2002 SUMMER FORUM

Brazil Dominates Discussion at EMTA's Summer Forum in London

Despite considerable market turbulence, driven in part by developments in the US corporate market and by

concerns over the Brazilian elections, approximately 150 Emerging Markets professionals attended EMTA's Summer Forum, which was again hosted by Salomon Smith Barney, on 26th June in London. Panelist sentiment was largely bearish on the Latin American market short-term, although a number of speakers discussed factors with positive longer-term implications for the Emerging Markets asset class. With spreads on Brazilian debt widening dramatically in the two weeks preceding the Forum, Brazil dominated much of the discussion. However, moderators Jerome Booth (Ashmore Investment Management) and Mark Franklin (Citigroup Investments) steered their respective sell-side and buy-side panels through a wide array of Emerging Markets topics.

Welcoming the audience to fifth annual London Summer Forum, EMTA Executive Michael M. Chamberlin's introductory remarks sounded a World Cup theme. Click Here for Remarks by Michael M. Chamberlin, EMTA Executive Director.

Sell-Side Analysts Concerned by Brazilian Economy, Risk of Default

Jose Luis Daza (Deutsche Bank) noted that the recent selloff of Brazilian debt should be attributed to the global

flight away from risky assets and secondary effects of reduced capital flows into the United States, which he stressed translates into reduced capital inflows into countries such as Brazil. The effects of these factors on the Brazilian currency and fiscal accounts result in "a serious question of fiscal sustainability in Brazil." The Brazilians need a larger primary surplus, according to Daza, who emphasized that such an accomplishment would be tricky in an election year; consequently, he opined, "the Brazilian situation looks extremely fragile." Daza added that complicating matters is the likelihood of an immediate market crisis if populist candidate Luiz Inacio Lula da Silva is elected president of Brazil this autumn; fears of his leading the country to a financial crisis might thus become a sort of "self-fulfilling prophesy."

Philip Poole (ING Financial Markets) agreed on the longer-term need for a primary surplus in order to achieve debt sustainability, but added that Brazilian officials have a difficult dilemma as a result of the structure of government debt, with approximately half dollar-denominated and the remainder linked to the SELIC rate. Poole noted that if Brazilian officials cut interest rates, a weaker real would make the dollar-denominated paper harder to pay, while higher local rates mean that the SELIC-linked paper would be more difficult to service.

Sell-side speakers viewed the risk of default by Brazil in the next eighteen months as not being negligible, and their estimates of a likelihood of default ranged between 20 and 50%. However, Poole expressed his belief that rather than an outright default, Brazil would instead be more likely to carry out a debt work-out via a series of exchange offers. Jonathan Bayliss (J.P. Morgan) suggested that, despite sudden industry bearishness on Brazil, its C-Bonds might be comparatively cheap at 58 (the price level on the day of the Forum). Despite some difference in the degree of concern between European and US investors, he asserted that in general US and European buyers foresaw less risk of default than was then implied by C-Bond price levels (40%).

As for what path a Brazilian default would take, Eric Fine (Morgan Stanley) predicted it might be more similar to the Russian crisis than the Argentine crisis. Fine stated this was based not only on the heavy weighting of Brazil in many portfolios, but also on the probability that Brazil would rebound as strongly as Russia did in the years following its 1998 default/devaluation. Fine urged investors not to be complacent about possible contagion effects from a Brazilian crisis. Daza expressed his concern that a Brazilian default would exacerbate the slowdown in capital flows to Latin America and would subsequently trigger defaults in other countries such as Peru, Panama, Turkey and Venezuela (although he specified that Mexico and Russia would be unlikely to follow suit).

Panelists See Some Long Term Positive Signs for Emerging Market Asset Class

Recent financial scandals in the United States have two contrasting effects on Emerging Markets, according to Bayliss. On the one hand, they add “another nail in the coffin to the view that US investors are better off in US credits,” and will likely increase flows over the longer term to Emerging Markets as investors realize the level of disclosure in the Emerging Markets has improved so dramatically. (“We don’t see cash balances posted by US credits posted on a daily basis,” he reminded attendees.) On the other hand, one of the immediate ramifications of US corporate scandals is a pronounced move to greater risk aversion that, for the time being, is driving investors out of Emerging Markets debt.

On a positive note, Bayliss affirmed that there has been a “significant change” this year in institutional investors’ attitudes vis-à-vis the Emerging Markets asset class, with large dedicated inflows ready to enter the market from both US and European pension funds. The pipeline of new money was, according to Bayliss, the largest he’d ever seen and much larger than at the onset of 2002, although many managers are sitting on the sidelines until the Brazil situation settles. In fact, Bayliss predicted a surprise rally once the market turbulence ended. Fine stated that one of the key themes for investors in the next twelve months is the likelihood that investors generally will move out of US and into international investments and out of equity and into debt investments, “and that essentially means us.” Fine added that pension fund managers in search of 8-11% returns with low volatility would find themselves looking at Russian and Mexican debt.

Reforms Still Needed in Russia Despite Harmonious Bush-Putin Relations

Despite the recent “lovefest” between US President Bush and Russian President Putin, Fine named some longer-term concerns. “I’m worried we [the US] will end up providing life insurance to Putin similar to the way we provided life insurance to [former President] Yeltsin,” he commented, “and allow a lot of things that are expedient but not in our long-term interest.” Fine was also troubled that the basis for improved US-Russian relations seemed largely predicated on personal chemistry between the two leaders, rather than deeper and more established cooperation.

Poole saw the good relationship between the two presidents as fairly irrelevant to the development of Russia. “At the margin,” he hypothesized, it will help with items such as WTO membership and increased access to US markets.

On the macro side, Russia has made tremendous progress, but “virtually zero progress, almost nothing” has been accomplished on the micro side, according to Daza, who stressed that the country has an “enormously distorted, inefficient economy with enormous reforms ahead.” President Putin has set an agenda, which could lead the country to investment grade if it is carried out; if not, Russia’s credit rating will remain in large part a function of oil pricing.

IMF Role May Be Unclear, But Praise for Its "Tough Love" Ecuador Policy

Moderator Booth also polled the speakers for their assessments of the IMF, asking if the institution's vision of its role in international finance had become unclear. Bayliss opined that the Fund's recent comments on an international bankruptcy court and changes in bond covenants suggest that the IMF is indeed searching for a new role and is uncertain of its future.

Daza praised the IMF for its "unusually" tough stance with Ecuador, stressing that the IMF was correct in pushing Quito to use oil revenues from the second oil pipeline to buyback debt, and thereby avert a future debt crisis. Daza lamented that the IMF was not equally tough with countries that have greater political power.

Argentine Restructuring Seen as Hardly Imminent

Booth also requested the panel discuss their perceptions of how quickly an Argentine debt restructuring would take place, noting he personally thought the situation would be resolved in no less than two years (and even much longer) due to constitutional issues and internal political squabbling. Fine posited that he saw no point in doing any serious analysis of an Argentine debt workout now with the socio-political situation still unresolved.

Daza agreed that the Argentine situation was unlikely to be resolved in the near-term, noting that there has been a complete breakdown of the social contract in Argentina. Furthermore, he declared, Argentina might only be put back on track by a new government that would follow a failed left-wing (or even right-wing) government. Bayliss predicted that the restructuring would be so complicated and so difficult that it could only be concluded "when everyone gives up hope." Finally, the speakers largely concurred that Argentine debt could trade down as much as ten points from current levels although they emphasized Argentina is largely "off the table" for the foreseeable future.

Turkey Remains a Concern Despite International Support

Several of the sell-side panelists voiced concern over debt sustainability in Turkey, although they declared that Turkey's geo-political importance has earned it "special status" from the official sector. Poole described a number of problems that he viewed as building, adding that following Turkey's receipt of a record amount of IMF funds, "the trigger [to a crisis] will probably be a reversal of flows *to* the official sector." Bayliss commented it would be extremely difficult for Turkey to "pull itself out of the debt trap" with real domestic interest rates which have rarely dipped below 20% in recent times, but he had difficulty identifying the trigger to a crisis because of its strong international support.

EMTA's panel of buy-side experts echoed many of the comments made by their sell-side colleagues, although several differences were apparent. Investor speakers tended to be slightly more optimistic in tone on Brazil, while their criticisms of slow reform progress in Russia were more muted. However, buy-side speakers largely shared sell-side "non-interest" in Argentina and also mirrored the sell-side panel with their unease with recent official sector policies.

Investors Discuss Market Turbulence in Brazil

John Cleary (Invesco Asset Management) affirmed that, despite current economic issues in Brazil, current

spreads were "probably not" justified by economic factors alone. "Risk aversion has kicked in, people are looking to sell risky assets, Brazil is one of the most liquid assets, it's also one of the biggest in the benchmarks, and [selling] is what they are doing" he stated. As a result, Cleary speculated that in order for Brazil to regain the confidence of market participants, investor sentiment generally must change towards risky assets. Ingrid Iversen (Rothschild Asset Management) expressed her belief that a Brazilian default should not be considered inevitable, and that Brazil could struggle through a high rate, high spread environment for several months if necessary (although she doubted whether the current situation was tenable for more than six months). Amit Gupta (MN Services) supposed that the simplest way for Brazil to get itself out of the current crisis was to borrow $50 billion from the IMF and buyback outstanding debt, though he admitted he didn't expect the IMF to be particularly receptive to the idea.

Buy-Side Speakers Agree Recent US Treasury Proposals Won't Be Beneficial…

Moderator Franklin commented that in the most recent investor meetings with US Treasury officials, policy makers appeared to confirm their recent initiative to limit IMF assistance packages to countries in distress, as well as to change bond documentation to facilitate bond restructurings. Investor panelists were in agreement in not seeing such new initiatives as being beneficial. Iversen and Gupta noted that changes in the collective action clauses of bond covenants might ironically facilitate sovereign defaults. In the opinion of Simon Treacher (Blue Bay Asset Management), the US Treasury is ultimately "unclear" about what it wants to do with the IMF, but that if such reforms occurred, he would find the corporate debt market more compelling than Emerging Markets.

Cleary declared collective action clauses to be problematic as a result of the recent promotion in emerging countries of local pension funds. The ownership of external bonds by local pension funds, and the greater susceptibility of such funds to government pressure in the event of default, tends to stack the deck against the foreign investor in any bond restructuring.

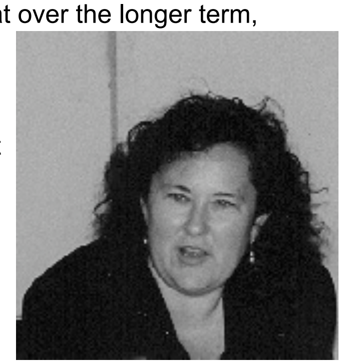
Franklin asserted that despite "tough talk," Washington would "ultimately flinch," in the case of Brazil, due to Western bank exposure and the substantial amount of FDI invested in Brazil in recent years. He concluded the new financial architecture discussion by noting that the scope of parties which would suffer in the event of a Brazilian debt default would go way beyond the Emerging Markets debt investors ("there are a lot of people who don't want to lose money that aren't sitting in this room," he emphasized).

…While Global Economic Environment Will Encourage New Inflows

Several panelists stressed that the international economic environment of low global interest rates and forecasts of a resumption in global growth would prove beneficial for the Emerging Markets asset class. Cleary anticipated that Emerging Markets allocations will increase over medium- and long-term as some money managers will be swayed by historical performance while some equity managers will also seek out Emerging Market assets as a result of lower dividend growth in equity markets. Cleary acknowledged that the increased understanding of the asset class by crossover investors is beneficial as such portfolio managers are not "just expecting positive returns with no volatility; they're expecting diversified returns with volatility that is less than equity and returns that could be equity-like." Iversen concurred with Cleary's assessment, and she joined Gupta in noting that the resolution of the Brazil issue would be critical to determining future inflows. Treacher believed that the global environment would facilitate new money being allocated to Emerging Markets as well, but was one of two speakers who expressed doubt that such money would, or should, use the EMBI+ as a benchmark index.

Panelists Generally Positive on Russia Despite Lack of Reform Progress

Franklin noted that most panelists at last year's Summer Forum had picked Russia as a top investment choice and asked panelists for an update on their views on Russia. Iversen emphasized that over the longer term, growth rates would determine Russian debt prices, but for the near term, she would continue to hold debt as long as the Russian government continued to carry out buy-back operations. "I would give them the benefit of the doubt; they've done a lot of tough things already," she stated, adding "I don't see any reason why they couldn't do the reforms they need to grow." Russian credit spreads could be in the 300s in June 2003, she speculated.



Gupta admitted he found Russia a difficult call, saying "I can see Russia trading at 300 over; equally I can see it trading at 1000 over," while agreeing that government buybacks were providing considerable support for the

bonds. He concluded that he wouldn't buy Russia at current levels; "however, I would be equally hesitant being short the paper." Cleary noted that despite the abundance of structural reforms still needed to be undertaken in Russia, he was generally positive on the credit, citing the geopolitical environment, FDI inflows into the oil industry, and Russia's increasing integration into the West. Finally, Treacher praised President Putin's progress to date on reforms, and added that reduced bank credit lines to Latin America may benefit Russia.

Argentina of Little Interest to Investor Panelists

Argentina did not offer a compelling investment story for most of the panelists. Treacher acknowledged he would buy the sovereign at "very distressed levels" but foresaw a workout that would be much more painful than previous crises. Iversen said only events, such as an IMF accord or credible economic policies, would prod her to look at Argentine debt. Cleary, Gupta and Treacher agreed that no restructuring was likely in 2002, with Gupta believing that Argentine paper is fairly valued at approximately 18-20.

Buy-Side 12-Month Picks More Varied than Usual Although Brazil a Common Theme

Asked for which credits would provide the highest total return during the next twelve months, investor panelist selections were more varied than in previous years when Russia was a unanimous choice--although three of four panelists (Iversen, Cleary and Gupta) included Brazil as a tempting investment over the period. Iversen and Gupta also concurred on Ecuador, although Treacher made note of his disagreement and disappointment with unfulfilled Ecuadorian promises. Other choices included Serbian blocked deposits (Iversen), Argentina (Gupta), Russia (Cleary), Mexico (Cleary), Indonesia (Treacher), Malaysia (Treacher), and a variety of Asian corporates (Treacher).

Moderator Franklin, prompted by an audience member to divulge his own selections, noted that he found certain, though not all, Argentine government debt "dirt cheap." He speculated that money could be made by simultaneously owning long-dated paper and default insurance on countries such as Brazil; and remained positive on oil exporters such as Algeria (especially illiquid yen-denominated paper).

Ending the day on a positive note, at least for Brazil partisans, EMTA hosted a big screen viewing of the World Cup semi-final between Brazil and Turkey immediately following the panel discussions for a crowd of over 100 enthusiastic football fans.

Transcript of Buy-Side Panel

Transcript of Sell-Side Panel

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