EM Bonds and USD.

Barely are we into the end of January 2014 and the emerging market debt markets are once again showing signs if weakness.

1. Emerging markets are suffering from a slow down in exports relative to imports relative to the US and other developed markets. This is a long term trend stemming from a technology deficit.

1. The supply of hard currencies, USD and EUR will be constrained. This will raise the effective short term interest rates for these currencies, LIBOR and other benchmarks notwithstanding. This is likely to also drive currency appreciation.

1. The demand for emerging market debt cannot be taken in isolation. The real money investor will want to minimize or at least manage FX risk. The high yield of an Indonesian government bond or a Brazilian government bond needs to be taken in the context of either FX volatility or the cost of hedging such FX volatility.

1. The cost of hedging the FX volatility is the short term interest rate of the currency of the respective bond. An important metric for assessing the economics of an emerging market sovereign bond is therefore the spread between the yield of the bond and the short term interest rate. Ceteris paribus, in particular ignoring inflation expectations, the flatter the yield curve, the worse the economics of owning the bond. For example, a 10 yr Brazilian government bond yields 11% but costs 10.75% to finance. A 10 year US treasury yields 2.8% but costs 30 basis points to finance. In addition, given that US treasuries are good collateral in the repo market, a 10 yr can in practice be financed at circa 6 basis points.

1. With Basel 3 and Solvency 2, US treasuries capital treatment and declining issuance could make them the surprise outperformer this year.