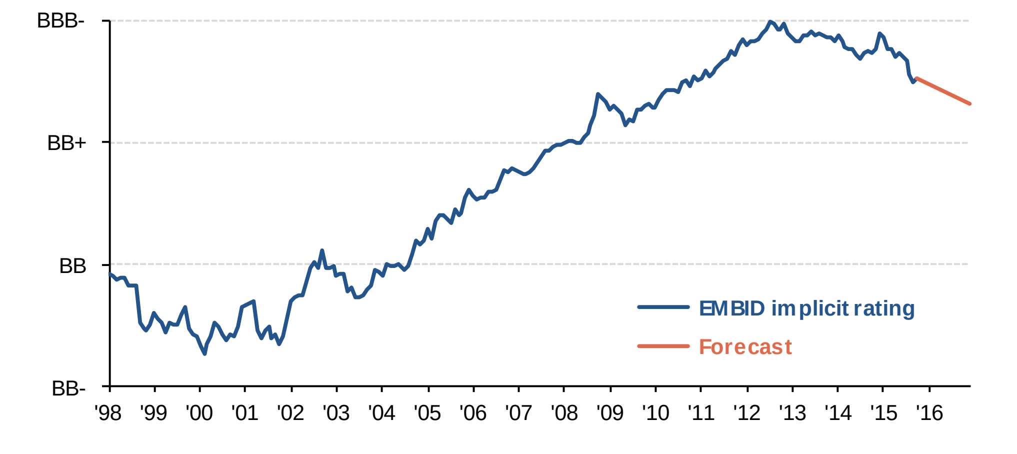
Among the potential downgrades, **Venezuela** is particularly at risk, as we believe the country is likely to default on its external debt – most likely by end 2016. **Brazil**, **Kazakhstan** and **Colombia** are also at risk of a downgrade, although we believe they should remain in the investment-grade (IG) category (excluding the recent BB+ assessment from S&P on Brazil). For these three countries, the potential downgrades are largely reflected in bond valuations, and we therefore remain market-neutral to slightly overweight for these three names in our EM portfolio (see EM Credit Hawk: Russian bonds expensive, Brazil still offering value, 20 November 2015). **Turkey** could lose its IG status next year given its high degree of external vulnerability.

Other countries could be downgraded, although less aggressively than the previous four names. This should be the case for **Malaysia, Peru, Russia, Thailand, Chile** and **South Africa**, and to a minor degree **Bulgaria** (see graph on the left).

On the other hand, some EM countries are likely to be upgraded, in particular **Hungary** and **Slovenia**. In **Hungary**, external debt remains high, but growth has notably improved, and the maintenance of a sizeable current account surplus has reduced the country's external vulnerability.

Other countries could potentially be upgraded, especially **the Philippines,** which has become one of the most resilient EM economies, but also **Poland**. Although the fiscal deficits are currently capping their sovereign ratings, an upgrade of **Vietnam** and **Sri Lanka** cannot be ruled out in the coming 12 months, as highlighted by our *Fair Rating* model.

Emerging markets should be downgraded by another 0.2 notches by end 2016
Weighted average rating(1) of the EM sovereign debt, and 2016 forecasts



(1) Based on EMBID index weights, using Moody's, S&P and Fitch sovereign ratings.
Source: SG EM Research

Technicals still supportive in 2016, despite risk of outflows

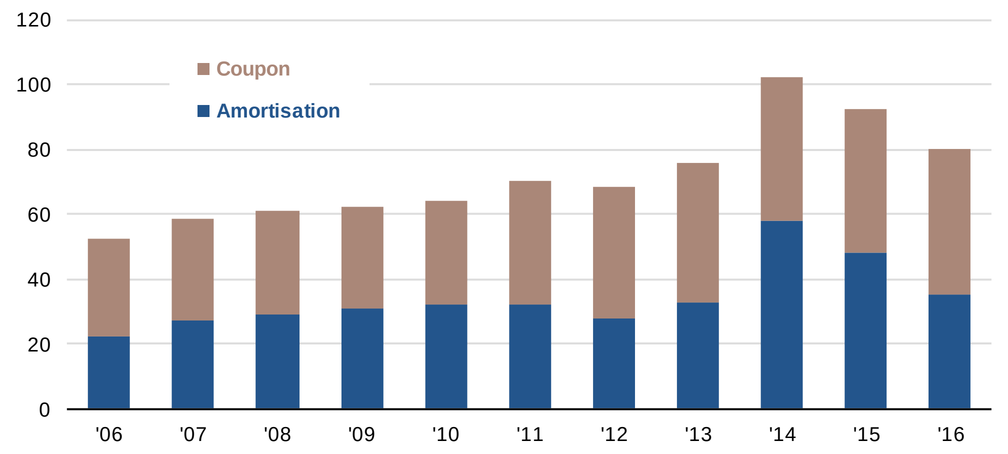
Expected EM sovereign bond payments 2016 (billions)

	Amort.	Coupon	Total
USD bonds ($)	17.3	37.5	54.9
EUR bonds (€)	14.6	6.0	20.6
Other CCY* ($)	1.9	0.5	2.4
Total ($ equiv.)	**35.4**	**44.6**	**80.1**

* Other currencies include GBP, CHF and JPY
Source: SG EM Research

Elevated bond payments in Q1 2016. Technicals will continue to play an important role for the EM credit market, bond payments being the main source of liquidity that is typically reinvested into the asset class. We estimate 2016's total payments on EM sovereign global bonds at around $80bn ($35.4bn in amortisations, and $44.6bn as part of coupon payments), which is $12bn lower than in 2015 but still $8.5bn higher than the 2011-13 average (bond payments reached a peak in 2014 at $102.5bn – see graph below). The highest payments due in 2016 are concentrated in Q1: $8.9bn in January, $12.9bn in February and $8.6bn in March – see table next page). The relatively high bond amortisations mitigate the risk of outflows that could affect the asset class next year, EM funds benefitting from a continuous source of inflows from bond payments.

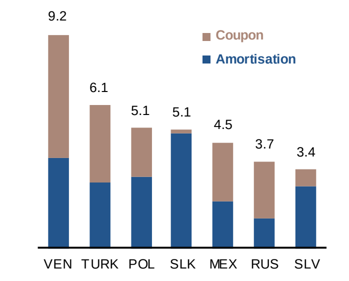
Global bond payments in 2016 are lower, but are still high by historical standards
EM sovereign bond amortisation and coupon payments, $bn



Source: SG Cross Asset Research

Venezuela, more than ever at risk of default. Bond amortisations are supportive for the market to the extent that they mechanically increase the level of cash to be reinvested into the asset class, but they also represent a risk factor for the countries facing high refinancing needs. This is notably the risk for Venezuela, which is facing elevated bond payments in 2016: $4.6bn is due by the government and another $4.6bn from state-owned oil company PDVSA. This represents a major constraint, as the country is already facing the impact of the collapse in oil prices. We think that Venezuela might not be able to face these payments, and the country is likely to default in the course of 2016 (most likely in Q4 2016, given the heavy payments scheduled over that period).

Sovereign bond payments in 2016 (Coupon and Amortisations, $bn)



Source: SG EM Research

Apart from Venezuela, three countries are facing relatively high bond payments, including Turkey ($6.1bn), Poland and Slovakia ($5.1bn each, which includes local euro-denominated government debt in the case of Slovakia). Although not unusual for Turkey, the heavy bond payments could be a risk for the country, especially in a context of geopolitical instability in the region. FX reserves in Turkey are quite scarce when compared with the external debt level and total imports. Although we believe the risk of default from Turkey is extremely limited, its refinancing conditions could be significantly higher, in our view. For Poland and Slovakia, the debt schedule is also quite heavy in Q1 2016 (see table next page).

*** See table of amortisations and coupon payments next page ***

EM sovereign bond payments 2016
USD-, EUR-, JPY-, GBP- and CHF-denominated global bonds ($bn equivalent)

	Amortisations 2016				Total '16	Total '16	Total '16
	Q1 16	Q2 16	Q3 16	Q4 16	Amortisations	Interest	Payments
Albania	-	-	-	-	-	0.01	0.01
Angola	0.06	0.06	0.06	0.06	0.25	0.07	0.32
Argentina (1)	-	-	-	-	-	2.00	2.00
Armenia	-	-	-	-	-	0.05	0.05
Azerbaijan	-	-	-	-	-	0.06	0.06
Bahrain	-	-	-	-	-	0.37	0.37
Bolivia	-	-	-	-	-	0.05	0.05
Brazil	0.86	-	0.10	-	0.95	2.23	3.18
Bulgaria	-	-	-	-	-	0.12	0.12
Cameroon	-	0.04	-	0.04	0.07	0.17	0.24
Chile	-	-	-	-	-	0.17	0.17
Colombia	0.08	-	-	-	0.08	1.44	1.52
Costa Rica	-	-	-	-	-	0.22	0.22
Croatia	-	-	-	-	-	0.67	0.67
Czech Rep.	-	-	-	-	-	0.36	0.36
Dominican Rep.	0.06	-	0.06	-	0.12	0.49	0.60
Ecuador	-	-	-	-	-	0.26	0.26
Egypt	-	-	-	-	-	0.14	0.14
El Salvador	-	-	-	-	-	0.40	0.40
Ethiopia	-	-	-	-	-	0.07	0.07
Gabon	-	-	-	-	-	0.13	0.13
Georgia	-	-	-	-	-	0.03	0.03
Ghana	-	-	-	-	-	0.19	0.19
Guatemala	-	-	-	-	-	0.10	0.10
Honduras	-	-	-	-	-	0.08	0.08
Hungary	0.75	0.20	0.95	-	1.90	1.16	3.06
Indonesia	0.90	-	-	-	0.90	2.14	3.04
Ivory Coast	-	0.03	-	0.03	0.05	0.22	0.27
Iraq	-	-	-	-	-	0.16	0.16
Israel	-	-	-	1.00	1.00	0.41	1.41
Jamaica	-	-	-	-	-	0.28	0.28
Jordan	-	-	-	-	-	0.02	0.02
Kazakhstan	-	-	-	-	-	0.11	0.11
Kenya	-	-	-	-	-	0.18	0.18
Korea	-	-	-	0.50	0.50	0.26	0.76
Latvia	-	-	-	-	-	0.20	0.20
Lebanon	0.43	0.54	-	0.64	1.62	0.96	2.57
Lithuania	1.09	-	-	-	1.09	0.52	1.61
Macedonia	-	-	-	-	-	0.03	0.03
Malaysia	-	-	1.20	-	1.20	0.08	1.28
Mexico	-	-	1.98	-	1.98	2.55	4.53
Mongolia	-	-	-	-	-	0.07	0.07
Montenegro	-	0.15	-	-	0.15	0.03	0.19
Morocco	-	-	-	-	-	0.22	0.22
Mozambique	0.08	-	0.08	-	0.15	0.05	0.20
Namibia	-	-	-	-	-	0.03	0.03
Nigeria	-	-	-	-	-	0.09	0.09
Panama	-	-	-	-	-	0.59	0.59
Pakistan	0.50	-	-	-	0.50	0.09	0.59
Paraguay	-	-	-	-	-	0.33	0.33
Peru	-	0.30	-	-	0.30	0.64	0.94
Philippines	0.63	-	-	0.43	1.07	1.53	2.60
Poland	2.82	-	-	0.20	3.02	2.11	5.14

EM sovereign bond payments 2016 (Cont'd)
USD-, EUR-, JPY-, GBP- and CHF-denominated global bonds ($bn equivalent)

	Amortisations 2016				Total '16	Total '16	Total '16
	Q1 16	Q2 16	Q3 16	Q4 16	Amortisations	Interest	Payments
Romania	-	1.63	-	-	1.63	0.81	2.45
Russia	0.64	-	0.64	-	1.27	2.43	3.71
Rwanda	-	-	-	-	-	0.03	0.03
Senegal	-	-	-	-	-	0.08	0.08
Serbia	-	0.02	-	0.02	0.04	0.34	0.38
Slovakia (2)	3.26	-	-	1.63	4.90	0.17	5.07
Slovenia (2)	1.04	-	-	1.63	2.67	0.68	3.35
South Africa	-	0.82	-	-	0.82	0.71	1.53
Sri Lanka	-	-	-	-	-	0.28	0.28
Tanzania	0.07	-	0.07	-	0.13	0.04	0.17
Tunisia	-	-	-	-	-	0.08	0.08
Turkey	0.82	-	2.00	-	2.82	3.30	6.11
Ukraine	-	-	-	-	-	0.74	0.74
Uruguay	0.06	-	-	-	0.06	0.49	0.56
Venezuela (3)	1.50	-	-	2.37	3.87	5.31	9.18
Sovereign	*1.50*	-	-	-	*1.50*	*3.11*	*4.61*
PDVSA	-	-	-	*2.37*	*2.37*	*2.22*	*4.59*
Vietnam	0.35	-	-	0.00	0.35	0.13	0.48
Zambia	-	-	-	-	-	0.13	0.13
Total EM Sovereign bonds	**15.99**	**3.75**	**7.13**	**10.53**	**35.45**	**44.62**	**80.07**

(1) Including local USD-denominated bonds (2) Including local bonds in EUR (3) Including PDVSA bonds
Source: SG EM Research

CORPORATE LEVERAGE: THE KEY EM RISK IN 2016?

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Gross debt and leverage have increased sharply in EM corporates in recent years, yet corporate bonds in US dollars have been the best performing EM asset class so far in 2015. This is most likely due to the difficulty in shorting the market; prices are likely to be driven wider next year by primary supply used to finance redemptions. A simple default calculation suggests spreads on the index could roughly double as a result.

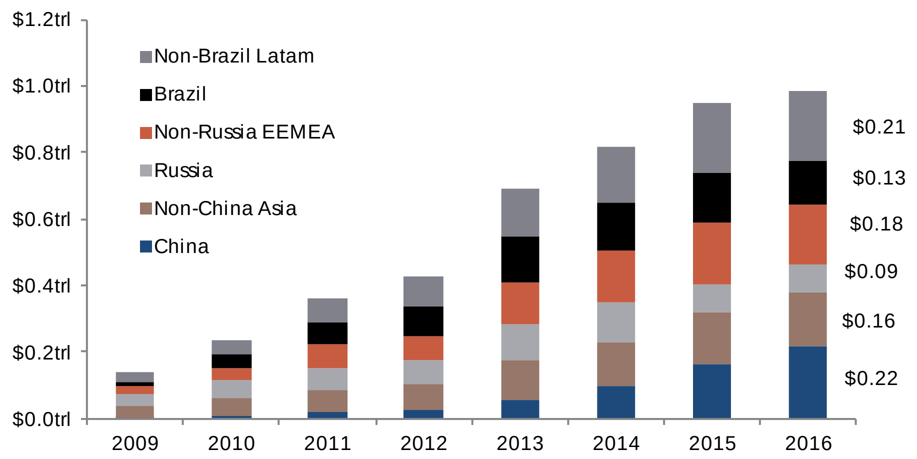
A mighty increase in dollar borrowing

Emerging market corporate debt has exploded since the start of the global financial crisis. In its recently published report on Corporate Leverage in Emerging Markets, the IMF calculates that EM corporate debt has risen from less than 50% of GDP in 2008 to almost 75% now, with Chinese corporate debt alone rising from less than $8tr to more than $16tr over the same period.

So, corporate debt has become the Achilles heel of emerging markets. But the news gets worse. Emerging market corporates have not only borrowed aggressively, they have borrowed in dollars. A report from the BIS earlier this year made the point that most of the dollars created since 2007 have either been lent to the US government, or to non-US corporate, particularly in emerging markets. Both the BIS and the IMF reports make the point that corporate bond issuance has grown as a percentage of total debt.

So it should come as no surprise that hard currency EM corporate debt has been growing by leaps and bounds. The chart 1 (based on the iBoxx USD-denominated hard currency debt index) shows the growth in outstanding dollar-denominated corporate bonds since 2009:

Chart 1: Tenfold increase in USD-denominated EM corporate bonds since 2009



Source: SG Cross Asset Research

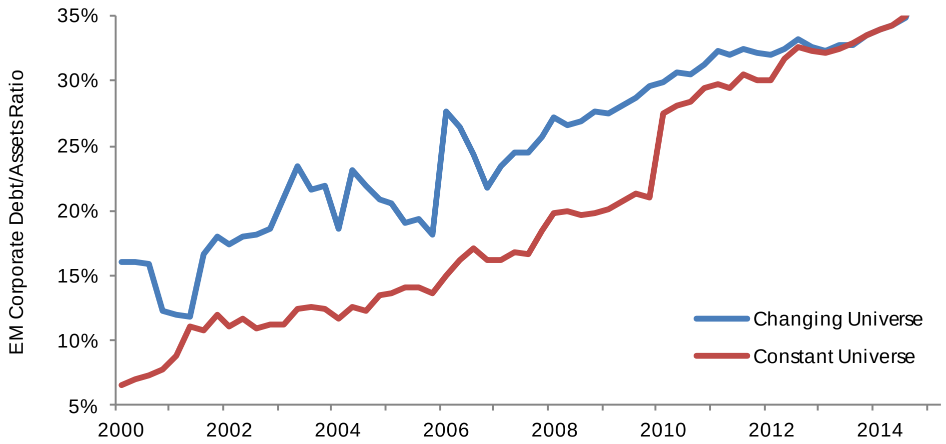
Three trends stand out:

- Total corporate debt has risen at a compound annual growth rate of more than 30% since 2009. The hard currency corporate debt market in 2009 was roughly the same size as the government market; it is now twice as big.
- Asian debt has risen slightly faster than debt in EEMEA and Latam, and now represents roughly two-fifths of the universe, up from a quarter in 2009. By contrast, EEMEA debt has gone the other way, and Latam debt has stayed at one-third of the total.
- Chinese debt has ballooned to almost 60% of all Asian corporate debt, while Russian debt has gone from almost two-thirds to one-third of EEMEA debt. Brazil still represents between a third and two-fifths of all Latin American debt.

Is the growth in corporate debt a worry? It has certainly boosted balance sheet leverage, as the IMF's recent report notes. In Chart 2, we show the evolution of the debt/equity ratio from the companies in the iBoxx emerging markets corporate index. The blue line shows the weighted average balance sheet leverage of the companies in the index at each period; the red line shows the leverage for a constant universe, based on the current weights of the current companies in the index.

The chart shows that balance sheet leverage has roughly doubled, and is now comparable to the levels in the US market (at 32%). The data from the start of this century is spotty, so we wouldn't necessarily be sure about the magnitude of the increase, but the trend at least is clear.

Chart 2: Balance sheet leverage amongst the iBoxx companies has doubled



Source: SG Cross Asset Research

Part of the rise in leverage on the index may be due to changes in the index, however. Charts 2 and 3 compare the composition of the iBoxx index by industry sector in 2009 and now. Six years ago, half the companies in the index were commodity and mining companies. Now that percentage has shrunk to a third, with financials making up another third. The rather worse news is that cyclicals, which normally have low levels of balance sheet debt, have overtaken non-cyclicals like telcos and utilities.

All the same, even with the changes in the index, the rise in balance sheet leverage is worrying, and one might have expected this sector to lead the recent EM sell-off. But it hasn't.

Chart 3: Index was dominated by mining & energy

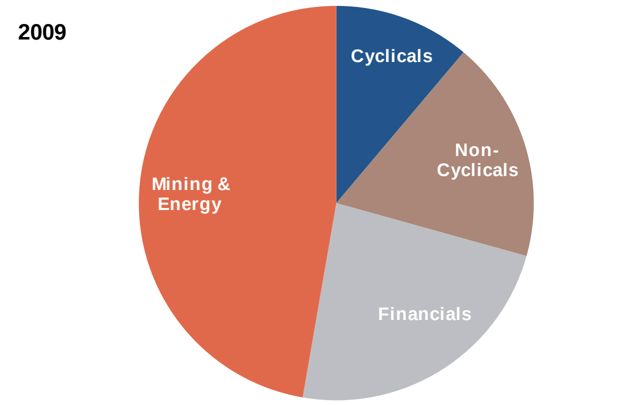
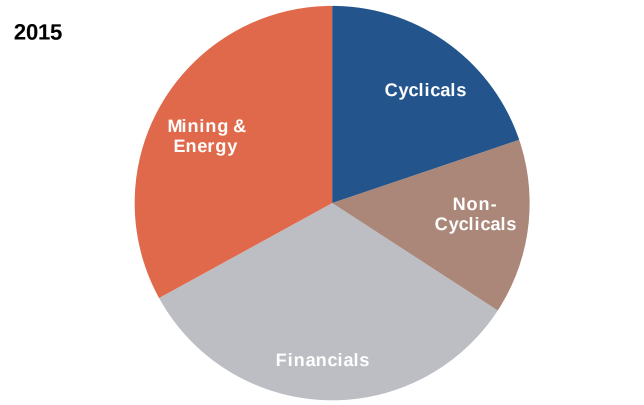


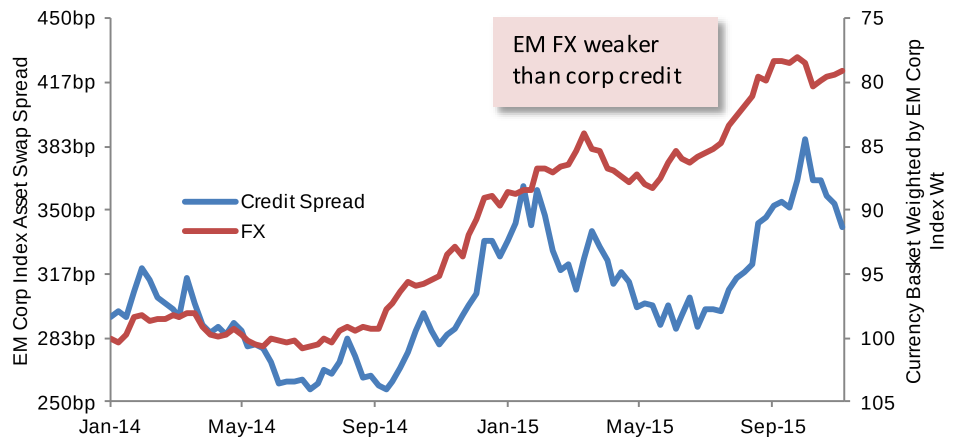
Chart 4: Now better balanced, but more cyclicals



Source: SG Cross Asset Research

Chart 3 compares the performance of the EM corporate bond index in USD with the performance of EM currencies since the summer of 2014, when both markets came under pressure. EM currencies dropped and spreads widened through the second half of 2014; however, between January and May 2015, the EM corporate bond market recovered, and almost returned to the levels seen in mid-2014. EM currencies, by contrast, remained weak – though they did not weaken further. When corporate bond spreads started to widen again from the end of Q2 2015, currencies suffered another decline. So the currency markets have had two successive waves of selling, while EM corporates are only back to the levels seen in early 2015.

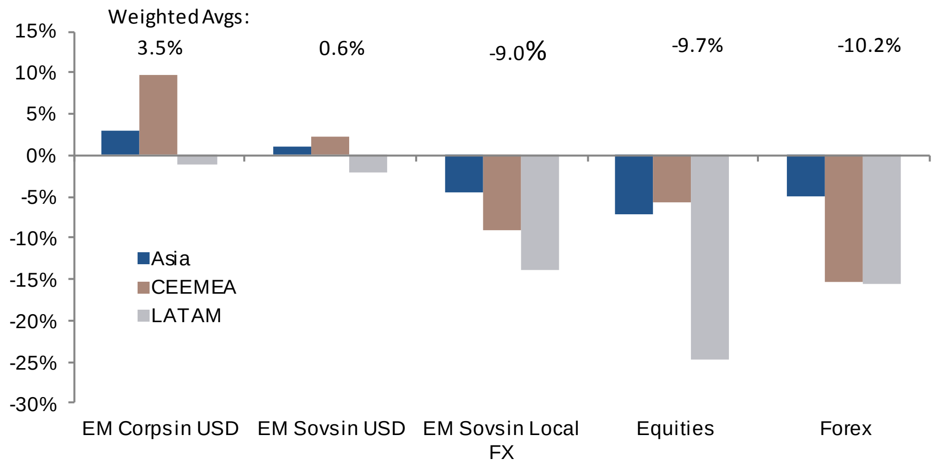
Chart 5: EM Corporates have held up better than EM currencies



Source: SG Cross Asset Research

There are three possible explanations for the relative resilience of EM corporate bonds. The first is that the Asian part of the index has grown, and despite the recent Chinese stock sell-off, Asian currencies and Asian equities have been better performers over the past fifteen months than Latam or CEEMEA forex and stocks. This, however, has been reflected in the FX index that we constructed above. Moreover, a look at the performance of asset classes by geographical sector suggests that corporate bonds have performed everything else, even on a regional basis:

Chart 6: Corporate bonds have outperformed other assets classes



Source: SG Cross Asset Research

The second is that the increase in the Chinese weight in the index has actually improved ratings. Charts 6 and 7 compare the evolution of the ratings in the corporate index over the past six years. Chinese corporations are some of the best rated in the index, so the increase in Chinese corporations has boosted the average rating from BBB to Single A.

Chart 6: The average rating used to be BBB

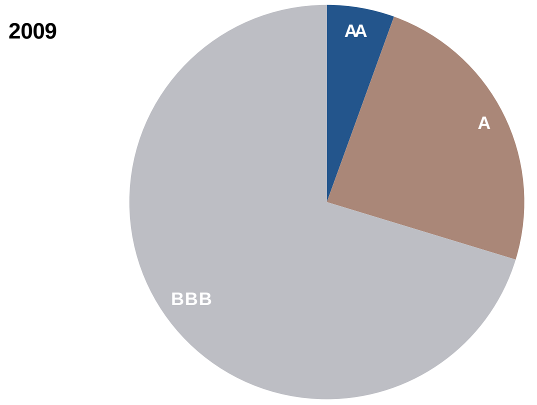
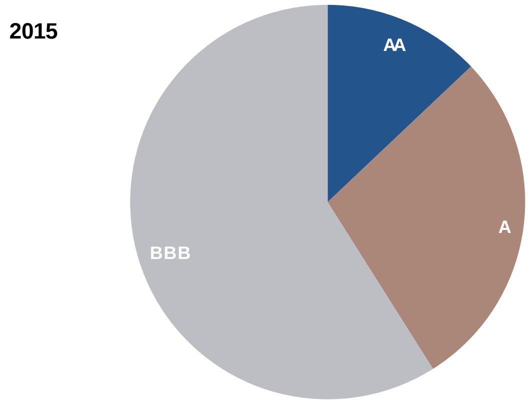


Chart 7: Now it's closer to Single A

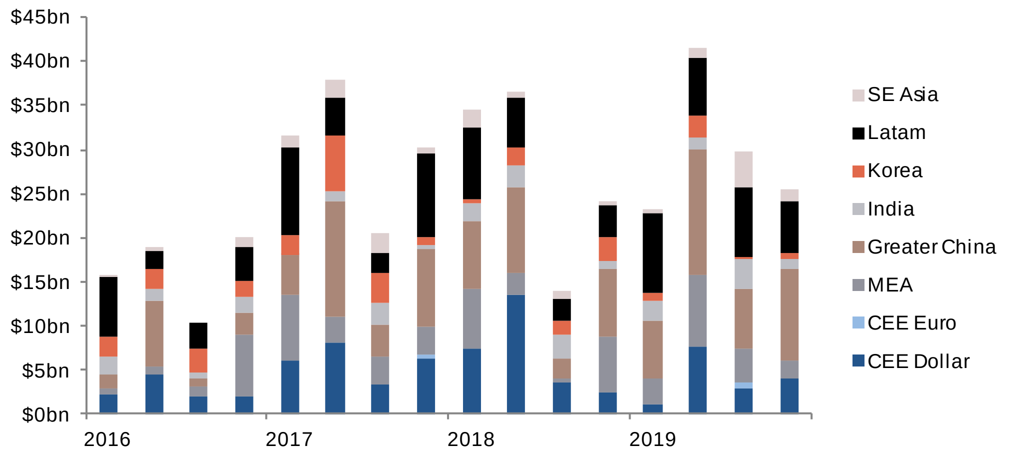


Source: SG Cross Asset Research

The final and most convincing explanation could simply be liquidity. EM corporate markets are far less liquid than EM FX. As a result, EM investors could simply be selling the currency as a proxy for shorting corporate bonds. In this case, corporates would only reprice when they need to issue.

And they will need to reissue. The weighted average cash level as a percentage of assets in the sector has dropped from 12% in 2008 to just under 8% now, while the weighted average quick ratio (current assets divided by current liabilities) has dropped from more than two to less than one over the same period. Chart 7 shows the EM country redemption schedule by country, and emphasises how there is close to $15bn of refinancing needs each quarter in 2016, and almost $30bn per quarter in 2017.

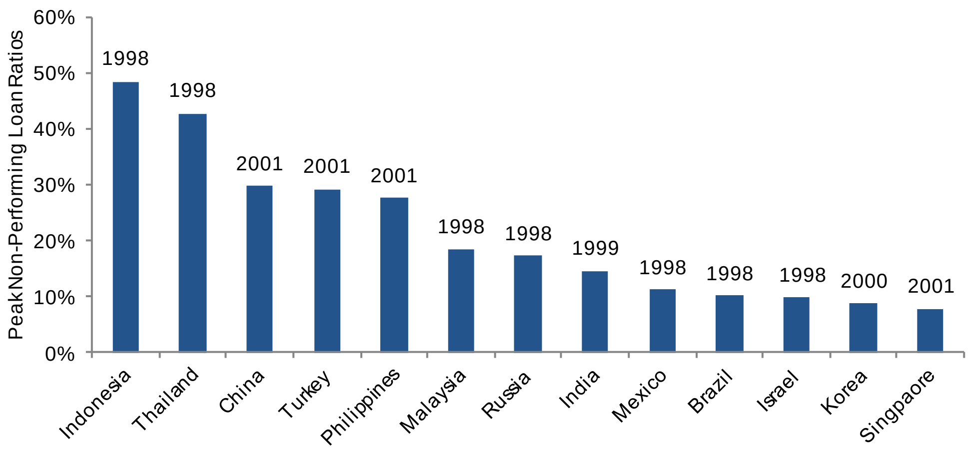
Chart 7: EM redemptions coming thick and fast



Source: SG Cross Asset Research

If EM corporates did sell off, how far could they drop? To answer the question, investors would need to make assumptions about defaults and recovery rates. Given the recent history of the EM corporate market, historic default rates are not much use; instead we should build default expectations from non-performing loans. Chart 8 shows the peak level of NPLs experienced by a range of EM economies over the past twenty years, ranging from almost 50% in Indonesia to closer to 10% in the Latam countries.

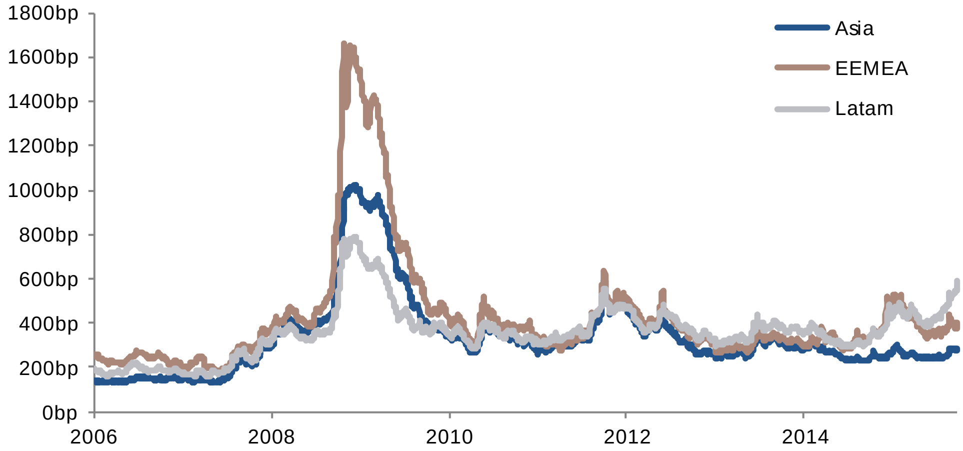
Chart 8: How high could defaults go?



Source: SG Cross Asset Research

Defaults are positively correlated with the growth in debt, so it would make sense to assume a high level of defaults in the very weak economic growth scenarios we are discussing. Assuming 30% defaults with a 30% recovery rate would imply cash prices on the index of just under 80, which in turn implies a spread on the index of 800bp. With a similar recovery rate and a 50% level of defaults, the implied spread would rise to 1200. In fact, the move could be worse than that. Chart 9 offers a reminder of where spreads went in the 2009 period, with an increase to 1600bp in EEMEA. The worst may well be yet to come.

Chart 9: History suggests EM corporate spreads could go a lot wider



Source: SG Cross Asset Research

Cross Asset Country Pages

SOUTH AFRICA

ZAR – vulnerabilities to trump technicals

- ZAR to depreciate further due to its use as an EM proxy and high exposure to China; NEER and REER weakness to remain in place
- A credibly hawkish SARB to act as the sole mitigating factor

USD/ZAR*: SG forecasts

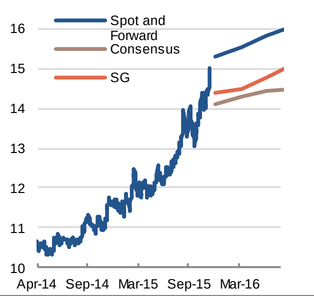
Date	Forward	SG	Consensus
Q1'16	15.55	14.50	14.3
Q2'16	15.81	14.80	14.3
Q3'16	16.09	15.10	14.5
Q4'16	16.41	15.45	14.5

Source: SG Cross Asset Research/EM

Outlook – Structural constraints dampen growth perspectives

Real GDP growth is likely to remain tepid in 2016, with electricity constraints both restricting aggregate output and discouraging investments. Just one year after the elections, support for the ANC is eroding and political tensions are increasing. A fast deterioration in the fiscal stance (plagued by SAA, Eskom) and weak growth threatens to shift the sovereign rating below investment grade in H1'16, following the budget release in February. High unemployment and regulatory uncertainties limit domestic demand and decelerating global growth is weighing on exports. The current account deficit is likely to remain elevated despite the stabilisation in terms-of-trade, with weaker export commodity prices outweighing modest tailwinds from depressed oil prices. Despite reliance on portfolio flows to finance the balance of payments, South Africa's limited USD debt exposure mitigates its external vulnerabilities.

Forwards trading in panic mode

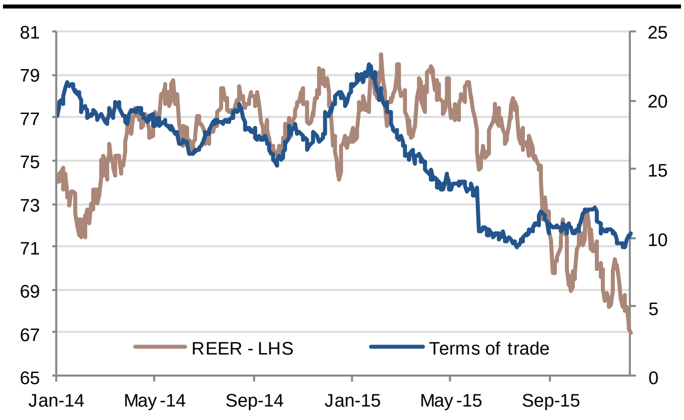


Source: SG Cross Asset Research/EM

ZAR – A potpourri of domestic vulnerabilities, bellwether for risk appetite

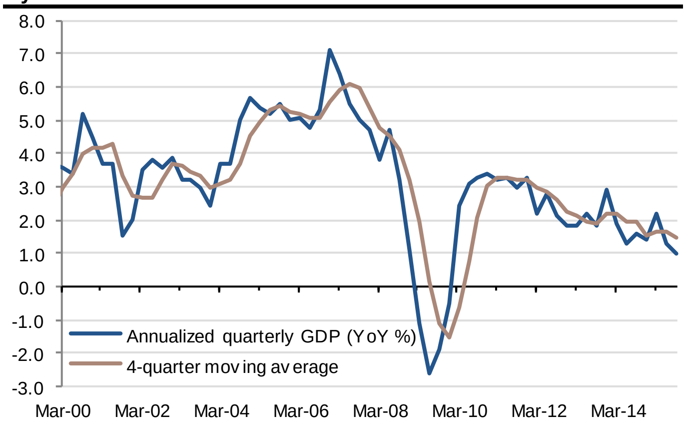
The prevailing trend of ZAR NEER and REER depreciation since 2011 is likely to remain in place in 2016, in light of lacklustre domestic growth prospects, output constraints, structural impediments to competitiveness, fiscal pressure, and the threat of higher sovereign financing costs. The ZAR's prominent usage as an emerging markets proxy will likely subject the currency to repeated bouts of violent oscillations, particularly on news regarding Chinese growth or demand for commodities, or as the FOMC rates lift-off gets underway. In the absence of a material improvement in domestic economic growth prospects, we believe the ZAR will continue on a trajectory of gradual currency depreciation by year-end 2016. Near-term unchecked depreciation due to deterioration in investors' confidence in the economic team and strong signs of political interference may need to be addressed by the SARB. The likelihood of FX intervention remains remote, allowing the currency to act as an economic shock-absorber. The depreciation path should be moderated by the SARB following through on its hawkish rhetoric in 2016. Above and beyond macroeconomic concerns, strongly compelling valuations for tactical trades might fuel sharp oscillations throughout the next year.

Sharp REER correction has front-run the deterioration in terms-of-trade



Source: Bloomberg, SG Cross Asset Research/EM

Structural impediments bode negatively for deeper growth dynamics



Source: Bloomberg, SG Cross Asset Research/EM

Rates – ZAR rates to march higher on risk re-pricing

- ZAR IRS and local government bond yields to increase as investors demand a larger term premium
- SARB's reaction function less sensitive to currency weakness and very data-dependant

SARB policy rate: SG forecasts

	SG	Consensus
Q1'16	6.50	6.45
Q2'16	6.50	6.50
Q3'16	6.75	6.75
Q4'16	7.00	6.85

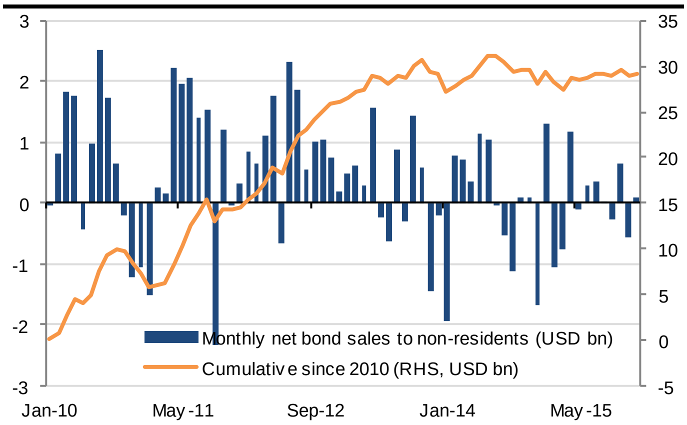
Source: SG Cross Asset Research/EM

Outlook – Beware of fiscal headwinds

Flagging global growth, concerns regarding prominent domestic economic challenges and still-accommodative monetary policy in most developed and emerging markets afford the SARB the leeway to enact a paced rate-hiking cycle in 2016. We project that policy rates will reach 7% by the end of 2016. Despite domestic growth worries, the SARB will be unlikely to heed calls for delaying normalisation to spur output, in the interest of defending its inflation-targeting mandate and protecting vital portfolio flows into the government bond market. Inflation will head higher, but is unlikely to soar unchecked, restrained by the frail demand environment and still-weak commodity prices. The SARB expects that inflation may temporarily breach the upper bound of the reserve bank's 3-6% target band in both 1Q 2016 and 4Q 2016, driven by ZAR depreciation and base effects from depressed 2015 petrol prices. SAGB real bond yields and spreads over US Treasuries may marginally decline, eroded by rising inflation in South Africa. In turn, we anticipate that nominal ZAR IRS and local government bond yields are likely to climb higher as investors demand a larger term premium to compensate for rising inflation and the troubled growth and fiscal outlook.

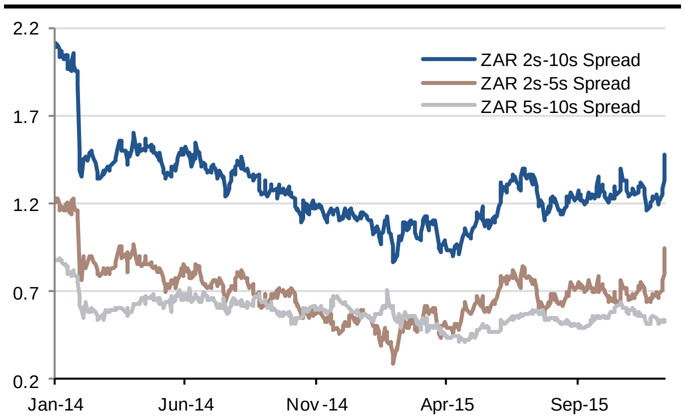
In light of the negative fiscal impact from the current public sector wage agreement and ongoing pressure to support state-owned enterprises (Eskom, SAA) the government remains at risk of further fiscal slippage. The recent changeover at the helm of the Ministry of Finance, boding for a rise in cronyism and political influence over economic policy, may entail higher budgetary allocation for the nuclear build programme and further support for inefficient SOEs next year. Delays in applying necessary fiscal restraint will weigh on sovereign credit ratings and reflect negatively on risk premium for South African assets. A downgrade below investment grade (below BBB- by S&P and below Baa3 by Moody's) will trigger South Africa's dropping out from selected flagship (EM) local currency bond indexes i.e. Citi's WGBI and GBI-EM Global Div IG. These actions could create a more sustainable negative stream of capital outflows, compared to a volatile path of portfolio investments over the past months.

Net local bond inflows data reflective of a volatile appetite and opportunistic foreign investors' appetite



Source: SG Cross Asset Research/EM, Bloomberg

ZAR IRS curve may maintain a flattening bias on gradual policy normalisation



Source: SG Cross Asset Research/EM, Bloomberg

TURKEY

- Internal political feuds, regional violence and reshuffle of the CBRT Board to act as idiosyncratic threats to the lira
- Improvements in external imbalances, resilient growth to mitigate negative bias

TRY – Back to business-as-usual

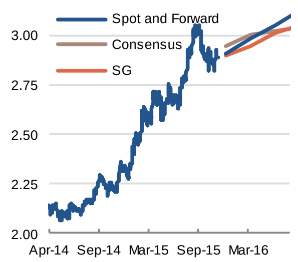
Outlook – Not all bad

	Forward	SG	Consensus
Q1'16	2.98	2.95	3.01
Q2'16	3.06	3.02	3.03
Q3'16	3.13	3.05	3.04
Q4'16	3.21	3.10	3.04

Source: SG Cross Asset Research/EM

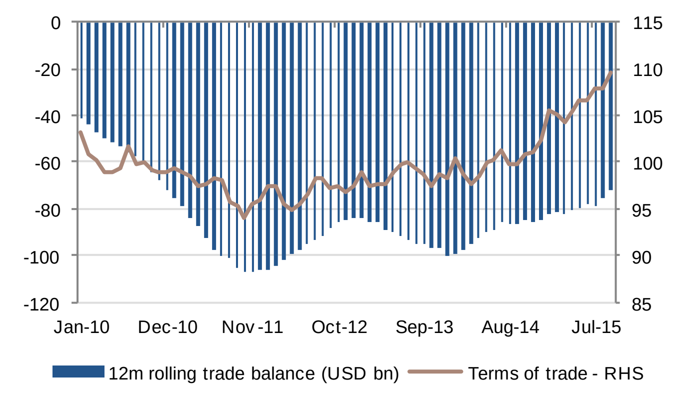
Following the triumph of AKP following the 1 November 2015 elections, investors' attention will be deflected towards the cabinet reform agenda. President Erdogan's daunting influence over AKP leadership and his ambitions to implement an executive presidency pose risks for internal political stability - these factors exacerbate the clash between Turkey and PKK/Kurdish separatists, and add to the strain of the regional conflict against Islamic State. Turkey's gross external financing needs in 2016 (exceeding 25% of GDP) render the country vulnerable to episodes of capital flow reversals, while elevated short-term debt (at roughly 16% of GDP, bulked in the private sector) highlights roll-over risks. On the positive side, the current account deficit may yet shrink further in 2016, as the country continues to benefit from lower energy import costs, a shift in growth composition toward net exports, and may likely enjoy a trade boost from the potential lifting of Iran sanctions. However, the upside might be eroded by potential economic sanctions applied by Russia. 2016 GDP growth may hover at 3%, with investment and domestic consumption hindered by lingering regional tensions, and by the corporate sector's prominent FX asset-liability mismatch.

SG view broadly aligned with consensus



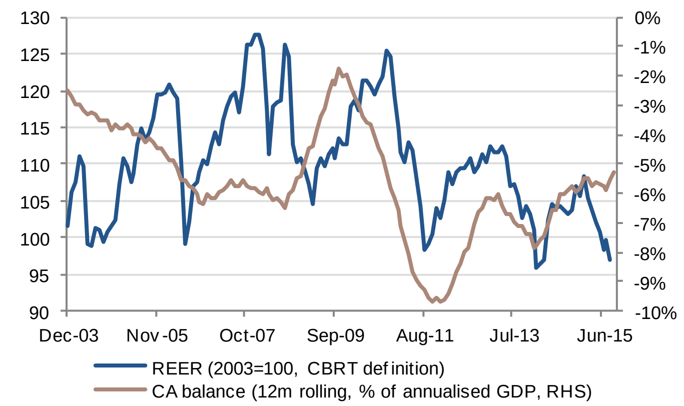
Given Turkey's still-high external vulnerabilities and large FX indebtedness of the private sector, TRY will remain at the mercy of poor risk appetite and weak capital inflow dynamics in 2016. Regional violence will likely persist through the year, existing alongside a central bank reluctant to adequately hike interest rates to address sticky and rising inflation. That said, we anticipate some further recovery in TRY valuations on the heels of the formation of a stable government, alongside the confirmation of a shallow FOMC rate normalization, and progress (albeit snail-like) on EU accession negotiations. The need for a strong cohesive geopolitical stance may dilute the frequency of internal political feuds and defer the President's ambitions for executive Presidency. A pick-up in economic activity during 1H'16 from the materialization of previously postponed investment and private consumption may prove supportive for TRY. That said, we see scope for entering relative value structures (i.e. long TRYZAR) as a cheaper worst-of option reflecting domestic idiosyncrasies.

Terms of trade have improved steadily over the past year



Source: SG Cross Asset Research/EM, Haver Analytics

...thus contributing to better TRY valuations



Source: SG Cross Asset Research/EM, Haver Analytics

Rates – A slow grind towards a simpler policy stance

- TURKGB nominal yields likely to remain elevated in light of rising inflation
- Front end rates to climb as monetary policy simplification progresses

CBRT 1 week repo: SG forecasts

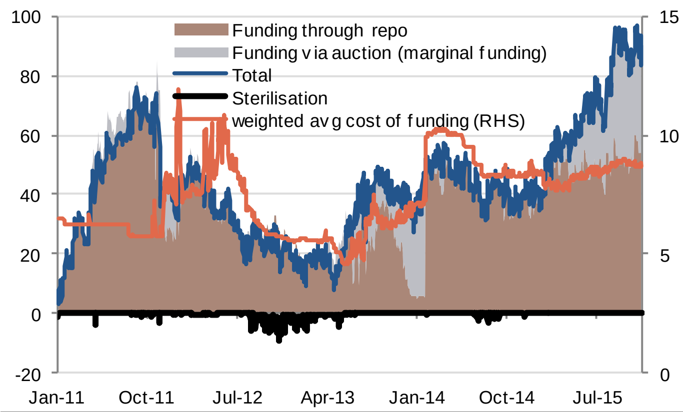
	SG	Consensus
Q1'16	7.75	8.65
Q2'16	8.00	8.75
Q3'16	8.00	8.80
Q4'16	8.25	9.35

Source: SG Cross Asset Research/EM

The Central Bank of the Republic of Turkey (CBRT) may transition toward more orthodox monetary policy via the narrowing of its interest rate corridor in 2016. We anticipate that the interest rate corridor will converge towards a tighter spread around the current effective funding cost (or weighted average cost of CBRT financing). The repo rate may climb by year-end 2016 roughly 50-75bp higher than the current level of 7.50%. Our base case scenario foresees the policy authority commencing the simplification of its monetary policy stance at its meeting on 22 December, by enacting a relatively symbolic 25bp hike in the overnight borrowing rate (to 7.50%) and the benchmark repo rate (to 7.75%). Down the road, further simplification of the policy stance will probably be very gradual. Although market participants will appreciate the improved transparency and predictability of the monetary policy stance, the reduced reliance on the wide interest rate corridor, accompanied by no progress in terms of political leeway might act as a strait jacket for the CBRT going forward. The overall impact on the cost of funding will be marginal, and could easily be neutralised by greater reliance on repo funding, rather than the marginal liquidity supply operation (at 10.75%). While we see scope for a de-facto tightening to anchor CPI expectations more decisively (2y breakevens at 9.2%), we suspect that this will be delivered reactively and only if the currency comes under intensified pressure.

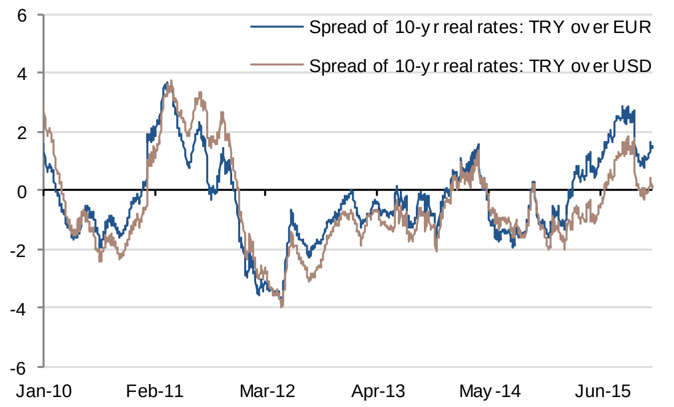
Headline inflation is likely to substantially exceed the CBRT's estimate of 5.5% at year-end 2016, due to lagged effects of currency depreciation and a trough in global commodity prices. Intense political pressure and scrutiny of the CBRT are unlikely to abate, which may translate into the central bank's continued reliance on liquidity-tightening facilities in periods of market stress. Front end TRY cross-currency rates may re-steepen (or become less flat), aided by the CBRT's gradual simplification of monetary policy, and by a stronger TRY in the context of relatively more stable domestic political dynamics. Bond outflows from the Turkish government bond market may slow to a halt during 1H 2016, possibly reversing modestly on improving investor sentiment. However, throughout the year, nominal cross-currency rates and TURKGB yields are likely to remain elevated in light of rising inflation, resulting in some further erosion of real yields and differentials over US Treasuries.

CBRT to (reluctantly) mimic liquidity conditions by gradually lifting repo rate (CB funding and weighted avg funding cost-RHS)



Source: SG Cross Asset Research/EM, CBRT

The recent compression in real TURKGB yields (vs DM rates) limit the appeal of long duration products (% yield spread)



Source: SG Cross Asset Research/EM, Bloomberg

Sovereign Credit – Unfavourable risk/reward

- Fiscal discipline remains a strong anchor point for the credit
- However, the country remains vulnerable to external shocks
- Turkish spreads are not pricing enough of a risk cushion; we are underweight Turkey

Turkey Credit Ratings

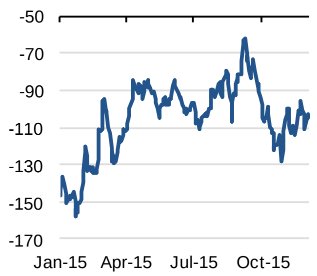
Agency	Rating	Outlook
S&P	BB+	Negative
Moody's	Baa3	Negative
Fitch	BBB-	-
SG Fair	BB+	-

Source: SG Cross Asset Research/EM

Credit fundamentals – Lots of risk ahead

Turkey's credit fundamentals are mixed. On the one hand, GDP growth remains higher than the EM average, the public debt/GDP is low (33%, in secular decline), lastly the track record in terms of fiscal policy is very solid, as the deficit is consistently kept below 2% of GDP. The commodity environment, on balance, is also very supportive for the Turkish economy, especially the fall in crude prices. On the other hand, Turkey remains fundamentally vulnerable to external shocks. The current account deficit has improved – to large degree due to the fall in oil prices – but with a gap reaching 4.5% of GDP, it is still one of the largest in EM (only Colombia and sub-Saharan countries have wider external deficits). If the Russian sanctions on Turkey (on food imports and tourism) were to be implemented, the deficit would be under pressure once again. Although the overall level of external debt is contained at around 53% of GDP, a high percentage (33%) is classified as short term. In fact, FX reserves cover only 75% of short-term external liabilities, which makes the country particularly vulnerable to capital outflows. In other words, the risk in Turkey is essentially linked to a hard currency liquidity squeeze (especially in the corporate sector), rather than a solvency issue. Lastly, the geopolitical situation in the region is an additional factor which could durably weigh on investor confidence and foreign direct investment, the latter being already quite low by EM standards. S&P and Moody's currently have Turkey on negative outlook; a downgrade from Moody's would mean Turkish bonds drop from the investment grade indices.

Turkey spread vs index (bp)

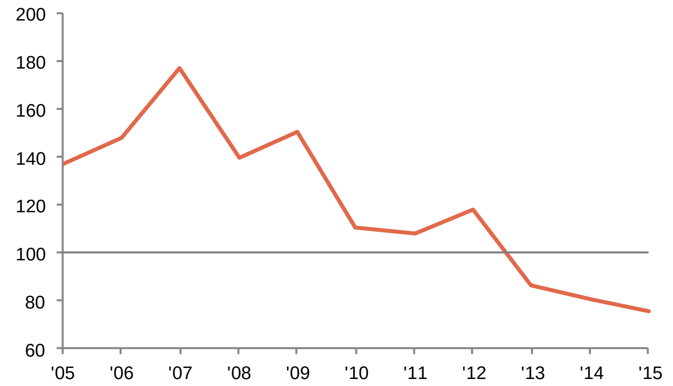


Source: SG Cross Asset Research

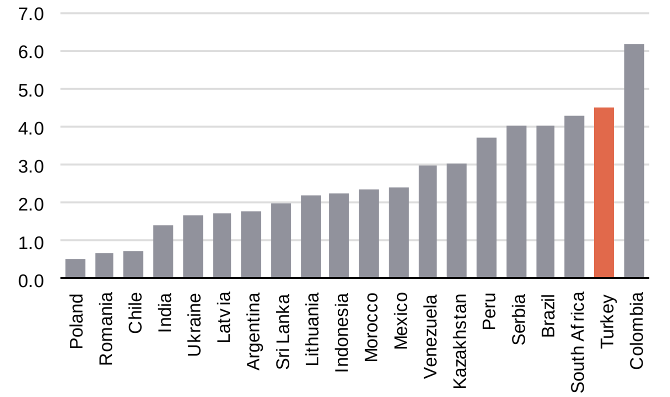
Positioning – Underweight

Turkish bonds are now trading close to fair value versus macro fundamentals, but a sustained Fed hiking cycle would put Turkey under intense pressure. Moreover, the risk is to see the implementation of extensive sanctions by Russia, which would hit the economy hard, and more specifically the current account which is already a weak point in Turkey. We think that risk/reward on Turkish external debt has become unfavourable, as the spread premium is insufficient to cover potential downside. We hold an underweight exposure to Turkey.

FX reserves cover only 75% of short-term external debt
Turkey FX official reserves/Short-term external liabilities (%)



Turkey still has one of the largest C/A deficits in EM
Current account deficit by country (Forecast 2015, % of GDP)



Source: SG Cross Asset Research/EM

RUSSIA

- Stabilising oil price, improving capital inflows and bourgeoning current account surplus to support the RUB next year
- RUB valuations to follow the RUB3,000-3,500 oil price range

RUB – Looking for solace in commodity markets

Outlook – Healing deep wounds

Persistently weak crude oil prices in 2016 (SGf: USD 50-60/bbl) are likely to limit Russia's economic recovery (SGf: 0% yoy in 2016 vs -3.5% yoy in 2015), with the government's budget constrained by bloated expenses, while private consumption will remain susceptible to negative income shocks from high inflation. Russia's fiscal stimulus programs may produce only negligible positive contributions to growth, although reductions in conditional spending and in transfers to regions may enable the fiscal deficit to decline to 3.4% of GDP in 2016. We anticipate that the current account surplus should stay robust in 2016 at about 5.1% of GDP next year, shrinking only slightly from 2015 levels, as the import volumes will remain subdued due to pressured consumer activity. Capital market sanctions against state-owned enterprises are likely to remain intact next year, but more open communication channels between Russia and the West should help reduce the geopolitical risk premium.

USD/RUB forecasts, forwards, consensus

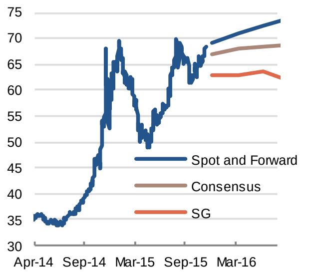
Date	Forward	SG	Consensus
Q1'16	70.80	63.00	68.00
Q2'16	72.43	63.50	68.52
Q3'16	74.03	61.90	68.69
Q4'16	75.60	59.80	67.60

Source: SG Cross Asset Research/EM

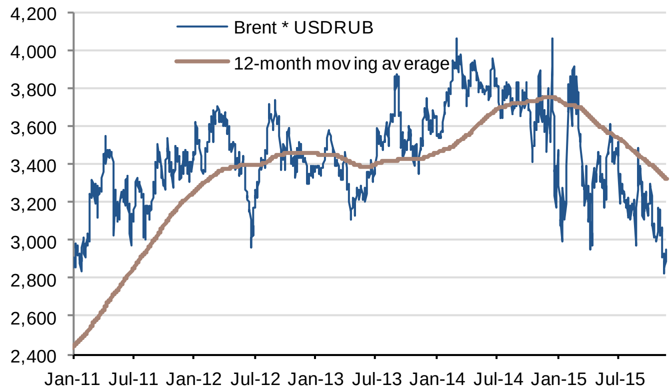
FX – RUB to gain on stabilising oil prices, supportive current account

The RUB continues to exhibit a high correlation with crude oil prices (correlation of 70-80%); the currency's trajectory in 2016 will likely depend largely on oil price developments. The relative de-escalation of geopolitical tensions, expansion of the current account surplus, ongoing government debt redemptions, and declining retail FX purchases have together helped to improve liquidity in the domestic currency markets. Despite the headwind of the Central Bank of Russia's (CBR) plan to replenish FX reserves (back to USD 500bn over a 3-7 year period), the CBR's FX liquidity facilities partially counter pressures on the RUB. Additionally, capital outflows are likely to subside further. We expect the RUB to strengthen in both REER and NEER terms in 2016, and forecast that the USD/RUB will decline to 59.8 by year-end 2016. We note that currency risks persist from elevated oil price volatility as well as a widening fiscal gap (to which letting the USD/RUB rise could be a solution).

SG view more bullish than consensus

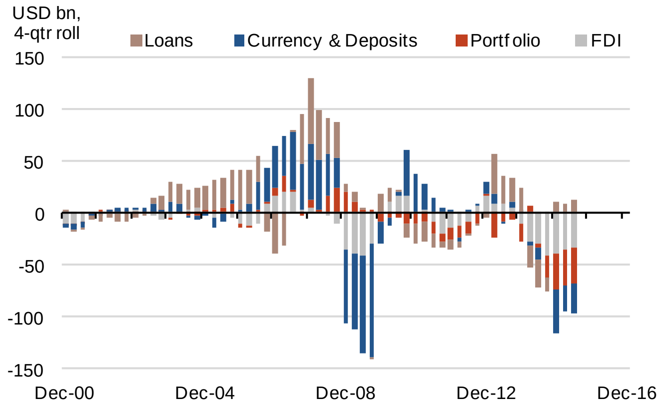


RUB-oil price remains a key indicator of ruble valuation (RUB-denominated Brent oil price and 12m ma)



Source: Bloomberg, SG Cross Asset Research/EM

Panic capital outflows prevailing in 2014 have subsided year-to-date (financial account breakdown, USDbn, 4q rolling)



Source: CBR, Bloomberg, Rosbank, SG Cross Asset Research/EM

Rates – Diligently front-running the CBR

- Parsimonious issuance allowing OFZ nominals curve to trade at a discount to the CBR key rate
- Steep disinflationary trend and renewed expectations for resumption of monetary easing by the CBR to support steepening bias

CBR policy rate: SG forecasts

	SG	Consensus
Q1'16	9.00	9.75
Q2'16	8.50	9.00
Q3'16	8.00	8.45
Q4'16	7.50	8.00

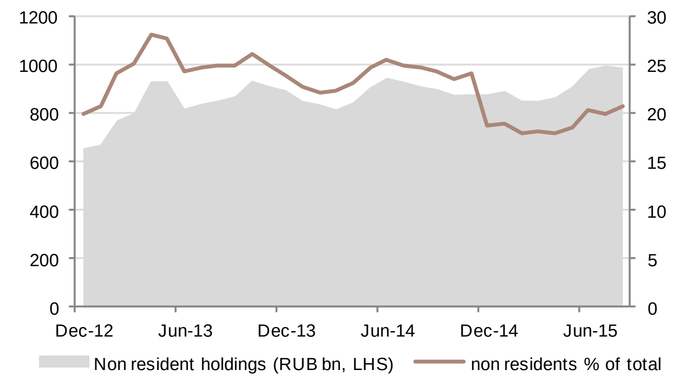
Source: SG Cross Asset Research/EM

While the CBR will likely remain sensitive to the external environment – in particular, the volatile pattern for the RUB – we expect prioritization of economic growth concerns to eventually take precedence. Demand-pull factors from the weak domestic demand environment and a supportive statistical base remain conducive to sharp yoy disinflation over the coming year. Indeed, inflationary risks stemming from higher tariff revisions and from fiscal expenditures are dissipating, although upward pressure on inflation from exchange rate pass-through still persists as a threat.

We anticipate further monetary easing through 2016, with the CBR's key rate descending to 7.5% yoy by year-end 2016, prompting intermittent steepening pressures on the 1s-5s spread of the RUB x-ccy curve. That said, any escalation in RUB weakness may slow the pace of CBR FX purchases and of monetary policy easing. Domestic liquidity conditions continue to improve, mostly due to sizeable inflows of budgetary liquidity (RUB2.6trn, ytd) that enables banks to decrease their indebtedness to the CBR and keep front-end money market rates within 100bp of the CBR key rate. Furthermore, unlike the same period in 2014, Russian banks appear to have no shortages of USD liquidity at present as utilization of the CBR FX repo facility continues to decrease (USD23.7bn now vs the USD50bn cap).

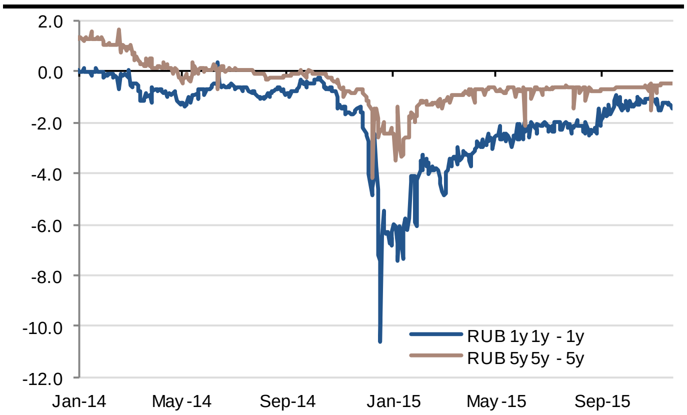
OFZs are likely to benefit from continued monetary policy easing in a disinflationary context. Reflecting normalization of previously tight monetary policy, the OFZ yield curve is likely to steepen further, while the yield on the 10-year local government bond may decline to 8.5% by year-end 2016. Despite Russia's sovereign credit rating downgrades in early 2015 to non-investment grade by both S&P and Moody's, non-resident holdings of OFZs have gradually increased since end-Dec to 20.7% in 3Q 2015. Investor absorption of future (paced) OFZ issuance will likely remain high, in our view. Retracement of Brent above $50/bbl will be supportive for international funds inflows, which are usually skewed towards the back-end in order to capitalize on duration effect. Our positive stance on OFZs is also supported by the moderate borrowing plans of the MinFin for Q4 15 and the year to come, while primarily relying on the utilisation of the Reserve Fund.

Foreign investor base for RUB bonds edging higher, despite a volatile Q3 for EM (OFZ holdings RUB bn and % of total, RHS)



Source: CBR, SG Cross Asset Research/EM

Expect further curve steepening, resulting in a gradual reduction of the negative carry in rates



Source: Bloomberg, SG Cross Asset Research/EM

Credit – Deteriorating fundamentals, but value in corporates

- From a pure sovereign standpoint, Russia's creditworthiness is still quite strong
- But depleted oil prices, banks and corporate liabilities are eroding fundamentals
- Russian corporate spreads can nonetheless return to EM average levels and outperform the index in 2016.

Russia facing deteriorated oil prices and contingent liabilities

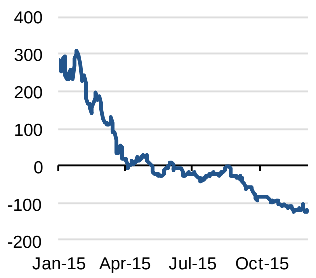
From a pure sovereign standpoint, Russia's creditworthiness is still solid: the fiscal deficit has soared due the fall in crude prices and the economic recession, but the level of public debt remains muted (21% of GDP), which gives the government room to manoeuvre. External short-term liabilities are very limited for the sovereign (only 2.4% of GDP), so the international sanctions are not real constraint in that respect. Despite the fall in oil prices, the current account has strengthened further to around 5.0-5.5% of GDP, although this improvement is due largely to the compression of domestic demand. In fact, the main weakness in Russia is the corporate and banking sectors, where the consequences of sanctions have been felt the most. The aggregate level of external private debt is moderate (33% of GDP, slightly below the EM average), but the sanctions have made it impossible for many Russian issuers to tap the international debt market to refinance the amortisations due. Although the amount of FX reserves is still high, and even comforted by the strong current account surplus, the use of FX reserves has been (and may continue to be) instrumental to fund the private sector. Banks also remain quite vulnerable: NPLs represent close 7% of total loans, and the sector is largely undercapitalised. Corporate spreads have tightened sharply this year, as the right-hand chart below shows, but the market remains slightly cheap compared with the European average and quite attractive on a relative value basis, particularly on the domestically focused sectors like banks and telecoms. We expect spread tightening to be led by the short end, and see the 5y-10y spread differentials widening in the financial and telecoms sectors.

Russia Credit Ratings

Agency	Rating	Outlook
S&P	BB+	Negative
Moody's	Ba1	-
Fitch	BBB-	Negative
SG Fair	BB+	-

Source: SG Cross Asset Research/EM

Russia spread vs index (bp)

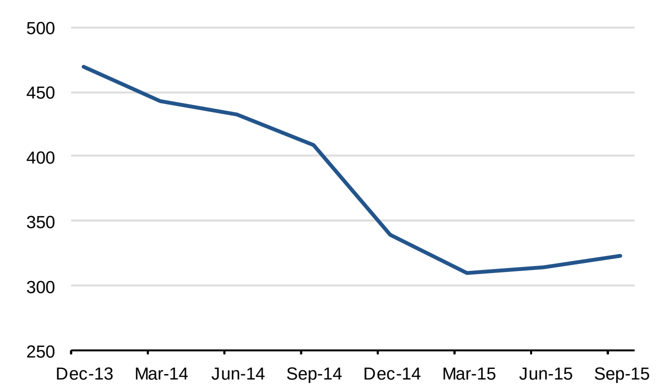


Source: SG Cross Asset Research

Positioning – Sovereign: Neutral; Corporates: Overweight

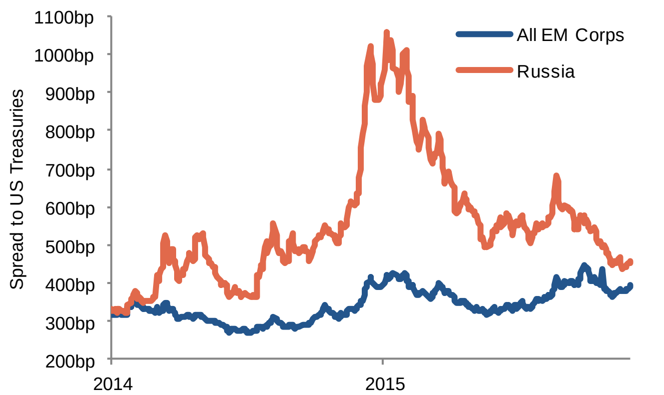
Russian bonds have strongly outperformed the index this year, but this was due largely to the continual buybacks of dollar debt by Russian issuers. In 2016, these technical factors should play a much more limited role, as the sovereign bonds are trading above par. FX reserves are likely to resume falling, but at current level we do not see a significant risk of default for the sovereign or quasi-sovereign names. We leave our exposure to sovereign Russian bonds close to neutral, but would be overweight Russian corporates.

The fall in FX reserves has been contained this year
Russia official FX reserves (USD bn)



Source: IMF

Russian spreads drop steadily in 2015



Czech Republic

CZK – High time to break free

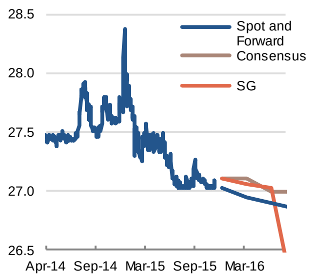
- EUR/CZK to hover above the floor until Q3 16; CNB likely to scrap the FX floor as soon as August 2016
- CZK to strengthen thereafter, but the CNB to actively curb appreciation

EURCZK forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	26.94	27.05	27.10
Q2'16	26.90	27.02	27.00
Q3'16	26.84	26.00	27.00
Q4'16	26.80	26.00	27.00

Source: SG Cross Asset Research/EM

SG bullish vs forwards



Source: SG Cross Asset Research/EM

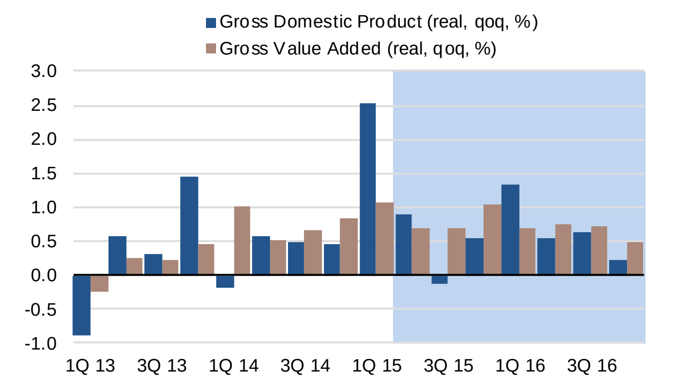
Outlook – Strong fundamentals to prevail, inflation to accelerate

We expect cconomic growth to normalise next year, following the massive expansion of 2015. However, this year's surge (KBf: GDP +4.2% yoy) was driven mostly by one-off factors (i.e. booming EU fund inflows, low oil prices, pickup in inventories). In 2016, household consumption is set to remain the driver of the economy, while investment will slow on the back of an expected drop in the inflow of EU funds. Household spending appetite will be supported by fiscal stimulus measures (higher welfare benefits, tax deductions), and a tightening labour market resulting in wage increases. Inflation is set to accelerate, such that the 2% yoy target will likely be attained by end-2016. The strong domestic economy should propel core inflation, while food and fuel prices could add further upside pressure.

FX – The time for exit is nigh

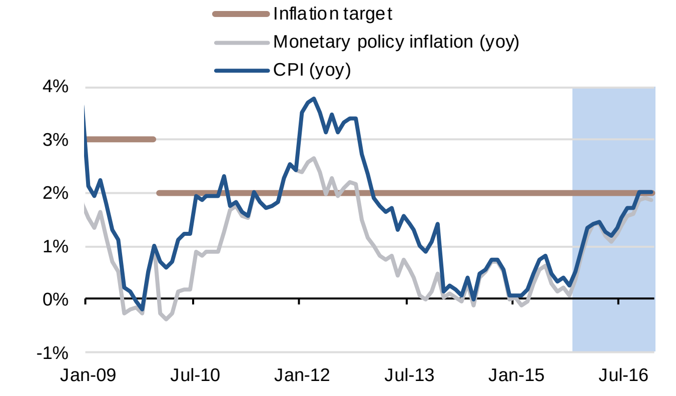
The EUR/CZK floor regime is set to survive until H2 2016. The Czech National Bank (CNB) currently suggests removing the floor at year-end 2016. However, we expect the floor to be scrapped in Q3 16 following a reshuffling of the CNB's board. As of July 2016, two members of the CNB board (including Governor Miroslav Singer) will be replaced by the president, who has long been a political opponent of the floor regime. Thus, the majority within the CNB should shift towards favouring a removal of the FX floor (potentially, in August 2016). Until that point, EUR/CZK will likely hover slightly above the floor level of 27, as fundamentals are expected to remain strong. Following the exit, we expect the CZK to strengthen, but, in line with credible pre-emptive commitments from board members, the CNB will curb any excessive appreciation. We thus look for EUR/CZK to decline no further than 26.00 in H2 16 (please refer to our Long-term view).

Czech economy to retain a solid growth momentum (GDP qoq GVA qoq)



Source: CZSO, Economic & Strategy Research, Komerční banka

Inflation to hit the 2% yoy target by late 2016 (CPI measures, yoy and forecasts)



Source: CZSO, Economic & Strategy Research, Komerční banka

Rates – CZGB yield curve to steepen... eventually

CNB policy rate: SG forecasts

	SG	Consensus
Q1'15	0.05	0.05
Q2'15	0.05	0.05
Q3'15	0.05	0.05
Q4'15	0.05	0.10

Source: SG Cross Asset Research/EM

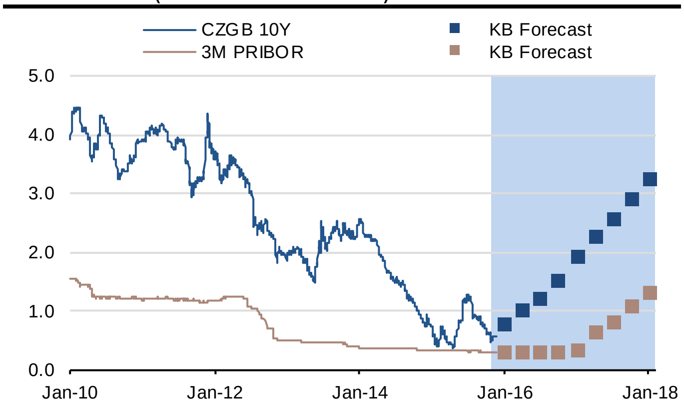
- Tight correlation to EUR rates to trump valuations and maintain the lure of the local market for nonresidents
- Strengthening domestic fundamentals, recovering inflation to eventually offset the ECB gravity force, with 2s5s spread to steepen

We only expect the CNB to commence the hiking cycle after the FX floor is scrapped. Our base case is that the floor will be removed in Q3 16, which would set the stage for the first hike in Q1 17. We expect a total of four hikes to be delivered in 2017. We assign a risk of 40% to a scenario of a CNB deposit rate cut into the negative territory should market pressures on the FX floor intensify materially after the ECB's policy decision in December.

Speculative positions against the floor have driven EUR/CZK x-ccy basis swaps deep into negative territory, while boosting non-resident interest in short-term CZGBs. However, having recovered from September lows, we see scope for recurrent reversal of the basis further into negative territory, particularly as the CNB needs to step up its defence of the floor. The CNB's outright market interventions inflate domestic liquidity and protect demand for local bonds. Indeed, the local bond market has been among the few in EMEA to experience net foreign inflows YTD (CZK59bn as of end September). This trend is set to continue, in our view, with the short end of the CZGB yield curve remaining below zero through mid-2016. Despite the already rich valuations, the long end of the curve will likely remain the most responsive among all CEE4 countries to the performance of Bunds, particularly in the absence of fiscal excesses. The local curve will only gradually start pricing in the reflationary pressures as we move closer to the anticipated changes in CNB policy towards year end.

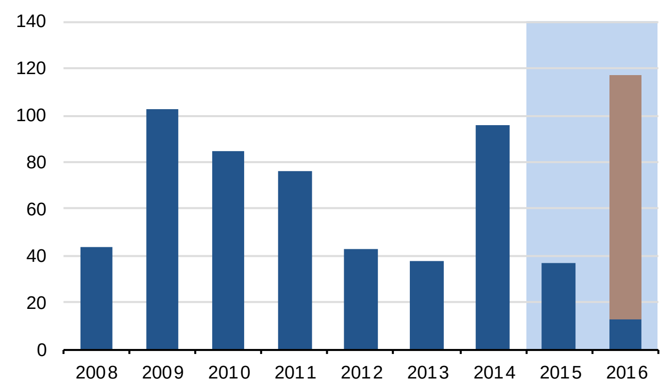
The flattening of the CZK swap curve (e.g. 2s5s) has already outpaced the performance of EUR instruments. Our core scenario relies on strengthening domestic fundamentals eventually offsetting the ECB gravity force, thus allowing (long-tenor) yields to move higher and the 2s5s spread to continue to widen. The plausible risk of a rate reduction to zero to deter speculative capital inflows has eased for now, but a gradual rebound in the CPI is still likely to contribute to more curve steepening in 2016. Our view is also contingent on a sizeable pickup in financing needs (refinancing at negative yields) and the resulting higher CZGB issuance next year, particularly if the Finance Ministry refrains from tapping foreign markets or depleting its liquidity reserve coffers.

CZGB to reflect improving fundamentals and pre-empt policy normalisation (CZK rates and forecasts)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

CZGB issuance likely to pick up in 2016, min/max (CZK bn)



Source: Bloomberg, SG Cross Asset Research/EM

HUNGARY

HUF – Fundamental support undermined by MNB's agenda

- Ample toolkit of monetary easing measures unveiled by MNB, growth slowdown and real rate erosion to result in negative pressures on HUF
- MNB to tolerate and welcome FX weakness
- Supportive account balance, sovereign rating upgrade and ECB QE to limit the upside drift in EUR/HUF

EURHUF forecasts, forwards, consensus

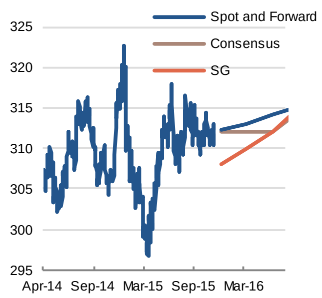
Date	Forward	SG	Consensus
Q1'16	313.33	310	312
Q2'16	314.33	312	312
Q3'16	315.40	315	313.5
Q4'16	316.57	316	315

Source: SG Cross Asset Research/EM

Outlook – Life after EU-funded boom

GDP growth is likely to decelerate closer to the 2.0-2.5% region, with momentum slowing due to limited private investment growth to bridge the hiatus in the use of EU funds (2014-20 financial allocation), still-fragile private consumption and the feeble eurozone recovery. Consequently, exports will continue to play a crucial role in 2016, with the MNB disbursing FX reserves for its FGS EUR lending pillar (for exporters) and entertaining currency depreciation. Given the still-low appetite for re-leveraging (SME +0.7% yoy, retail -12.3% yoy Sep), the MNB's efforts to improve disposable income (FX conversion scheme), and stimulate SME lending (FGS, preferential IRS and deposit facilities) are unlikely to unlock much upside in domestic demand. The Hungarian authorities are likely to reduce external vulnerabilities further via stimulating domestic ownership of HUF securities and using FX reserves to extinguish upcoming external debt repayments.

SG bullish vs forwards

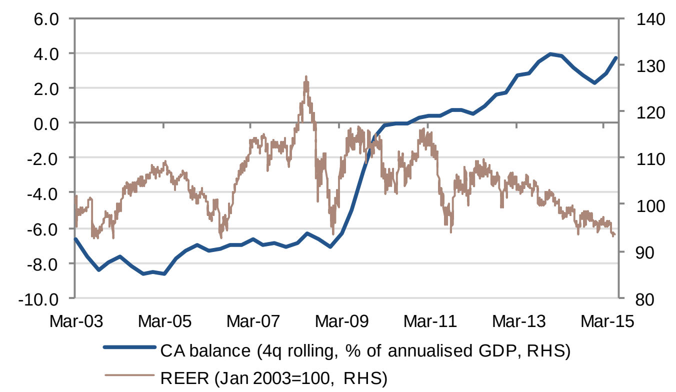


Source: SG Cross Asset Research/EM

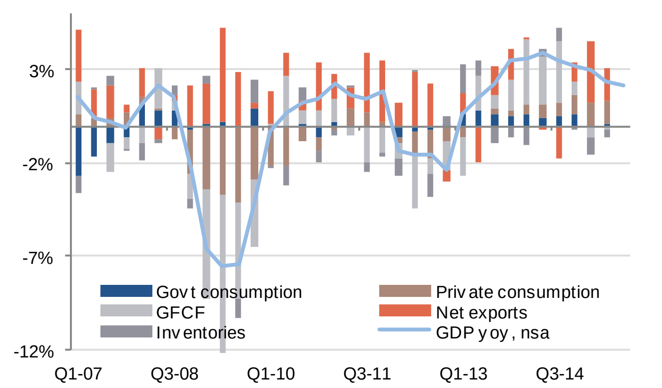
FX – MNB laying groundwork for a weaker HUF

In the current environment, the HUF enjoys net appreciating pressures stemming from a substantial trade surplus, large EU transfers (3.8% of GDP YTD), improvements in the country's resilience to external vulnerabilities, and upward pressure on sovereign credit ratings. Accommodative ECB policy and persisting bouts of political noise deflecting some interest away from Poland may contribute to a strong HUF performance in Q1 16. Barring unforeseen announcements of injurious economic policies, we anticipate a well-contained drift higher in EUR/HUF thereafter, largely reflecting lax liquidity conditions and the steady erosion in carry. The MNB has limited appetite for currency intervention and is likely to favour gradual HUF depreciation to bolster the vital manufacturing and export sectors.

HUF valuations supported by buoyant current account balance (REER Jan'03=100 RHS, CA balance 4q rolling % of annualised GDP)



Weaker forint will protect net exports' dynamics (GDP breakdown, pp contribution to yoy nsa)



Source: SG Cross Asset Research

Rates – Unfettered efforts for a flatter curve

- Approaching deadline for compliance with stringent LCR requirements, attractive carry conditions and ECB policy signal to contribute to tighter ASW
- The compound effect of MNB easing and ECB signal likely be supportive of further IRS curve flattening in H1 16

Outlook – MNB going all in

MNB policy rate: SG forecasts

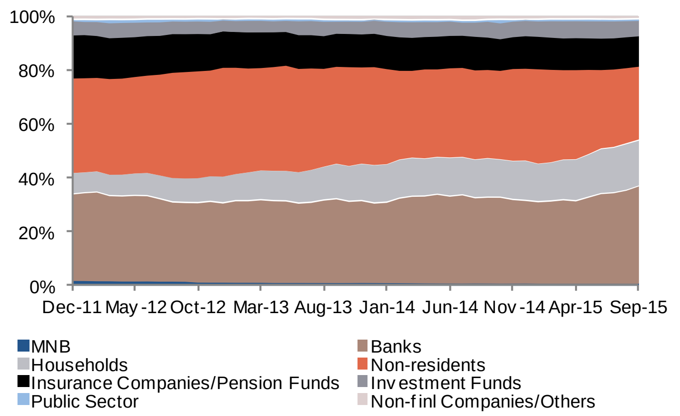
	SG	Consensus
Q1'15	1.35	1.30
Q2'15	1.35	1.30
Q3'15	1.35	1.30
Q4'15	1.35	1.40

Source: SG Cross Asset Research/EM

We project unchanged policy rates at 1.35% (and 0.1% for the depo facility) throughout 2016, consistent with an MNB staff assessment of an impaired monetary policy transmission mechanism, favouring targeted measures. Amidst continuing disinflationary trends from slack in the domestic economy and the frail external environment, the MNB projects that headline inflation will only approach the 3% midpoint of the target range toward late 2017. With preservation of GDP growth being the overriding objective, officials are willing to tolerate some HUF weakness to maintain the low (real) policy rate environment while bolstering financial stability via reducing Hungary's sensitivity to currency fluctuations. Instead, the authorities will continue relying heavily on monetary easing via the self-financing program, which involves financing state debt via the banking sector (through the MNB's subsidized provisions of IRS), differentiated treatment of liquidity coverage ratios (LCR) and the potential addition of maturities to its existing discount swap instruments.

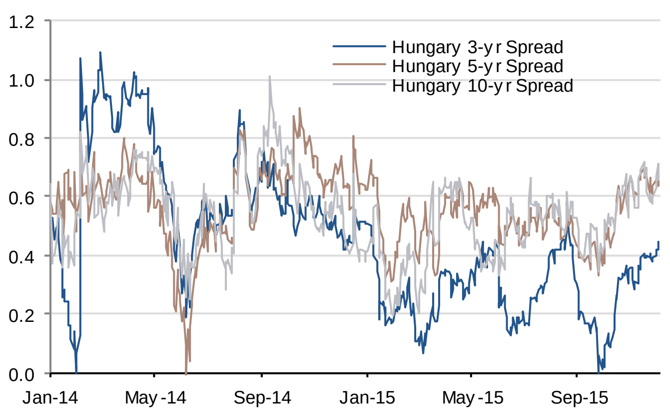
The compound effect of liquidity enhancement via MNB IRS swaps conditional on lending activity (cumulative HUF1tn up to 3y) and the preferential depo facility (HUF0.5bn) will likely be supportive of further IRS curve flattening, particularly for relatively shorter tenors (2-5y). Preferential/discount MNB facilities aimed at compressing term premiums may be a powerful and targeted tool, but irrespective of ongoing efforts, longer maturities are likely to maintain the high-beta behaviour on the back of the remaining high degree of foreign positioning (33.1% at end September). While longer-dated HGBs remain exposed to a scarcity in natural local demand and the prevalence of HUF issuance to cover financing needs, the reversal in non-resident positioning may slow in Q1 16 on the ECB effect and pre-rating upgrade. The ultra-lax liquidity conditions across the banking sector should act relentlessly as anchor for the front end of the curve, thus preserving a higher relative steepness, particularly in 2s10s, compared with CEE3 peers. Approaching the deadline for compliance with stringent LCR requirements (100%, by Apr 2016), paced issuance of 3m T-bills and attractive carry conditions may prompt local banks to accelerate their purchases of government securities, which is best expressed via narrowing ASW.

MNB's stimulus shifted the bulk of net HGB issuance to banks HUF1.4tn YTD (% of outstanding HUF denominated securities)



Source: SG Cross Asset Research, Bloomberg

Bond asset swaps to crawl lower on compounded effect of monetary policy stimulus (mid yield-IRS, %)



Source: SG Cross Asset Research, Bloomberg

Sovereign Credit – Back to investment grade

- Hungary has seen a solid recovery in the past three years
- Banks are still facing a difficult situation, but external vulnerability has decreased
- We see limited scope for further outperformance and retain a market-neutral position

Credit fundamentals – The return to investment grade is long due

The economic situation in Hungary has substantially improved over the past three years, and the country clearly deserves an upgrade. Growth is now solidly anchored in positive territory, although the pace is slowing. The fiscal deficit has remained well below the 3% of GDP threshold, containing the rise in public debt. But Hungary's strength is undeniably its very strong current surplus (5% of GDP in 2015), in stark contrast to the prevailing situation before the 2008 crisis. The effort to decrease the amount of external debt in favour of local financing has also paid off: from a peak at 185% registered in 2009, the external debt/GDP ratio has fallen to 137%. This is still very high, but 40% of the debt is comprised of intercompany loans, which artificially boosts the level of external liabilities (the rollover ratio is typically very high for this kind of debt, as inherent of the functioning of multinationals). The two main issues are probably the still-fragile situation of the banking sector and the weakness of foreign direct investments. Indeed, NPLs are high (close to 13%) and the profitability of the banking sector is extremely low (not to say negative). The recent reform to swap CHF and EUR loans into HUF has hit the Hungarian banking sector, and many international banks have been reducing their local exposure, which has translated into negative FDI. Despite these pitfalls, the external vulnerability in Hungary has undeniably decreased, and this will eventually lead to an upgrade. Fitch maintained its BB+ rating with a positive outlook on 20 November, and Moody's recently raised its outlook; the upgrade is just a matter of a few months, in our view.

Hungary Credit Ratings

Agency	Rating	Outlook
S&P	BB+	-
Moody's	Ba1	Positive
Fitch	BB+	Positive
SG Fair	BBB-	-

Source: SG Cross Asset Research/EM

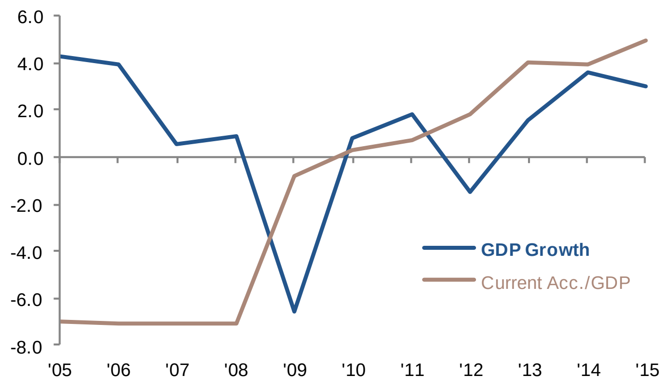
Positioning – Neutral

Hungary has been a solid outperformer this year, and its bonds are now trading through the global sovereign credit curve. This situation is widely shared by other CEE countries, however, due to the ECB's quantitative easing measures having broad repercussions on CEE assets. Supply factors are also supportive: Hungary has not issued in the hard currency bond market since March 2013, and the lack of new issuance over time has created a scarcity effect. In view of current valuations, we maintain market-neutral exposure to Hungary.

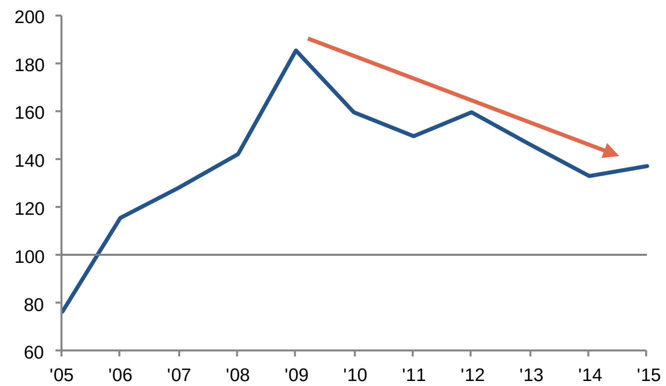
Hungary spread vs index (bp)

Source: SG Cross Asset Research

Successful recovery from a dismal situation in 2009
Hungry GDP growth and current account/GDP (%)



A sustained decline in external debt
Hungary external debt/GDP (%)



Source: IMF, SG Cross Asset Research/EM

POLAND

PLN – Navigating (politically) unsettled waters

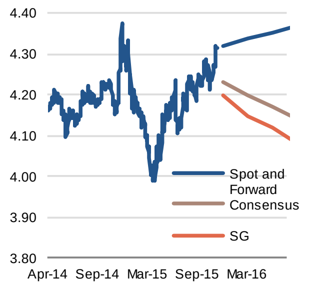
- PLN to gain from unwinding of political risk premium and supportive capital inflows
- PLN's valuation not to act as a barrier to appreciation, given Poland's relatively lower dependence on net exports compared with peers

EURPLN forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	4.34	4.15	4.20
Q2'16	4.35	4.12	4.17
Q3'16	4.37	4.08	4.14
Q4'16	4.39	4.08	4.12

Source: SG Cross Asset Research/EM

SG bullish vs forwards



Source: SG Cross Asset Research/EM

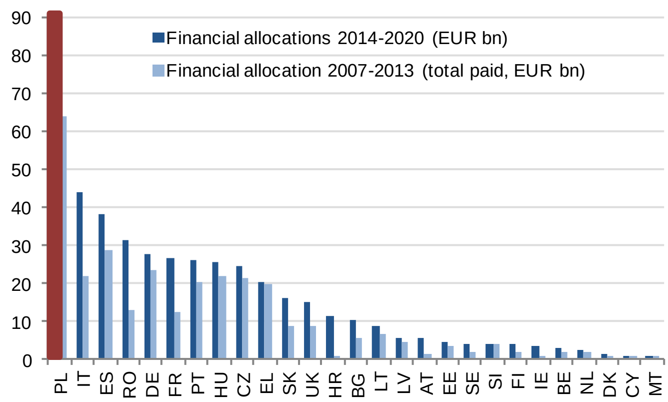
Outlook – Strong domestic-generated growth

Poland's new government under the Law & Justice (PiS) party is set to prioritize economic growth, with an array of programmes to address credit growth expansion and increasing disposable income (benefits for low-income families, raising the minimum wage). The dilution of the expenditure rule warrants caution, and acts as definite setback for Poland's fiscal outlook. With that said, PiS may have limited space for fiscal excesses, as its inheritance of the previous administration's 2016 budget bill and the EDP limit constrain budget deficit increases. The high EU structural fund allocation and absorption capacity will support the expansion of domestic capital stock, with Poland set to be the biggest beneficiary of the 2014-20 financial allocation (EUR89bn, including rural development). We expect GDP growth in Poland to remain relatively steady at 3.5% in 2016. Poland's adequate FX reserves, its IMF FCL, and diversified FDI flows help to mitigate its external vulnerabilities (including a large negative net international investment position and a modest current account deficit).

PLN – Don't lose faith

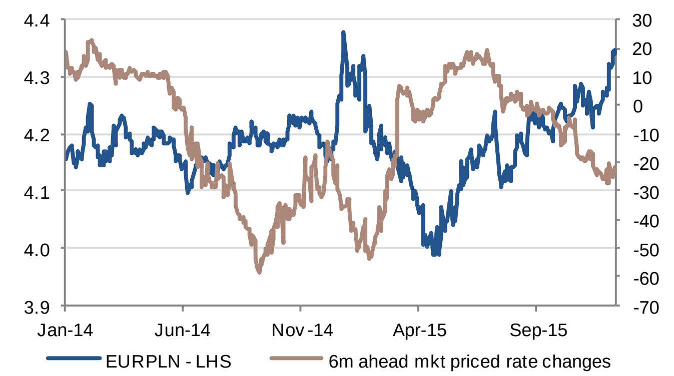
For the time being, the steep EUR/PLN forwards curve reflects a significant amount of political risk, reassessment of creditworthiness as well as post-ECB EUR strength. To the extent that all measures proposed by PiS are collectively implemented and exert unchecked pressure on the fiscal balance, or damage profitability or investment prospects of key industries (notably, banking), the PLN may display intermittent bouts of weakness during 2016. However, our base case envisages fiscal initiatives being disbursed gradually, paying due attention to the EDP threshold and, importantly, spurring growth dynamics. We anticipate an underlying trend of PLN strength on positive ECB QE spill-over effects and robust domestic growth, with EUR/PLN gradually declining through 2016. A faster than expected acceleration in CPI growth, uninterrupted economic expansion and inherent impact on the banking sector should reduce expectations of monetary policy easing, thus reinforcing the downward drift in EUR/PLN. In the event of excessive PLN weakness, the MinFin would likely intervene on the FX market to limit potential downside.

Large EU fund allocation provides fundamental support to PLN



Source: SG Cross Asset Research, European Commission

PLN pricing in the resumption of policy easing



Source: SG Cross Asset Research, Bloomberg

Rates – Favour receivers

- Further policy accommodation likely to be debated in a broader context of ECB policy spill-overs, economic performance and negative impact on the banking sector
- ECB QE and still-high real yields to support POLGB duration, IRS receiver positions

NBP policy rate: SG forecasts

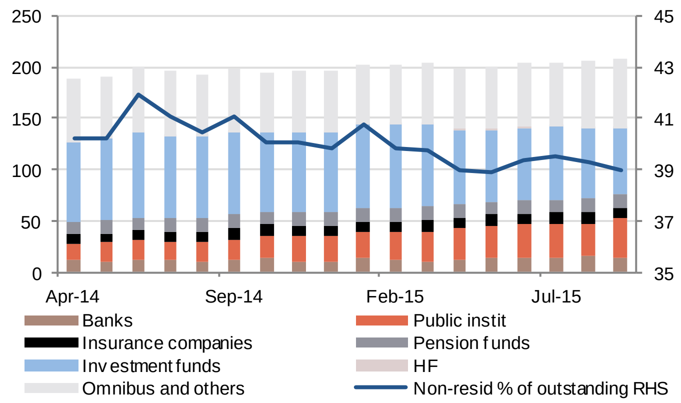
	SG	Consensus
Q1'15	1.50	1.35
Q2'15	1.50	1.25
Q3'15	1.50	1.25
Q4'15	1.50	1.30

Source: SG Cross Asset Research/EM

Next year's MPC changeover at the NBP will result in PiS appointing 9 new members into the Council (including the governor). The ruling party's expressed proclivity for broadening the Central Bank's mandate to more actively support growth has already translated into an abrupt repricing of monetary policy expectations, denting the PLN performance. Nonetheless, we believe further policy accommodation in 2016 will be set against a broader context of material ECB policy spill-overs, domestic economic performance at that point in time and the added negative impact on the banking sector (net interest margins compression). Our baseline scenario is for the NBP to keep its policy rate at 1.50% throughout 2016, with the MPC's dovish bias materialising via higher and prolonged tolerance for below-historical-average real interest rates. We expect inflation to accelerate to around 0.8-1.0% in 2016, well below the 2.5% midpoint of the NBP's target range. The sizeable front-loaded repricing of monetary policy accommodation and (politically induced) underperformance of duration products should allow the PLN IRS curve to flatten, in line with core eurozone rates.

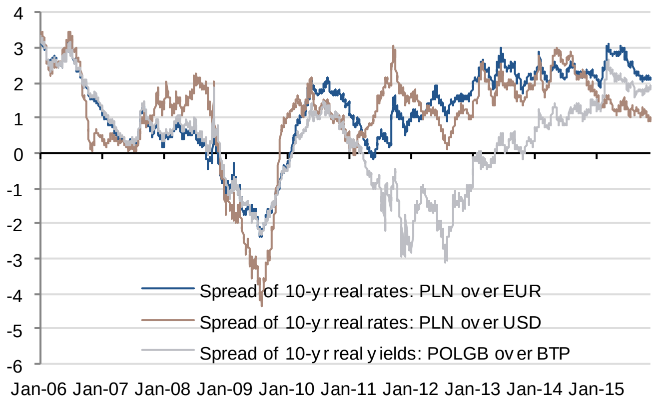
Real yields on POLGBs are still attractive thanks to persistent disinflationary pressures, although real differentials over US Treasuries have substantially declined since mid-2014. Despite shrinking differentials over US Treasuries, robust Polish growth from exposure to the recovering eurozone, still-prominent disinflationary forces acting on this commodity-importing market, and the potential beneficial spill-over effects from ongoing ECB QE enhances the appeal of Poland's high vol-adjusted real interest rates. In light of muted inflationary pressures during the early part of next year, we expect mid- and long-dated real yields to decline only modestly during 1H 16. Nominal POLGB yields will likely closely correlate with core European markets, and may remain sheltered from violent sell-offs by a well-diversified, geographically-diverse investor base.

Institutionally well-diversified nonresident holdings bode well for POLGB resilience (total holdings, PLN bn and % of total, RHS)



Source: SG Cross Asset Research, Haver Analytics

Real rates still attractive, particularly vs EUR (spread of 10y real PLN rates and EU, USD and real yields spread to BTP, %)



Source: SG Cross Asset Research, Bloomberg

ROMANIA

RON – Little cause for excitement

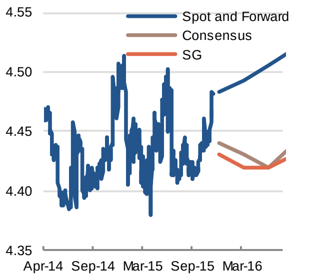
- Appreciation pressure on RON to peak in H1 16 and decline thereafter
- Little impetus for NBR to tolerate wider trading channel; politics as the only major risk to RON's range-bound behaviour

EURRON forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	4.46	4.42	4.43
Q2'16	4.48	4.42	4.42
Q3'16	4.49	4.43	4.44
Q4'16	4.51	4.42	4.42

Source: SG Cross Asset Research/EM

Forwards largely disconnected to forecasts



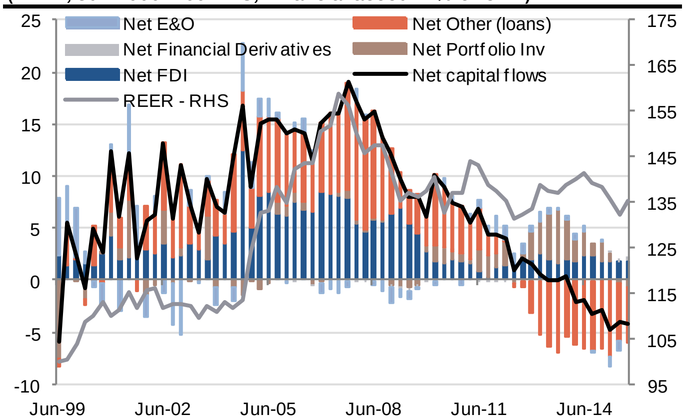
Source: SG Cross Asset Research/EM

Outlook – Growth to channel the impact of fiscal stimuli; RON to move to the same beat

The powerful cumulus of fiscal easing measures and monetary policy accommodation is likely to propel GDP growth above expectations next year (IMF: 3.9% yoy). Private demand will likely act as the main growth driver, as successive VAT cuts and wage hikes contribute to leaps in disposable income. With the caveat of limited clarity over the 2016 budget, we exclude any roll-back of legislated wage indexations and expect the EDP deficit threshold to be narrowly avoided via tweaks in revenues (local taxes, higher royalties). We are sceptical about the ensuing medium-term sustainability of public finances, but the jury is still out on the potential benefits of personnel expenditures on migration and potential growth. The interim cabinet's focus on structural reforms, better investment planning and EU fund absorption may act as a credit positive, but the dense electoral schedule (local elections in June, general elections Nov/Dec) will realistically act as a time constraint. Despite a predictable acceleration in import demand, the overall impact on the current account deficit may be credibly mitigated by reinvigorated private and public (EU funds) transfers. Given the ongoing political shifts, derailments from fiscal adjustment trajectory and limited appetite to reapply for precautionary support, the IMF is unlikely to become involved in Romania over the coming year.

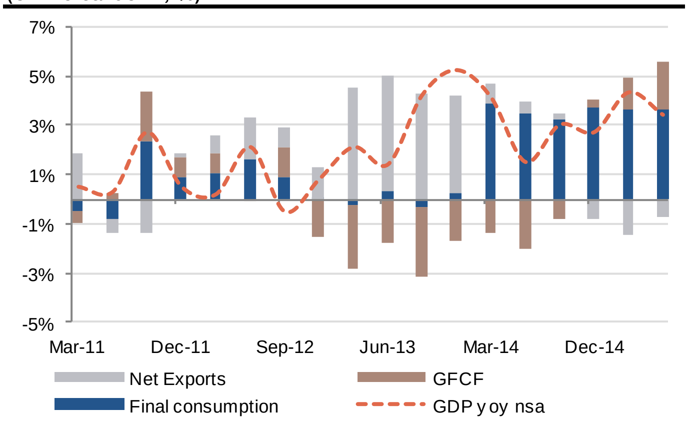
EUR/RON is likely to preserve its low-beta status and will probably remain confined within its recent range, given remaining financial system sensitivities to currency weakness (FX loans still 49.7% of total). Political events (notably, risk of snap elections) can jolt the currency, while the impact of fluctuations in global risk sentiment should be relatively muted. The modest REER deviation from the historical average (-2% vs. 5y avg) reflects its monotonous swings over recent years. Any breakdown of the market's self-limiting behaviour to the optical range (4.40-4.55) may trigger targeted covert FX interventions from the NBR. Even from an FX perspective, a policy rate cut should be out of the question, although distorting factors (large VAT cuts) will keep real interest rates artificially high. Instead, lax liquidity conditions across the banking sector, squeezing market rates significantly below policy rate, can sway the EURRON cross higher.

RON REER highly resilient through large capital outflows
(REER, Jun 1999=100 RHS, Financial account % of GDP)



Source: SG Cross Asset Research, Haver, Bloomberg

Accelerating growth dynamics to be supportive of RON
(GDP breakdown, %)



Source: SG Cross Asset Research, Eurostat

Rates – Tempting real returns, cloudy outlook

- Highly attractive real yields and steep ROMGB curve to offer compelling tactical opportunities
- Fiscal concerns and troubled inflation outlook to dent the glitter of duration products

NBR policy rate: SG forecasts

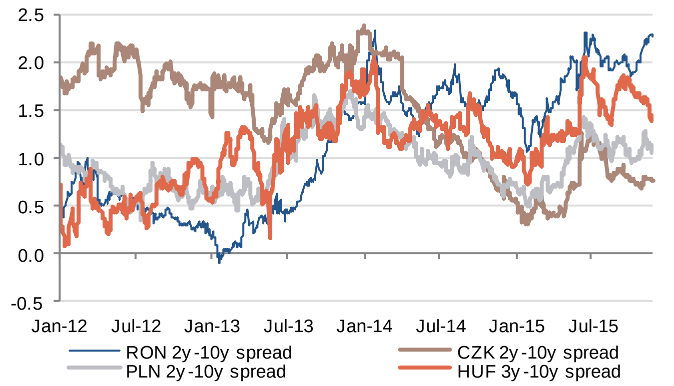
	SG	Consensus
Q1'15	1.75	1.75
Q2'15	1.75	1.75
Q3'15	1.75	1.85
Q4'15	1.75	2.15

Source: SG Cross Asset Research/EM

Our base case scenario envisions unchanged policy rate throughout 2016, irrespective of the optically tight policy stance prevailing in H1 16. Further easing steps might occur via liquidity conditions (MRR cuts in H1 16), but the bar for resorting to those will be set quite high, possibly prompted by speculative capital inflows lured by widening inflation and rate differentials applying pressure on the local currency (versus the EUR). Even so, the complex interplay between global forces and ever-stronger fundamentals should dissuade the monetary authority from stimulating the economy further. The prevailing concern at the NBR remains the high degree of suppressed inflation (peaking at 4.4pp at end-Mar 2016) which, together with monetary global factors, compounds into a severe obstruction to the policy signal. The likely steep acceleration in headline CPI as of H2 16 and the looming need to curb the double-digit advance in RON lending (18.5% yoy, real) may warrant a pre-emptive liquidity squeeze in H2 16.

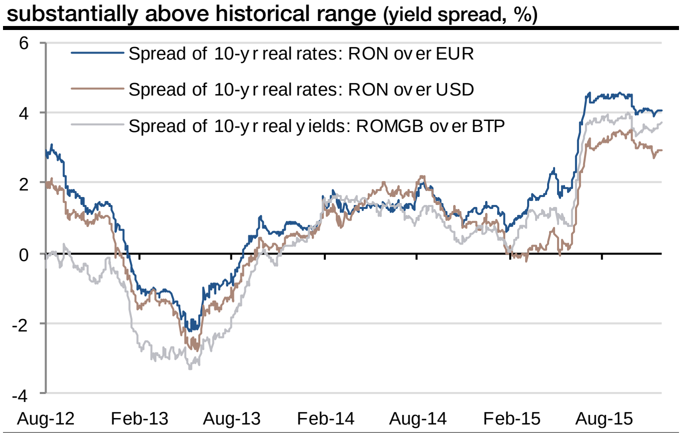
Save for somewhat more limited market liquidity conditions compared to peers, Romania possesses the technical attributes to remain a prominent recipient of bond inflows occasioned by ECB policy. The current steepness of the curve and tactically attractive valuations reflect the shifting sentiment in response to expectations of fiscal excesses and heightened political risk, materialising in cumulative portfolio outflows of EUR2.5bn (end-Sep). Non-resident holdings have declined to around 17% of total outstanding, similar to the levels recorded in 2014, creating a favourable technical backdrop for reloading exposure. Notwithstanding the admittedly high looming threat of fiscal slippage, we would downplay the imminent impact on local bond issuance. In fact, (unlike Hungary) the MinFin has the flexibility to diversify its financing sources to avoid putting undue pressure on the ROMGB market, and it retains wide scope to ride the bouts of sell-off by relying on a hefty fiscal buffer (covering 4-6 months of financing needs). With inflation likely to plummet as far as -3% yoy early next year (end-Q1 16), we see tactical scope to fade recent underperformance in ROMGB duration but prefer shorter maturities (5-7y) for better risk-return. In the absence of the IMF credibility anchor, investors may remain skittish given the admittedly still-large political risk in an election year, the climbing uncertainty related to policy digressions and the degree of economic overheating. Therefore, we see limited scope for ROMGB 10y nominal yields to return to historical lows.

The RON curve offers the highest pickup in the region (yield spread, generic LCY bonds, %)



Source: SG Cross Asset Research, Bloomberg

Tax cuts' disinflationary impact propelled real yields substantially above historical range (yield spread, %)



Source: SG Cross Asset Research, Bloomberg

Sovereign Credit – Strong fundamentals, low carry

- Romania has gained from strong fundamentals
- An upgrade in the near term is unlikely, but the outlook could be raised to positive
- Romania's low carry could hamper its performance, but EUR bonds are attractive

Credit fundamentals – Sound

Romania has been the success story of the last few years. Solid growth performance, fiscal discipline, control on inflation, moderate debt levels, a contained external deficit and continuous efforts to strengthen the banking system have been the recipe for this success. The situation in the banking sector was still a serious concern a few years ago, but although credit growth is rising again, we do not see this as a real contingent risk for the sovereign anymore. NPLs are very high (close to 14%), but they have drastically improved since the peak of 22% registered in 2013 due to a defeasance programme. Risk-weighted capitalisation has also considerably improved at 18.6%, versus 15.5% in 2013. As opposed to the vast majority of EM countries and even developed markets, the stock of external debt has decreased, and particularly so the private external debt owing to the deleveraging of international banks. External debt (public and private combined) now represents around 54% of GDP, which is nearly 23pp lower than in 2012. Romania is back to full IG status since May 2014, when S&P upgraded the country to BBB- (Moody's and Fitch already rated the country in the IG category). For now, the three majors are keeping a stable outlook, suggesting that an upgrade in the near term is unlikely despite strong growth. For this to happen, we think Romania would need to strengthen its FX reserves for better coverage of short-term debt, while more needs to be done to consolidate the banks' balance sheets. Lastly, the still rather jittery political context and the ongoing corruption probe make upgrades unlikely, in our view, although we are confident that Romania's outlook may be raised to positive during the course of 2016.

Romania Credit Ratings

Agency	Rating	Outlook
S&P	BBB-	-
Moody's	Baa3	-
Fitch	BBB-	-
SG Fair	BBB-	-

Source: SG Cross Asset Research/EM

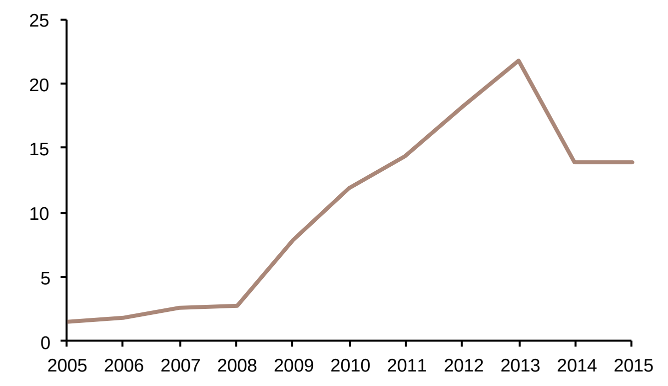
Positioning – Underweight

Romanian global bonds' performance has been in line with the EMBI index this year, but this is hiding a solid resilience to market turbulences, which is rather new for the country. Going forward, its low carry (compared to the index) may hamper its relative performance, and we therefore maintain underweight exposure to Romania USD bonds. Romania's EUR-denominated bonds are still attractive, however; our cross-currency spread model indicates that Romania's EUR assets are trading substantially cheap versus their USD counterparts.

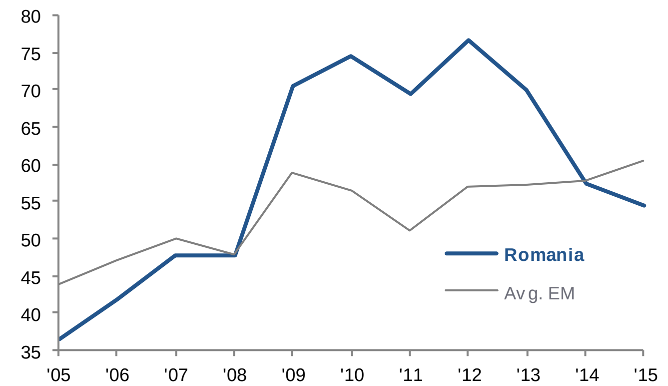
Romania spread vs index (bp)

Source: SG Cross Asset Research

The Romanian banking sector has improved since 2014
Romania's NPLs/total loans (%)



Romania's external debt has sharply declined since 2012
Romania's external debt/GDP vs EM average (%)



Source: IMF FSI, SG Cross Asset Research/EM

CROATIA

Sovereign Credit – Fading the consensus on gloomy outlook

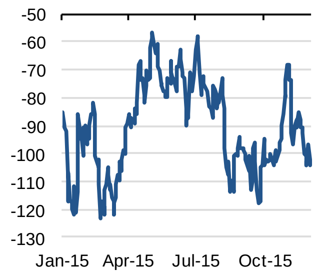
- Croatia has a negative outlook from the three major rating agencies
- We believe fundamentals will improve
- We retain overweight exposure to Croatia

Croatia Credit Ratings

Agency	Rating	Outlook
S&P	BB	Negative
Moody's	Ba1	Negative
Fitch	BB	Negative
SG Fair	**BB**	-

Source: SG Cross Asset Research/EM

Croatia spread vs index (bp)



Source: SG Cross Asset Research

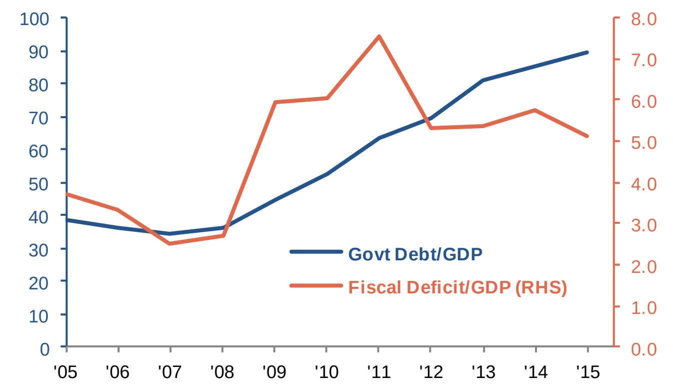
Credit fundamentals – A fiscal consolidation may start very soon, in our view

The rating agencies have a gloomy outlook on Croatia: the three majors have the country under negative outlook, two of them since this summer. The fundamentals are indeed challenging, in our view, particularly on the fiscal front: over the last seven years, the deficit has been consistently above 5%, public indebtedness doubling over the period to 92% of GDP. The country's external debt is among the highest in EM (103% of GDP), and the unemployment rate is elevated at 16%. But we think fundamentals will improve: Croatia is the only country in the region that has not gone through a fiscal consolidation process, but we think this will be difficult to avoid, and the timing of the adjustment is becoming clearer. Now that the general elections have passed, we may see the start of a fiscal tightening process; in fact, one of the main themes of the HDZ (the centre-right party that won most of the votes in the November elections) was to tackle the fiscal deficit. Although a coalition is still needed to form the new government, we believe the fiscal adjustment will be one of the main focuses. Improving macroeconomic conditions are also helping: the Croatian economy is recovering from a long recession, and we expect GDP to rise by around 1% in 2016, slightly higher than the estimated 0.9% of this year. The current account is now strongly anchored in positive territory, and the surplus for 2016 should be in line with that of this year at 1.5% of GDP.

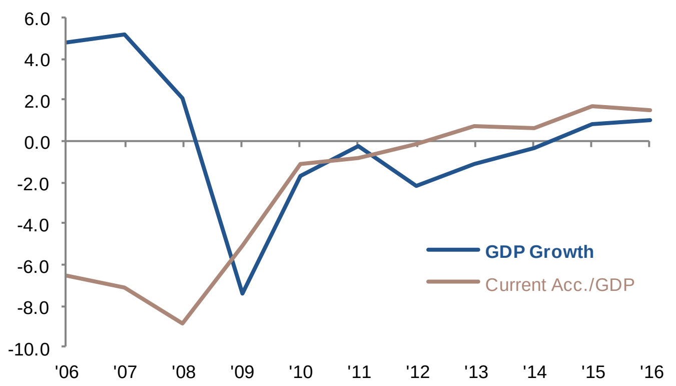
Exposure – Overweight

We disagree with the rating agencies and tend to think that fundamentals in Croatia are set to improve. Croatian bonds should be supported by a relatively benign macroeconomic environment in the EU, with growth picking up amidst very accommodative monetary conditions from the ECB. We retain overweight exposure to the credit and also like EUR-denominated Croatian bonds on a cross-currency basis.

Public debt/GDP has doubled in seven years...
Croatia public debt/GDP (%)



... But growth and current account have been steadily improving
Croatia GDP growth and CA/GDP (%)



Source: IMF, SG Cross Asset Research/EM

SERBIA

RSD – Not the time to break monotony

- Ongoing adjustment across the public sector and commodities tailwinds to fully compensate for rigid exchange rate channel
- NBS to maintain a still-firm grip on the currency to build up credibility and reinforce confidence in the dinar

EURRSD: SG forecasts

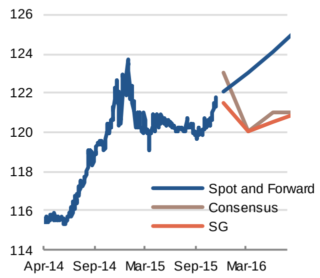
Date	Forward	SG	Consensus
Q1'16	123.05	120.0	120.0
Q2'16	124.12	120.5	121.0
Q3'16	125.32	121.0	121.0
Q4'16	126.60	121.5	123.0

Source: SG Cross Asset Research/EM

Outlook – Hang on tightly to the anchor

Serbia's fortunes remain inextricably connected to the IMF credibility anchor, and the government's continued ability to deliver on its commitments. Large progress has been made towards reducing headline fiscal metrics this year (est. -3.5% of GDP vs. -6.7% in 2014), above and beyond initial IFI programme targets, but a longer lasting period of budget restrain is eyed by investors to help curb the spiralling public indebtedness. In 2016 and beyond, the onus will fall on the long overdue public sector reform and fruition of large-scale privatisation plans, all expected by the IMF to yield improvements in economic productivity and close the leaks on budget spigots. The current account deficit may stabilise around 4% of GDP, with increased imports of capital goods linked to large-scale projects in the pipeline offsetting the cyclical slowdown in consumption goods. Real GDP is likely to remain on a recovery trajectory in 2016 (NBS: 1.8% yoy vs. 0.8% in 2015), as the tailwinds to disposable income stemming from low commodity prices partially offset the fiscally-induced strains on domestic demand. As Serbia approaches the opening of the first negotiation EU accession chapters this year, its balanced approach to the migrant crisis are likely to have gained it pockets of political support, but a credible accession timing remains a dis.

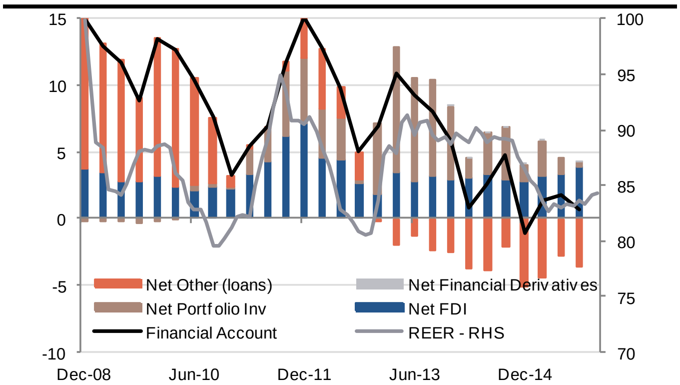
Forwards severely out of tune with consensus



RSD – The windy road of dinarisation

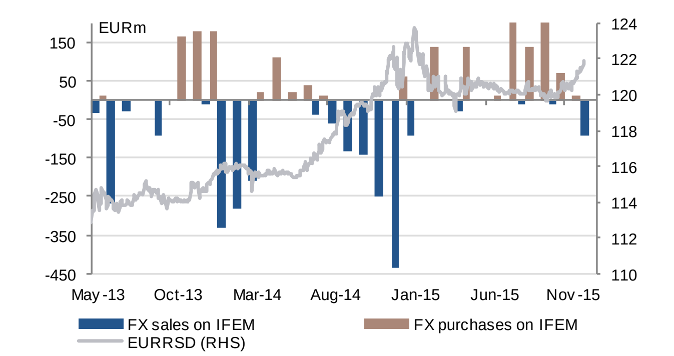
Ongoing official efforts to boost financial sector domestic usage of RSD beckon a continued tight (bi-directional) management of the dinar and reduced currency volatility. Protecting financial stability should prevail in 2016, though a stable RSD may fuel the inertia in FX lending (75%) and FX savings (92% of total). Given its support for a gradual transition to an export-led growth model, NBS will likely remain disinclined to tolerate fast moves in EURRSD above 3% either way. So far, external adjustments have been achieved via a cyclical cool-off of imports and productivity gains. Low turnover on the FX market exposes the RSD to choppy illiquid trading, seasonality effects and heightened corporate FX demand around year-end.

External adjustment accommodated a reduced reliance on portfolio inflows (% of GDP)



Source: Bloomberg, SG Cross Asset Research/EM

Still-large euroisation and shallow FX market turnover warrant recurrent NBS forays (FX sales/purchases, EURm and EURRSD – RHS)



Source: Bloomberg, SG Cross Asset Research/EM

Rates – Some room to ease further

- Global risk sentiment permitting, the NBS will ease policy rates further
- Duration products still attractive, but expect a slower grind, more oscillations

NBS policy rate: SG forecasts

	SG	Consensus
Q1'16	4.50	
Q2'16	4.00	
Q3'16	4.00	
Q4'16	4.00	

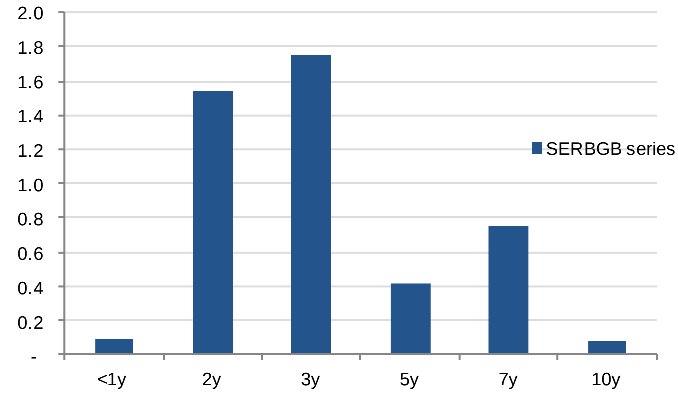
Source: SG Cross Asset Research/EM

Outlook – Entering a new phase

Because of the high (anecdotal) non-resident positioning in regional comparison, the NBS will need to find a fine balance between supporting the economy and avoid the creation of market disruptions. Currently, inflationary risks remain subdued (CPI 1.4% yoy, Oct) and, assuming a gradual indexation of administrated prices and a modest targeted increase in entitlements, the fundaments for a sharp acceleration to the mid-point of NBS 4% target are feeble. Certainly, the post-ECB market reaction will have a bearing on the central bank's stance, as a drawn-out rather than front-loaded added stimulus may dissuade the policymaker from easing further. Over-compressing real interest rates is likely to be penalised by the market, initially via a sell-off in RSD. That said, we believe the currency can withstand another policy rate cut given the still-wide room for manoeuvre and only provided that economic policy continues to excel on its targets. That said, the compression in SERGB term premium remains limited by the large liquidity compensation that Serbia is still liable for to its portfolio investors. Indeed, with still-limited perspectives of Serbian RSD-denominated bonds being added to flagship indexes (notably, GBI-EM) next year, we believe the appeal of Serbian assets may still reside in carry rather than improving quality in fundamentals.

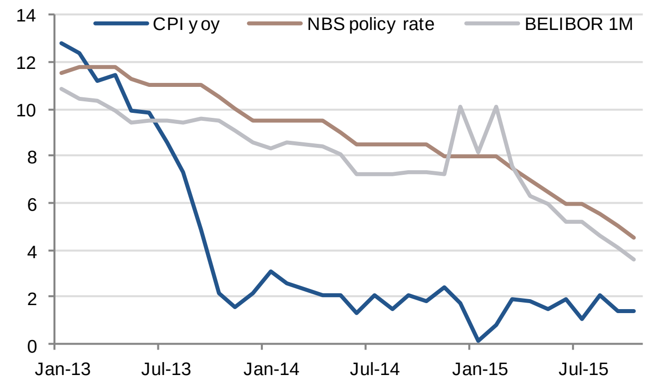
With those caveats in mind, we remain constructive on Serbian duration, as a still low-beta product compared to the region. As previously highlighted, we would look to move higher along the local yield curve (e.g. 7Y SERBGB) for remaining value. We believe that subdued inflation pressures, still-wide output gap and favourable spill-overs from the ECB policy remain supportive of fixed income valuations in Serbia. Also, MinFin's efforts (backed by EBRD and the IMF) to improve secondary market liquidity, extend weighted debt maturity and create benchmark sizes are supportive of maintaining or re-gaining exposure. We believe that local bond supply will be capped by still-low market capacity, and opportunistic tapping of concessional WB/IBRD and UAE financing lines. According to MinFin estimations, gross financing needs should decline in 2016 from EUR5.8bn to EUR5.3bn, with only EUR3bn expected to be financed through RSD-denominated issuance.

SERBGB market – limited liquidity and large potential for maturity extension (EUR bn, nominal maturities)



Source: SG Cross Asset Research/EM, Bloomberg

Assuming the attainment of NBS 4% CPI target, policy rate is steadily becoming accommodative



Source: SG Cross Asset Research/EM, Bloomberg

KAZAKHSTAN

Sovereign Credit – Attractive valuations

- Kazakhstan is suffering from three external shocks, but fundamentals remain strong
- The country should retain its investment status
- Kazakh global bonds are among the cheapest in the sovereign credit market

Credit fundamentals – Kazakhstan should remain in the IG category

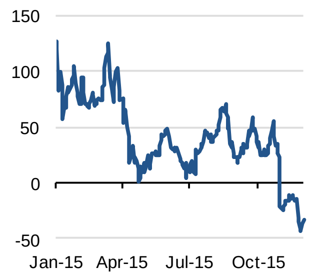
Kazakhstan is facing three external shocks: the fall in crude prices, the recession in Russia and the economic slowdown in China. The country is heavily reliant on the oil and gas industry, as it represents about a quarter of GDP and 60% of total exports. The Kazakh economy is also adversely impacted by the recession in Russia: the latter absorbs around 8% of Kazakhstan's exports and it represents a third of Kazakh imports. After dropping to an estimated 1.5% this year, the IMF expects Kazakh GDP to rebound to 2.4% in 2016, albeit this is well below the 6.4% average of the last ten years. The fall in crude prices is having a major impact on exports and fiscal revenues: the current account has moved from a surplus of 2.1% of GDP in 2014 to an estimated deficit of 3% this year, while the large fiscal surplus (1.8% in 2014) is turning into a substantial deficit (3.2% in 2015). Nevertheless, Kazakhstan remains a relatively strong credit, and although a downgrade seems inevitable, we think that a fall from IG status is unlikely. The fiscal deficit remains moderate, and given the planned cuts in public expenses, it should be brought back below 1% of GDP next year. The government still has ample room to manoeuvre, as public debt is very low (19% of GDP). External debt is elevated (76% of GDP), but the share of short-term liabilities is low (6% of total external debt). At first glance, official FX reserves look small ($21bn), but if we include the sovereign oil fund ($69bn) the National Bank's cushion seems comfortable.

Kazakhstan Credit Ratings

Agency	Rating	Outlook
S&P	BBB	Negative
Moody's	Baa2	-
Fitch	BBB+	-
SG Fair	**BBB-**	-

Source: SG Cross Asset Research/EM

Kazakhstan spread vs index (bp)

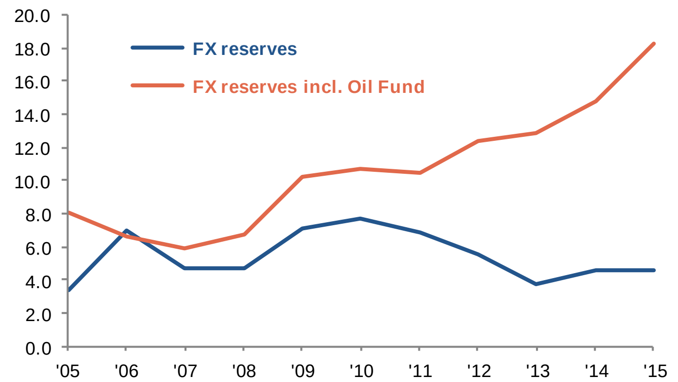


Source: SG Cross Asset Research

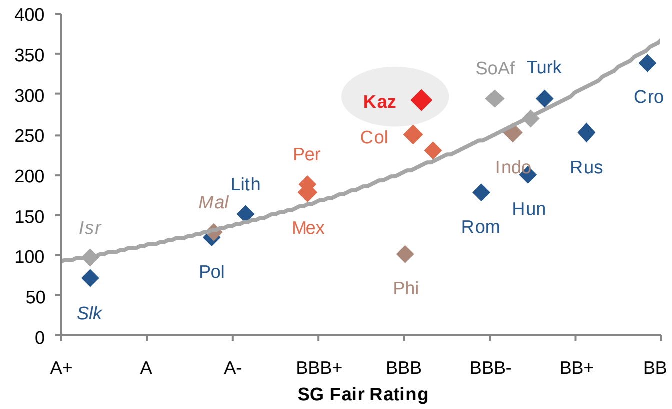
Positioning – Overweight

The recent KZT devaluation has been painful for the Kazakh standard of living, but combined with the extensive privatisation programme, the country is adopting the right measures to counteract the oil shock. As the downside on crude prices may now be limited, Kazakh sovereign bonds offer good value; our model suggests that Kazakhstan is one of the cheapest credits on relative fundamentals; we retain overweight exposure to Kazakhstan.

When including the Oil Fund, FX reserves are very high
(FX reserves + value of Oil Fund)/total Imports (number of months)



Kazakh sovereign bonds are trading cheap to fundamentals
10y Z-spread vs SG fair value rating



Source: SG Cross Asset Research/EM

UKRAINE

Sovereign Credit – Carry versus distressed fundamentals

- Growth may come back to positive territory, but fundamentals will remain distressed
- The debt restructuring and the support from the IMF have removed the risk of default for the coming 12 months, in our view
- We retain overweight exposure to Ukrainian bonds due to their high carry

Fundamentals – Growth may be back, but the economy remains in dire straits

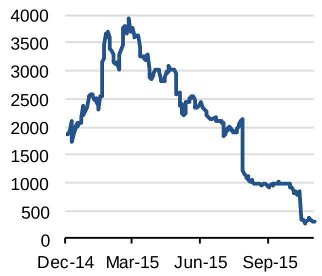
The war in the Donbass region and Russia's commercial sanctions against Kiev have put enormous pressure on the economy – knowing that Ukraine was already in dire straits prior to the Maidan revolution. The short-term outlook has somewhat improved: after falling 6.8% in 2014 and nearly 11% this year, growth is expected to come back to positive territory at around 2% in 2016. The IMF funding programme and the $16.2bn public debt restructuring may have removed the risk of default for the coming years, but the situation in Ukraine is still extremely challenging. Public debt has soared to 94% of GDP, and the 180% collapse of the UAH since early 2014 has pushed the external debt/GDP ratio to 115%. The current account deficit has narrowed to 1.7% of GDP, providing some relief for the National Bank's very depleted FX reserves , but this improvment is due to a massive compression in domestic demand and not an increase in competitiveness. In essence, the very structure of the economy has to be rebuilt: Ukraine has lost the Donbass, its most productive region, as well as its main trading partner, Russia. In our view, the collapse in investments is making a sustained recovery practically impossible in the short to medium term. Besides, the debt restructuring was too soft to ensure a long-term recovery: with only a 20% haircut applied to nominal amounts, a maturity extension of four years but coupon payments remaining relatively high, we cannot rule out a resumption of funding pressure very soon, but we expect the IMF to continue to support the country, limiting the downside.

Ukraine Credit Ratings

Agency	Rating	Outlook
S&P	B-	-
Moody's	Caa3	-
Fitch	CCC	-
SG Fair	B-	-

Source: SG Cross Asset Research/EM

Ukraine spread vs index (bp)

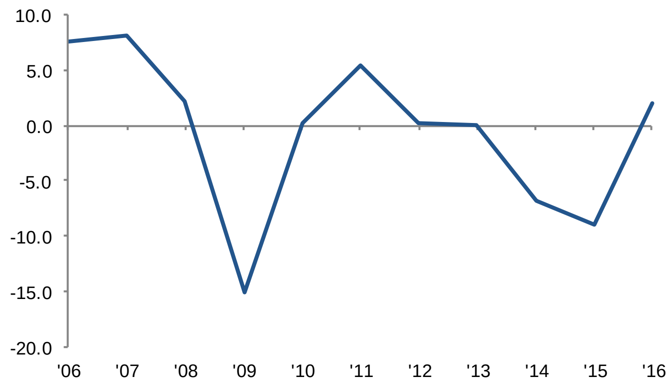


Source: SG Cross Asset Research

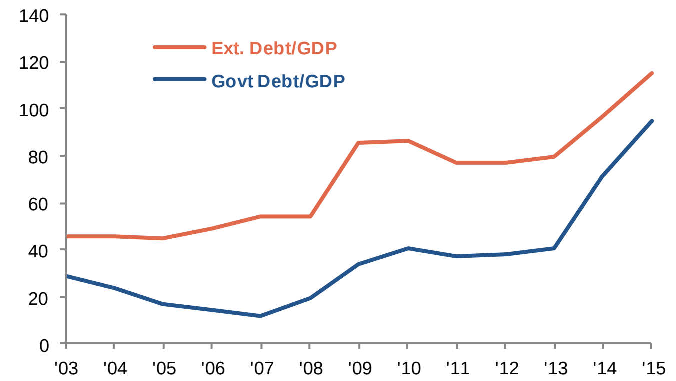
Exposure – Overweight

The economic situation is still extremely difficult, and we do not see Ukraine being upgraded to single-B in the next two years. That being said, the risk of default may have been removed for the coming 12 months, and at an average spread of 700bp, Ukrainian bonds remain an important source of carry. We therefore retain a slight overweight position on Ukrainian bonds.

Growth should be back to positive territory in 2016...
GDP growth and IMF forecasts for 2016 (%)



... But debt ratios have deeply deteriorated
Public and external debt (% of GDP)



Source: IMF, SG Cross Asset Research/EM

CHINA

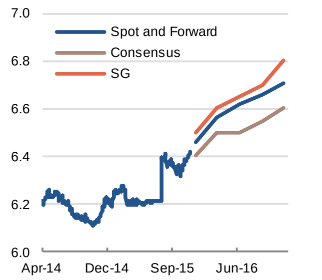
CNY – path of least resistance favours currency weakness

- Gradual but largely controlled RMB depreciation toward 6.80
- CNY needs to de-link from the strong USD
- More currency flexibility, capital account liberalization, and volatility to come

CNY forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	6.56	6.60	6.50
Q2'16	6.62	6.65	6.50
Q3'16	6.66	6.70	6.55
Q4'16	6.71	6.80	6.60

SG bearish vs forwards



Source: SG Cross Asset Research/EM

Outlook – Don't be caught short USD-RMB

More currency flexibility, volatility, and continuation of RMB weakness is likely forthcoming. The cumulative increase in USD-CNY since early 2014 (6.5%) will be matched over the next twelve months. Short dollar positions are highly discouraged due to asymmetric risks of greater depreciation. Trades that have more favourable risk-return characteristics compared to long dollar positions plain vanilla call options, include: a) USD-CNH call spreads, b) proxy trades (long USD against TWD or KRW) and c) relative value structures (long CNH vs TWD, KRW or THB).

Rationale - RMB depreciation through 2016

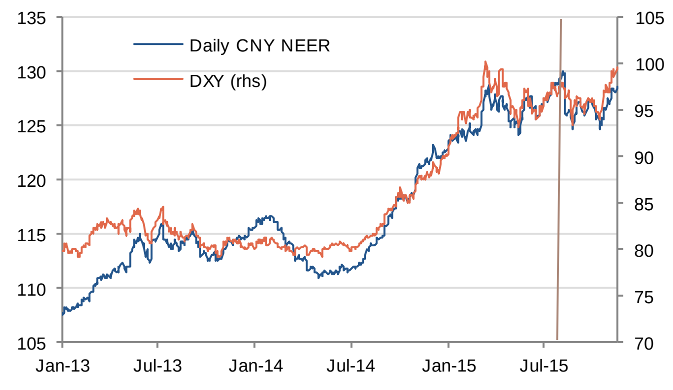
The trade-weighted CNY has started to rise once again and is approaching the highs posted prior to August 11. Further CNY depreciation will be required to de-link from the USD and to provide a cushion to the growth slowdown through a stable to lower REER. Unlike other brief periods of capital outflows, the current string of money leaving China is larger and more persistent. Outflows will persist if the authorities truly move to a more flexible regime.

By allowing more currency flexibility, China can escape the impossible trinity and effectively lower domestic interest rates further. Depreciation can take place in a gradual and controlled manner, with larger moves possible if regional currencies depreciate more than the RMB and the associated trade-weighted appreciation is too much for policymakers to bear relative to growth and employment objectives.

Risks – competitive devaluation, financial stability risks

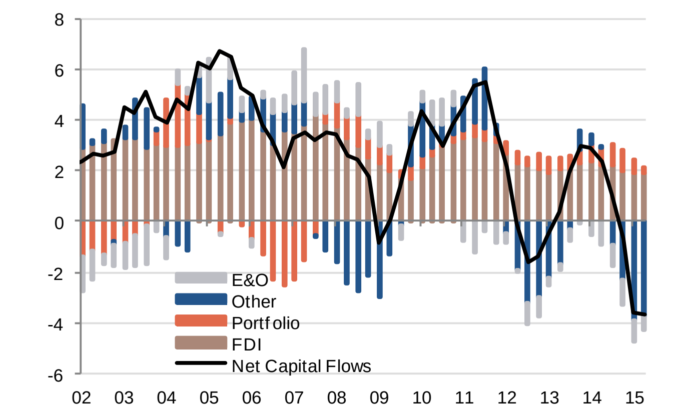
Hasty liberalization, domestic banking problems, or corporate defaults could trigger capital flight and increase financial stability risks. A revival in economic growth or a sharp depreciation in the USD would reduce the need for a weaker CNY.

Link between CNY and DXY needs to be severed



Source: Bloomberg, SG Cross Asset Research/EM

Capital outflows deepening (% of GDP, 4qma)



Source: Bloomberg, SG Cross Asset Research/EM. % of GDP

Rates – Front-end well anchored by policy; mid- to long-tenors face supply risk

- Monetary easing points to further downside to front-end CNY rates
- Mid- to long-tenor CGBs face continued LGB supply risk
- CNH CCS and CNY IRS may not necessarily converge

10Y CGB: SG forecasts

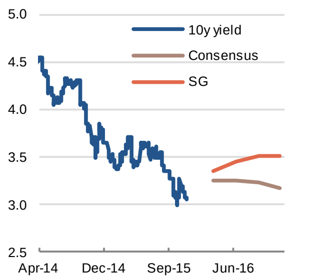
	SG	Consensus
Q1'15	3.35	3.25
Q2'15	3.45	3.24
Q3'15	3.50	3.22
Q4'15	3.50	3.17

Source: SG Cross Asset Research/EM

Ongoing accommodative monetary policy points to downside to front-end CNY rates. The PBoC is likely to cut the 1Y deposit rate further, as a signal even though there is no longer a cap on deposit rates, and cut the rate on its 7-day OMO reverse repo. Monetary policy is domestically-driven and pretty much de-linked from the Fed policy cycle. Indeed, correlations between front-end CNY rates and USD rates have not been high.

In mid- to long-tenors, however, we continue to see supply risk from Local Government Bonds (LGBs). Annual gross issuance of LGBs, in the order of CNY3-4trn, is significant compared with the usual CNY1.5-1.6trn gross CGB issuance. LGB supply risk is to linger for the next three to four years given the estimate of CNY16trn worth of local government debt. LGB issuance so far has been clustering at the tenors of 5Y and beyond, accounting for more than 80% of total issuance, hence our relative bearishness there. Growth concern is a counteracting force which is likely to dissipate over the course of 2016 as investors get used to the new normal for economic growth.

SG bearish vs consensus



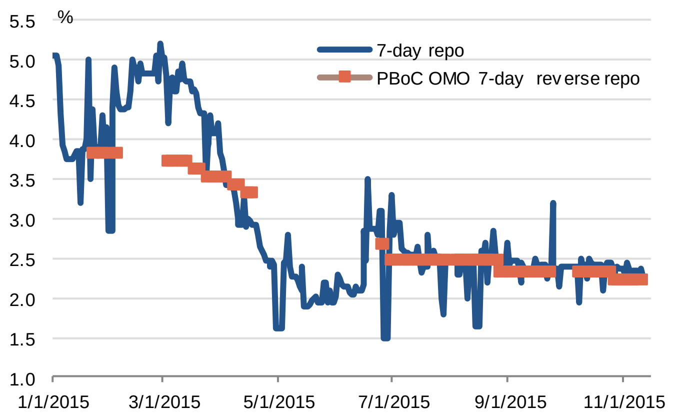
Source: SG Cross Asset Research/EM

SDR status does not automatically translate into a sudden surge of inflows into the onshore fixed income market, not least because reserve diversification is a slow process. We expect no material impact on CNY rates and CGB yields at this stage before the onshore bond market is opened to more foreign investors.

CNH CCS and CNY IRS may not necessarily converge given the different nature of the two rates. FX can become an important factor driving CNH CCS from time to time, during which the CCS curve temporarily does not function as a pure interest rate curve. The offshore RMB bond market can become more active in 2016 when investors realise any CNY depreciation represents normal volatility rather than a one-off devaluation.

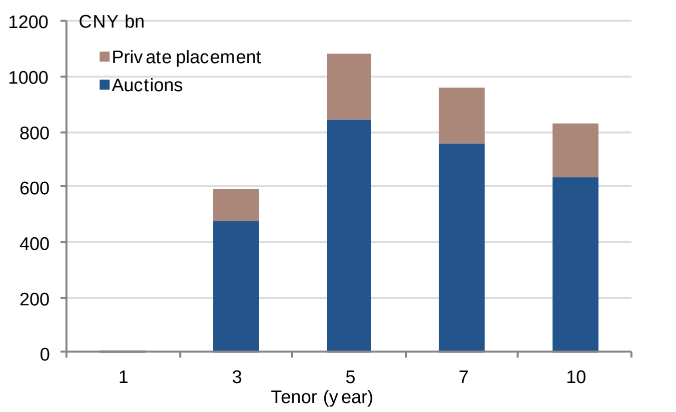
Risks to our views above include a worse-than-expected deterioration in economic growth, or an unexpectedly hawkish PBoC.

Front-end rates to be guided lower



Source: SG Cross Asset Research/EM, PBoC, Bloomberg

LGB issuance, YTD 2015



Source: SG Cross Asset Research/EM, various official websites

KOREA

KRW – beware of the butterfly effect

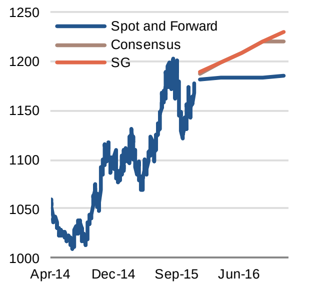
- Strong external position insufficient to prevent KRW weakness
- Direct and indirect exposure to China presents significant risks
- Authorities to remain accommodative toward currency weakness

KRW forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	1184	1200	1210
Q2'16	1185	1210	1210
Q3'16	1185	1220	1220
Q4'16	1185	1230	1220

Source: SG Cross Asset Research/EM

SG bearish vs forwards



Source: SG Cross Asset Research/EM

Outlook – watch out for the butterfly effect

Our base case envisages a gradual depreciation around a volatile trend, with cumulative losses broadly matching those in 2015. Sensitivity to Chinese growth expectations, RMB depreciation, and Fed policy uncertainty will dictate the ebb and flow of KRW. Our bias is to trade USD-KRW from the long side, but tactical opportunities will manifest in both directions as risk sentiment oscillates based on external conditions. A self-reinforcing cycle could emerge from RMB depreciation, especially if the KRW is used as a proxy trade for going short China.

Rationale – Exposure to China to pull KRW lower

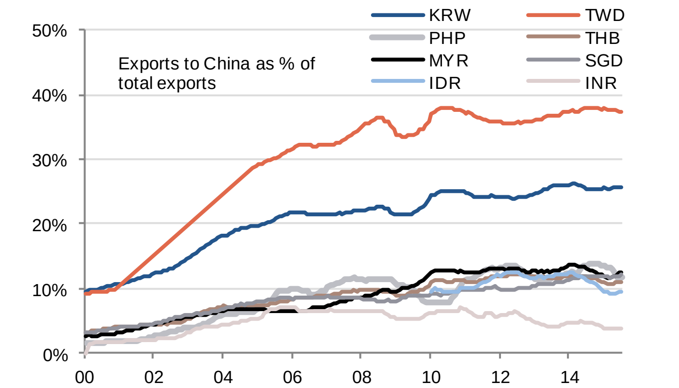
The KRW is particularly exposed to downside Chinese growth risks and RMB depreciation. First, a high proportion of Korean exports (25%) are destined for China (direct effect). Second, there is a high degree of similarity between China and Korea's export structure (indirect effect). Stable reserves over the past 18 months (when negative valuation effects were present) points to a preference of policymakers for a weaker currency. If small changes in RMB produce large changes in regional currencies (butterfly effect), the KRW will depreciate more rapidly, especially if investors use KRW as a proxy to short CNH given smaller negative carry.

Compression in rate spreads versus the G3 has reduced the attractiveness of Korean bonds, while local residents continue to accumulate significant foreign currency deposits. A bullish dollar environment will ensnare even those currencies with strong external positions, and the KRW is no exception. The REER is close to its 5- and 10-year averages, so valuations will not drive currency performance next year.

Risks – currency war vs repatriation of foreign currency holdings

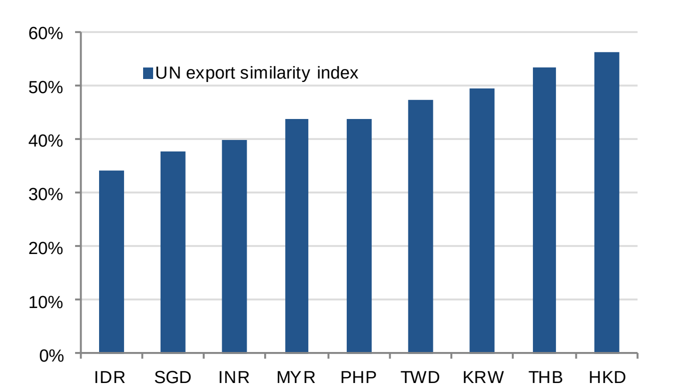
Downside risks arise from a currency war erupting due to RMB depreciation while the upside risk requires an improvement in general EM sentiment that would spur local residents to repatriate back the substantial foreign currency holdings that have been accumulated.

High direct export exposure to China



Source: Bloomberg, SG Cross Asset Research/EM

Similar export structure



Source: Bloomberg, SG Cross Asset Research/EM

Rates – a year of two halves

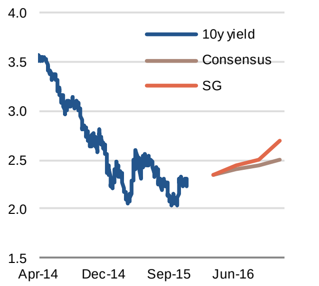
- Market has priced out further policy rate cut and unlikely to become dovish again
- Bearish steepening during the early months of 2016, before flattening afterwards
- Favourable supply-demand points to KTB outperformance over regional peers

10Y KTB: SG forecasts

	SG	Consensus
Q1'15	2.35	2.34
Q2'15	2.45	2.40
Q3'15	2.50	2.44
Q4'15	2.70	2.51

Source: SG Cross Asset Research/EM

SG higher vs consensus



Source: SG Cross Asset Research/EM

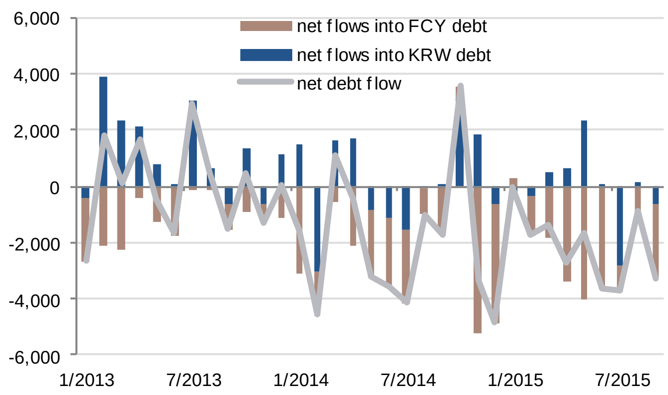
The KRW rates market has priced out further policy rate cuts since the October MPC minutes, which suggests that there was no dovish MPC member at the BoK. It is unlikely that market will go back to more dovish expectations, given the Fed is embarking on a rate hiking cycle, and domestically consumption and investment is expected to continue to recover supported by income and credit growth.

KRW rates have bottomed out. With the BoK outlook taking a back seat as it is seen as fairly stable, KRW rates are likely to follow USD rates higher. That said, the market is unlikely to price in an imminent rate hike, even after the Fed liftoff, rendering the KRW rates curve biased towards steepening in the early months of 2016, especially given higher correlations with USD rates at the mid to longer end, than at the short end. Looking further ahead, as the US hiking cycle goes on, the KRW rates curve is to follow the USD rates curve flatter. During the second half of 2016, the KRW rates market may also start to price in some prospect of the BoK starting its own tightening cycle, while SG economics expect it in 2017, adding to the flattening momentum of the KRW rate and KTB yield curves.

Against a rising interest rate environment, KTBs are likely to outperform their regional peers with favourable demand-supply dynamics. On supply, the 2016 budget goes for fiscal tightening, expecting slowing government spending growth, while the increase in MBS issuance has been digested. On demand, around half of foreign demand has come from the foreign public sector, which makes the KRW bond market relatively resilient. For most months in 2015, Korea saw net debt portfolio outflows, but these were mainly due to increased overseas investments rather than reduced foreign inflows into KRW fixed income products. We do not expect any diversion into FCY products to materially undermine KTBs, as an aging population should support demand for fixed income assets as a whole.

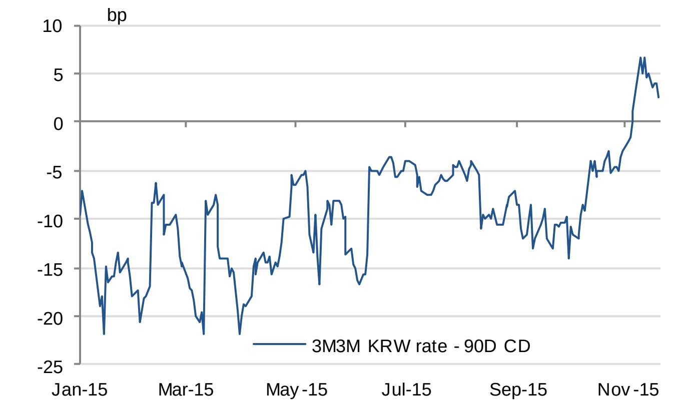
Risks to our views include an extreme risk-off trading environment, which pressures down KTB yields with safe-haven flows, or an unexpected pick-up in inflation leading to a steeper rate curve.

BoP – portfolio flows in debt



Source: SG Cross Asset Research/EM, CEIC

Market expectations to remain neutral in coming months



Source: SG Cross Asset Research/EM, Bloomberg

INDIA

INR – Still the best total return trade in Asia

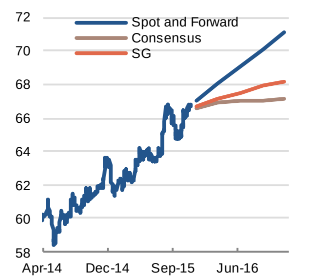
- Broader dollar strength to cause further INR depreciation
- Improved macro and foreign inflows supportive of regional outperformance
- Low beta characteristic likely to remain in place on RBI intervention

INR forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	68.02	67.2	66.9
Q2'16	69.06	67.5	67
Q3'16	70.10	68.0	67
Q4'16	71.11	68.2	67.1

Source: SG Cross Asset Research/EM

SG bullish vs forwards



Source: SG Cross Asset Research/EM

Outlook – Positive total return on improved macro

The INR should depreciate modestly through the year on a stronger dollar trend and weakness in the regional currency anchor (CNY). Our preferred strategy is long INR via relative value positions against regional currencies which are most susceptible to the CNY weakness (TWD, IDR etc.). Selective opportunities for short USD-INR exposure will arise on sell-offs while tactical outright long dollar positions would only be considered if positioning becomes heavily skewed to short INR.

Rationale – No escape from broader dollar strength

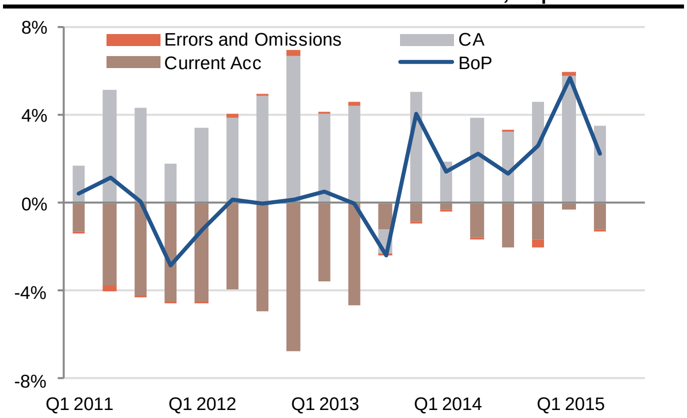
Historical highs in the real effective exchange rate and soft export growth leave little scope for the INR to remain unaffected if USD strength continues. Dollar strength, higher US rates and CNY depreciation will have a bearing on INR performance. The RBI will allow measured depreciation during the year as it continues to build up FX reserves although the BoP is expected to remain in positive territory on strong foreign inflows.

A strong macro environment, measured increase in government debt limits, government policies to attract FDI flows, and favourable volatility-adjusted carry characteristics will lead to regional outperformance, despite some hiccups on the political front. The political logjam on legislative bills and latest loss of BJP in the Bihar state election has taken the shine off strong reform momentum. The market is still awaiting progress on GST and land acquisition bills and further disappointment might cause the capital flow picture to turn less favourable.

Risks – political momentum, competitive currency devaluation, Rajan's replacement

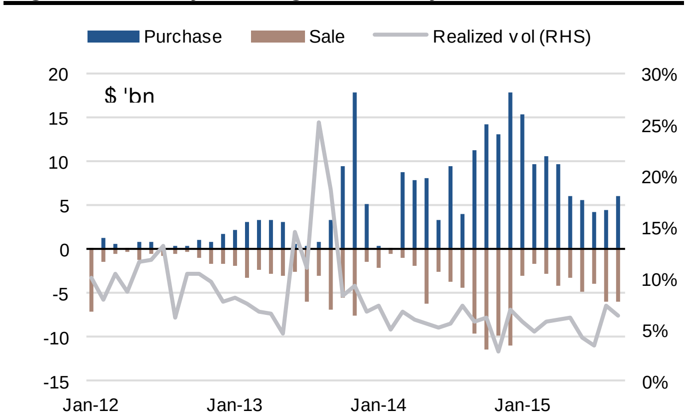
Political impasse on important bills - GST, land and labour; tax issues - and regional competitive currency devaluations are the key risks. If the government doesn't extend Rajan's term as RBI government in Sep-2016, investors might be disappointed.

Positive BoP on better current account balance, capital flows



Source: Bloomberg, SG Cross Asset Research/EM, % of GDP

Higher RBI activity checking INR volatility



Source: Bloomberg, SG Cross Asset Research/EM

Rates – Breaking away from rising US yields

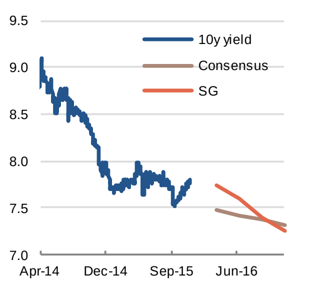
- IGB 10y yield lower on subdued CPI, FII buying to 7.25% by end of 2016
- Limited impact from US rate hike due to low foreign ownership on govt bonds
- NDOIS curve to steepen and normalize as we approach terminal target CPI

INR 10Y: SG forecasts

	SG	Consensus
Q1'15	7.75	7.47
Q2'15	7.60	7.42
Q3'15	7.40	7.37
Q4'15	7.25	7.31

Source: SG Cross Asset Research/EM

SG higher vs consensus



Source: SG Cross Asset Research/EM

Outlook – Yield to move lower on CPI, FPI demand

INR rates will likely move lower next year on subdued CPI, RBI's inflation fighting commitment toward lower CPI and foreign investor demand for high yielding local currency (LCY) bonds. We look for opportunities to build NDOIS steepener positions and long positions on local currency bonds, depending on entry levels. Higher US rates, and the narrowed yield differentials between G-Sec and UST would put upward pressure on INR rates but this impact is likely to be transitory around the Fed lift-off event. Beyond this, INR rates and yields should move lower later in 2016 as market volatility subsides and foreign investor – along with domestic - demand for LCY bonds becomes the major driver. Rates volatility should remain contained on RBI's strong commitment to inflation targeting regime.

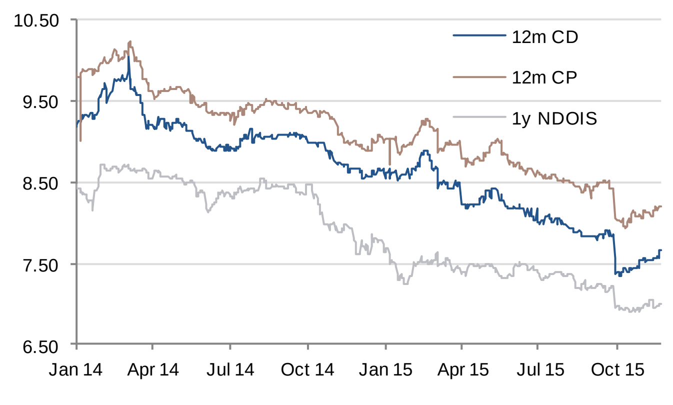
RBI plans to lower target CPI from 5% by early-2017 to 4%±2% by FY17-18 and above. It also, talked about a real interest rate of 1.5%-2%. The CPI is expected to stay within target levels for early-2016 and the medium term goal at 4% for early-2018 (see: GEO page 11,132). The short end of the curve remains driven by the policy rate and has the scope to move little lower during the year, given the forecast of unchanged policy rates in 2016 and some easing in 2017.

The measured increase in foreign investor limits on LCY government bonds towards 5% of outstanding bonds, and supply risks arising from civil servant salary hikes put balanced risks at the long end of the curve. Overall, the NDOIS curve may normalize (to upward sloping) on the narrowing of onshore-offshore spreads as market prices in term premium and policy rate approach terminal rates. As a result, bond-OIS swap spreads will also narrow on lower bond yields over the next year.

Risks – Fiscal deficit slippage, unchanged CPI target, Rajan's replacement

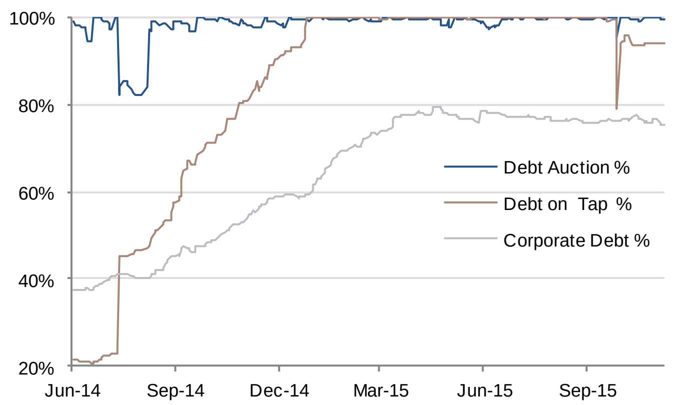
The derailing of the fiscal consolidation plan on increase in government staff salary under the 7th pay commission recommendations, CPI pickup and basket selling on EM LCY bonds are key risks to our views. If the RBI does not take the path of a lower CPI target as planned, INR rates would move higher on reduced investor confidence.

Rates finding bottom for now on US rate hike concerns



Source: SG Cross Asset Research/EM, Bloomberg

Strong demand for G-Sec



Source: SG Cross Asset Research/EM, Bloomberg, NSDL

TAIWAN

TWD – no escape from the China growth vortex

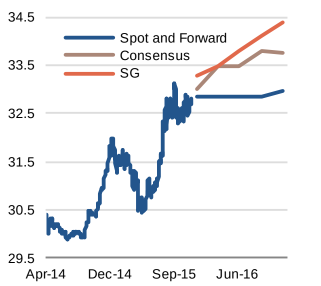
- TWD caught between a rock and a hard place
- Exposure to China weighs on sentiment while policymakers prefer a weaker currency
- Low yields and no positive differentiating factors argues for underperformance

TWD forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	32.87	33.5	33.5
Q2'16	32.84	33.8	33.5
Q3'16	32.83	34.1	33.8
Q4'16	32.97	34.4	33.75

Source: SG Cross Asset Research/EM

SG bearish vs forwards



Source: SG Cross Asset Research/EM

Outlook – butterfly effect

The TWD is caught in a precarious situation with downside risks exceeding upside risks. A Chinese slowdown, RMB depreciation, and higher US rates are decidedly negative while unattractive yields and a lack of positive differentiating factors argue for underperformance in both an EM rally and sell-off. Utilizing the TWD as a funding currency is preferred, either against high yielders such as the INR, for directional bullish dollar exposure, or relative value structures to capture relative sensitivities to RMB weakness. The TWD should stay closely linked to moves in CNH and elevated volatility will persist.

Rationale - RMB depreciation through 2016

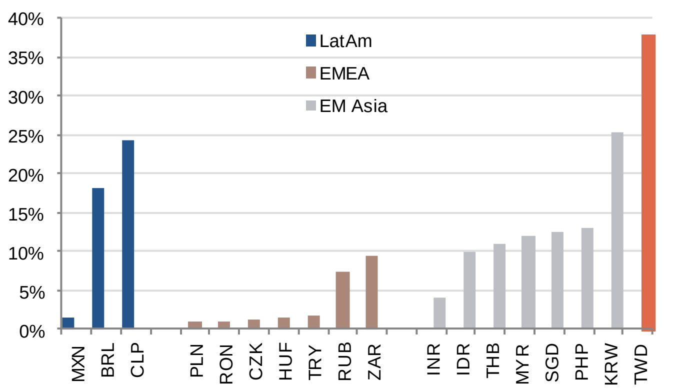
Taiwan's direct exposure to China, by far the highest in EM, introduces significant downside potential to the TWD if Chinese growth disappoints (SG economics expects below consensus GDP growth at 6% in 2016). The similarity of Taiwan's export structure to China's will weigh on market sentiment as USD-CNY heads toward 6.80. The acceleration in local resident overseas portfolio investment over the past year, mainly into foreign bonds, should speed up further as US interest rates rise. Foreign portfolio inflows are miniscule relative to local resident outflows, but the TWD tends to be sensitive to changes in external demand for local stocks. In this regard, continued weakness in the EM capital flow cycle does not bode well for the TWD.

The TWD has scope to underperform regional currencies, and even CNH at different points through the year. Investors could increasingly use Taiwan as a proxy trade for China given smaller negative carry. A strong reserves position prevents a destabilizing sell off, but the increase in FX reserves in 2015 highlights the CBC's preference for a weaker currency.

Risks – politics and China growth

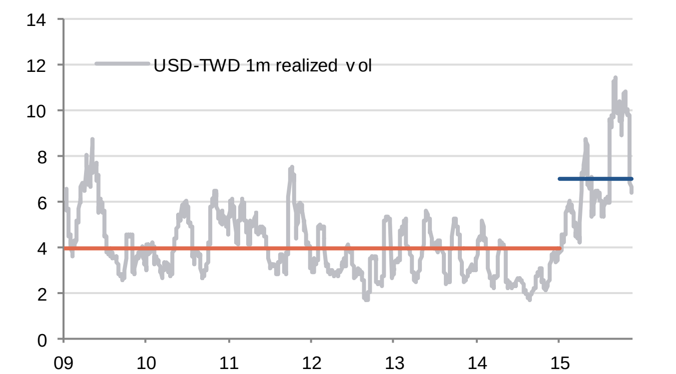
If the opposition party wins both the general election and Parliament the TWD could suffer, while stabilization in China growth or RMB depreciation expectations could be beneficial.

Highest direct export exposure to China



Source: Bloomberg, SG Cross Asset Research/EM

Higher volatility regime



Source: Bloomberg, SG Cross Asset Research/EM

Rates – slow move as usual

10Y TGB: SG forecasts

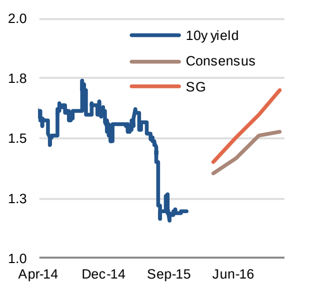
	SG	Consensus
Q1'15	1.40	1.35
Q2'15	1.50	1.42
Q3'15	1.60	1.51
Q4'15	1.70	1.53

Source: SG Cross Asset Research/EM

- Further cuts in NCD rates have marginal impact on TWD rate market as a whole
- Upward move in long end TWD rates as only a slow, medium-term trend
- Flattening in H2 as slow economic growth mitigates increases in long-end rates

Further cuts in already near-zero NCD rates may not have a meaningful impact on TWD rates beyond the very short-end. Front-end TWD IRS may remain fairly stable during the early part of 2016, before edging up gradually in line with the expected upward move in their USD counterparts and with no further headline policy rate cut from Taiwan. Upside to longer-end TWD rates is seen as well, as a medium-term move upon investor diversification efforts. Economic recovery is slow at best, with growth likely remaining below trend and underlying inflationary pressure easing. These mitigate the increases in long-end TWD rates. On balance, TWD IRS and TGB yield curves should bearish steepen during the early months of 2016, before flattening as front-end rates rise more rapidly.

SG higher vs consensus



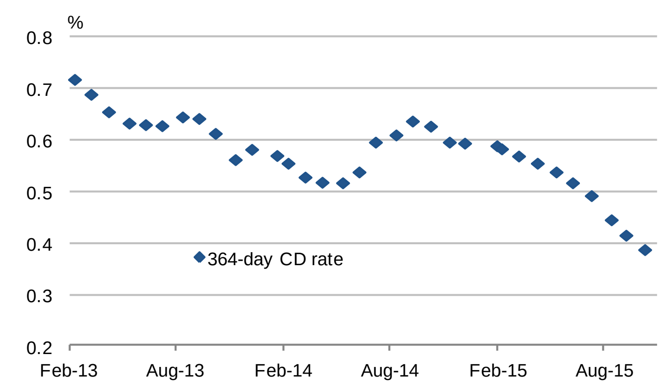
Source: SG Cross Asset Research/EM

While the rates on NCDs issued by the central bank have been edging lower, outstanding NCDs have been on the rise against ample liquidity in the banking system. Overall, it does not look like that the central bank is dovish on every aspect. We see TWD rates as bottoming out, with the unattractive yields likely leading to diverted investment flows away from TGBs.

Major domestic investors of TGBs have been diversifying their investment into overseas assets, a process that is slow and has been in place for years. Life insurance companies, for example, hold slightly more than 10% of their assets in domestic government securities, compared with a high of 20.5% as at end-November 2008. Meanwhile, their foreign asset holdings have risen to 48% of total assets, from around 25%. This trend should put upward pressure on TGB yields, especially at the long end. That said, counteracting factors include TGB demand from other investors and a high concentration of bonds among few major investors. Recent proposals or regulations to try to reduce holding concentration may not be effective. Overall, higher long-end TGB yield remains only a slow, medium-term trend.

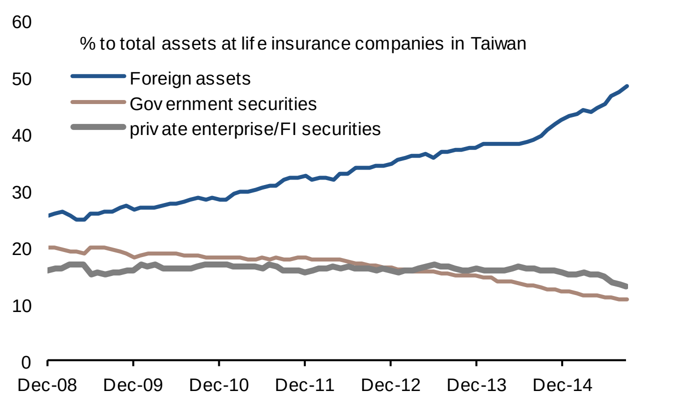
Risk to the above views include unexpected robust growth that leads to risk-on sentiment paying up TWD rates more aggressively, or further headline policy rate cuts by the central bank and/or a hard landing from China impacting Taiwan negatively.

Diminishing marginal impact?



Source: SG Cross Asset Research/EM, Bloomberg

On a slow process



Source: SG Cross Asset Research/EM, CEIC

MALAYSIA

MYR – political albatross weighs on FX

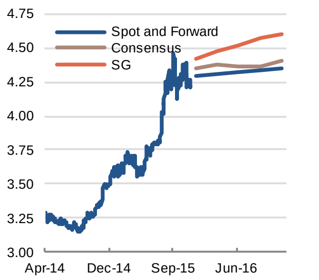
- More weakness, but nothing like the past twelve months
- Portfolio investments flowing out for past six quarters unlikely to reverse
- Reserve adequacy has sharply deteriorated; BNM firepower significantly curtailed

MYR forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	4.30	4.47	4.38
Q2'16	4.32	4.52	4.36
Q3'16	4.34	4.58	4.37
Q4'16	4.35	4.60	4.40

Source: SG Cross Asset Research/EM

SG bearish vs forwards



Source: SG Cross Asset Research/EM

Outlook – weaker MYR, but watch for two-way trading opportunities

Depreciation pressures on the MYR will be evident throughout the year, though a re-run of the precipitous plunge over the past twelve months is not expected. Political risks have calmed down, but could flare up again, and the long term damage to investor confidence from the 1MDB saga could remain an albatross hanging over currency performance. However, two-way risks could prove larger compared to regional peers due to oil exposure, low reserve adequacy, high foreign bond ownership, and politics. Trading strategies should be nimble and geared toward capturing short-term two-way opportunities with a medium-term long dollar bias.

Rationale – capital flight, poor reserve adequacy, depressed sentiment

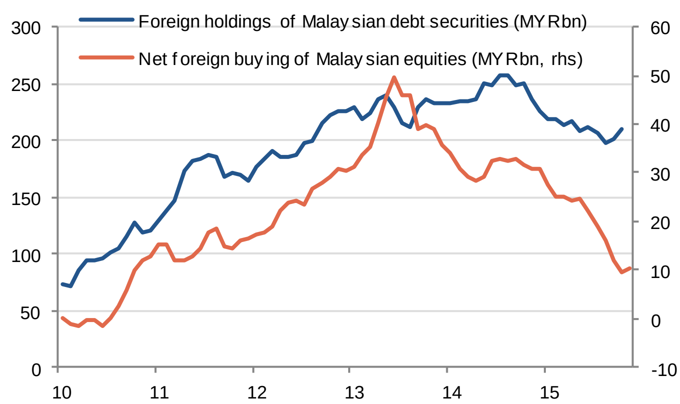
Foreign investors have been exiting Malaysian equities and fixed income for the last six quarters. Foreign holdings of debt securities have fallen as BNM bill issuance has ceased and money has left rather than being deployed into bonds. Foreign investors have been net sellers of local equities since mid-2013. Outflows might not be as intense over the coming year, but a dearth of capital entering EM should persist in 2016. Investor confidence will stay depressed for a long time following the 1MDB scandal even though contingent liability risks to the sovereign might be reduced from 1MDB asset sales. Malaysia is partly protected from a wave of capital outflows given the large weight in EM bond benchmarks, but this leaves the currency susceptible to hedging flows related to local bond market exposure.

As the only net oil exporter in the region, the MYR is particularly sensitive to developments in crude prices. BNM should maintain a hands-off approach to currency intervention after the steep drop in the level and adequacy of foreign currency reserves.

Risks – surge in oil prices, capital flows

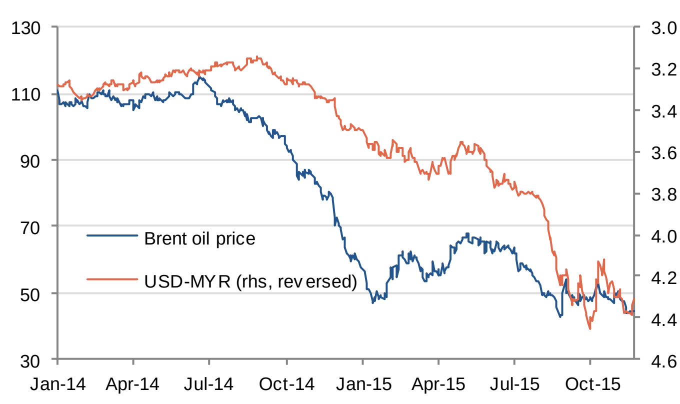
A sustained surge in oil prices would negate our bearish outlook, while ongoing capital flows would reinforce the upward momentum as speculative and hedging flows increase.

Foreign bond holdings / foreign equity flows



Source: Bloomberg, SG Cross Asset Research/EM

Oil linked



Source: Bloomberg, SG Cross Asset Research/EM

Rates – Prefer shorter duration

- MYR rates to rise along with USD rates, amid capital outflow risks
- Prefer shorter duration if exposure is desired
- Under a risk-on scenario the short-end is also likely to benefit more

MYR rates are to rise along with USD rates, with the MYR rates market relatively vulnerable to capital outflow risk. Real yield differentials between MGS and UST were also significantly compressed, rendering any catch-up in MGS yield in reaction to higher UST yields more imminent.

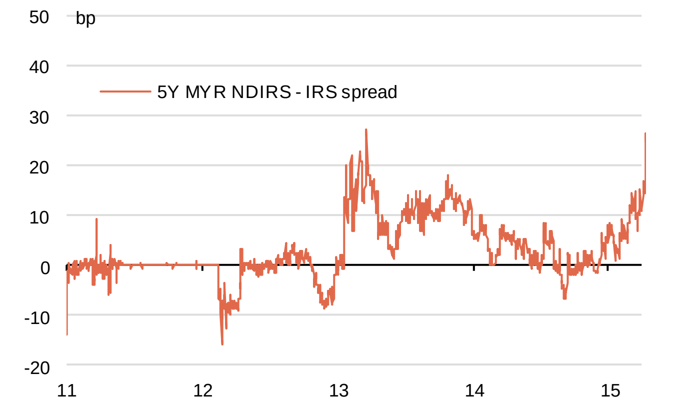
If exposure to the MGS market is desired given the positive absolute real yield and presence in bond indices, we prefer shorter duration as a guard against potential capital outflow risk. During recent episodes of risk-off trading, MYR rates were impacted relatively more compared with regional peers. Trading in the two weeks after China changed its RMB fixing mechanism was a good case in point. Apart from front-end SGD and THB rates, which are directly linked to FX performance via the FX swap implied floating legs, MYR rates (and SUN yields) were particularly paid up.

We acknowledge that MYR rates were sometimes unexpectedly resilient and this irregular relationship with risk sentiment is also reflected by the unstable correlation between 10Y MGS and USD/MYR. Still, high foreign ownership of LCY bonds (46% of MGS is held by foreign investors) and low FX reserves represent the risk factors. When offshore-onshore MYR rates spreads widen, we tend to believe that this represents offshore players building up pay positions suggesting heightened worries over capital outflows.

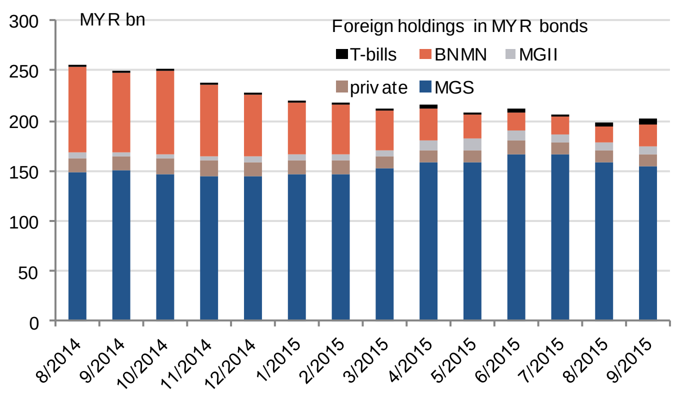
Under a risk-on scenario, the short end is also likely to benefit more. A majority of the reduction in foreign holdings of MYR bonds in the past months was from BNMN, as investors did not switch entirely to other bonds when those bills matured with no fresh supply. Hence, if there is any return of capital upon the better risk sentiment, flows are more likely to be at the short-end than at mid-tenors. Indeed, as BNMN issuance resumed in late 2015, foreign flows came back to this instrument. Flows into short-end papers can also potentially become more active as and when NDF points are favourable for hedging.

Risks to our view include more severe than expected capital outflows and/or a more hawkish Fed resulting in coupon payments insufficient to compensate for capital loss even at the short end.

Watch offshore-onshore rate spreads



"Returning" capital could be for short-term instruments



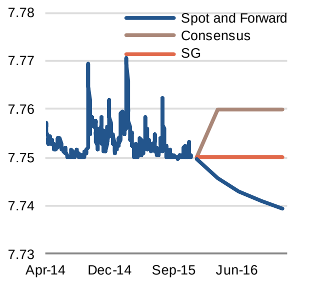
Source: SG Cross Asset Research/EM

Hong Kong

HKD – Economics won't dictate when the peg ends

- No catalyst for HKD peg to change in the near future
- Yuanization or pegging to RMB are most likely long-term outcomes

SG vs consensus



Source: SG Cross Asset Research/EM

Outlook – no catalyst for the change in the peg

There is no near term catalyst for the HKD FX regime to change. Reserves-to-GDP have stabilized in recent years and inflation is well contained. As in the case of Switzerland, politics trump economics. Future long term possibilities include a) status quo, b) managed float, c) a peg or managed float against a basket, d) pegging to CNY, or e) RMB becoming the defacto unit of exchange through "yuanization". Differences in economic structure and financial market development pegging to the CNY or the RMB becoming HK's currency is many years, if not decades, away. A NEER basket would be the most logical near term choice if there was a catalyst.

Risks – Beijing and inflation

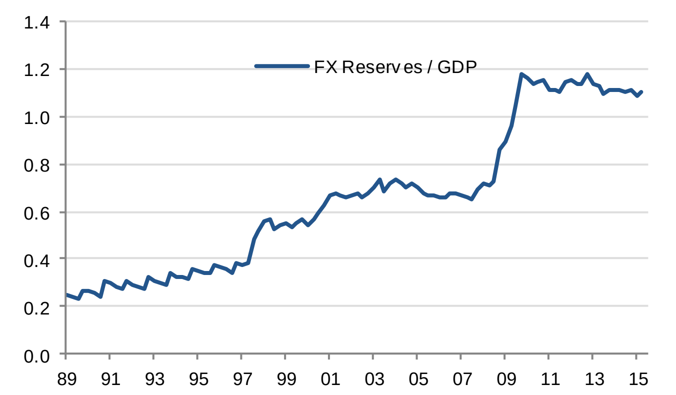
The decision on the future of the HKD peg resides with Beijing. An inflation surge would increase the economic incentives for a different policy construct.

Rates – no escape

Given the usually high correlations with USD rates, HKD rates are to follow their USD counterparts higher. Ample interbank liquidity may mitigate the upward move in short-end HKD rates in the near term, rendering their outperformance over USD rates.

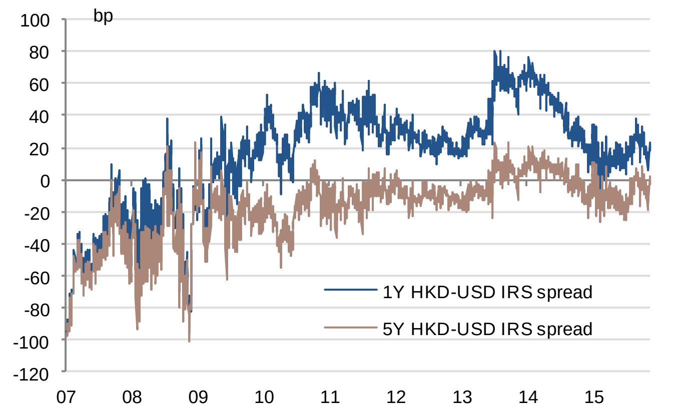
But the HKD IRS curve should stay no steeper than the USD curve given issuer flows pressuring down longer-end HKD rates from time to time. Hi-Li (HKD basis) should remain around or below par with no sign of HKD liquidity tightness – the HKD loan-to-deposit ratio has come down from previous highs, and the share of HKD loans for use outside Hong Kong in total HKD loans has tapered off as well. The risk is, however, that a sudden or disorderly RMB depreciation triggers negative sentiment towards the HKD that pays up Hi-Li and implied rates.

Reserves-to-GDP have stabilized



Source: Bloomberg, SG Cross Asset Research/EM

To follow USD higher, with potential outperformance



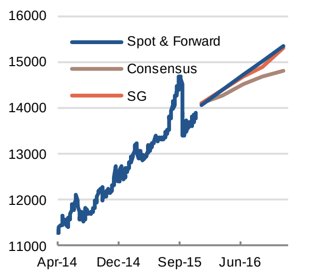
Source: Bloomberg, SG Cross Asset Research/EM

INDONESIA

IDR – still susceptible to a sudden stop

- Dearth of EM capital flows does not bode well for the rupiah
- NDF steepeners and relative value structures preferred due to high negative carry

SG inline vs forwards



Source: SG Cross Asset Research/EM

Outlook – It's all about capital flow dynamics

The IDR remains susceptible to depreciation on a dearth of capital flows to EM (IDR ranks highly on our scorecards in regards to capital flow vulnerability) coupled with lingering risks related to private sector external debt (stock and debt servicing costs). The bullish case for IDR rests on a fragile equilibrium that requires too many positive developments occurring in unison: a) current account improvement, b) continuation of strong capital inflows, c) positive political developments and d) ultra risk friendly EM backdrop. Short IDR positions are expensive so NDF curve steepeners or relative value structures against other EM Asia high yielders are preferred.

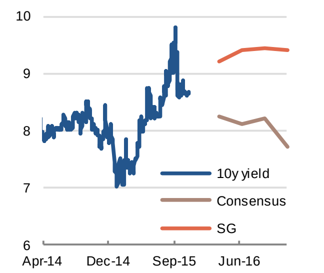
Risks – corporate defaults, EM sentiment

Corporate defaults trigger massive capital flight (bearish); carry trade comes back into vogue on a mega turn in EM sentiment (bullish).

Rates –higher yield on FX selloff, outflow concerns

- IDR yields to move higher to 9.40% on lower FX, foreign ownership vulnerability
- Higher US yields reduce appetite for high yielding IDR bonds

10y – SG expecting higher yields



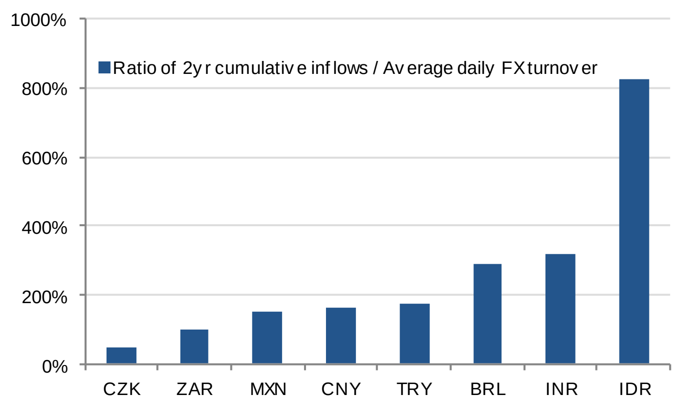
Source: SG Cross Asset Research/EM

Outlook – IDR yields to move up on IDR sell-off, high foreign ownership

IDR yields are likely to move higher on expected IDR sell-off and LCY bonds' vulnerability towards potential outflow risks. Foreign ownership of IDR bonds is high at around 38% of outstanding. Correlation between bond and FX performances are high on MTM needs on un-hedged bonds amid a lack of hedging instruments. Higher US yields next year are likely to reduce the appetite for risk assets and the SUN yields are likely to remain volatile.

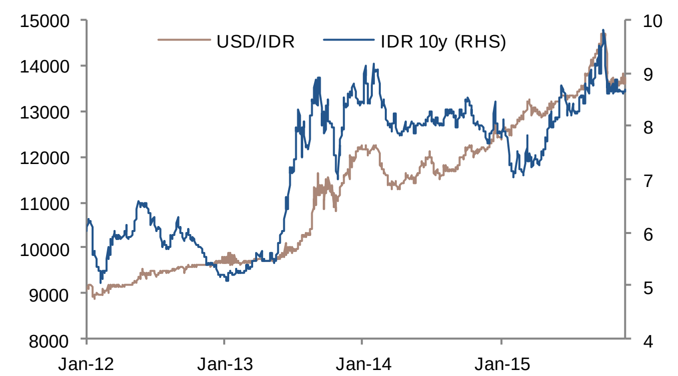
Small, positive moves on politics, expected reduction in benchmark rate, narrower fiscal and current account deficits would likely help limit macro-vulnerabilities, and bouts of bond rallies are likely to occur during the risk-on phases.

Previous inflows large vs FX market liquidity



Source: Bloomberg, SG Cross Asset Research/EM

IDR 10y and USD/IDR are closely linked



Source: Bloomberg, SG Cross Asset Research/EM

Sovereign Credit – Valuations arguing for overweight exposure

- Credit fundamentals have become more resilient, but we highlight the corporate risk
- The upgrade of Indonesia to full investment grade status may be delayed
- Bond valuations argue for slightly overweight exposure

Credit fundamentals – Upgrade to IG status may be delayed

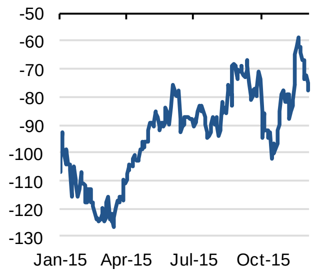
The Indonesian economy has been slowing down, with this shift being particularly tangible in PMI readings (46.9 in November). In absolute terms, however, the growth performance has remained substantially higher than the EM average. The IMF expects Indonesian GDP to rebound next year to 5.1%, from an estimated 4.6% in 2015. Fundamentals have tended to be more resilient than the rest of EM, partially due to a relatively low degree of openness of the economy. Both public debt and external debt levels are quite low, and the current account deficit is contained at 2.2% of GDP. The resilience of Indonesia has prompted S&P to put the country under positive outlook in May: a potential upgrade from S&P would bring the country to full investment grade status, in line with Moody's and Fitch. We think, however, that the upgrade decision may be delayed to at least the second half of 2016. Although less vulnerable to external shocks than in the past, the country is still reliant on capital flows, and its FX reserves are too thin to comfortably cover for short-term external debt. More importantly, the risk on corporate debt has substantially increased in the past few years, and we cannot rule out several corporate defaults in the context of rising US rates. On the political side, we have seen some significant improvements following the elections of summer 2014 with Mr Joko Widodo becoming the first democratically-elected president. Despite the clear willingness to reform the State, the pace of structural reform remains quite slow, which could also be a factor delaying the upgrade.

Indonesia Credit Ratings

Agency	Rating	Outlook
S&P	BB+	Positive
Moody's	Baa3	-
Fitch	BBB-	-
SG Fair	BBB-	-

Source: SG Cross Asset Research/EM

Indonesia spread vs index (bp)

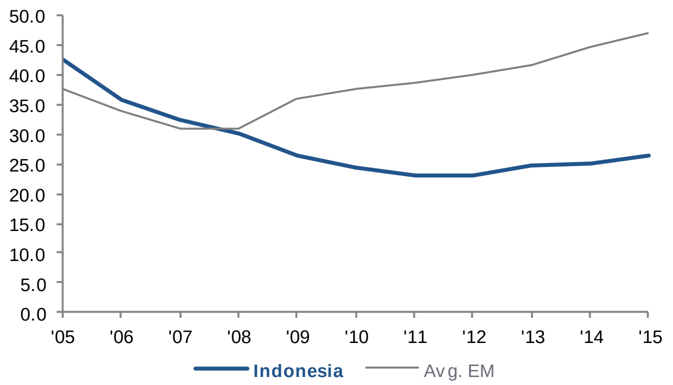


Source: SG Cross Asset Research

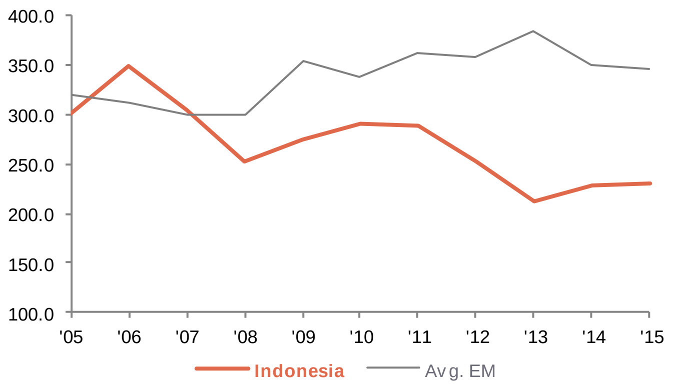
Positioning – Overweight

Indonesia has become a major component of the sovereign credit market; it has the third largest weight in the EMBID index. After a long period where investors were consistently overweight Indonesia sovereign and quasi sovereign bonds, the sell-off of last summer has improved the overall positioning on the credit. According to our Rich & Cheap model, Indonesia dollar bonds are slightly cheap versus fundamentals, which argues for slight overweight exposure. The Indonesian sovereign curve is quite flat compared to other EM credit peers, and the belly of the curve (10Y) may be more attractive than the long end (30Y). The new Indonesian EUR bond is very attractive, as this bond is trading very cheap on a cross currency swap basis.

The rise of public debt has been contained
Indonesia Public debt/GDP (%)



FX reserves still insufficiently covering short-term external debt
Indonesia FX reserves/Short term external debt (%)



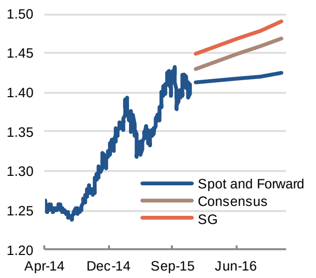
Source: SG Cross Asset Research/EM

SINGAPORE

SGD – NEER destined to stay in lower half of the band

- Structurally slower growth and downward price pressure
- Risks remain slanted toward further policy easing

SG bearish vs consensus



Source: SG Cross Asset Research/EM

Outlook – weak fundamentals argues for weak NEER

The SGD NEER is destined to remain in the lower half of the trading band. Economic activity has been structurally slower over the past three years compared to the previous decade, while core inflation pressures will remain subdued due to general economic malaise. Further policy easing cannot be ruled out as a mechanism to ease monetary conditions if Fed rate hikes lead to higher domestic borrowing costs. With the EUR expected to fall toward parity and USD-Asia to head higher, USD-SGD will be biased upward over the course of the year.

Risks – government policies, external demand, commodity prices

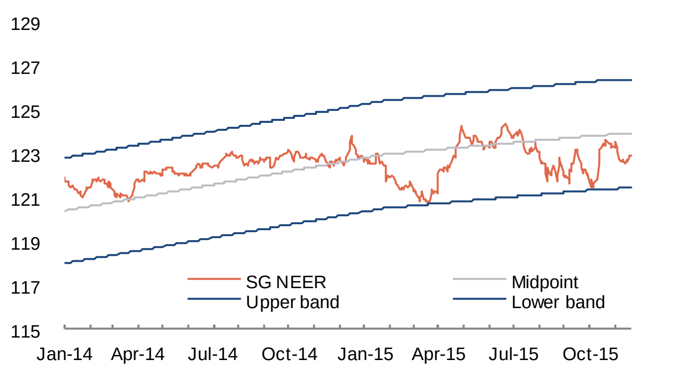
Easing of property market restrictions and immigration standards or acceleration of external demand would boost domestic growth. Higher commodity prices would raise inflation.

Rates – higher on USD rates and bearish SGD

Higher USD rates and continued bearish sentiment towards the SGD point to higher SGD rates in 2016. That said, since SGD rates have underperformed USD rates ahead of the expected Fed liftoff, we expect some normalisation in SGD-USD spreads at the mid- to long tenors, which should be less affected by FX sentiment than the short-end. In other words, in a rising interest rates environment, we look for outperformance of mid- to long-end SGD rates over USD rates, leading to a flatter SGD IRS curve.

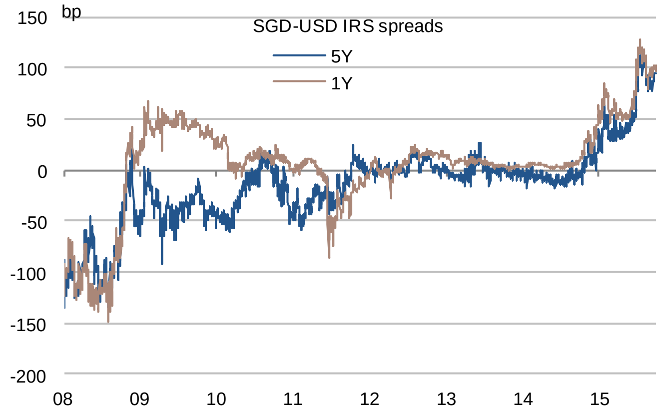
We do not, however, expect SGD rates to go back below USD rates as the FX and growth outlook differs from the previous cycle. The MAS's decision will be the swing factor. If the MAS eases its SGD policy - a non-trivial risk given subdued growth prospect and inflation – and fails to manage expectations on the SGD, then the FX impact may stay even at the mid- to long tenors while potentially leading to spikes at front-end SGD rates.

SGD NEER to remain in lower half of band



Source: Bloomberg, SG Cross Asset Research/EM

SGD rates have run ahead already



Source: Bloomberg, SG Cross Asset Research/EM

THAILAND

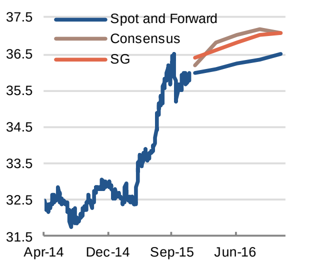
THB – foreign investors continue to exit

- Structurally weak foreign appetite for Thai assets to keep the THB on the back foot
- Politics and RMB depreciation to weigh on foreign investor sentiment

Outlook – Capital flows, politics, and RMB working against the THB

A sharp improvement in the current account has failed to benefit the THB as money continues to exit Thailand via portfolio investments and more recently the errors and omission channel. Further weakness in the EM capital flow cycle will maintain pressure on the THB, especially as trade similarity with China is one the highest in the region (greater than Korea or Taiwan), which risks investors becoming even less enamoured with the baht as the RMB depreciates. Until a sufficient democratic process is reinstated, foreign investors may continue to shun Thai assets.

SG bearish vs forwards



Source: SG Cross Asset Research/EM

Risks – politics key issue for sentiment toward THB

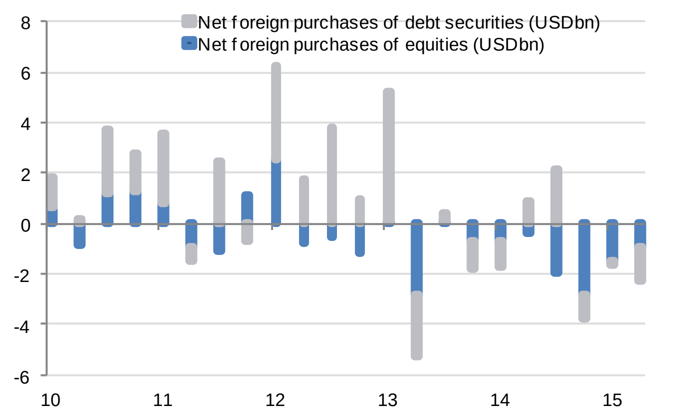
A faster resolution to returning Thailand to democracy could turn out to be very bullish if general appetite toward EM assets improves.

Rates – competition for capital outweighs asset swap impact

The BoT could afford to remain accommodative during the early stage of the Fed tightening cycle. However, front-end THB rates are sensitive to sentiment towards the THB, with the floating leg being an FX swap implied rate. The largely bearish EM FX environment points to upside to THB rates.

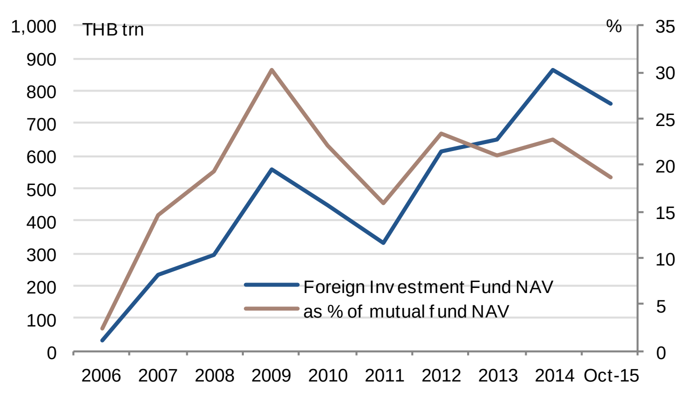
On the other hand, the impact from portfolio flows is less straightforward. Soft THB rates in most of the months in 2015 have been partly caused by increased overseas investment by locals and/or reduced inflows into THB assets, via the asset swap channel. However, if these trends were to intensify because of capital outflow fear, the impact on THB rates could reverse as the FX channel would dominate, pushing up THB rates. The upward move in front-end THB rates during the couple of weeks after China changed it CNY fixing mechanism is a good case in point. On balance, we see upside to THB rates on competition for capital when the USD rates go higher.

Poor foreign appetite for local assets



Source: Bloomberg, SG Cross Asset Research/EM

Overseas investment flows as one factor



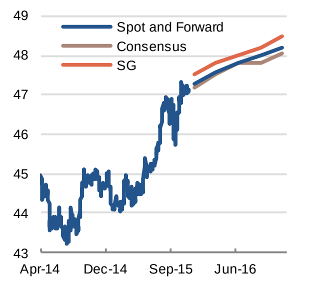
Source: Bloomberg, SG Cross Asset Research/EM, AIMC

PHILIPPINES

PHP – steady trade-weighted appreciation to continue

- Remittances offset REER appreciation in maintaining healthy external surplus
- Low liquidity prevents investors from using PHP as proxy bet for the region

SG bearish vs forwards



Source: SG Cross Asset Research/EM

Outlook – remittance flows provide a large buffer to regional weakness

The PHP should continue to be able to sustain real exchange rate appreciation as robust remittance inflows have mitigated any detrimental impact from a loss of competitiveness on the current account. Robust economic growth, led by steady increases in bank lending, will keep the BSP from engaging in a rate cutting cycle despite weak inflationary pressures. Further weakness should be forthcoming as the broader Asia FX complex softens, but the PHP is anticipated to decline in line with the forwards while the majority of currencies in the region should do worse.

Risks – risk-on for EM and BSP rate cuts

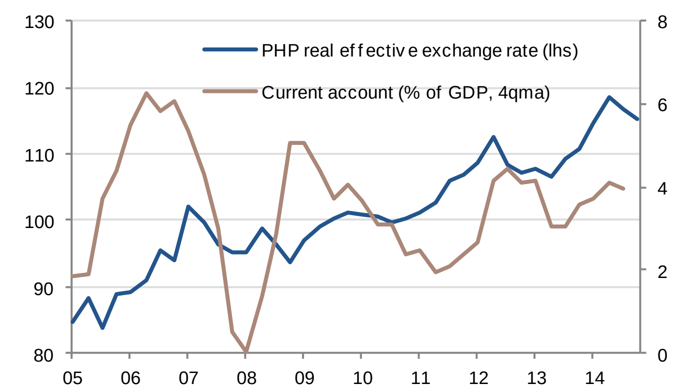
A sustained risk-on mood in EM would cause the PHP to underperform regional peers, while a deceleration in local growth could spur the BSP to cut rates.

Rates – paying interest comes later

The benchmark 3M PHIREF appears to be running ahead of forward points in the uptrend which has been in place since late 2013 but only by a small margin. Meanwhile, spreads between 3M PDST and PHIREF is volatile as usual.

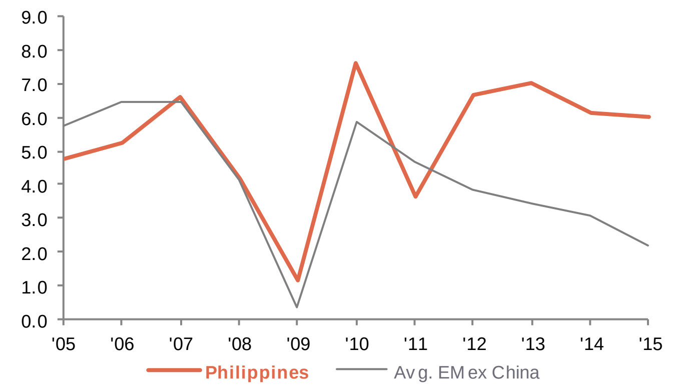
Hence, paying interest among corporates is unlikely to intensify before Fed liftoff or shortly after it, and we expect no strong upside to front-end PHP IRS during early 2016. Afterwards, upside to PHP IRS is seen as the Fed hiking cycle goes on, and with the relatively strong economic fundamentals in the Philippines PHP rates will be able to move higher with USD rates. Risk is PHP underperformance versus forwards which could put upward pressure on front-end PHP rates earlier than we expect.

Current account surplus resilient to REER appreciation



Source: Bloomberg, SG Cross Asset Research/EM

GDP growth remains strong and very resilient to the downside



Source: IMF, SG Cross Asset Research/EM.

Sovereign Credit – Solid fundamentals, expensive valuations

- Credit fundamentals are strong, and the country clearly deserves an upgrade
- The low GDP per capita and the relative weakness in total investment is capping the upgrade, in our view
- Filipino dollar bonds are trading expensive; we are underweight Philippines

Credit fundamentals – Strong fundamentals point to a rating upgrade

The Philippines are showing strong fundamentals: solid growth (6% expected by the IMF in 2016, in line with 2015), contained inflation, strict control of fiscal deficit, large current account surplus, low public and external debt and high level of FX reserves. The country is also benefitting from large remittances from the diasporas around the world, which not only boost the current account surplus but also act as an important buffer against a potential economic slowdown. The Philippines are clearly due for an upgrade, and we estimate the fair rating at BBB. In light of Philippines' fundamentals, the country could deserve a much higher rating, but two variables are capping the upgrade in our view. First, with a GDP per capita of USD3000, the Philippines remains a poor country, even by EM standards. Secondly, the level of investment remains subdued (21% of GDP) compared to other Asian countries (close to 27%, on average), and net foreign direct investment is even negative. Any progress on these two fronts would make the Philippines a clear candidate for an upgrade to BBB+, and potentially to A-, in our view.

Philippines Credit Ratings

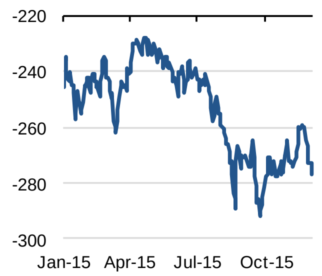
Agency	Rating	Outlook
S&P	BBB	-
Moody's	Baa2	-
Fitch	BBB-	Positive
SG Fair	BBB	-

Source: SG Cross Asset Research/EM

Positioning – Underweight

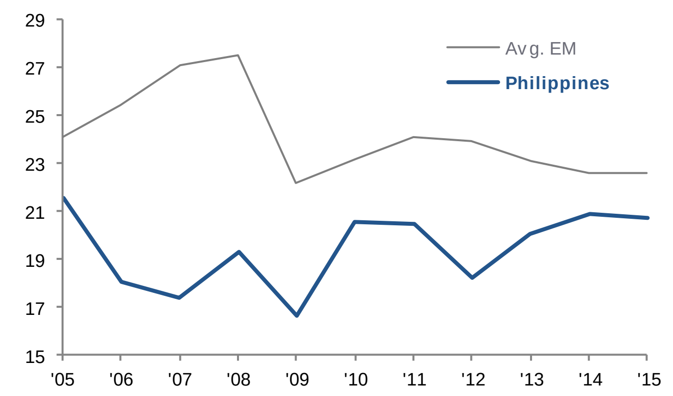
Despite the recent revamp of the EMBI Diversified methodology which has seen the weight of Filipino bonds substantially dropping in the aggregate index, The Philippines still retains the fifth largest weight in the EM sovereign credit index. The Philippines are clearly due for an upgrade, but the potential upgrade is largely priced in by the market, with the country virtually trading like an A+ rated credit at present. The Philippines have outperformed the index this year, especially in spread terms (the Philippines spreads have hardly moved this year, while the index has widened by more than 40bp). At current valuations, we remain underweight the Filipino sovereign global bonds.

Philippines spread vs index (bp)

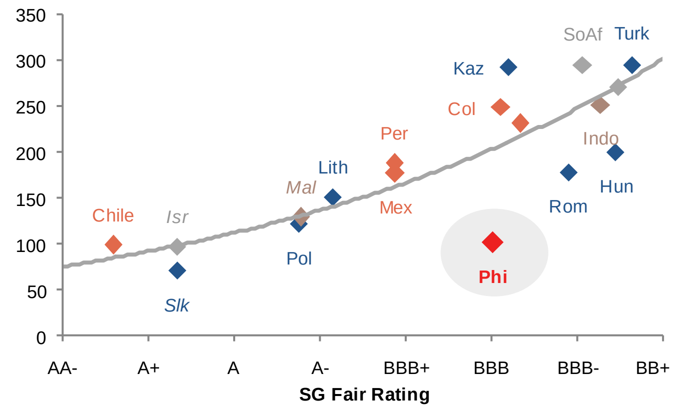


Source: SG Cross Asset Research

The level of investment remains subdued
Philippines total investment/GDP (%), vs EM average (%)



Philippines dollar bonds implicitly trading as A-rated assets
10y Z-spread vs SG Fair Rating



Source: IMF, SG Cross Asset Research/EM

BRAZIL

BRL – Domestic challenges remain driving force

- BRL to depreciate, but less than the forwards imply
- Improvement of political environment essential for stabilization of BRL

Outlook – BRL to depreciate less than implied by the forwards

Our base case envisages the BRL to only marginally depreciate in 2016 after posting significant losses in recent years. The BRL was one of the most overvalued EM currencies during the commodity-induced EM boom up to 2012, when the USD/BRL was trading at around 1.55. Over the past three years, the USD has gained 130% against the BRL, and the latter is now one of the five EM currencies with the largest degree of undervaluation (see also REER valuations – fool's gold). While we expect some stabilisation of the currency after a Fed rate hike, domestic politics and the economic outlook will be the main drivers of the currency's performance in 2016. We expect a tactical trading environment for the BRL next year. Overall, we predict a slightly better performance than what the forwards are currently pricing.

BRL forecasts, forwards, consensus

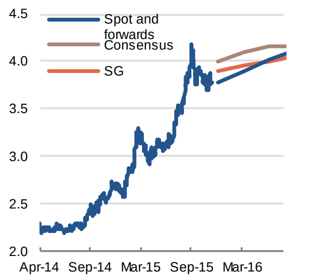
Date	Forward	SG	Consensus
Q1'16	3.90	3.95	4.10
Q2'16	4.01	4.00	4.15
Q3'16	4.13	4.05	4.15
Q4'16	4.25	4.10	4.15

Source: SG Cross Asset Research/EM

Rationale – Valuations relatively attractive but domestic outlook negative

The BRL has been suffering from rating downgrades, political turbulence, capital outflows, the steep drop in commodity prices and the growth slowdown in China, which have all had negative repercussions for the domestic economy. Domestically, unemployment is on the rise, investor sentiment is deteriorating, inflation is rising and is above 10% and the economy is facing its worst recession since the 1930s. Overall, the economy is poised to contract more than 3% in 2015, but we expect an improvement in 2016 with the economy contracting less than this year. At this point, the economic contraction and the political risk premium seem to be priced in, with the BRL trading around 3.85 against the USD. While the negative domestic backdrop and Fed monetary policy tightening will likely weigh negatively on the BRL in the final weeks of 2015 and early 2016, we expect more attractive valuations and the high-carry to lead to tactical rallies later in 2016, especially once domestic growth data improve.

SG more bullish than consensus

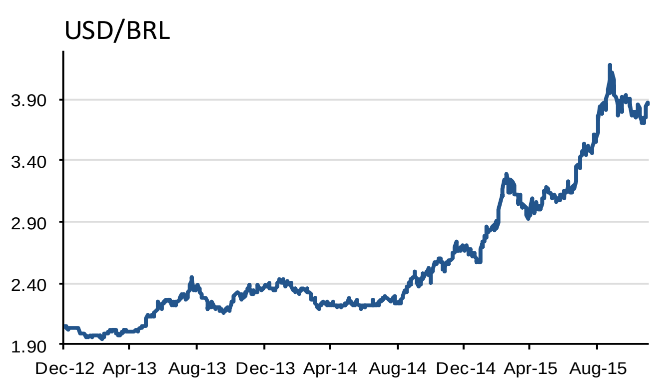


Source: SG Cross Asset Research/EM

Risks – Hard landing in China

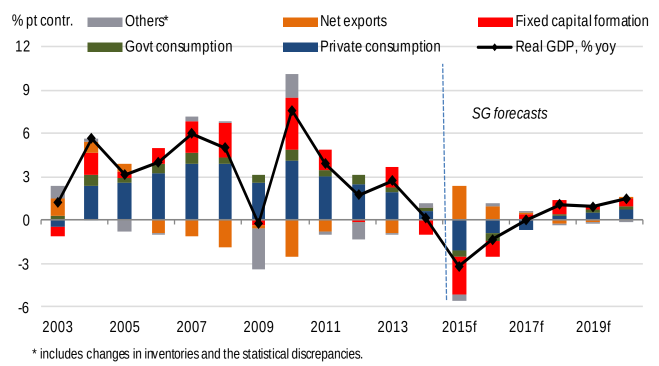
Downside risks include a hard landing in China and a further sell-off in commodity prices in 2016. Brazil is among the most exposed EM countries to a Chinese hard landing, and investors would further reduce exposure to Brazilian assets in this case.

BRL recording a steep selloff in recent years



Source: Bloomberg, SG Cross Asset Research/EM

Economy in back-to-back recession in 2015 and 2016



Source: Bloomberg, SG Cross Asset Research/EM

Rates – Expect the Brazilian curve to steepen

- Curve in Brazil too flat
- Inflationary and fiscal concerns to weigh negatively on long end of curve
- Front end pricing too many rate hikes

BCB policy rate: SG forecasts

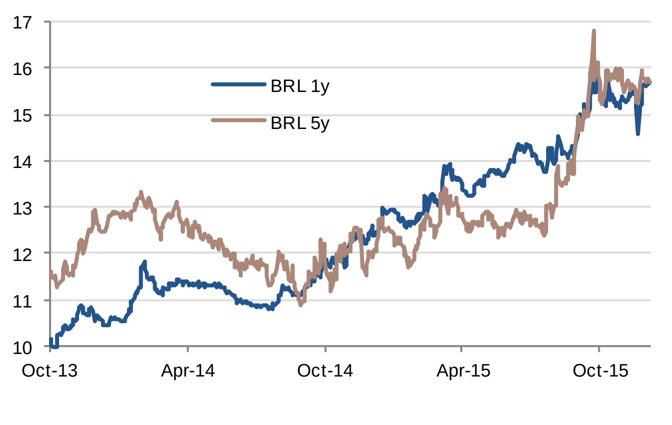
	SG	Consensus
Q1'15	14.25	14.35
Q2'15	14.25	14.35
Q3'15	14.25	14.05
Q4'15	14.25	13.60

Source: SG Cross Asset Research/EM

Inflation in Brazil surpassed 10% at end 2016. The central bank is currently assuming that IPCA inflation will start to subside from January 2016 onwards and reach the upper end of the inflation target +/-2% of the official target at 4.5% within 2016. We think this target is too ambitious. While we expect inflation to moderate in H2 16 from current high levels, we do not expect inflation to revert towards the central bank's target. Therefore, we do not believe monetary policy will turn accommodative any time soon. We also think the market is pricing in too many rate hikes over the next 12 months (currently 130bp of hikes). We see the central bank remaining very cautious in raising interest rates due to the "fiscal dominance". This will keep front-end rates anchored.

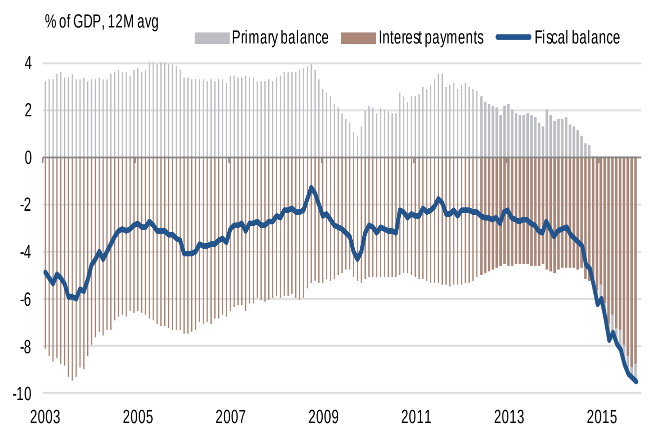
The long end of the curve in Brazil, after a massive rally in October- November 2015, looks vulnerable to a renewed sell-off, in our view. The 1s5s spread is almost flat at present, and the 5y pre-Di swaps have rallied from an intraday peak of 17.00% at end September towards 15.19 at end November, a 181bp move. We think inflationary pressures and fiscal concerns will keep 5y rates elevated. On the fiscal side, the deficit in Brazil rose from 2.3% of GDP in 2012 to around 10% in 2015. The deficit is increasing despite central government spending cuts, as the economy is contracting and growth of revenues are low. Overall, we expect rates at the longer end of the curve to remain under pressure and the currently inverted curve to steepen throughout 2016.

Pre-Di yield curve currently relatively flat



Source: SG Cross Asset Research/EM, Bloomberg

Fiscal balance deteriorating



Source: SG Cross Asset Research/EM, various official websites

Sovereign Credit – Dollar bonds cheap vs fundamentals

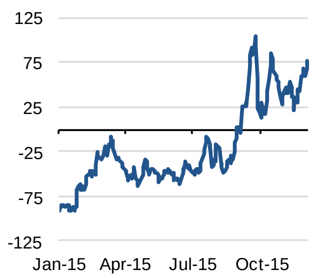
- Fundamentals have been deteriorating fast, the main concern being the fiscal deficit
- However, the external debt position remains strong
- We retain strategic overweight exposure to Brazil's external debt

Brazil Credit Ratings

Agency	Rating	Outlook
S&P	BB+	Negative
Moody's	Baa3	Neg. Watch
Fitch	BBB-	Negative
SG Fair	BBB-	-

Source: SG Cross Asset Research/EM

Brazil spread vs index (bp)



Source: SG Cross Asset Research

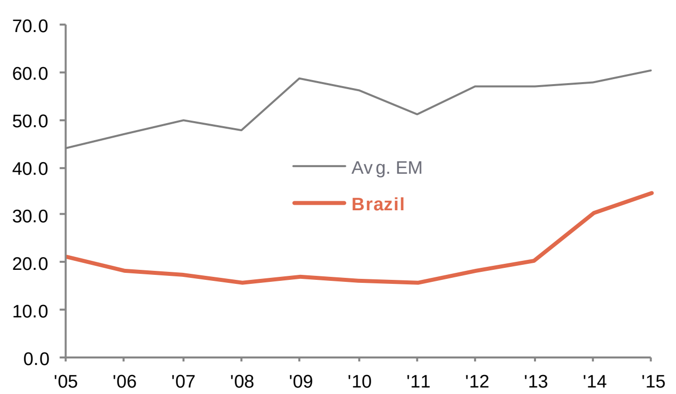
Credit fundamentals – Continuous deterioration, but limited risks for the external debt

Brazil was downgraded to BB+ in September by S&P, the agency retaining a negative outlook on the country. Moody's also put Brazil under negative watch this week, the country having now a high chance to fall from IG status. Although fundamentals are deteriorating rapidly, we believe that the downgrade to "junk" status is somewhat overdone from the pure external debt standpoints. Brazil still has strong external credit metrics, external debt representing only 34% of GDP, and although this ratio will inevitably deteriorate over the coming months due to sharp BRL depreciation, it will remain one of the lowest in EM. More importantly, only 8.5% of the external debt is classified as short-term. FX reserves are close to $360bn, covering more than six times the level of short-term external debt. This represents a very comfortable buffer and allows Brazil to meet its external liabilities without having to tap the external debt market. The current account has been deteriorating at a fast pace: the IMF market consensus expects the deficit to reach 3.9% of GDP this year. This deficit is undeniably a weakness for Brazil, but it is still a manageable level. In fact, BRL depreciation combined with the compression of the domestic demand may reduce the external deficit to an estimated 3.5% of GDP next year. If we compare the external debt coming due with the level of official reserves – adjusted for the current account deficit – we find that Brazil's external vulnerability remains very low. That being said, we reckon that the economic situation has largely deteriorated, with heightened concerns about growth, inflation and the fiscal deficit. That being said, the country is still a quite strong position from an external debt standpoint, in our view.

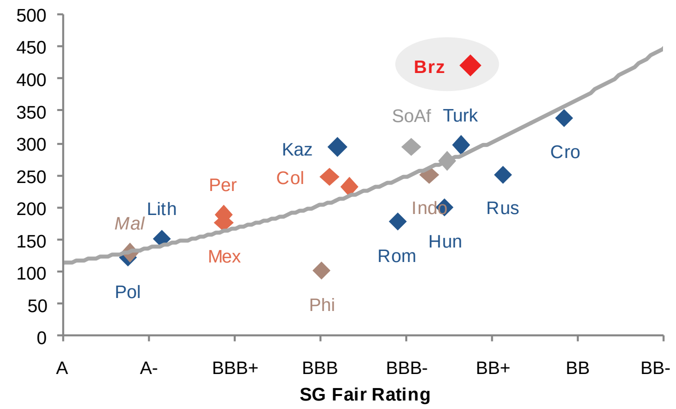
Positioning – Overweight

From an external debt standpoint, Brazil has no liquidity or solvency issues, and although we remain concerned about the country's long-term prospects, we would not classify the Brazilian external debt in the sub-investment grade category. Brazilian bonds have largely outperformed the index over the past month, but our sovereign credit Rich & Cheap model indicates that the Brazilian global bonds are still trading very cheap to fair value. We retain a strategic overweight view on Brazil.

External debt is rising, but it is still very low vs GDP
Brazil external debt/GDP and versus EM average (%)



Brazil trades cheap to fundamentals
10y Z-spread vs SG fair value rating



Source: SG Cross Asset Research/EM

MEXICO

MXN – Bright spot in the region

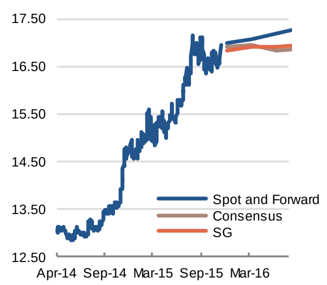
- After a massive fall in 2015, we expect the MXN to stabilise in 2016
- Stronger growth to re-attract capital inflows
- Mexican economy to outperform in 2016

MXN forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	16.70	16.85	16.95
Q2'16	16.82	16.90	16.75
Q3'16	16.94	16.90	16.60
Q4'16	17.08	17.00	16.35

Source: SG Cross Asset Research/EM

SG in line with consensus



Source: SG Cross Asset Research/EM

Outlook – Mexico has disappointed but might come back in 2016

The MXN has disappointed EM investors over recent years. In fact, it was amongst the worst performing EM currencies in 2015, as uncertainty surrounding the Fed outlook and a general rout on Latam currencies hit the MXN, which, due to its liquidity, was used as a proxy for international investors to hedge against macro risks, and it reached a low of 17.36 USD/MXN in September 2015. Nevertheless, we see Mexico as one of the bright stories across the EM space. We expect growth to make a significant comeback in 2016, and MXN debt has compelling relative value and will attract international investors, especially after the uncertainty surrounding the Fed rate liftoff resides. We also think the MXN will bounce back from its recent lows and enter into an appreciation bias over time. Overall, we are constructive on Mexico for 2016 and think the stars are aligned for a recovery in the economy and Mexican asset prices.

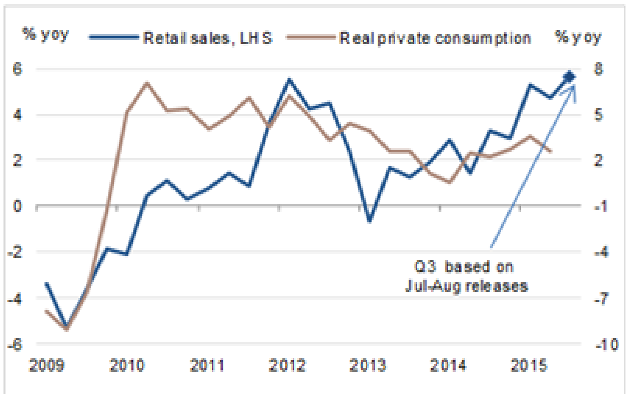
Rationale – Economy to bounce back in 2016

After hitting a soft patch in 2015, the economy only growing a little more than 2.0%, we expect to see acceleration in 2016 and beyond due to the strong US economy, solid domestic consumption and strength in investment momentum. As such, Latin America's second biggest economy is well positioned to be a bright spot in the region, which is facing headwinds from the widespread commodity-led slowdown. We expect Mexico to post above-trend growth of 3.1% in 2016.

Risks – Disappointing growth comeback, security concerns

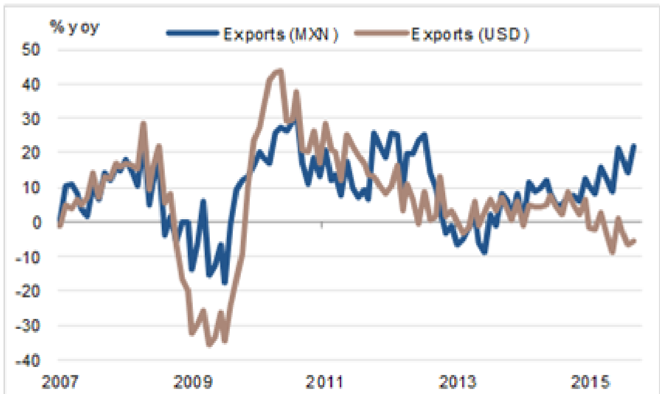
One of the main risk to our forecast is another disappointing year of growth failing to meet its potential, which could result in a reduction of bond holdings amongst foreigners and capital outflows. Also, deterioration of the domestic security situation is a threat to our outlook.

Retail sales bode a rebound in private consumption



Source: Bloomberg, SG Cross Asset Research/EM

Stronger exports point to better growth conditions



Source: Bloomberg, SG Cross Asset Research/EM

Rates – Mexican curve looks steep

- Curve already the steepest in EM
- Curve is pricing in aggressive Banxico rate hikes
- Expect renewed bond inflows in 2016

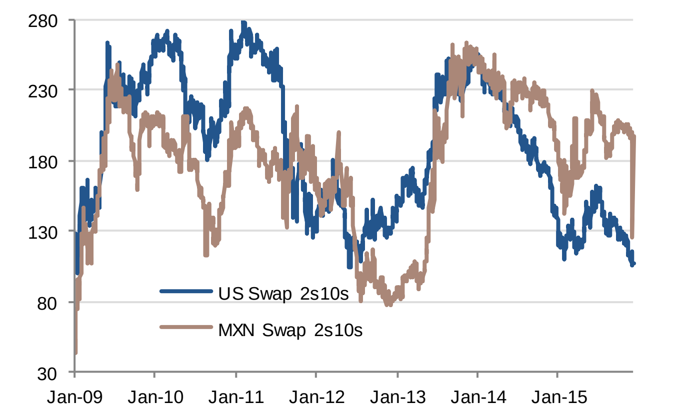
Banxico policy rate: SG forecasts

	SG	Consensus
Q1'15	3.50	3.45
Q2'15	4.00	3.70
Q3'15	4.50	3.95
Q4'15	5.00	4.15

Source: SG Cross Asset Research/EM

On the monetary policy front, we think Mexico's central bank will hike rates in 2016, but we think that the market is mispricing the magnitude of the rate hiking cycle. Two factors will be key for the central bank to determine the next steps of its expected rate hiking cycle. The first relates to growth and inflation, and the second, which in our view is the main driver for monetary policy in 2016, is the pace of rate hikes in the US. With the economy recovering in 2016 and inflation moving towards the central bank's target, as outlined above, we think domestic factors alone could lead to a turnaround in the monetary policy cycle. The central bank recently moved its monetary policy meetings behind the FOMC meetings in order to be able to discuss and reflect on the Fed's decision in its own monetary policy decisions. The market is pricing in 200bp of rate hikes over the next two years at this point. However, downside risks to this forecast exist in case the Fed is more dovish than expected or inflation in Mexico fails to rise towards 3.5% in 2016. One of the main drivers for Mexico's historically low inflation was a cut in telecom and energy prices. We think these base effects will ebb in 2016 and inflation numbers will start to rise back to the central bank's target. The curve in Mexico is currently pricing in around 200bp of rate hikes over two years. We think market pricing is excessive and the curve is mirroring the outlook for rate hikes in the US despite the domestic growth/inflation backdrop in Mexico having decoupled from the US over the last two years. While the central bank has repeatedly raised hawkish expectations that it would raise rates to shield its market from turbulences surrounding the Fed rate hike, we see the risk that the hiking cycle, if it comes as soon as the market expects, will not be as aggressive as the market is pricing. Accordingly, we recommend receiver positions in the front end, but advise hedging this position against rising US short-term yields. Overall, we expect a flattening bias of the TIIE curve, which is the steepest across EM. A key risk to the flattening bias is inflation in Mexico rising faster than expected or a significant steepening of the US curve

Mexican curve looks steep compared to US curve



Mexican 2y swap rates have fallen in recent years

Source: SG Cross Asset Research/EM

Sovereign Credit – Fed weighing on UMS bonds

- Mexican fundamentals remain strong, but progress on the fiscal front is slow
- From a credit standpoint, the main issue is the structure of the public budget
- We are underweight Mexican USD bonds due to their high sensitivity to US rates

Credit fundamentals – Sound, but little progress on fiscal front

IMF expects the Mexican economy to grow 2.3% this year and 2.8% next as the US economy gains momentum; this should help ease the pressure on the fiscal deficit, at around 3.5% of GDP in 2016 (vs 4% this year, based on IMF numbers). The level of public debt (52% of GDP) is not of real concern, although it has tended to rise over the long term. The current account has been consistently negative for decades, but it remains moderate at 2.0-2.5% of GDP, and external debt is still low (35% of GDP). The amount of FX reserves is reasonably high and covers five months of imports. From a pure credit standpoint, the main issue in Mexico is the structure of the public budget and its long-term reliance on Pemex for funding. An ambitious energy reform was launched in January 2014 to end Pemex's monopoly and incentivise foreign direct investment in the country. The collapse in oil prices is largely mitigating the impact of this reform and weighing even more heavily on the short-term public budget. In fact, the overreliance on Pemex remains an issue, considering the fact that oil reserves in Mexico are becoming scarce. Facing long-term competition from Chinese products, Mexico's manufacturing sector has to reposition itself, attract FDI and gain competitiveness. Although Mexico remains a relatively strong credit, we expect no rating upgrade in the foreseeable future. The A3 rating from Moody's looks a bit overstretched, in our view, and we view Mexico as a BBB+ credit.

Mexico Credit Ratings

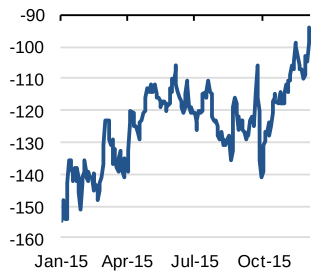
Agency	Rating	Outlook
S&P	BBB+	-
Moody's	A3	-
Fitch	BBB+	-
SG Fair	BBB+	-

Source: SG Cross Asset Research/EM

Positioning – Underweight

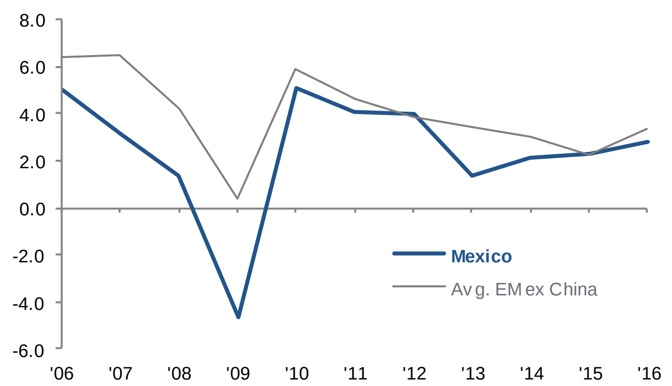
Mexico has the biggest weight in the EMBI index (combining essentially sovereign and Pemex bonds). Its performance has been disappointing this year, along with other Latam, low-beta names like Peru and Chile, due to their low carry and high sensitivity to US rates. Mexican bonds are trading in line with their fair value, we estimate, but 2016 could be another difficult year in terms of absolute return, UMS bonds being particularly sensitive to US Treasuries. We would hold an underweight position on Mexico.

Mexico spread vs index (bp)

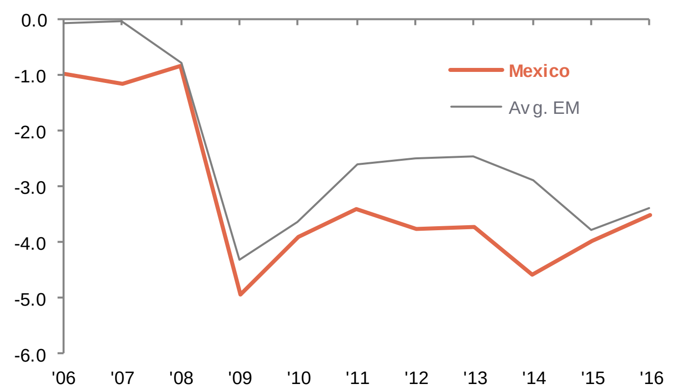


Source: SG Cross Asset Research

GDP growth should slightly improve
Mexico GDP growth vs EM average (ex-China, %)



Progress on the fiscal front is slow
Mexico fiscal balance/GDP vs EM average (%)



Source: IMF, SG Cross Asset Research/EM

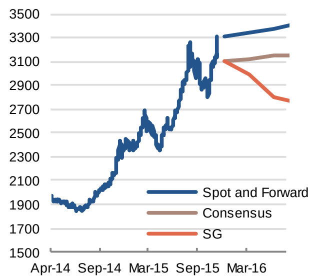
COLOMBIA

COP forecasts, forwards, consensus

Date	Forward	SG	Consensus
Q1'16	3329	3000	3150
Q2'16	3368	2800	3150
Q3'16	3411	2750	3158
Q4'16	3461	2600	3100

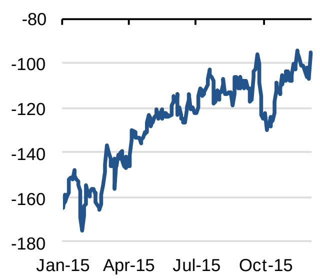
Source: SG Cross Asset Research/EM

SG bullish vs forwards



Source: SG Cross Asset Research/EM

Colombia spread vs index (bp)



Source: SG Cross Asset Research

COP – Expect a rebound in 2016

- A stronger economy will lead to a rebound in capital inflows
- COP to rebound in 2016
- We hold a slight overweight on Colombian USD bonds.

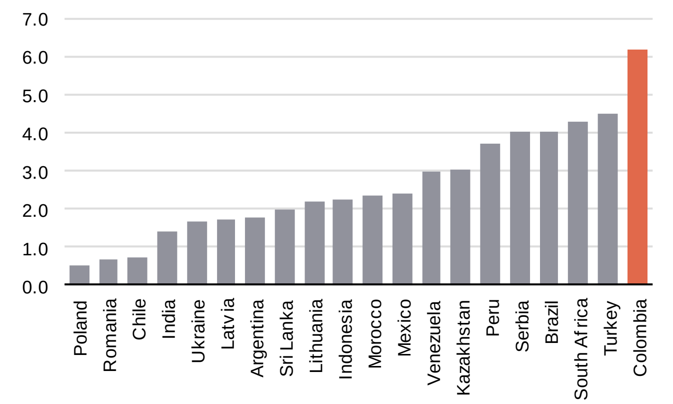
Outlook – COP one of the winners in 2016

The COP, together with the BRL, has been the worst performing EM currency in 2015. It was hit by falling commodity prices, especially oil, and lower capital inflows, as investor enthusiasm was dented by the drop in Colombia's growth performance. The outlook for 2016 is a bit more positive, the IMF forecasting growth at c.2.8%, versus 2.5% in 2015e. In our view, the rebound in growth and a possible stabilisation of crude prices should lead to renewed capital inflows, as Colombia offers attractive valuations after an almost 80% fall in its currency since 2014. On the rates side, the central bank made several hikes in 2015 to 5.50%, but we think these will be less aggressive going forward than the market currently anticipates. We expect the Colombian central bank to hike rates at a very gradual pace, as a spike in inflation towards 5.90% at end 2015 might prove to be transitory, in our view.

Sovereign credit – Slight overweight

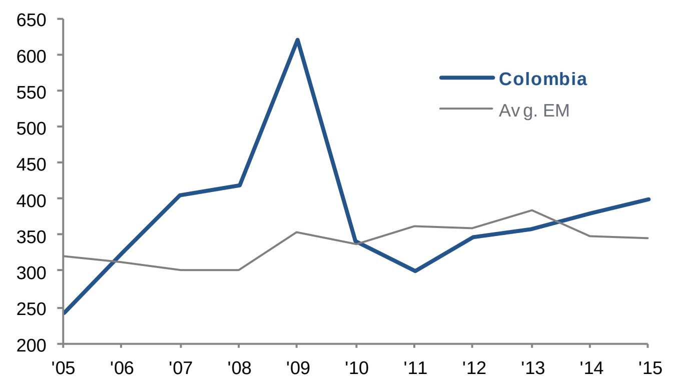
Colombia's growth performance has been badly hit by the fall in commodities, and the current account deficit is now amongst the worst in EM at 6.2% of GDP in 2015. However, we do not think the situation is desperate: the fiscal deficit remains contained at 35% of GDP, public and external debt levels are low (49% and 33% of GDP, respectively), and FX reserves still largely cover short-term liabilities. Fundamentals have clearly deteriorated, but we think the risk of downgrade in 2016 is limited; in fact, the three major agencies are all rating Colombia as a BBB credit with a stable outlook, and our proprietary model indicates that downgrade pressure are moderate. Colombian USD bonds look cheap compared to fundamentals, and we believe the downside is now limited. We retain a modest overweight on Colombian USD bonds.

Colombia has one of the worst current account deficits in EM
Current account deficit (%GDP)



Source: IMF, SG Cross Asset Research/EM

Short-term external liabilities are well covered by FX reserves
FX reserves/Short-term debt (%)



Source: IMF, SG Cross Asset Research/EM.

CHILE

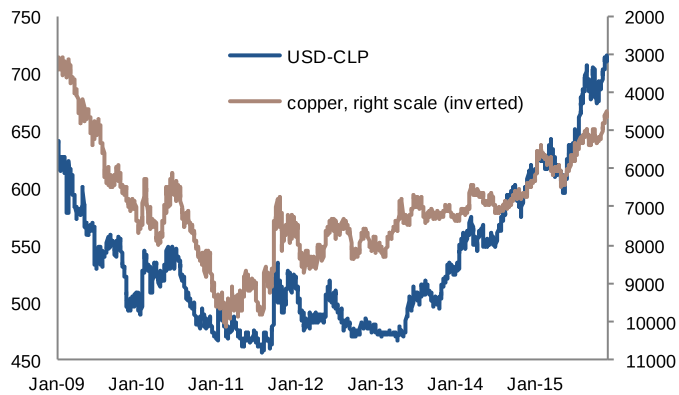
CLP – all eyes on China and global growth

- CLP one of the EM currencies most sensitive to commodity outlook
- High correlation with global copper prices
- Developments in China will be key for CLP performance

Outlook – CLP muddling through

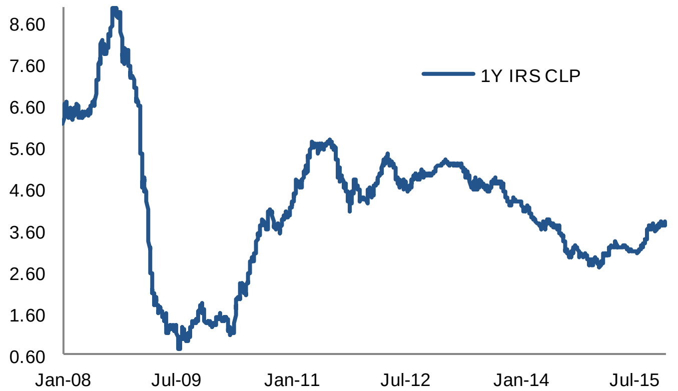
The CLP has consistently depreciated in 2015 amid falling commodity prices, especially copper, below-trend growth and rising inflation, all factors that undermined investor confidence in the currency's outlook. Looking ahead, the key channel to sustain investment growth – exports – remains in weak shape, and we expect Chile will post one of the lowest growth rates in Latam in 2016, with only Brazil faring worse. We expect the economy to grow just 2.5% yoy in 2016, which would be a minor recovery from the expected 2015 GDP growth rate of 2.3%. The weak growth outlook is one of the reasons why we think the CLP could underperform other EM currencies in the region next year. On the monetary policy side, the central bank hiked rates in October, citing inflationary concerns. If the it raises rates further, we would expect the policy rate to peak in H1 16. Overall, we think the inflation outlook is benign and we lower our forecasts to 4.3% in 2015 and 3.6% in 2016. We think the risks are skewed so that front-end rates trend lower next year, especially if inflation falls further and the central bank does not hike rates further, as currently priced in by the market.

CLP selling off in line with steep fall in copper prices



Source: SG Cross Asset Research, Bloomberg

The risk is skewed toward lower front-end rates next year



Source: SG Cross Asset Research, Bloomberg

VENEZUELA

Sovereign Credit – Default may be inevitable in 2016

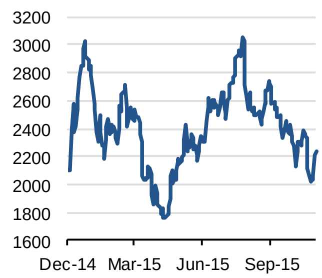
- The results of the general elections are bringing new hope for investors
- However, Venezuela may not be able to avoid a default next year, in our view
- We are market-neutral Venezuela, but we may drastically reduce our exposure

Venezuela Credit Ratings

Agency	Rating	Outlook
S&P	CCC	Negative
Moody's	Caa3	-
Fitch	CCC	-
SG Fair	D	-

Source: SG Cross Asset Research/EM

Venezuela spread vs index (bp)



Source: SG Cross Asset Research

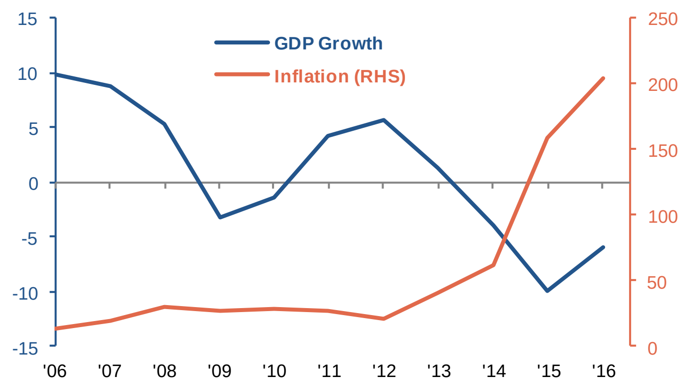
Fundamentals – Default likely in 2016

The large defeat of the Chavista party in last weekend's general elections was a massive setback for the government: after winning more than two-thirds of the seats in Parliament, the opposition (formed by a large coalition) can now block the government's decisions and even change the Constitution. President Nicolas Maduro has formally asked for the resignation of its goverment, but it remains unclear if he intends to remain in power (in theory, Mr Maduro still has more than three years to run). The elections have brought new hope for the investment community, but we think the country may be unable to avoid a default next year, its fundamentals beign far too deteriorated. The oil price collapse has pushed the Venezuelan economy into a deep recession (GDP is expected to plunge nearly 10% this year), and inflation is reaching an astounding 160% due to the endemic shortage of basic consumer goods. At 25% of GDP, the fiscal deficit is simply abysmal, while the pressure on FX reserves has intensified after the current account turned negative this year (-3% of GDP). The external deficit – susbequent to the fall in crude prices – may prove to be fatal for FX reserves, as they are already very low (c.$15bn, including gold, covering less than three months of imports). The debt schedule does not put Venezuela under immediate threat (although $2.2bn falls due in February, including coupon payments), but the risk is high in Q4 16, when the government and state-owned oil company PDVSA have to repay $4bn. The restructuring of $64bn in Venezuelan hard-currency bonds looks inevitable, in our view.

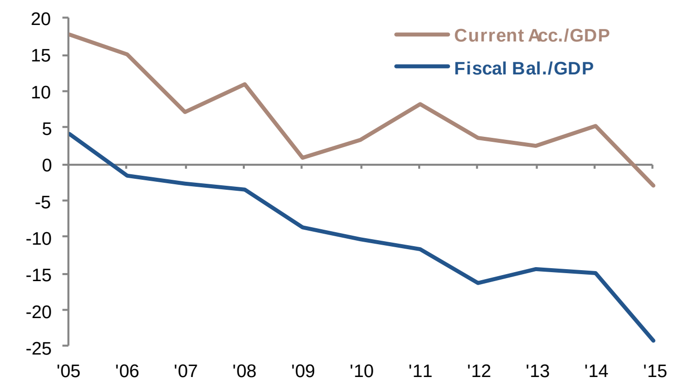
Exposure – Short term: Neutral; medium term: Underweight

The elections are likely to boost Venezuela's bonds in the short term, and at an average spread of 2,500bp, the carry on Venezuelan bonds is very high. Therefore, it makes sense in the short term to keep at least market-neutral exposure to Venezuela. However, given the very distressed situation and a likely credit event towards end 2016, we might drastically reduce our Venezuela exposure in the next few months.

Deep economic recession combined with soaring inflation
Venezuela GDP growth and annual inflation (%)



Abysmal fiscal deficit, current account turning negative
Venezuela current account and fiscal balance (% GDP)



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