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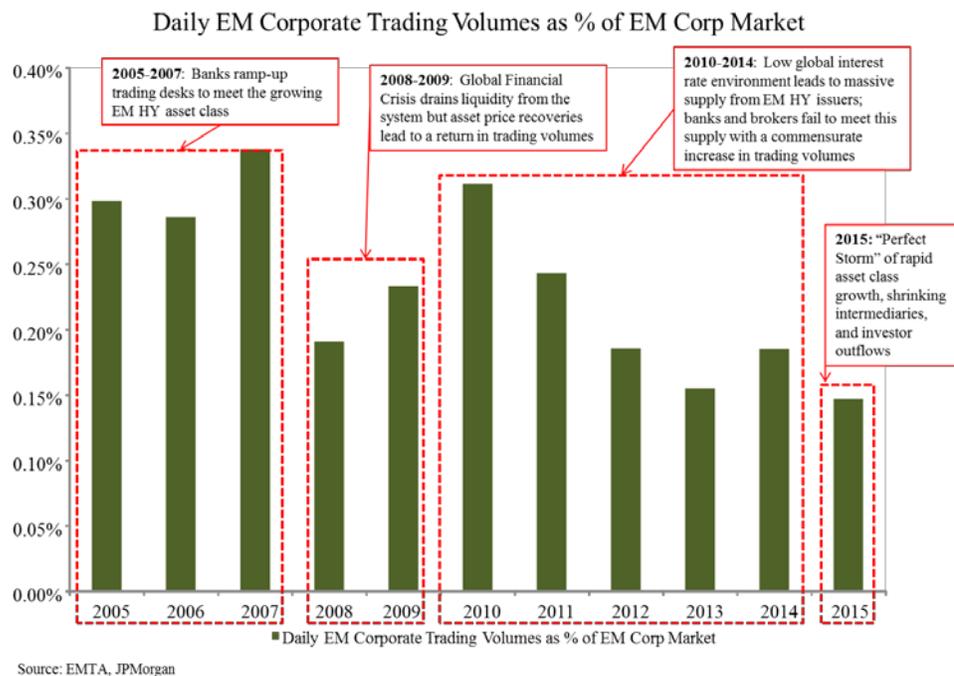
Emerging Markets Distressed Credit How Much is that Rug in the Window?

Over the past few years we have been discussing the possibility of a potential perfect storm in Emerging Markets, in particular in corporate credit. Our anticipated concern was anchored on the notion that in a more difficult external environment, the size of the asset class/buy side was at all-time highs while simultaneously the size of intermediaries was massively shrinking and the amount of balance sheet committed to market-making groups at sell-side institutions had never been so constrained.

In fact, as 2015 came to a close with this perfect storm scenario, the “market” for EM credit appeared to be less of an over the counter securities market and more akin to the carpet shops in the Grand Bazaar in Istanbul. In order to transact, one was forced to go from stall to stall (broker to broker) for price discovery and in doing so drove down prices sometimes without even transacting!

The Perfect Storm

Broker dealers, aka “BD’s,” have taken the D out of BD. This should be no surprise given the increased regulation of banks which prevents proprietary trading and makes it difficult at best for banks to define and defend market-making positions versus proprietary positioning. This kills two important forms of traditional liquidity provisions in EM credit. Market-making has historically been a loss leader for many banks that was tolerated due to the ability of the banks to profit by positioning behind their clients and disguise prop trading positions as making markets to clients. In essence the Street was running hedge funds camouflaged as market making operations. Once the prop desks were shut down by regulators, the banks were no longer willing to operate the loss leading market making operations. Hence the massive pull-back from market-making. Ironically this exodus has resulted in an environment whereby those with the proper fund structures and credit skills can earn the best liquidity premium this market has ever offered, certainly on a risk-reward basis.



Meanwhile, as all these changes on the street were draining liquidity from the marketplace, the buy side was growing to record levels year after year. By 2015 EM credit was \$1.65T (EMHY was \$604B). In 1998, when I left the Street, the largest dedicated EMD manager had approximately \$3Billion of AUM. Today, the asset class has multiple managers over \$50BN. In fact, various dedicated EM shops lost \$20B plus due to outflows in 2015. EM credit has grown by nearly 2.5x since 2010 yet trading volumes in 2015 were roughly flat to those in 2010. Something had to give.

Further exacerbating the liquidity mismatch in 2015 is imbalance of inelastic supply versus elastic demand. That is, year after year, as EM credit AUM hit record amounts due to inflows, inelastic supply ensured that at every price an issuer could be found to satiate the demand for paper. Yet as we finally witnessed in 2015, the same is not true for demand. That is when outflows emerged, demand to repurchase those securities was limited at best. Hence the perfect storm.

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