Markets

Veteran Emerging-Market Investor Says EM Risk Could Be Higher Than in 2008

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by **Ben Bartenstein**
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- Koenigsberger warns that fund inflows raise liquidity threat
- Venezuela is 'scraping the barrel' to pay, fund manager says

Since entering the world of emerging markets nearly three decades ago, Robert Koenigsberger has seen more than his share of changes.

One of the most consequential is the migration of allocators from hedge funds to exchange-traded and mutual funds in recent years. That's effectively made them one-day liquidity vehicles, versus the 90-day instruments leveraged funds typically offer.

"We're potentially sitting on one of the most illiquid market conditions in emerging markets that I've ever seen," said Koenigsberger, who oversees $6 billion as chief investment officer at Greenwich, Connecticut-based Gramercy Funds Management. "This market isn't well set up for outflows. It showed its stripes in the taper tantrum, and I think this will challenge the taper tantrum, if not 2008."

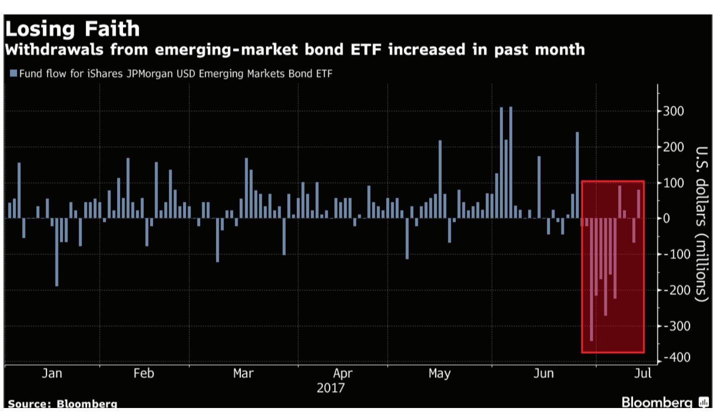
Since the global financial crisis, the amount of emerging-market high-yield debt has quadrupled to about $763 billion, according to data compiled by JPMorgan Chase & Co. At the same time, dealer inventories have been scaled back to about a fifth of what they were in 2009 due to regulations, Koenigsberger said, meaning many banks no longer participate in emerging markets as intermediaries or proprietary traders.

"The question is: Is this a market or a bazaar?" Koenigsberger said. "In 2017, with the absence of banks providing liquidity, who will facilitate the flows for the one-day ETFs and mutual funds?"

Here's what Koenigsberger had to say about the state of developing-nation debt trading:

Where does an emerging-market investor make money today?

- "In today's illiquid environment, one of our favorite instruments is cash. When bonds prove to be illiquid, the relative value will make private credit less attractive."
- Up to half of Gramercy's portfolio is focused on direct lending, particularly in Argentina, Brazil and Colombia.
- The firm favors long-lock credit vehicles, which are usually over five to seven years and allow the fund to underwrite illiquidity and get compensated for it.
- With banks no longer lending, "there's a vacuum to be filled."
- About two-thirds of their investments are in Latin America, whereas Asia offers the least value and most crowded trades, Koenigsberger said.
- The firm also have favors distressed opportunities. It bought bonds from the Australian miner Consolidated Minerals Ltd. last year at a distressed level and tendered them at 101 cents on the dollar. Gramercy no longer holds the notes.



Will Venezuela continue to pay on its debt?

- "We don't want to pick up pennies in front of a steamroller. Looking at the numbers, they've run out of money. These guys are scraping the barrel. They had to sell 'hunger bonds' and do a repo transaction with Fintech Advisory Inc. That's not a sustainable debt model."
- Although the fund has no exposure to Venezuela, Koenigsberger says he expects the recovery value on the nation's bonds to eventually exceed 65 cents on the dollar. He compares it to Peruvian bonds, which traded in the low single digits in 1990, yet eventually were worth 125 cents through a consensual restructuring in 1996.
- "In 30 years, I can't recall human conditions being so bad beneath a debt stock. When President Nicolas Maduro is gone, some people think there might be a 'Macri of Venezuela' that will quickly solve the problem. That's a bit crazy because the issues are so much more dire."

Which high-yield debt do you prefer?

- "There aren't a lot of high-yield sovereigns left. Argentina is pretty well played out. I'm definitely not a believer in Ecuador. Even without oil, Ecuador has shown itself to have a very challenged credit culture with multiple defaults. Greece played itself out and Ukraine doesn't offer much at 7.5 percent yield now."

How can traders leverage with credit-default swaps?

- "We run beta hedges on our portfolio -- we're willing to buy CDS or short sovereign credit to isolate risk and protect against risk we don't want, such as gap risk."
- Koenigsberger says Peru and Mexico's sovereign swaps contracts have biggest asymmetries as there's about 750 basis points for them to trade at their post-crisis historical wide values.