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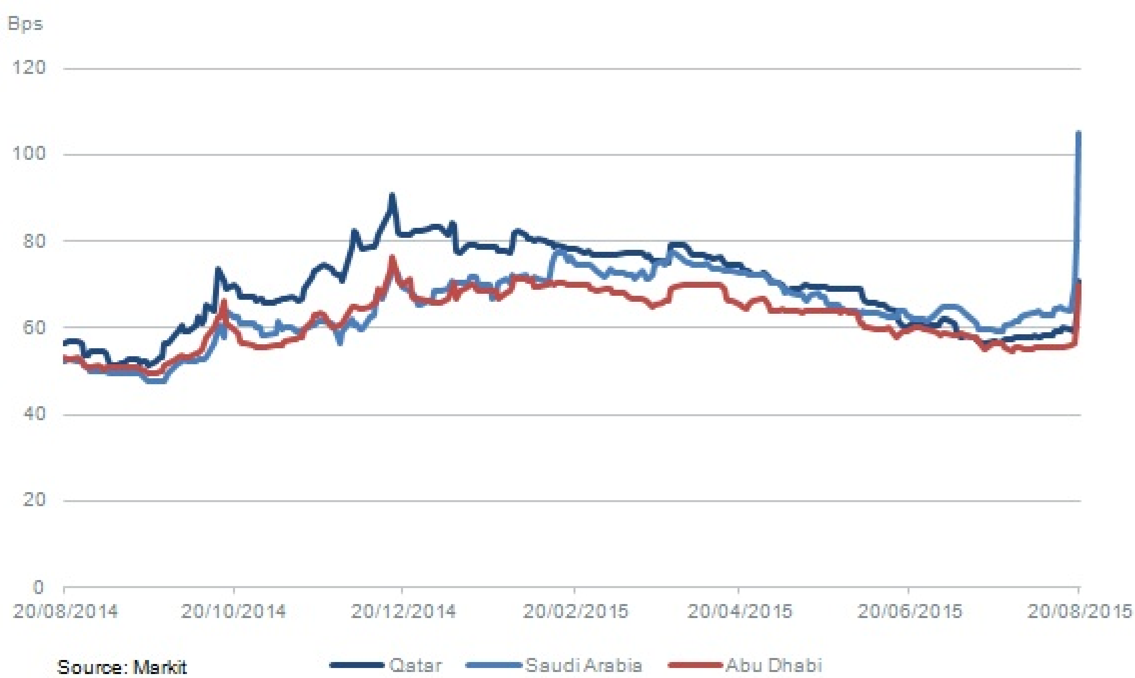
Markit Recap – 8/17/2015

THE LEAD | August 20, 2015

We remarked last week that emerging markets could face a difficult time ahead. Well, we didn't have to wait long before the early maneuvers in a possible currency war had an impact on sovereign CDS spreads.

Vietnam was one of the first to move by devaluing its currency and widening the trading band. The decision was no doubt prompted by China's devaluation of the yuan last week, a policy shift that was bound to have ramifications across the global economy. Vietnam is an export-driven economy, and it is logical that the government would seek to protect its terms of trade.



Kazakhstan swiftly followed with an even more radical change in exchange rate policy. The government initially widened the trading band, but then decided to scrap the band and allow the currency to float freely. Kazakhstan has been hit hard by a sharp decline in the price of oil, its main export, as well the depreciation in the Russian ruble, so the consequent 20% fall in the currency should improve its external position.

But the credit markets didn't take the news well. Vietnam's spreads widened 20bps to 250bps, their widest level since February 2014. The movement in Kazakhstan's spreads was more dramatic – they widened from 275bps to 315bps after the free float announcement. Exporters may gain from the devaluations but debtors won't. Emerging market countries have considerable amounts of debt denominated in US dollars, and the falling currencies will make this debt more expensive to service. China's surprise devaluation could trigger solvency issues in many of its Asian neighbours.

Solvency problems are not normally associated with oil-rich countries in the Middle East, but GCC sovereigns saw considerable widening in their spreads. The drop in the price of WTI crude to $40 a barrel has placed pressure on state finances, forcing the UAE to scrap fuel subsidies and consider introducing VAT. Abu Dhabi and Qatar both saw their spreads widen from 60bps to 70bps, which were large daily moves for these normally stable credits. The widening in Saudi Arabia's CDS spreads was of a different magnitude altogether – its spreads widened from 70bps to 105bps, the first time it has breached the 100bps level for almost three years.

US rates are set to go up soon – though expectations for the first hike were put back after a dovish set of Fed minutes – and China's economic trajectory remains unknown. We can expect more volatility and further capital outflows from emerging markets over the remainder of the year.

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