How To Make Big Money Trading In All Financial Conditions

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SAMPLE

Finding Value In Emerging Markets

The situation for emerging markets (EM) **requires a similarly nuanced approach, with RORO-delineated parameters according to the degree to which all assets correlate in a particular country or region, or whether they do so according to asset class, or any combination thereof, sometimes strongly manifesting themselves and sometimes not**.

The trick is to follow what's going on all the time across all key developed and emerging markets every day and to know inside and out what is happening on the fundamentals side of the countries involved.

In broad terms, of course, **all emerging markets can be regarded as the ultimate convergence trade,** in the same way that, for example, the valuations of eastern European countries in line for EU-accession gradually began to align (equities up, bond yields down, currencies strengthening) with those of EU countries the nearer to the accession they drew. How far off an EM is from having converged into being a DM, of course, can be seen from its credit rating, most palpably, aside from other tangential factors:

Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3		BBB-		BBB-		
Ba1	Not prime	BB+	B	BB+	B	Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC	C	Substantial risks
Caa2		CCC				Extremely speculative
Caa3		CCC-				In default with little prospect for recovery
Ca		CC				
		C				
C		D	/	DDD	/	In default
/				DD		

Consequently, **they could be regarded as pure 'risk-on' trades, whatever the asset class involved. However, within this encompassing description, there has been a re-emergence of those EMs that can be regarded as further along the development path than all of the others and thus investable in a marginally risk-off environment**.

Prior to 2008, the former group was probably best symbolised by the **BRIC** group, comprised of Brazil, Russia, India and China, which led the way on EM valuations by dint principally of their projected growth paths. These were followed by the **Next-11** (Mexico, Indonesia, South Korea, Turkey, Bangladesh, Egypt, Nigeria, Pakistan, the Philippines, Vietnam and Iran), of which the first four of the grouping had consistently outperformed the remainder, earning the sobriquet of the **'MIST'** countries along the way.

In pure currency trading terms, investment in selected emerging markets can accrue the benefits both of carry compensation in the short-term (which may or may not show up directly on your trading P&L sheets, depending on the platform you are using, but will be reflected in the movement of the currency overall) and of growth prospects supporting real exchange rate appreciation over the longer term.

The carry trade element of this is predicated, of course, upon the interplay of two key factors: wide (but stable) interest rate differentials (between the currency being sold to fund a higher-yielding currency) and low currency volatility on the first leg of the trade.

Before the 2008 crisis, the rolling correlation between returns from a traditional carry basket and returns from the S&P500 fluctuated around zero in developed markets and positive for emerging markets currencies. In the most recent major 'risk-on' environment, though, it is interesting to note that the same rolling correlation for both developed and emerging markets moved into positive territory.

Consequently, it might be said that either the emerging markets' currency carry trade risk has converged to that of the developed markets one or, more accurately, that this risk for developed markets' currencies has moved up the risk curve towards a level more associated with an EM currency equivalent. Indeed, holding a carry basket today is almost the equivalent of holding a pre-crisis carry basket together with some S&P futures. Given this more level playing field on the risk side of the equation, then, attention tends to focus on the underlying fundamentals of EM countries now and on their projections going forward.

In this regard, any gaps in the developed markets' landscape is likely to be filled increasingly over time by the currencies of those emerging economies that meet **the basic criteria of an investment destination:**

1. **A sustainable fiscal policy**
2. **A sound balance of payments profile**
3. **A solid financial and political system**

The **additional benefits of EM investment destinations is that more often than not they benefit both from momentum trading and carry trading strategies, given their relatively high interest rates in a broadly zero interest rate policy developed markets world**. In this context, it is highly likely that incrementally value-added returns will be accrued from investment in the BRICs, MIST and N-11 countries over time simply as they converge towards developed markets status.

Basic Convergence Premise

As mentioned above, in the most basic terms, **the reason for traders having become increasingly interested in emerging markets over the past decade in particular is the belief that, at some undefined point in the future, their fundamental characteristics will converge with those of the 'developed' markets (DM)**.

Consequently, the idea runs, **there is money to be made as the risk involved in trading these EM assets declines, they are traded more and their assets gain in quality and return more true value**.

Indeed, as the relative risk perception between DM countries and EM ones began to narrow from around the 1980s investment flows into emerging markets increased from $25 billion in 1980 to $1.2 trillion in 2013, and over the past ten years alone these flows have averaged 5%-6% of GDP of the recipient countries, up from around 2% in the '80s and 4% in the '90s.

As a concrete example, all other things being equal, if the Indian rupee was regarded in precisely the same risk category as the US dollar, then the exchange rate between the two would go from the current level of around 60 rupees to the US dollar to just 1, parity: i.e. a 60:1 convergence.

The underlying notion of 'convergence' to developed market status underpins all emerging markets in general terms (including the even riskier 'frontier markets') but in recent years has been most obviously present in the currencies of countries that have been in various stages of joining the EU and then, it is logically inferred, the euro, although exactly the same process is relevant in trading terms to all other emerging markets at whatever stage of development they may be.

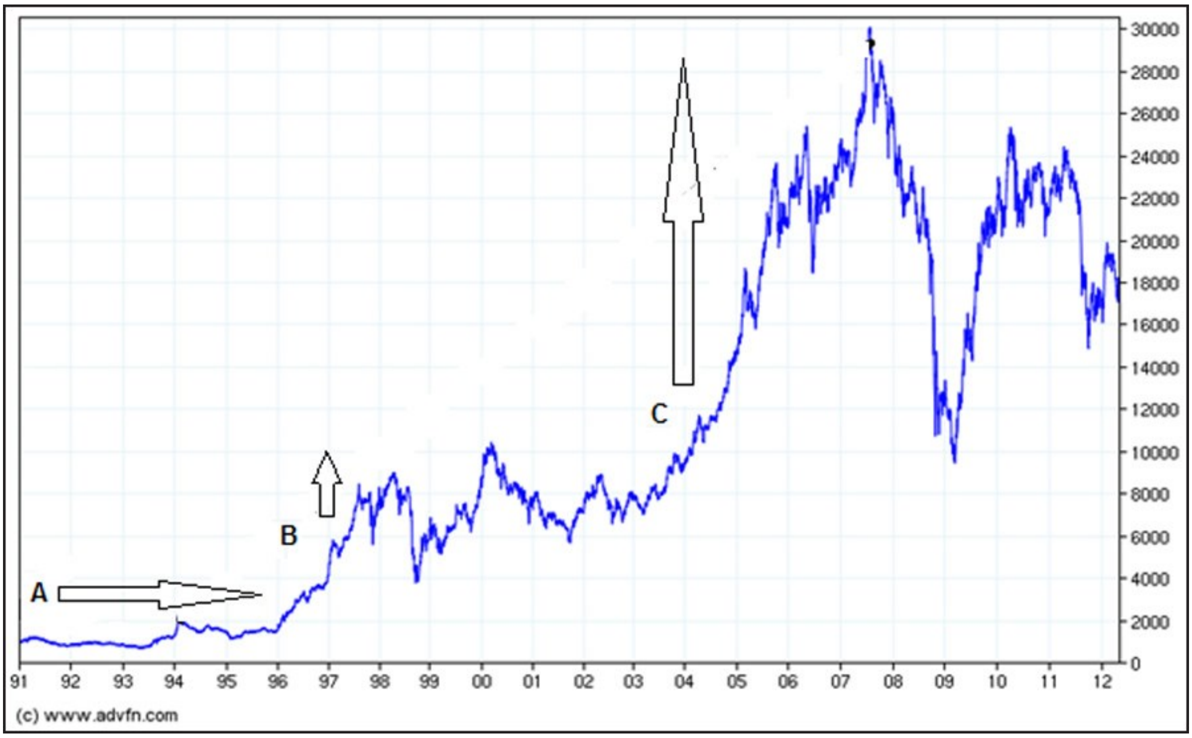
Euro Convergence Template

All of the countries that used to be part of the Soviet bloc but gained independence as the USSR disbanded saw their currencies gradually strengthen as the time of their accession to the euro grew closer. These were specifically entitled **'euro convergence trades'** and every one of them was an absolute winner.

For example, despite the appalling economic and then social consequences that have befallen Greece since its adoption of the euro in 2001, from the currency trading perspective it was a complete 'no-brainer' up to its accession. **Prior to joining the euro, there were, roughly, around 250 Greek drachma (GRD) to the US dollar. After it joined the euro project all drachma were replaced by euros, meaning that the rate had gone from 250 to under 1 within a year: nice trade indeed**, if you'd sold the drachma, and if you hadn't then clearly there was something profoundly wrong with you.

Exactly the same can be seen in the stock markets of those countries looking to join the EU. For example, Hungary's BUX stock exchange progress can be regarded for a long time as a simple convergence trade: first, away from the USSR and towards the West; secondly, from the West towards the EU; and thirdly, from the EU to the euro, as seen below:

Hungary BUX (15 Years, Monthly)



[Chart Key:
A = After the fall of the USSR in 1991, Hungary flatlines for a while before traders start to view it as gradually becoming an EU-grade state
B = Traders are regarding Hungary as an EU state more firmly by the month, as it approaches official EU accession date of 1 May 2004
C = Traders now looking for Hungary to replace the forint (HUF) with the euro at some point in the relatively near future]