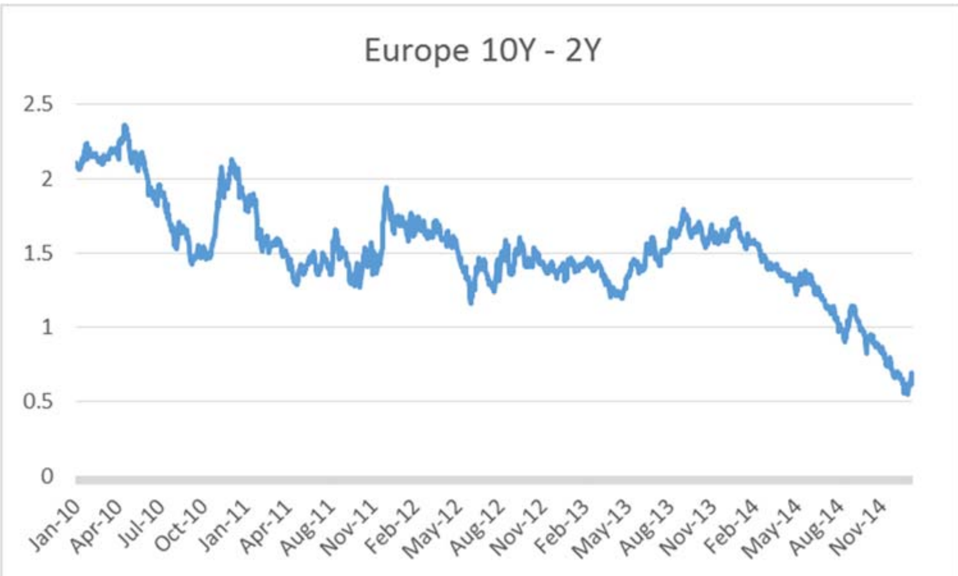
SIGNALS FROM BOND MARKET CURVES FOR EMERGING MARKET EQUITY INVESTORS

Economic growth expectations for the majority of developed and emerging markets have been ratcheted down in recent years. Interest rates in many of these countries have been cut accordingly. 2Y bond yields tend to track central bank controlled rates.

In a robust economic scenario observers would witness that following a cut, yields on 10Y bonds would most likely decrease less than yields on 2Y bonds. The resulting slight steepening in the shape of the bond market yield curve would convey the message that expected future nominal growth is still healthy. Tomorrow's real growth and inflation is expected to be above the levels of today. In short, the spread between 10Y and 2Y yields serves as a good read into market expectations of future nominal economic growth.

What then, should investors make of the dramatic collapse in spreads, for the vast majority of countries, since early 2014? The spread contraction has occurred as 10Y yields have fallen more than 2Y yields as interest rates have been cut over the past 12 months.



Source: Bloomberg. (Generic Eurozone Government Bonds)
Deflationary conditions have brought about the ultimate monetary response in Europe.

A fair conclusion to draw is that the long term outlook for nominal economic growth is looking increasingly poor and hence is being pared back. In turn this would suggest a less prosperous environment for equity returns. Furthermore, it also suggests additional measures are likely in the months ahead to reduce interest rates and which encourage currency depreciation.

In simple terms, the 2Y to 10Y portion of the yield curve can be regarded as a synthetic bank, after all banks borrow short term and lend long term. The spread therefore has a relationship to the profitability of a bank loan. Other things being equal, declining spreads should translate into lower loan profitability for banks and therefore reduced earnings.

In economies with weak loan growth, the move in spreads directly relates to bank profits.

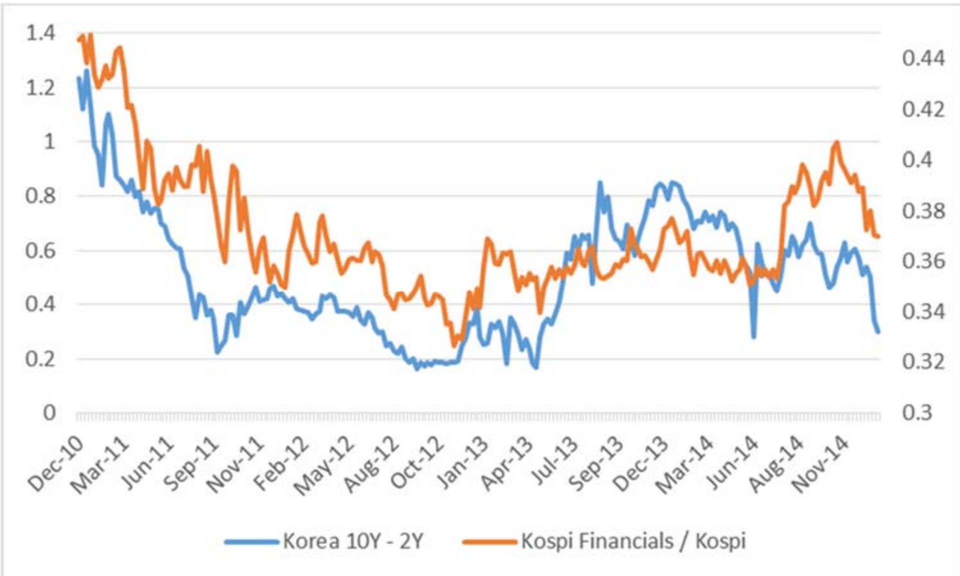
Japan is a good example.

Source: Bloomberg

Japan-like symptoms can be seen in some emerging markets today. Korea, for example, has a very high level of debt. Household debt as a share of disposable income is approximately 160%, one of the highest in the OECD. The appetite for new loans (despite Government policy) is correspondingly low. Competitive challenges to Korea, not least from Japan's policy of JPY devaluation, have left the economy struggling to grow at even 3%, a sharp fall from the 6% rate of 2010.

Korea's bond market curve has experienced a rapid decline from early 2014. The spread between 10Y and 2Y bonds has fallen from 90bp to 34bp today.

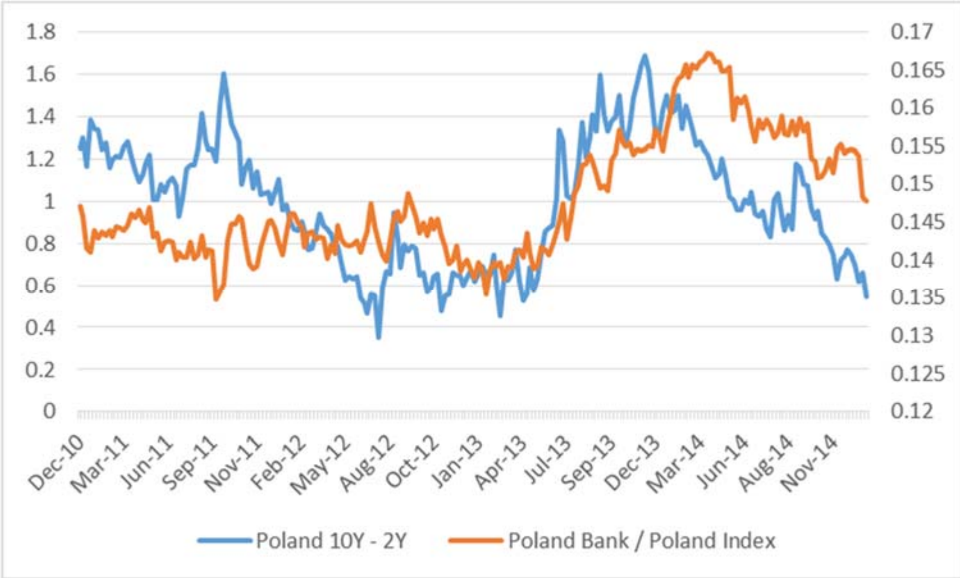
The Kospi Banks index is some way above where it was in 2012 when the spread was last at these levels.



Source: Bloomberg

The prospects for the banks therefore, looks poor. Correspondingly, a policy to further depreciate the value of the KRW could well materialise before long in my view.

Poland too is an economy which has exhibited a collapse in the bond market curve. The 10Y-2Y spread has fallen from over 160bp in late 2013 to 63bp today.



Source: Bloomberg

The index of Polish banks is some 40% above where it was in 2012 when spreads were last at this level. Again, policies of interest rate reduction and currency decline have been implemented in recent months. I suspect more is to come.

Korean and Polish banks, plus each country's respective currency look to be good shorts in my view.

INFORMATION

Issue Date:	26th January 2015
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