Morgan Stanley

MORGAN STANLEY RESEARCH

August 5, 2013

Global EM Investor

The Fragile Five

We continue to see scope for a bear market rally in EM risk assets through the summer, but within established ranges – leading us to retain our tactical directional stance of Hold. Market technicals are favourable, and short-term momentum is normalising. The divergence in EM and DM growth conditions remains in place. In addition, as policy guidance towards still-low rates in G3 remains in place, further EM currency stability may present opportunities to extend duration selectively in local rates.

Comments of the Week

EM Currencies – The Fragile Five: The EM currency bear market that has been in place for the past two years is likely to continue over the medium term, as the factors supporting BoP flows over the last decade continue to unwind. Currencies will likely be held back by high inflation, large current account deficits, challenging capital flow prospects and potentially weak EM growth.

The prospective normalisation of Fed monetary policy simply exacerbates these underlying fundamental weaknesses. BRL, IDR, INR, TRY and ZAR will likely remain under medium-term pressure, and we continue to recommend accumulating long USD positions versus these currencies on any meaningful dips.

Rate hikes and FX intervention only provide breathing room, and we continue to highlight the importance of structural reforms to attract capital on a sustainable basis. Future differentiation on these grounds will likely be high. MXN remains the bright spot.

EM Credit – Belarus Potash Crisis: Trigger for Repricing: Belarus has underperformed EM peers in the past week; however, it is still one of the best-performing credits this year. We see the recent collapse of the potash marketing arrangement and the likely negative impact for the Belarus economy as a trigger for investors to reprice Belarus credit wider.

Assessment Changes

Currencies: We downgrade **BRL** to neutral/underweight from neutral.

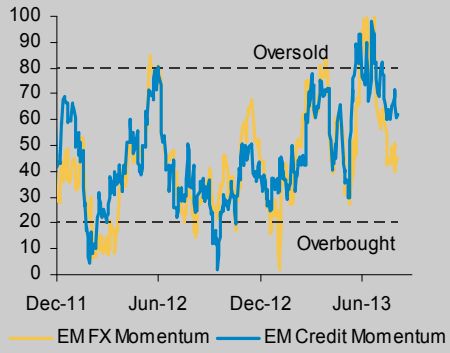
Asset Class Stance

Currencies	Local Rates	Sovereign Credit	Corporate Credit
Hold	Hold	Hold	Hold

GLOBAL EM MACRO STRATEGY TEAM

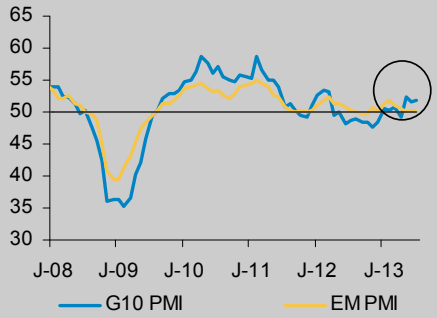
For research analysts, please see contact list at the back of this material.

Short-Term Momentum Index



Source: Morgan Stanley Research, Bloomberg

DM – EM PMI Divergence



Source: Morgan Stanley Research, Bloomberg

Note: Due to the nature of the fixed income market, the issuers or bonds of the issuers recommended or discussed in this report may not be continuously followed. Accordingly, investors must regard this report as providing stand-alone analysis and should not expect continuing analysis or additional reports relating to such issuers or bonds of the issuers.

Global EM Cross-Asset Compass

James Lord, Rashique Rahman

EMFX	Sell	Reduce	**Hold**	Accumulate	Buy
Rates	Sell	Reduce	**Hold**	Accumulate	Buy
Sov Credit	Sell	Reduce	**Hold**	Accumulate	Buy
Corp Credit	Sell	Reduce	**Hold**	Accumulate	Buy

- We see scope for a resumption in the bear market rally for EM risk through the summer, but within established trading ranges; this keeps us with our Hold stance.
- As currencies stabilise, we look to extend duration, selectively, in EM local rates.
- This week's policy decisions from DM central banks could prove a tailwind for risk appetite, but we recommend highly selective exposure, given ongoing concerns about growth in China and other fundamental concerns in EM.

What We Think

We continue to see scope for a bear market rally in EM risk assets through the summer, but within established ranges, leading us to retain our tactical directional stance of Hold. There is likely to be considerable differentiation in relative performance going forward and, given the challenging medium-term outlook for BRL, IDR, INR, TRY and ZAR, we see these currencies as offering not particularly compelling risk/reward even in the current context. We like MXN and RUB.

With the weaker-than expected US non-farm payrolls and the increased emphasis by the FOMC on downside risks to inflation, the market is likely to continue to pare back expectations of the pace of rate normalisation in the immediate term. This is coupled with the guidance of late from G4 central banks that extraordinarily low policy rates are likely for some time.

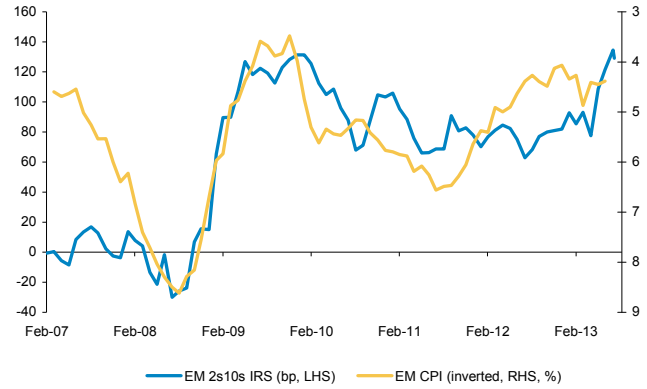
Our economists see 3Q13 real GDP in the US tracking at 2.2%, and expect to see tapering of asset purchases beginning in September, even if this means an extended period of near-zero policy rates. Bond and EM currency bears be aware – given our sense of positioning, disappointment in the data is skewed towards bond buying and USD selling.

No doubt, the data-dependent nature of the Fed stance is likely to keep volatility elevated in the rates space, but for now this dynamic is likely to support our recommendation for remaining exposed to high grade sovereign credit.

For local rates, the extent of steepness – and risk premia embedded – in the back end of curves is notable, particularly considering a still-muted growth and inflation outturn for EM economies. Concern over the eventual normalisation of monetary policy in the US is serving to sustain this steepness, we believe.

Exhibit 1

EM 2s10s versus EM CPI



Source: Morgan Stanley Research, Bloomberg

Though we maintain our Hold stance in local rates, we are looking for an opportunity to extend duration on signs of stability in EM currencies and core rate market yields. Indeed, in terms of sequence, we should see EM currencies stabilise first, followed by front-end rates and high grade credit, and only then the long ends of both local and credit curves.

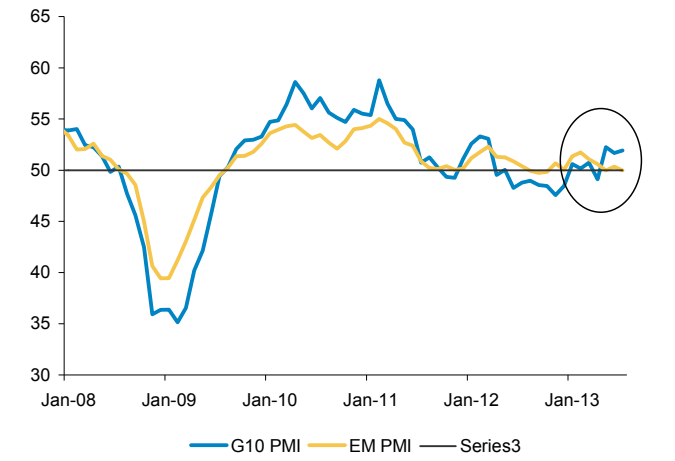
We believe that extending duration is likely to be one of the most important risk-calibration exercises in the coming weeks.

One argument for extending duration in EM remains the ongoing growth divergence between EM and DM. Strong growth in DM that threatens to raise long-term yields in the US will raise the risk of EM yields heading higher too. But with evidence growing that the growth slowdown in EM continues to intensify, there are still good grounds for EM central banks to keep policy rates well anchored.

As Exhibit 2 highlights, the average G10 country PMI has rebounded substantially in the past 6-9 months, while EM PMIs have continued to flounder, now verging on heading below the 50 threshold that (in theory) separates expansion from contraction.

Exhibit 2

DM PMIs Rebounding as EM Stagnates

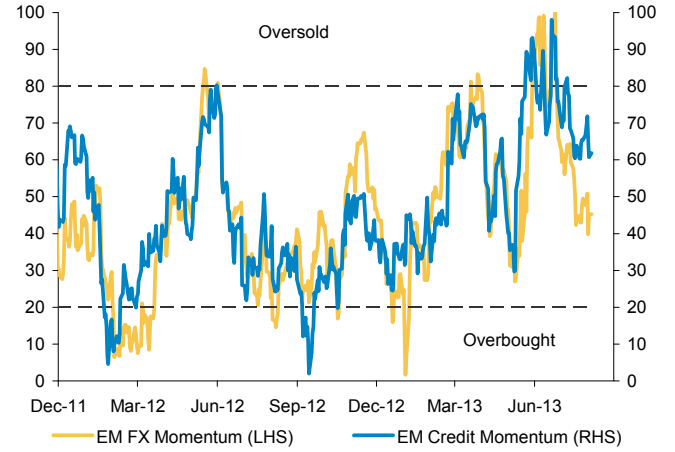


Source: Morgan Stanley Research, Bloomberg

A key aspect of our anticipated recovery in the market is that the underlying technicals remain favourable; cash balances by EM-dedicated funds have increased substantially, to 8.6% on a weighted-average basis, dollar long positions in many currencies are at multi-year highs and – based on our short-term indicators – market momentum looks to be normalising.

Exhibit 3

Momentum in FX and Credit Is Not Stretched



Source: Morgan Stanley Research, Bloomberg

What We're Watching

This week will be less intensive than last week on the data front with regard to both G10 and EM economies. The most important releases for near-term direction, and our medium-term outlook, will come in the form of the China data pack released on Thursday and Friday. On the whole, our economists expect some stabilisation in data, with exports (Thursday) coming in strong due to base effects, and CPI (Friday) expected to remain low.

Elsewhere, Russia, South Africa, Malaysia, the Philippines, Poland, Singapore and Israel will all report FX reserves holdings for July this week. While not typically market-moving, we will pay attention to these numbers, given the declines in EM FX reserve holdings seen through May and June. Part of our medium-term bearish outlook on EM assets is based on our view that EM economies will have a more difficult time attracting foreign currency inflows, and we expect this to be reflected in FX reserve accumulation slowing and/or possibly reversing over the medium term.

On the policy front, there will be MPC meetings in Korea (Wednesday), Peru (Thursday) and Russia (Friday) this week. Our economists think that all three central banks will keep rates on hold, in line with consensus expectations. However, according to the Bloomberg survey, the risk of a cut is perhaps largest in Russia. Our economists expect the CBR to remain on hold, as inflation has not yet returned to the target range; however, they expect the cutting cycle to start in September with an initial 25bp cut.

Risk Events of the Week

Date (ET)	Time (ET)	Ccy	Event	Ref period	MS Fcast	Market	Previous
05-Aug	9:00	BRL	PMI Services	Jul			51
05-Aug	9:00	MXN	Consumer Confidence Index	Jul			93.3
05-06 Aug	19:00	RUB	CPI YoY	Jul		6.50%	6.90%
05-Aug	20:00	COP	CPI MoM	Jul	0.15%	0.09%	0.23%
05-Aug	21:00	PHP	CPI YoY	Jul		2.90%	2.80%
06-Aug	3:00	HUF	Industrial Production WDA YoY	Jun P			-2.10%
06-Aug	3:00	CZK	Industrial Output YoY	Jun		-2.50%	-2.20%
06-Aug	3:00	CZK	Trade Balance	Jun		31.2B	28.8B
06-Aug	7:00	BRL	FGV Inflation IGP-DI MoM	Jul		0.24%	0.76%
06-Aug	9:00	MXN	Leading Indicators (MoM)	Jun			0.02
06-08 Aug	19:00	RUB	Official Reserve Assets	Jul		508.5B	513.8B
07-Aug	0:01	MYR	Industrial Production YoY	Jun		3.70%	3.40%
07-Aug	2:00	ZAR	Gross Reserves	Jul			$46.98B
07-Aug	4:00	CZK	International Reserves	Jul			43.8B
07-Aug	5:00	SGD	Foreign Reserves	Jul			$259.82B
07-Aug	5:00	MYR	Foreign Reserves	Jul-31			$137.9B
07-Aug	8:00	PLN	Official Reserves	Jul			106915
07-Aug	8:00	BRL	IBGE Inflation IPCA MoM	Jul	-0.03%	0.00%	0.26%
07-Aug	8:00	HUF	Hungarian Central Bank's Minutes				
07-Aug	8:30	CLP	Trade Balance	Jul	-$250m		$608.0
07-Aug	8:30	CLP	Copper Exports	Jul			$3402.0
07-Aug	9:00	MXN	Gross Fixed Investment	May	-0.1%		5.90%
07-Aug	10:00	HUF	Budget Balance YTD	Jul			-721.7B
07-Aug		HKD	Foreign Reserves	Jul			$303.5B
07-Aug		MXN	Central Bank 2Q Inflation Report				
07-Aug		ILS	Foreign Currency Balance	Jul			78.2B
07-Aug		PHP	Foreign Reserves	Jul			$81.3B
07-Aug	**21:00**	**KRW**	**BoK 7-Day Repo Rate**	**Aug**	**2.50%**	**2.50%**	**2.50%**
08-Aug	4:00	TWD	Trade Balance	Jul	$3.3B	$2.26B	$3.25B
08-Aug	4:00	TWD	Exports YoY	Jul	3.70%	5.00%	8.60%
08-Aug	4:00	TWD	Imports YoY	Jul	-5.90%	-0.10%	6.80%
08-Aug	5:30	ZAR	Mining Production YoY	Jun			-0.70%
08-Aug	5:30	ZAR	Gold Production YoY	Jun			-14.60%
08-Aug	7:00	ZAR	Manufacturing Prod NSA YoY	Jun			2.20%
08-Aug	7:00	BRL	FGV CPI IPC-S	Aug-07			-0.17%
08-Aug	8:00	CLP	CPI MoM	Jul	0.40%	0.30%	0.60%
08-Aug	9:00	MXN	CPI MoM	Jul	0.03%	0.02%	-0.06%
08-Aug	17:00	COP	Exports FOB	Jun			$5266.8
08-Aug		CNY	Trade Balance	Jul	$34.0B	$25.90B	$27.12B
08-Aug		CNY	Exports YoY	Jul	5.00%	1.00%	-3.10%
08-Aug		CNY	Imports YoY	Jul	0.00%	1.00%	-0.70%
08-Aug	**19:00**	**PEN**	**Reference Rate**	**Aug**	**4.25%**	**4.25%**	**4.25%**
08-Aug	21:30	CNY	CPI YoY	Jul	2.60%	2.80%	2.70%
08-Aug	21:30	CNY	PPI YoY	Jul	-2.30%	-2.10%	-2.70%
09-Aug	1:30	CNY	Industrial Production YoY	Jul	9%	8.90%	8.90%
09-Aug	1:30	CNY	Fixed Assets Ex Rural YTD YoY	Jul	20%	20.00%	20.10%
09-Aug	1:30	CNY	Retail Sales YoY	Jul	13.30%	13.40%	13.30%
09-Aug	3:00	HUF	Trade Balance	Jun P			
09-Aug	3:00	CZK	CPI YoY	Jul		1.60%	1.60%
09-Aug	3:00	RON	Trade Balance	Jun			-498.6
09-Aug	3:30	THB	Foreign Reserves	Aug-02			
09-Aug	9:00	MXN	Trade Balance	Jun F			855.0M
09-Aug		RUB	Exports	Jun		41.3B	41.4B
09-Aug		RUB	Imports	Jun		27.9B	26.4B
09-Aug		**RUB**	**Refinancing Rate**	**Aug-09**		**8.25%**	**8.25%**
09-Aug		**RUB**	**Overnight Deposit Rate**	**Aug-09**		**4.50%**	**4.50%**
09-Aug		**RUB**	**Overnight Auction-Based Repo**	**Aug-09**		**5.50%**	**5.50%**
09-Aug		PEN	Trade Balance	Jun			-$404M
09-Aug		COP	Colombia Monetary Policy Minutes				

Source: Morgan Stanley Research, Bloomberg; *Note: Italics indicates earliest possible release date. Bold indicates a monetary policy meeting.*

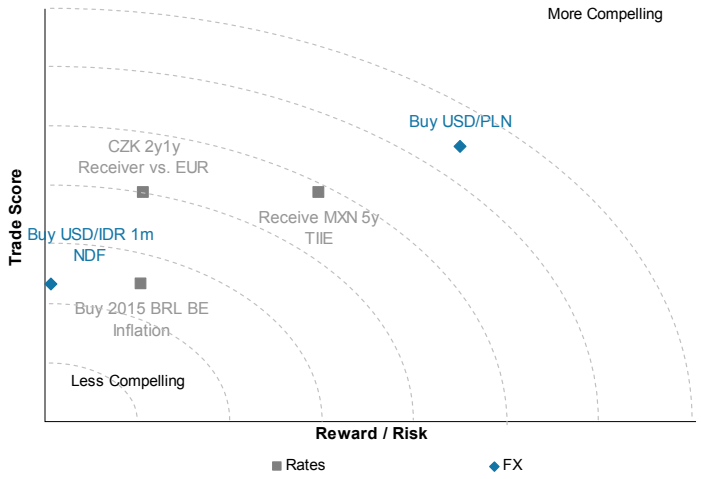
AXJ Weekly Publication, August 2; CEEMEA Weekly Publication, July 26; LatAm Weekly Publication, August 2

Trade Radar (All Open Trades)

Cross-Asset

Robert Habib, Simon Waever

Local Markets



Recent Opened Trades

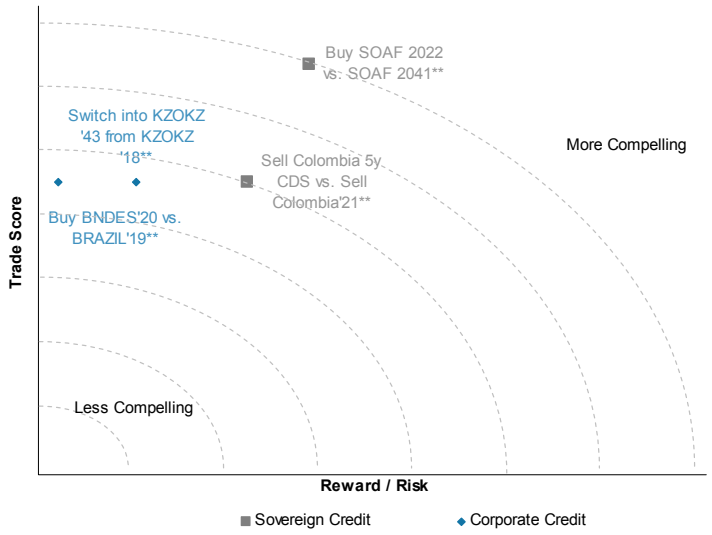
Receive MXN 5y TIIE

Reduced volatility in both the DM/EM rates space has improved risk/reward on initiating receivers. The 5y tenor offers the most attractive vol-adjusted carry on the curve, and we target 5.0%, given Banxico's dovish outlook on the economy and the expected reduction of risk premium.

Buy CZK 2y1y Receiver versus EUR

CZK rates have underperformed EUR rates sharply despite the CNB forecasting low rates over the next two years and very low inflation. We see their spread tightening back in the coming weeks.

Credit



Recent Opened Trades

Sell Colombia 5y CDS vs. Sell Colombia '21

The positive basis in LatAm appears too high in countries with strong fundamentals and where CDS hedges may therefore be unwound. Colombia is one such country and, by looking at the basis versus all bonds, we find that that Colombia '21 is furthest away from its historical average.

*Trade score is a simple sum of four components, with the maximum score for each component given in parentheses. Conviction (4): This is subjectively assigned based on the trade rationale, with four being the highest conviction level and zero the lowest. Directionality (2): Between zero and two, with two indicating a non-directional trade and zero indicating a directional trade. Carry (2): A score is given depending on the trade's three-month carry. Negative carry gets a value of zero. Positive carry, which is less than the stop-loss of the trade, gets one. Carry in excess of the stop-loss gets two. Z-Score (2): The difference of the current level of the trade and its mean, divided by the one-year standard deviation of weekly changes. In any case where mean > current > target, or where mean < current < target, a score of zero is awarded. Otherwise, a z-score above 4 is given a score of 2, one between 2 and 4 is given a score of 1 and one below 2 is given a zero. Trade Score is represented below each recommended trade (except for Hedges).

Trades We Recommend

Trade	Status	Entry Date	Entry Level	Current	Target	Stop	Notional ($m or DV01*)	Gross P&L bp	Gross P&L US$k
CREDIT									
Sovereign Credit									
Buy SOAF 2022 vs. SOAF 2041**		18-Feb-13	-26	-14	-51	-11	10x5	-9	(9)
Sell Colombia 5y CDS vs. Sell Colombia'21**		25-Jul-13	47	30	10	70	15.5x10	-1	143
Corporate Credit									
Switch into KZOKZ '43 from KZOKZ '18**		1-Jul-13	313	317	270	370	10	+1	58
Buy BNDES'20 vs. BRAZIL'19**		25-Jul-13	142	103	100	160	10x10	+42	297
RATES									
Buy 2015 BRL BE Inflation		18-Apr-13	5.53	5.67	6.20	5.00	10	+14	280
CZK 2y1y Receiver vs. EUR		9-Jul-13	49	42	15	60	40	+7	36
Receive MXN 5y TIIE	NEW STOP	17-Jul-13	5.38	5.67	5.00	5.90	10	-29	4
CURRENCIES									
Buy 1y USD/ CNY Put Spread (K = 6, 6.18)		26-Apr-13	6.22	6.18			10		
Buy USD/IDR 1m NDF		10-Jun-13	10,327	10,428	10,500	10,000	-10		(135)
Buy USD/PLN		20-Jun-13	3.29	3.19	3.40	3.14	-10		(351)

Trades Closed This Week

Trade	Status	Entry Date	Entry Level	Exit Date	Exit Level	Notional ($m or DV01*)	Gross P&L bp	Gross P&L US$k
CREDIT								
Sovereign Credit								
Corporate Credit								
RATES								
CURRENCIES								

**Trade spreads (entry, current, target and stop) are displayed in z-spreads, all other credit trades are displayed in yield (bp). Gross P&L in always in yield terms
Gross P&L includes carry but excludes transaction costs. These are hypothetical, not actual, trades. Past performance is no guarantee of future results.
Source: Morgan Stanley Research

For a longer history of our recommended trades, see *Recommended Trade Summary*, July 12, 2013.

Credit

Sovereign	Sell	Reduce	**Hold**	Accumulate	Buy
Corporate	Sell	Reduce	**Hold**	Accumulate	Buy

- We maintain our Hold stance in EM sovereign and corporate credit. On the sovereign side, we remain overweight low-beta LatAm following the weaker-than-expected non-farm payrolls data and the recent spread widening.
- We expect further repricing wider in Belarus following the collapse of the potash marketing agreement last week.
- On the corporate side, we continue to stay positioned in quasi-sovereign issuers offering relative pick-up over sovereign names.

Sovereign Credit

EM sovereign bond spreads widened another 10bp last week, with low-beta LatAm and Asian credits among the underperformers. As the correction we highlighted two weeks ago has continued, there appears to be increasing value in the low-beta sector. Furthermore, a weaker-than-expected non-farm payroll number lends further support to high grade credits, in our view. We remain overweight low-beta credits, especially in LatAm.

While most high-beta names have been more resilient, the worst performer in the EM sovereign complex has been Belarus, with a 4% loss last week. Yet, we see the recent collapse of the potash marketing arrangement and the likely negative impact for the Belarus economy as a trigger for investors to reprice Belarus credit wider (see *Belarus Economics and Strategy: Potash Crisis?* August 2, 2013).

Corporate Credit

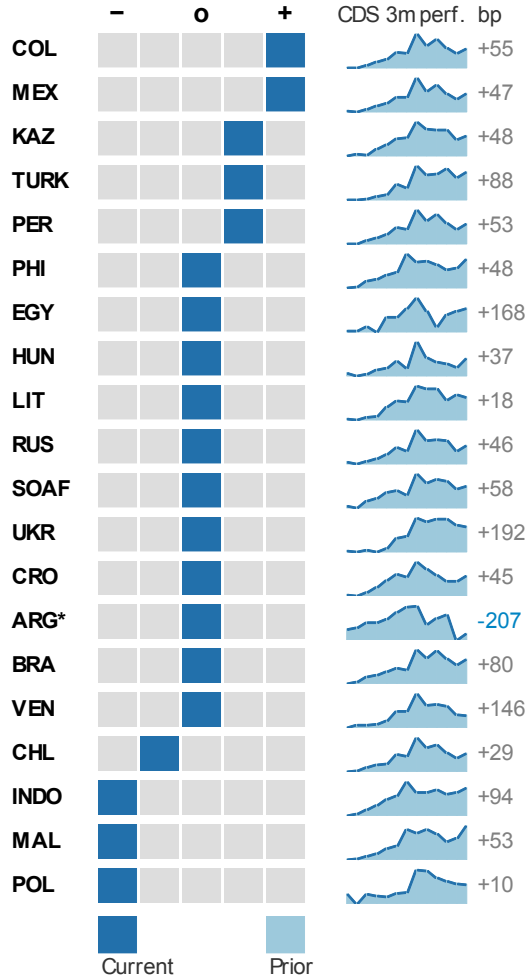
We maintain our Hold stance in corporate credit. EM corporate credit spreads moved slightly wider over the past week, in line with a move wider in sovereign spreads. On a regional basis, CEEMEA corporates outperformed, while Asia continues to lag. On a sector basis, banks outperformed, while M&M was the weakest.

Subdued activity in August: The relative stability we have seen in EM credit markets has eased the outflows compared to June. However, retail outflows remain highly sensitive to performance, and we expect this to be a source of volatility. Primary market activity in August tends to be relatively low, and we expect the next four weeks to see a limited number of deals, similar to 2012 and 2011. Additionally, we expect the secondary market to remain range-bound this month, with only idiosyncratic stories such as a potash pricing reset to drive meaningful spread moves in selected names.

The start of August saw US$3.3 billion of issuance, coming mostly from CEEMEA, including a 10-year US$1 billion bond by quasi-sovereign Eskom as well as a 7-year US$ debut issue by IG Turkish transportation company Mersin. Total issuance year-to-date amounts to US$201 billion, which represents 72% of total issuance from last year.

Exhibit 1

Relative Assessment and 3m Performance



Source: Morgan Stanley Research; *We allocate all exposure to the Par bond.

Local Rates

Sell | Reduce | **Hold** | Accumulate | Buy

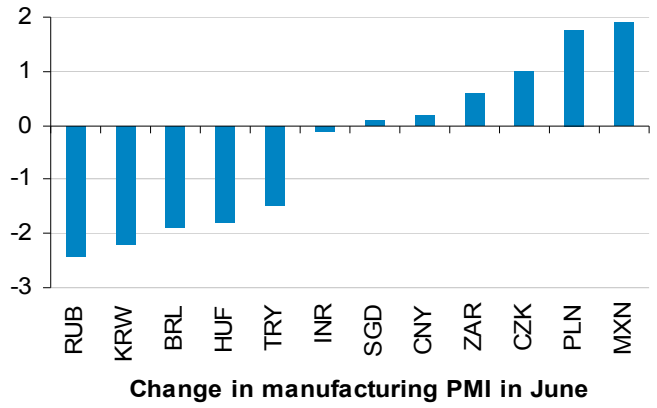
- We maintain a Hold stance in EM rates. Markets might be calming down for now, but we expect more volatility as the September 18 FOMC meeting approaches.
- EM data have been mixed of late, which does not provide a consistent signal for markets. However, the front end of local curves has generally outperformed. This week we get July inflation in Mexico and Russia, our two top picks in local bonds, and we expect declines in both.
- Markets with particularly attractive carry and roll-down, such as ZAR and MXN, might outperform in the near term if global fixed income and currency markets stabilise.

We maintain a Hold stance in local rates. EM fixed income remains highly linked to DM, as the volatility over the last month showed. With most key US events behind us and mixed signals from EM data, we could see a near-term summer rally in thin liquidity in markets where carry and roll-down is attractive.

The fate of EM rates, particularly the longer end of local curves, remains tightly linked to DM rates, as the last few weeks have shown. With markets still undecided on the timing of QE tapering, we believe that the direction of US rates will be key to watch as we approach the September 18 FOMC meeting.

Exhibit 1

EM PMIs Mixed in June



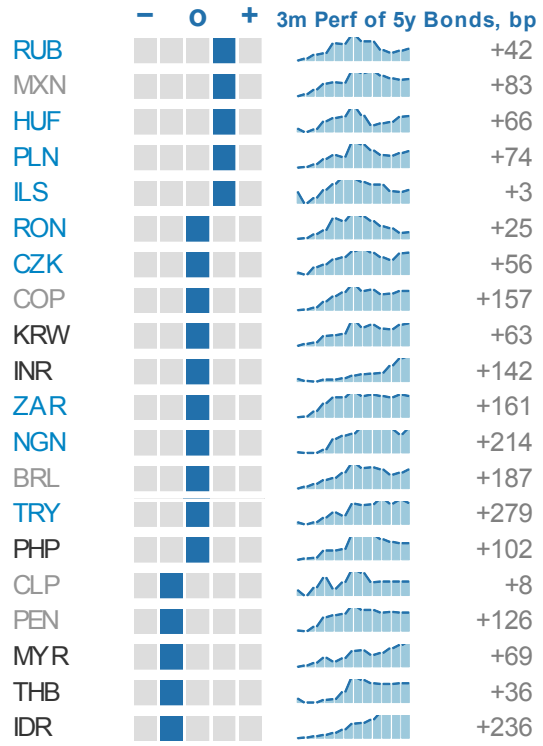
Source: Morgan Stanley Research, Haver Analytics

In addition, EM data are mixed, which does not provide a consistent dovish or hawkish signal for EM to start diverging from DM rates. June PMI increased in as many countries as it declined, for example. That said, the front end of local curves continues to outperform the long end and curves have remained steep. On the data front this week, we have July inflation in Russia and Mexico, our top picks in local bonds, and we expect to see declines in both countries.

If global fixed income markets manage to remain quiet in the near term, we could see outperformance in EM rate markets where carry and roll-down is particularly attractive, such as ZAR and MXN.

Exhibit 2

Relative Assessment and Recent Performance



Source: Morgan Stanley Research

Currencies

Sell Reduce **Hold** Accumulate Buy

- We maintain a Hold stance for EM currencies, as with the broader EM asset class. The positioning backdrop remains relatively healthy in EM, and we expected a continued gradual bear market rally over the summer.
- This week's data releases from China represent a near-term risk, given the role that the slowdown there has played in the overall deterioration in EM external positions. Upcoming data releases on FX reserves will probably show continued deterioration in the pace of FX reserve accumulation.

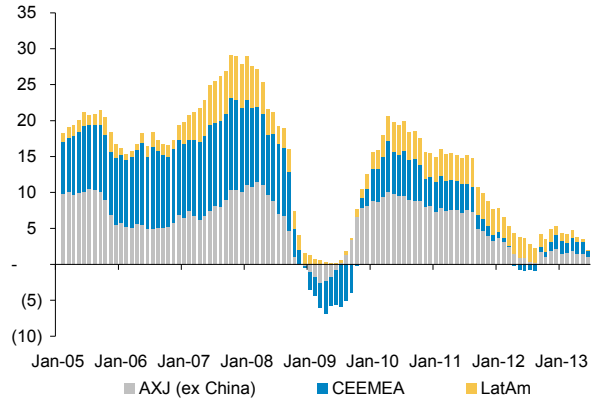
We maintain our Hold stance for EM currencies. Our expectation of a summer bear market rally has been tested in the past couple of weeks, with EM assets resuming a weakening trend. Nevertheless, we continue to believe that the technical backdrop to the market remains relatively healthy and, as such, we continue to believe that the balance of risks is tilted towards a modest recovery in the coming weeks. With few major data points to be released in the near term, markets may well refocus attention back on what we consider to be the major long-term driver of EM currency markets – the deteriorating external position of EM economies.

As Exhibit 1 shows, the annual growth rate of central bank FX reserve accumulation is on the verge of heading into negative territory. This highlights the fact that EM currencies have been struggling to receive foreign currency inflows for the best part of the last two years, reversing years of high reserve growth and significant upside pressure on EM currencies. This longer-term story goes beyond concerns about Fed tapering, and speaks to an underlying loss of competitiveness and terms of trade deterioration related to the slowdown in China. As we explain on page 11, we believe that INR, BRL, ZAR, TRY and IDR have a lot to lose from the changing global landscape and, as such, we call them the 'Fragile Five'. High inflation, weakening growth, large external deficits and in some cases exposure to the China slowdown and high dependence on fixed income inflows leave these currencies vulnerable, in our view.

This week's data releases from China represent a key risk. Our economics team anticipates a stabilisation in the data, but any further sign of a slowdown in IP and retail sales would likely place EM currencies under some renewed pressure.

Exhibit 1

Annual FX Reserve Growth* Heading Into Negative Territory



Source: Haver Analytics, Morgan Stanley Research; *Growth rates calculated using constant exchange rates and represented as percentage point contribution to the total.

Exhibit 2

Relative Assessments

	–	o	+	3m Perf vs USD*
CNY			■	0.2%
MXN			■	-4.8%
ILS			■	0.1%
PEN			■	-7.2%
RUB			■	-4.4%
RON			■	0.0%
PLN		■		0.0%
COP		■		-3.0%
PHP		■		-6.1%
SGD		■		-2.7%
TWD		■		-1.3%
INR		■		-11.5%
CLP		■		-8.1%
KRW		■		-1.6%
CZK		■		2.0%
MYR	■			-8.8%
BRL	■			-13.2%
HUF	■			0.5%
THB	■			-5.0%
TRY	■			-6.9%
IDR	■			-6.1%
ZAR	■			-7.8%

Source: Morgan Stanley Research; *CEE performance is versus EUR

Assessment Changes

We downgrade BRL to neutral/underweight from neutral, given the sharp deterioration in the country's trade balance and high external vulnerabilities. Despite stretched positioning, relief in BRL is unlikely.

Focus

EM Currencies: The Fragile Five

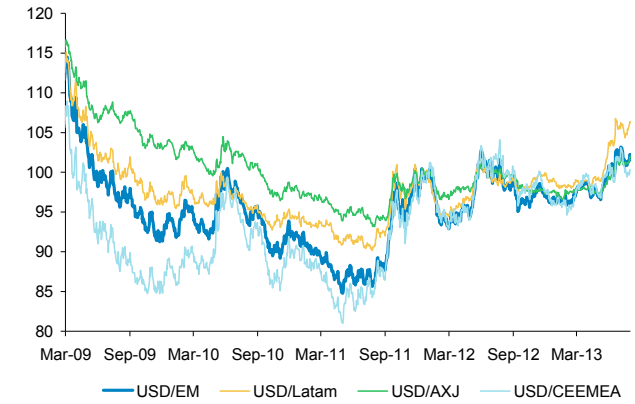
James Lord

- The EM currency bear market that has been in place for the past two years is likely to continue over the medium term, as the factors supporting BoP flows over the last decade continue to unwind.
- Currencies will likely be held back by high inflation, large current account deficits, challenging capital flow prospects and potentially weak EM growth. The prospective normalisation of Fed monetary policy simply exacerbates these underlying fundamental weaknesses.
- BRL, IDR, INR, TRY and ZAR will likely remain under medium-term pressure, and we continue to recommend accumulating long USD positions versus these currencies on any meaningful dips.
- Rate hikes and FX intervention only provide breathing room, and we continue to highlight the importance of structural reforms to attract capital on a sustainable basis. Future differentiation on these grounds will likely be high. MXN remains the bright spot.

EM currencies have had a torrid time in recent months, depreciating significantly against USD and on a trade-weighted basis. While price action has of course been more volatile, recent weakness simply extends the bear market in EM currencies that has been in progress for the last two years.

Exhibit 1

EMFX Bear Market Goes Beyond Fed Tapering Risk

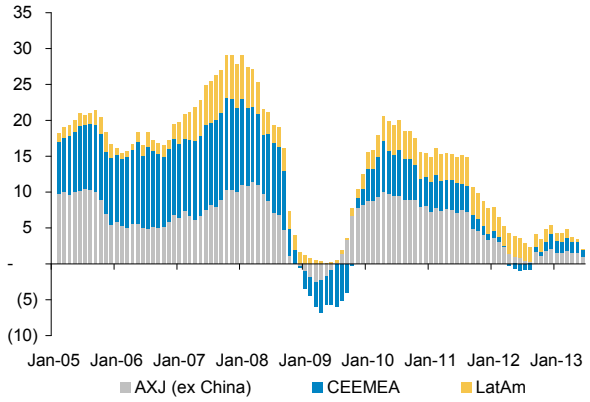


Source: Bloomberg, Morgan Stanley Research

The factors which have afflicted EM currencies should be familiar to investors: The long-term trend has been driven by the deterioration in current account positions – driven by subdued DM growth, falling commodity prices, a slowing China and, importantly, deterioration in external competiveness related to elevated real exchange rates and high inflation. All this means that the various factors that have led to the long-term trend of FX reserve accumulation are starting to go into reverse, with growth rates in FX reserves likely to turn negative soon.

Exhibit 2

Annual EM FX Reserve Growth* About to Turn Negative



Source: Haver Analytics, Morgan Stanley Research; *Growth rates calculated using constant exchange rates and represented as percentage point contribution to the total.

Against this already challenging backdrop, the prospective normalisation of Fed monetary policy simply exacerbates the risks: EM economies are already having a hard enough time attracting foreign currency inflows (whether export revenues or capital flows), and rising US Treasury yields simply supply another reason for capital to flow back to the US (see *EM FX Strategy Update: Tapering EMFX Exposure*, June 4, 2013).

Exhibit 3 shows a ranking of EM currencies based on how they are affected by a number of variables that we consider important for the medium-term outlook: Inflation, REER levels, exposure to industrial metal prices (a proxy for China rebalancing risks), balance of payments reliance on fixed income flows, current account positions and our metric of overall external vulnerability (External Coverage Ratio).

We normalise these metrics into z-score terms and provide an overall ranking based on a simple average.

Exhibit 3

Ranking Vulnerabilities*

	CPI	REER	Net Indus Metal Exp	C/A	FI Flows	ECR	Av.
CLP	-0.33	0.13	3.31	0.94	0.31	0.50	0.69
TRY	1.44	-0.32	-0.59	1.34	0.70	1.06	0.40
PEN	-0.69	0.65	1.65	0.85	-	-0.63	0.34
IDR	0.97	0.54	-0.03	0.41	-0.20	0.66	0.30
BRL	1.15	0.65	0.09	0.64	-0.70	-0.05	0.25
MXN	0.02	-0.71	-0.27	0.13	1.95	0.64	0.23
ZAR	1.03	-2.41	0.52	1.15	0.78	0.92	0.16
INR	1.97	-0.31	-0.26	0.78	-1.17	0.52	0.15
COP	-0.39	1.21	-0.27	0.50	-0.50	0.28	0.07
THB	-0.21	1.20	-0.59	-0.27	-0.04	-0.26	0.01
PLN	-1.16	-0.81	-0.23	0.50	1.62	0.57	-0.01
CZK	-1.22	0.28	-0.46	0.15	0.83	0.69	-0.02
RUB	0.97	1.59	-0.07	-0.78	-1.06	-2.57	-0.04
HUF	-0.10	-0.47	-0.36	-0.90	-0.50	0.59	-0.26
ILS	-0.92	0.76	-0.26	-0.50	-1.28	0.06	-0.32
MYR	-0.75	0.13	-0.55	-1.46	-	-0.64	-0.44
KRW	-0.63	-1.32	-0.84	-1.15	0.43	-0.13	-0.50
SGD	-2.22	-0.31	-0.25	-0.20			-0.58
TWD	-1.16	-0.80	-0.80	-2.32	-1.16	-2.22	-1.03

*Higher Av value indicates greater risk; normalised data in z-scores terms
Source: Bloomberg, Haver Analytics, Morgan Stanley Research

There is of course a degree of overlap in a number of these metrics, but each is important in its own right, in our view, and deserves separate consideration. Even so, to prevent excessive bias to external vulnerability, we give half as much weight to the C/A and our External Coverage Ratio as we do to the other variables. In following sections, we go through our rationale for including these variables.

The results show a number of currencies that are vulnerable, including CLP, TRY, IDR, PEN, BRL, ZAR and INR.

We discount the ranking for Mexico for two reasons. First, its vulnerability centres on a high reliance on fixed income flows rather than any broad-based vulnerability. Second, we think that Mexico's ability to attract capital will be high compared to other markets, given its push forward on structural reform measures. While PEN and CLP are certainly vulnerable, risks for these currencies stem primarily from the very high scores associated with the commodity price channel and China, which possibly overstates the riskiness of these currencies compared to others.

The Fragile Five: BRL, IDR, ZAR, INR and TRY

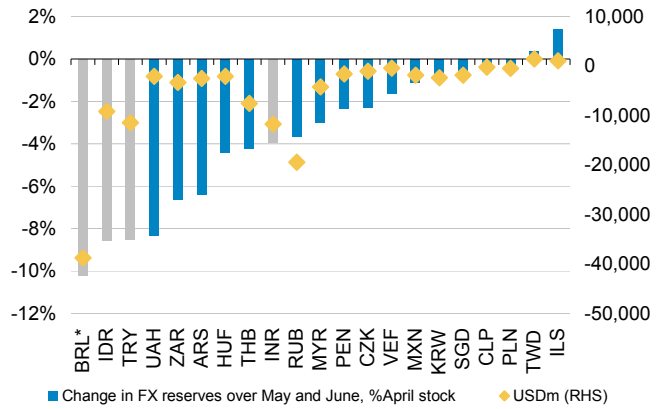
Meanwhile, BRL, IDR, ZAR, INR and TRY will likely face headwinds over the medium term from various factors ranging from high inflation, high REERs, external vulnerability from initial conditions and vulnerability to further external deterioration based on a heavy reliance on fixed income flows and/or China-related risks.

The risks associated with these particular five currencies are also evident from the fact that central banks in these countries have been among the most aggressive in their bid to support their currencies.

Of these five, South Africa is the only one that has not seen rate hikes ZAR, but this is mainly due to the central bank's non-interventionist philosophy in terms of exchange rate management.

Exhibit 4

Which Currencies Have Received Official Support*?



Source: Haver Analytics, Morgan Stanley Research; *Grey bar indicates those economies which have seen rate hikes. Changes in FX reserves may also reflect valuation adjustments (including gold prices).

India has lost fewer reserves compared to others, but support measures have also been backed up by reform measures aimed at curbing the current account deficit and attracting capital flows, thus easing some of the pressure for the central bank.

Keeping it Simple: High Inflation Is Bad for FX, Particularly amid a Large C/A Deficit and High REER

In an environment of strong and growing global demand, central banks will care less about expensive currency valuations. Growth in global demand would drive growth in global trade, which is a process that benefits everyone. However, in a world where global demand is stagnant and global trade volumes are flat-lining, currency valuations come into play to a greater extent as policy-makers fight to take a larger share of the demand pie.

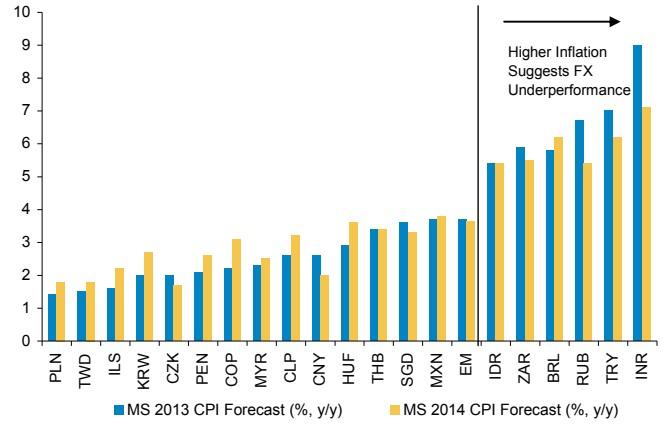
Countries that have higher inflation than their trading partners are more likely to run into currency valuation problems, sooner or later. As such, there is a risk that currencies in higher inflation economies see greater nominal depreciation as policy may becomes more biased towards preventing real appreciation, particularly if the economy suffers from a large current account deficit and an already elevated REER.

Indeed, without adjustment in the nominal exchange rate, countries with high inflation will naturally see their currencies appreciate in real terms, potentially posing a risk to growth and further deterioration in trade and current account positions.

As Exhibit 5 shows, Indonesia, South Africa, Brazil, Russia, Turkey and India are all expected by our economists to have the highest rates of inflation over the next 18 months. As such, these countries will need to see a greater degree of nominal depreciation in order to prevent real exchange rates from appreciating faster than peers. This places IDR, ZAR, BRL, RUB, TRY and INR at an immediate disadvantage.

Exhibit 5

High Inflation Suggests Underperformance



Source: Morgan Stanley Research

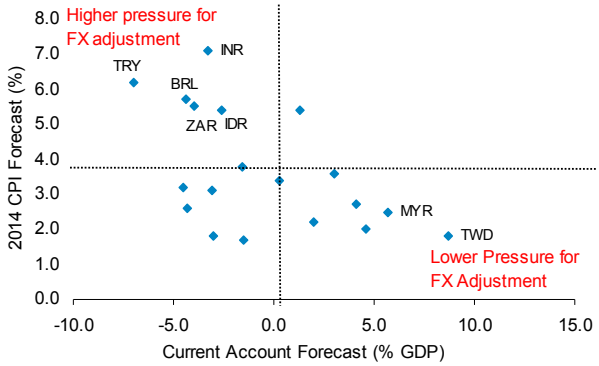
The pressure this poses on RUB is arguably less severe than for others, given Russia's large oil-related current account surplus. Indeed, the value of RUB has little bearing on its ability to compete in the oil market, given that oil is priced in USD. Nevertheless, to the extent that policy-makers may worry about the risks that a high REER pose to the non-oil export sector, high inflation clearly raises risks of policy being biased to a weaker RUB.

Of course, currency depreciation is not a sustainable way of improving external competitiveness. Ultimately, the higher inflation that is generated by currency weakness will undermine competitiveness sooner or later again. Nevertheless, the alternative of allowing real appreciation risks exacerbating external imbalances for those economies that suffer from them, which is perhaps a worse alternative.

BRL, ZAR, IDR, INR and TRY all have C/A issues: With the exception of Russia, all the high-inflation economies have C/A worries. Preventing these external imbalances from deteriorating has been a policy priority for many countries. A rising REER for TRY, BRL, ZAR, INR and IDR would raise the risk of C/A deterioration. Colombia, Peru and Chile have growing C/A issues which could undermine their currencies, but the risks are less acute, given lower inflation.

Exhibit 6

High CPI and High C/A Deficit Raise FX Pressure

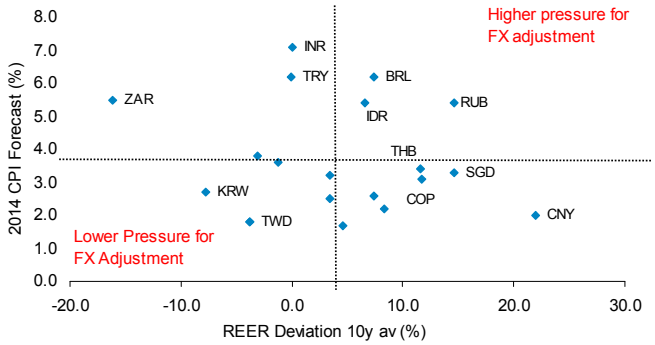


Source: Morgan Stanley Research

BRL, RUB and IDR have elevated REERs: Current valuations are clearly important, too. Countries that have elevated REERs and high inflation face a more immediate need to encourage nominal adjustment in their exchange rates. We use deviations of REER from 10-year averages as a (admittedly imperfect) proxy for valuations. Exhibit 7 shows these deviations, along with our economists' CPI forecasts for 2014. Of the high-inflation economies that we highlighted previously, BRL IDR and RUB show a higher deviation than average from the average REER level of the last 10 years. Valuation is less of a threat for INR and TRY but could soon become so again, given inflationary pressures. On this REER basis, valuation appears less of a headwind for ZAR.

Exhibit 7

High CPI and High REER Also Present FX Risks



Source: Morgan Stanley Research

Otherwise, CNY, SGD, COP and THB all have relatively elevated REERs, though with lower-than-average inflation.

These REER measures are calculated using CPI adjustments to nominal exchange rates. Using alternative measures such as unit labour costs would give another indication of export competitiveness, and we suspect would indicate greater concerns over competitiveness.

CLP, PEN and ZAR Particularly at Risk from Further Industrial Metal Price Declines

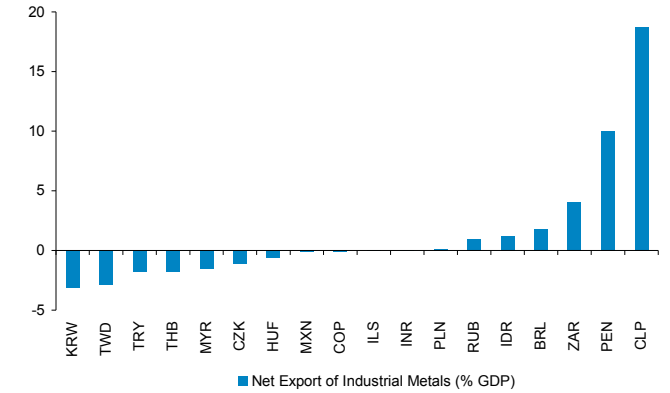
All EM economies are at risk from a slowdown in the pace of China's growth. Nevertheless, some have more direct linkages than others. Those more directly at risk are those that would suffer should commodity prices continue to decline as China rebalances away from investment-led growth (our AXJ colleagues highlight that the price impact of China's commodity demand has been much greater in the industrial metals area than elsewhere (see *Asia Pacific Economics: Asia Insight: What Could the Risk of a China Slowdown Mean for Asia?* June 28 2013), as well as those that export directly to China.

The raw EM export numbers do not capture the full extent of the relative risks for currencies, in our view. Indeed, those that are more heavily reliant on China for the export of machinery and raw materials are more at risk than those which export more consumption-based products and services. This may mean that KRW and TWD are less at risk than it first appears.

Exhibit 8 simply highlights the risks involved in terms of commodity price declines. As is clear, further declines in the price of industrial metals pose a significant risk for PEN, CLP and ZAR.

Exhibit 8

Who Is at Risk from Falling Industrial Metal Prices?



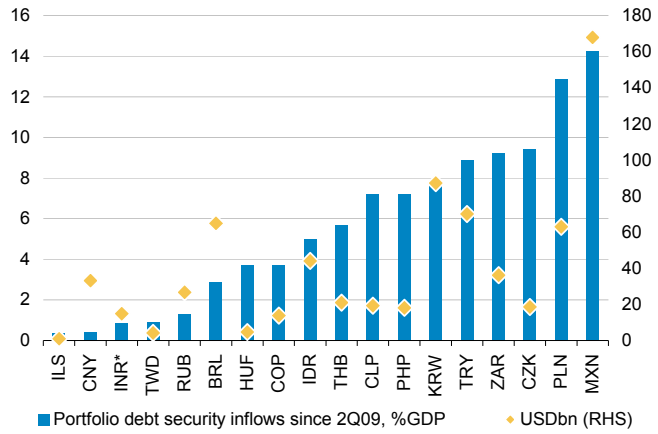
Source: UNCTAD, Morgan Stanley Research

Fed Policy Creates Capital Flow Challenge, Particularly for Those with Low Coverage of External Liabilities

The prospect of the Fed tapering its asset purchases raises questions over the sustainability of capital flows into EM, particularly at a time when much of EM is struggling to sustain decent growth. As we and others have discussed at length, bonds have contributed significantly to overall balance of payments flows in EM over the last few years. Mexico, Poland, South Africa and Turkey are in the top five in terms of reliance on bond market flows, and we suspect that Malaysia is too (though the data are not fully comparable). Brazil, Indonesia and India (in particular) have relied less on foreign purchases of bonds for overall inflows on the balance of payments.

Exhibit 9

Who Has Benefitted the Most from Fixed Income Inflows?



Source: Haver Analytics

The capital flow risks extend beyond just bond flows though, with rising US Treasury yields on the back of higher expected US growth raising question marks about capital flows in general to EM.

The cost and availability of external funding for EM has become more prohibitive, which means that those countries with the largest external funding requirements will face more pressure for currency adjustments. Of course, this is closely related to the size of current account deficits, which we discussed earlier. However, funding is also required to roll over existing external debt. We calculate total external funding requirements by summing the current account deficit, short-term external debt and amortisations of medium-term debt coming due in the next 12 months. We compared these liabilities to the stock of FX reserves at the central bank to give an assessment of whether central banks will allow currency adjustment to prevent the loss of FX reserves. This is our External Coverage Ratio. As shown in our rankings in Exhibit 1, Turkey and South Africa score particularly badly in this respect, with Indonesia not far behind.

The Importance of Structural Reforms

Emerging markets have not had to work so hard in order to attract capital over the past 10 years, as various combinations of attractive yields, strong growth and loose DM monetary policy have meant that capital easily flooded in. Now, with the tide turning the other way, EM needs to work harder in order to attract capital, or at least soften the blow.

Using FX reserves does little except smooth the trend and is ultimately an impotent tool to prevent currency depreciation in the face of systemic balance of payments pressures. Hiking interest rates is more effective, but in the current context also only buys some breathing room for EM. Indeed, with growth already weak, hiking rates risks a steeper downturn and further capital flight.

Central banks that opted for the interest rate tool in prior years (such as in Turkey in 2012) were more readily able to control the currency in the face of pressure because that pressure was typically short-lived, and against a background of increasingly accommodative DM monetary policy and large bond inflows into EM. Now, with DM policy heading in a less accommodative direction and more systemic medium-term BoP issues, we believe that the interest rate tool will be less effective in maintaining currency stability, particularly given the growth implications already mentioned.

The most sustainable way to improve capital flow prospects is for governments to engage in structural reform, enhance competitiveness and boost growth potential. Because of the ease with which EM has attracted capital over past 10 years, reforms have been on the back burner. Now, they are at the centre of our attention and we believe that countries that engage in structural reform efforts will see currency and broader asset price outperformance.

Mexico and (to Some Extent) India Pushing Ahead

This is why we are less concerned about the fate of MXN, despite the obvious risks associated with its dependence on fixed income portfolio flows. Mexico's reform agenda should mean that MXN is likely to outperform over the long term, and we would use any dips caused by fears over Fed tapering as an opportunity to rebuild exposure for the long term.

Mexico is one of the few countries that are pushing ahead in this respect. We have seen India respond to the weakness in its currency by accelerating reforms in certain areas, easing restriction on certain forms of capital inflow, which is encouraging. But ultimately more will need to be done in order to boost the investment climate and productivity, and the ability of the economy to attract long-term capital.

Elsewhere, we see limited progress. Against the backdrop of the risks that we have highlighted that we think will cause underperformance for BRL, IDR, TRY and ZAR, we have seen little in the way of serious reform measures that make us more comfortable about the medium-term prospects of these currencies.

Adding to the medium risks, in 2014 **India** (May), **South Africa** (April-June), **Brazil** (October) and **Indonesia** (mid-year) **will all hold general elections,** while **Turkey** will hold a presidential election. This election calendar raises the risks that tough reforms will be placed on the back burner, diminishing the prospects for a meaningful currency recovery. See *Indonesia Economics: Asia Insight: Why the Next Election Is More Important Than the Last,* July 30, 2013, for the risks involved for Indonesia.

Belarus Potash Crisis: Trigger for Repricing

Vanessa Barrett, Simon Waever, Robert Tancsa

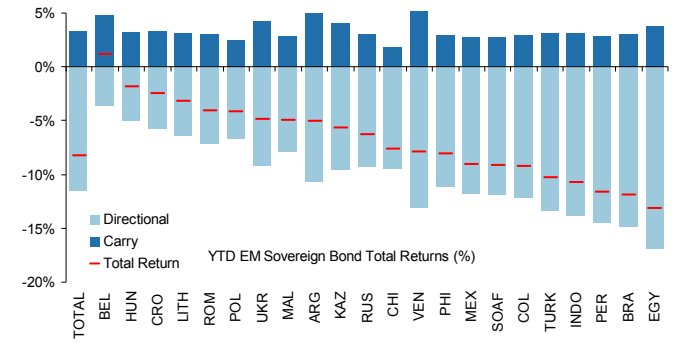
- Belarus has underperformed EM peers in the past week; however, it is still one of the best-performing credits this year. We see the recent collapse of the potash marketing arrangement and the likely negative impact for the Belarus economy as a trigger for investors to reprice Belarus credit wider.

This is an excerpt from recent publication, *Belarus Economics and Strategy: Potash Crisis?* August 2, 2013.

Scope for further repricing: We see the recent events regarding the collapse of the potash marketing arrangement between Russia and Belarus and the likely negative impact for the Belarus economy as a trigger for investors to reprice Belarus credit. While Belarus has underperformed EM peers in the past week, widening more than 100bp, it is still one of the best-performing credits this year (see Exhibit 1). We see further scope for negative price action due to both overall EM weakness and escalating country-specific risks.

Exhibit 1

Belarus Has Outperformed so Far



Source: Bloomberg, Morgan Stanley Research

External vulnerabilities recently brought to attention across EM… Higher UST yields and prospects of a stronger USD on the back of tapering expectations have served to highlight the external imbalances that many EM countries have developed. A reliance on external funding markets in particular has been brought to attention, as abundant global liquidity is in the process of being withdrawn. The lack of required reforms to increase the productivity of economies across EM is also a main concern (see *Emerging Issues: How Will EM Play Out from Here?* July 1, 2013).

…with Belarus a prime example: As highlighted in the previous section, the vulnerabilities in Belarus have been building up gradually. A surge in non-energy imports, supported by strong wage growth coupled with a slowing of exports, has resulted in a sharp deterioration in the current account. This is now putting pressure on the FX reserves, which at US$8 billion are equivalent to less than two months of imports. Furthermore, the potential impact of the recent potash market changes only serves to further increase this pressure, potentially reducing export earnings by 1.8% or nearly US$900 million.

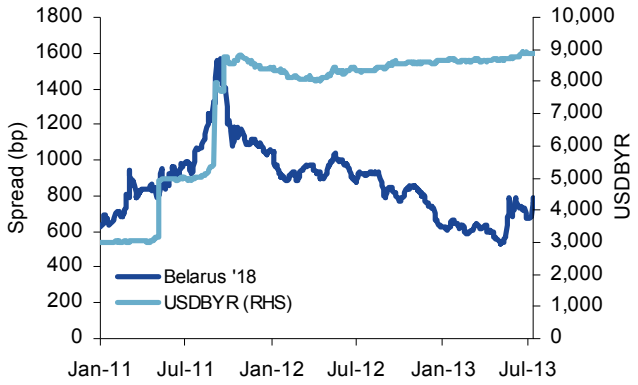
Liquidity, not solvency: A burgeoning current account deficit, reserves under pressure and sizeable external debt redemptions relative to FX reserves – similarities with Ukraine are striking. However, in addition to the option of a 'Russian Rescue', as discussed in the full report, Ukraine still has an IMF deal as a viable option. Belarus, we estimate, may need to fund a current account of US$4-5 billion in the next 12 months, in addition to government external debt redemptions of US$1.8 billion. This is close to 80% of the level of FX reserves, pointing to heightened liquidity concerns. At the same time, looking at Belarus from a solvency standpoint is less alarming, with an external debt/GDP ratio of 49.9%.

Too late for a Eurobond: As the country will likely want to avoid another uncontrolled currency depreciation, external funding is therefore required. Back in February, Belarus was courting the market for potentially US$1 billion in funding (see *Belarus: A Search for Funding*, February 25, 2013). However, given that the market is now less forgiving on external imbalances and funding is no longer as abundant, we believe that Belarus is very vulnerable. Having said this, a Eurobond issuance is not inconceivable, but it would be very difficult, given the current environment, and would certainly need to come with a significant concession.

Russian rescue: This leaves Belarus with few options, other than more funding from Russia. This would be in addition to the last disbursement of the existing anti-crisis loan from the Eurasian Economic Community of US$440 million due later this year. However, given the increased tension between Belarus and Russia, as evidenced by the recent potash market changes, this is unlikely to be a straightforward deal.

Exhibit 2

A Depreciation May Not Be as Effective This Time



Source: Bloomberg, Morgan Stanley Research

Volatility ahead: A protracted negotiation between the parties is likely to increase pressure on the currency. Lukashenko, the Belarusian president, is likely to try his best to both avoid sharp currency weakening and secure the best deal for Belarus. However, as highlighted above, depreciation may be unavoidable. In this scenario, we expect bond prices to react negatively. Eventually, securing funding from Russia, even with a controlled currency weakening, may help to stabilise bond prices. Note that while a depreciation of the currency coupled with the Russian-led loan helped to restore the external balances back in 2011 and pushed bond yields lower, higher inflation expectations may limit the gains in competitiveness this time round, thus limiting the upside to bond prices.

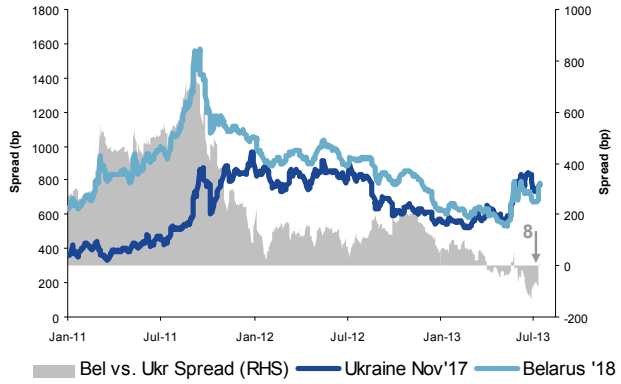
As such, we do not expect meaningful bond price appreciation, unless we see the implementation of more moderate domestic policies reflecting a move towards permanent rebalancing the external accounts.

Valuations appear rich: Belarus has outperformed the wider EM sovereign credit universe this year and is one of the very few EM countries with a positive total return year to date (see Exhibit 1). Limited liquidity and the apparent absence of a near-term negative event, evident in other EM high yield sovereign credits, contributed to the outperformance.

Comparing to Ukraine shows Belarus trading tighter for most of the past three months (see Exhibit 3). While it is clear that Ukraine also faces numerous challenges, Belarus still appears more vulnerable, given the current situation, in our view. Even with funding from Russia and currency weakening as potential solutions, they are likely to provide relief only in the very short term. Second, as the recent events highlight, the escalation of political risk in Belarus and reimplementation of unorthodox policies warrant an additional premium, in our view.

Exhibit 3

Scope for Further Widening



Source: Bloomberg, Morgan Stanley Research

More broadly, we remain defensive in EM credit… Our overall view on EM sovereign credit is Hold (see *Global EM Investor: Technically Speaking*, July 29, 2013). We prefer low-beta countries as a defensive allocation and remain cautious on high-beta.

…with Belarus no exception: Given the valuations, we expect further weakness as the market prices the idiosyncratic risks into market valuations. A first step would be to reprice back to the average level in 2012, around 140bp wide to Ukraine. A further deterioration in the situation, mainly the absence of a credible funding strategy, would see spreads going wider. Note that spreads in September 2011 were much wider (>1600bp); however, these levels also reflected broader market weaknesses stemming from concerns surrounding the eurozone.

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