

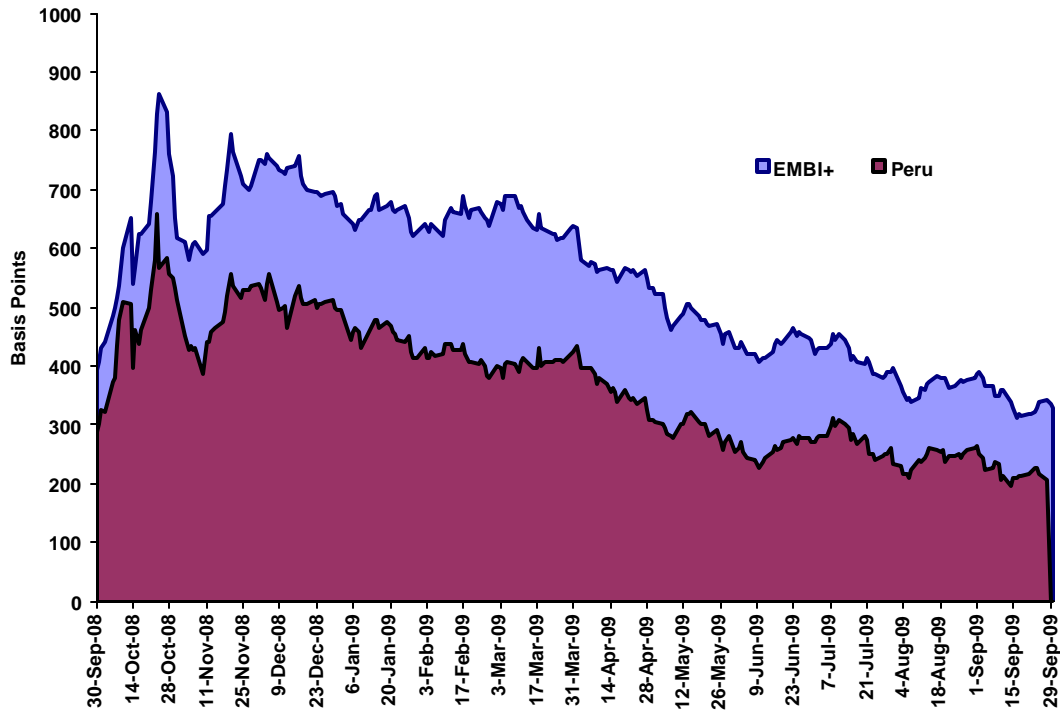


Surviving the 'Ultimate Stress Test'

There is little doubt that emerging markets (EMs) have felt the brunt of the global economic slowdown over the past 22 months but talk of an early recovery in the United States has opened up investor's risk appetite which has been of great benefit to the EMs. Emerging markets are said to have faced the 'ultimate stress test' throughout the global credit crisis which has been evident by EM indicators such as JP Morgan's Emerging Market Bond Index (EMBI+). The EMBI measures the total return performance of international EM government bonds that meet certain criteria while the JP Morgan EMBI+ spread represents the difference between the Treasury yield and the average yield of emerging market bonds. The spread is an indication of the higher default risk faced by investors in emerging markets i.e. the wider the spread the greater the perceived risk of default compared to safer credits; the US in this instance which is still viewed as the safest credit. Since reaching a high of 862 basis points on 24 October 2008, the overall EMBI+ has fallen significantly to 329 basis points, at the time of writing. This marks a contraction of 533 basis points in a little less than a year.

Of all the Latin American countries in the EMBI, Peru has had the lowest average spread over the past year at a level of around 367 basis points (See Figure 1). This average is just 4 basis points under the most popular EM economy, Brazil. Like Brazil, Peru is rated BBB-/Stable/A-3 by the rating agency Standard and Poor's (S&P) on account of the government's commitment to economic stability and a positive investment climate. The slowdown in demand consequential to the global crisis resulted in a slump of Peru's exports of metals, fishmeal and natural gas: Peru is the world's third-largest exporter of copper and zinc. Consequently, after growing at a rate of 4.72% in 2008, the country's finance minister is predicting the economy will expand by 2.5% this year and 5% in 2010 on account of "increased bank lending, greater export demand and infrastructure investment".

Figure 1: Graph of Overall EMBI+ and EMBI+ Peru



Source: Bloomberg

Like most of the EM countries, Peru has experienced a fall-off in inflation with its policy rate at a record low. In September 2009, declining food and transportation costs saw prices decrease by 0.09% from the month before bringing the year-on-year inflation rate to 1.2%. This is on the lower end of the central bank's target inflation range of 1%-3%. The bank's policy rate is expected to remain at a record low of 1.25% "for a long time" as inflation slows and economic growth shows some sign of recovery. The country's currency, the Peruvian new sol, has also appreciated, currently trading at a level of 2.8915 new soles per US dollar. This measures a 3.05% return on the currency since September 2008. Peru's Eurobond prices have also weathered the storm as seen in the performance of its bonds, namely Peru 9.125% 2012 and Peru 8.75% 2033. Both these bonds have seen price appreciations over the past year with the longer tenor even reaching a current high of US\$134.26 yielding 6.035%, up from US\$118.294 with a yield of 7.168% in September 2008. This represents a return on the bond of 13.5% over the past year based on price appreciation.

S&P forecasts that the country's "net general government debt will likely remain close to 20% of GDP over the next three years which is well below the 'BBB' median". One of the largest risks to Peru's informal economy is political given prevalent poverty and an inequitable distribution of income which is said to make the country "susceptible to populism".

During times of economic and financial downturns, having a diversified portfolio and finding that 'diamond in the rough' is key to any portfolio manager. In our opinion, the main lesson to be learnt from the economic downturn is that no country is immune to what happens in another country. What differs is the extent to which each country is affected and sometimes the greatest benefit comes from weathering the storm.

Peru's track record of prudent fiscal and monetary policies has paid off and the economy is ranked as high as its Latin American neighbour, Brazil. There is no doubt that as the US economy recovers and global demand continues to pick up, we can expect to see spread levels fall as risk appetite increases. Does this mean a possible upgrade for Peru? Will rating agencies act as they did during times of high spreads with downgrades across the board? Or will they be more hesitant to upgrade sovereigns as spreads fall off? Time will tell. In the mean time, fundamentals, technicals and speculation will continue to drive the market. The level of risk exposure to this volatility however, has to be determined by the investor.

FINANCIAL & ECONOMIC INDICATORS

As at 1 October, 2009

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	89.60	91.27
Euro	1.45	1.47
Jamaica	88.99	89.10
Guyana	204.20	204.90

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	70.18	65.89
Natural Gas (US\$/mmbtu)	2.92	3.56
Gold (US\$/Troy Ounce)	999.20	994.10

Eurobond Indices (As at 01-10-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	7.91
JP Morgan EMBI+ (Basis points)	340
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	32.65

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0.10	0.13
Euro Zone	1.00	1.00
Japan	0.10	0.13
Brazil	8.75	8.75
Trinidad	6.25	6.75
Jamaica	12.50	12.50
Barbados	2.50	2.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.10	0.09
US 10-Yr Treasury	3.18	3.38
3-month UK Libor	0.54	0.56
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	8.65	8.65
TT 90-day T-Bill	1.86	1.98
Jamaica 90-day T-Bill	16.39	16.39
Barbados 90-day T-Bill	3.65	3.65

Sources: Bloomberg, J.P. Morgan, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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