Morgan Stanley

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MORGAN STANLEY RESEARCH

2015 Outlook

2015 Global EM Strategy Outlook

Favour Fixed Income Over FX

The lowflation struggle of DM and EM central banks will provide a favourable external funding backdrop in 1Q15, but higher rates and a strong USD will turn into headwinds later in the year. Initially, global monetary easing will offset the impact of still poor EM fundamentals, leaving EM fixed income attractive. However, EM currencies will weaken in the battle with deflation as policy space for conventional tools continues to diminish.

We have an Accumulate stance in both local bonds and sovereign credit, while we retain a Hold stance in EM corporates and a Reduce in FX.

Currencies – Lowflation Risks for FX

We look for further adjustment in EM currencies versus the USD: EM growth will remain challenged relative to the US, low inflation will persist, putting pressure on currencies where leverage is high, and sustained USD strength versus the EUR and JPY will lead to further competiveness challenges for EM. We look for underperformance in the currencies most exposed to the commodity cycle and productivity weakness (including BRL, COP and ZAR) and those exposed to low inflation dynamics and the continued weakening of the EUR and/or JPY (KRW, SGD, CEE and ILS). We think improved prospects for reform should allow for MXN and INR outperformance.

Local Rates – Staying Selective

We expect EM rates to outperform the other asset classes in 1Q15 as central banks' continued policy accommodation and relatively stable DM rates broadly support rate curves. Countries with scope for additional policy easing and those that are less sensitive to currency weakness should see their bonds outperform. We then expect the external environment to become less supportive, and, given EM's large indebtedness, higher funding costs will put upward pressure on EM local yields for the remainder of 2015.

Credit – Diverging Destinies

We keep our stance at Accumulate for sovereign credit going into 2015 as a result of a benign external environment, favourable technicals, and valuations that are no longer expensive. We expect spreads to rally into 1Q15 before widening into the end of the year because of a strong USD and rising core rates. We remain cautious on corporate credit, given the weakening fundamental trend, potential US rates volatility, commodities weakness and still somewhat rich valuations versus the sovereign. With an overall uninspiring total return outlook in EM credit, our focus is more on differentiation to generate excess return.

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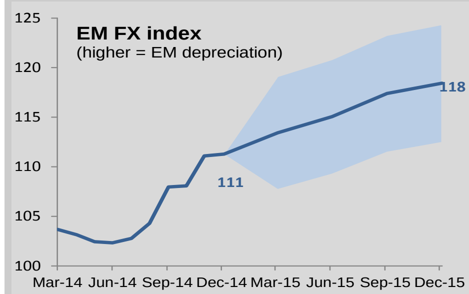
GLOBAL EM STRATEGY TEAM

For research analysts, please see contact list at the back of this material

Exhibit 1

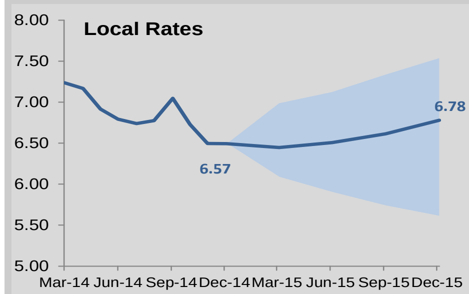
Outperform: MXN, INR
Underperform: BRL, KRW, SGD, ZAR



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 2

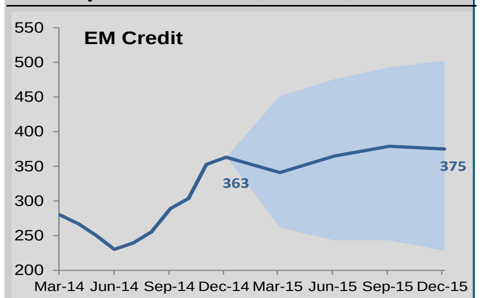
Outperform: India, China, South Africa, Colombia
Underperform: Indonesia, Malaysia



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 3

Outperform: MEX, COL, PER, CEE
Underperform: UKR, SOAF, TURK



Source: Bloomberg, Morgan Stanley Research forecasts

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Global EM Strategy Outlook

- **While EM growth remains weak due to subdued domestic demand and exports, the external funding environment is still favourable as central banks across DM and EM focus their policies on lowflation.**
- **Against this backdrop, we have a preference for EM fixed income over FX. We have an Accumulate stance in both local bonds and sovereign credit, while we retain a Hold stance in EM corporates, due to less compelling risk/reward.**
- **'Lower DM yields for longer' supports a positive total return for EM fixed income in 1Q (local bonds FX hedged 1.2%, sovereign credit 0.8%), but EM bonds are likely to be challenged in the second part of 2015 by US rates normalisation and possible concerns about external funding as well as FX mismatch.**
- **Persistent deflationary pressures are set to continue to cause EMFX weakness, particularly in countries characterised by below-target inflation, open economies, low rates and rich REER. We retain a Reduce stance, as we project a -3.2 % total return in 2015.**
- **The main risks to our view are China exporting deflation via the currency and a sharp move higher in core rates. The drop in oil prices is overall positive for growth but leaves important winners and losers in the EM space.**

We continue to believe that asset prices in EM will adjust to the weak macroeconomic outlook. As we have been emphasising in our recent research, this means that fixed income markets are likely to continue outperforming FX as growth and disinflationary pressure continue to weigh (see *Global EM Investor: Favouring Fixed Income over FX*, October 21, 2014). We therefore stick to our Reduce stance in FX, Accumulate in local rates and sovereign credit, while we stay on Hold in the EM corporate space. Recent spread widening makes the medium-term risk/reward on credit particularly attractive; however, our total return forecast suggests that local bonds and rates should outperform credit in 1H and lose momentum in 2H (see Exhibit 4).

Global EM Macro Backdrop to Remain Weak…

Weak EM growth and global disinflationary pressure remain key themes of our global macro outlook, which highlights the ongoing battle that policy-makers are expected to have with low inflation (see *Global Macro Outlook: The Battle Against Lowflation*, November 30, 2014). Our global growth forecast for 2015 has been revised down to 3.5%Y from 3.7%Y, despite our US growth forecast upgrade to 3.0%Y, from 2.8%Y previously (see Exhibit 1).

This partly reflects weaker growth elsewhere in the DM world, but also in large parts of EM where China, Brazil and Russia growth have all been revised down. This is a long-standing theme, where growth in EM remains structurally challenged, which means they are less likely to benefit from a cyclical pick-up from the US, particularly as US growth is not expected to result in a significant pick-up in EM export performance – in line with recent experience.

Expectations for weak exports have been a key pillar behind our negative view on EM FX in particular, and Exhibit 2 highlights not only how weak the annual growth in EM exports has been in recent years, but also that the large majority of the modest pick-up seen in recent months has been due to China. In other parts of the EM world, there is little evidence of an export-led pick up that could lift EM out of its structural funk. Weak exports and sluggish growth potential also limit the ability of EM economies to attract capital and thereby boost currency valuations in the process (see Exhibit 3).

Amid the weak growth, inflation is expected to remain low in many countries. At a global level it is forecast to rise, but this reflects expectation of ongoing policy accommodation from the Fed, rising risks of ECB action, more easing from China and rate cuts from Korea as well as a number of other EM central banks. There have been downgrades to our CPI forecasts to a large number of economies, particularly in Asia.

Despite the strong economic outlook in the US and the expectation for hikes in January 2016, UST yields are expected to be stable at low levels thanks to a strong USD and low inflation in both the US and the rest of the world. This is a benign external environment that is supportive of our call for further gains in both local and hard currency bonds.

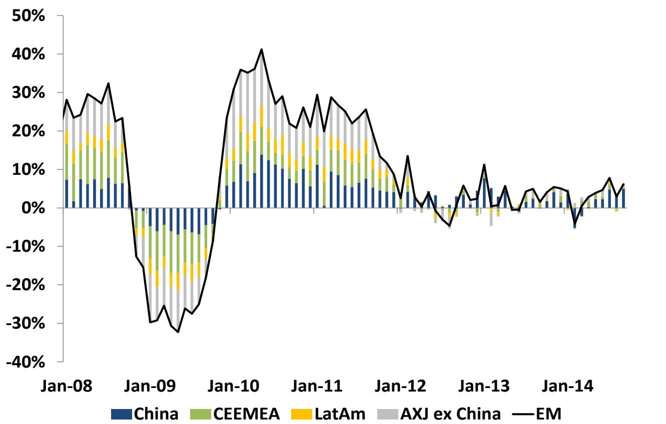
Exhibit 1

Selected Real GDP Growth Forecast Changes

	14e	2015e		2016e		17-19
%Y	Dec	Sep	Dec	Sep	Dec	
GLOBAL	**3.2**	**3.7**	**3.5**	**4.0**	**3.9**	**3.9**
G10	**1.6**	**2.1**	**2.0**	**2.0**	**2.0**	**1.9**
US	2.2	2.8	**3.0**	2.3	2.3	2.3
EA	0.8	1.2	**1.0**	1.7	1.7	1.4
Japan	0.2	0.8	**0.6**	0.7	**1.8**	0.8
UK	**3.0**	2.7	**2.5**	2.5	**1.9**	2.0
EM	**4.5**	**4.9**	**4.6**	**5.4**	**5.2**	**5.3**
China	7.3	7.1	**7.0**	7.3	**7.2**	6.6
India	5.3	6.3	**6.3**	6.8	6.8	7.0
Brazil	0.2	0.3	**-0.3**	2.0	**1.3**	2.2
Russia	**0.4**	-0.5	**-1.7**	1.1	**0.8**	1.5

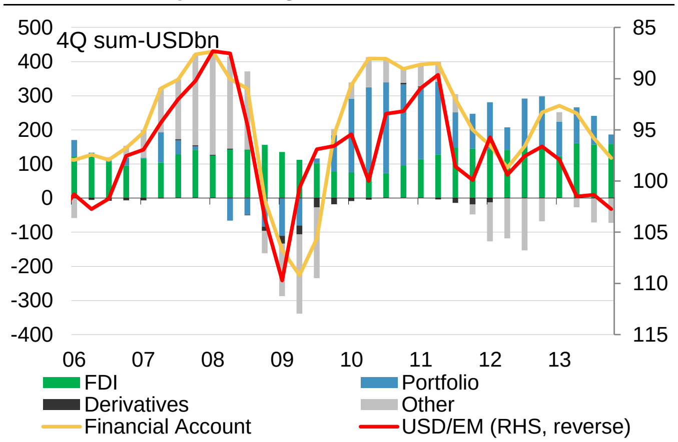
Note: Global, G10 and EM aggregates are based on new PPP weights and are not comparable to the aggregates published in the September Back-to-School report. Sep data shown in this table have been recalculated using the new weights.
Source: Morgan Stanley Research forecasts.

Exhibit 2
EM Export Growth Still Weak



Source: Haver Analytics, Morgan Stanley Research forecasts

Exhibit 3
EM Flow Story Turning Around



Source: Haver Analytics, Morgan Stanley Research

….Suggesting Continued Fixed Income Outperformance Relative to FX

The macro backdrop laid out by our economists feeds nicely into our preference for fixed income over FX (see *Asset Allocation* on the following page), and we explain why through four key themes that we explore in our four studies, on pages 9, 11, 13 and 15, and summarised here.

The first theme relates directly to market implications of the central bank battle against deflation: As we explain on page 9, many central banks across DM and EM are increasingly using their exchange rates to battle deflation risks as policy space via conventional tools has diminished. Recent JPY weakness is the latest turn in the ongoing global trade of deflation, following on from policy-induced EUR weakness since May 2014.

From an exchange-rate perspective, this process exports deflationary pressure to the rest of the world, at a time when many other economies across EM and DM are already undershooting their inflation targets. Falling oil prices and still-weak demand in large parts of the global economy are contributing to falling inflation expectations globally, and we see a significant risk of more EM currency adjustment offsetting the deflationary spillover from EUR and JPY weakness. There are several variables to consider when thinking about which currencies could become more vulnerable to disinflationary trends, such as the deviation of current inflation from the targeted rate, the openness of the economy, existing policy space through rate cuts, and the recent performance of the REER. This latter variable is where the spillover from JPY and EUR weakness will show up, we think.

Of course, falling inflation is not a negative for all currencies, particularly if inflation is high and above target, like in Turkey, Russia, India and elsewhere. Falling inflation rates back to target in these economies is a net positive for FX, provided monetary policy is not eased prematurely, as it removes a key macro vulnerability. The possibility of inflation falling significantly *below* target for a prolonged period of time is when risks to FX market rise, as it suggests a higher probability of a more aggressive central bank reaction that involves FX.

The loose monetary conditions that central banks in EM could be required to generate in order to battle against the lowflation risks are reflected in the monetary policy rate changes that our economics team has made, with rates expected to stay at low levels for longer than previously anticipated in CEEMEA (with the exception of Russia, where RUB weakness is expected to result in another hike in 1Q15), Asia – or in the case of China and Korea more cuts – and Colombia, in the LatAm region.

This domestic monetary policy dynamic, amid the benign external conditions created by relatively stable UST, EUR and JGB yields, creates a positive environment for local and hard currency bonds. These inflows are naturally supportive components for the currency on the balance of payments, but the weakness of the export picture combined with increasing focus on FX as a policy tool to prevent the excessive import of further disinflationary pressure likely means that hedging activity increases and currencies fail to strengthen – consistent with recent trends.

The China factor: The second theme focuses on the specific role that China is playing in the global trade of deflation. We explore this in more detail on page 11. Monetary conditions have not been loose in China, the annual growth of headline

CPI has fallen to new cycle lows amid persistent PPI deflation, while growth is slowing. China's REER has gained more than most in recent years. Because of this, the risk of CNY weakness is a key focus for the market. Our China economist Helen Qiao is expecting the PBOC to maintain its current strong CNY policy over the course of the year, to help facilitate a rebalancing of the economy and to help maintain confidence in the currency. However, the risk case that the PBOC decides to make a policy switch with the currency poses a major risk for the broader FX market, particularly EUR, AXJ currencies and indirectly PLN, HUF and ILS. More monetary easing could be priced into local bond curves as FX pressures prompt a central bank reaction.

The only market where currency strength is consistent with the economic outlook, and thus central bank action to mitigate seems unlikely, is USD. As such, as the rest of the world participates in a bid to raise their competitiveness and stave off deflation risks through currency depreciation, USD emerges to reign supreme, while bond yields stay low.

Impact of DM rates on EM fixed income: The direction of US Treasury (UST) yields and Bund yields is one of the key factors which shape our view on EM local rates and sovereign credit. In our base case, we expect a mixed performance in the EM fixed income market in 2015 as both UST and Bund yields slowly rise. We build a case for a constructive stance in the first part of the year, while the investment strategy becomes more complicated in 2H15. With regards to the DM rates trajectory, a major risk to our call is an abrupt movement in core rates.

Using a Granger causality test, we show that while UST was the dominant factor before 2014, Bunds became a leading driver through parts of 2014 (see page 13).

Using our G10 colleagues' bull/bear scenarios to gauge impacts from lower/higher Bund yields or higher UST yields, we conclude the following:

- In the **Bund bull case,** with Bunds rallying by 20bp on the back of 2016 ECB QE expectations, we expect EM local rates to see most upside, whereas EM credit will be more dependent on UST yields remaining contained. We would expect the CEEMEA region to see the most benefit.
- In the **Bund bear case,** with ECB government bond QE in 2015 but Bund yields higher, we believe that the excess liquidity from balance sheet expansion should offset the higher Bund yields. However, the pace of the UST yields normalisation would have an important impact as well. LatAm and MEA should benefit the most while CEE will likely underperform.
- In the **UST bear case,** EM would again be impacted negatively and we expect the countries with double deficits to suffer the most.

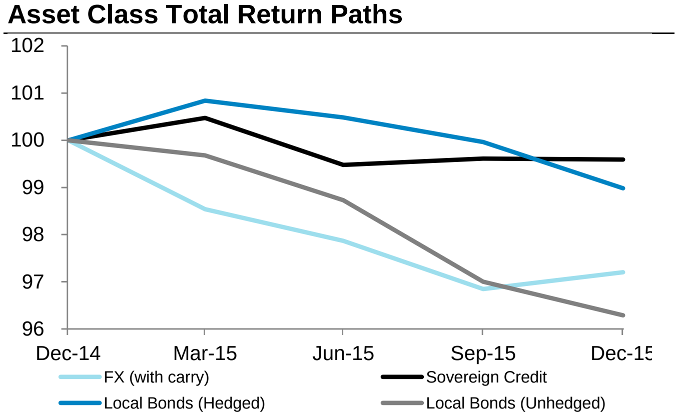
What about oil? The oil price remains weak due to demand and supply imbalances and a shift in OPEC's reaction function. A continuation of the recent trajectory could improve the global long-term growth prospects, but add to the broad deflationary pressures, causing further FX weakness in the near term. Global low inflation and monetary policy accommodation would continue to support local bonds, unless the FX weakness manifests itself in a more-than-anticipated volatile fashion.

The EM credit benchmark has a roughly 50/50 split between countries gaining and losing from lower oil prices and, as such, the overall impact on benchmark performance is more muted, in our view. While there are some large oil importers in the benchmark, such as Turkey or Indonesia, it is mostly smaller names that are among the winners. On the contrary, oil producers are more concentrated in the benchmark, driven by countries such as Mexico, Colombia, Russia and Venezuela. Due to their idiosyncratic developments and large dependency on oil, it is the latter two that are most in investors' focus (see page 15).

Asset Allocation

The global trends that we anticipate strongly support a preference for fixed income assets relative to currencies. We expect currencies to weaken more than forwards, implying a negative return of 3.2% in 2015 (see Exhibit 4). On the bond side, we expect local markets to outperform credit, but to lose momentum in 2H, due to upward pressure in DM rates, continued EM FX weakness and consequent concerns on FX mismatch and external funding conditions. As returns are likely to be uninspiring for the respective indices and important idiosyncratic drivers are at play, differentiation is critical.

Exhibit 4
Asset Class Total Return Paths



Source: Bloomberg, Morgan Stanley Research

Reduce stance in currencies: Loose monetary policy suggests currencies can weaken; we are bearish on those markets that are exposed to both a EUR and JPY decline, amid low levels of inflation, which means that CEE, ILS and KRW in particular are vulnerable.

The weak growth outlook adds further risks as it diminishes the prospects for capital flows to EM that would otherwise support currency valuations.

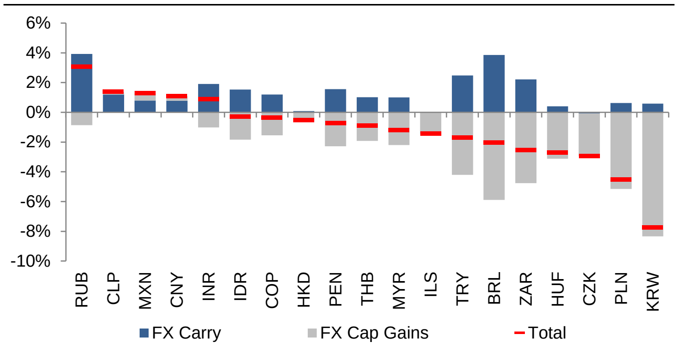
While EM growth is being held back by insufficient export momentum, growth *potential* has also been held back by limited reform efforts by EM policy-makers, which is limiting the ability of EM economies to attract capital and thereby boost currency valuations in the process (see Exhibit 3).

This is why a key upside risk for currency markets is the possibility that policy-makers pursue reforms in order to boost growth potential, narrow the growth divergence that exists with the US, and help to pull capital back into their economies. So far, we see limited evidence of EM policy-makers pursuing the reforms necessary to boost growth, outside of India, Mexico and to some extent Indonesia. We have noted some recent shift towards orthodoxy in Brazil with the nomination of the new cabinet lately, but implementation risks remain. We see outperformance from INR and MXN, two long-standing favourites of ours.

Economies that are in need of productivity-enhancing reforms are likely to see FX weaken in the absence of those reforms as structural headwinds weigh on competitiveness and risk capital flight. Brazil and South Africa are two economies we are watching in this regard, as we expect underperformance.

Exhibit 5

FX Returns Until 1Q15



Source: Bloomberg, Morgan Stanley Research

Accumulate stance in local rates: As the above macro dynamics play out, we see scope for EM rates to remain well-supported in 1Q. We favour those rate markets where we expect further policy easing, less sensitivity to currency weakness, and less rich valuations. We recommend tactically hedging EMFX weakness and forecast that local rates will return 1.2% on average (in USD) for 1Q15.

We then expect the external environment to become less supportive and, given EM's large indebtedness, we believe higher funding costs will put upward pressure on EM local yields on average for the remainder of the year. For the remainder of the year, we expect EM local bonds to return -3.8% (FX-unhedged), including 7% of overall carry and roll-down, 9% capital losses in FX versus USD and -2% capital returns for rates. Overall, however, we see a distinctively bifurcated market between the more fundamentally sound economies and those perceived as more externally and domestically vulnerable.

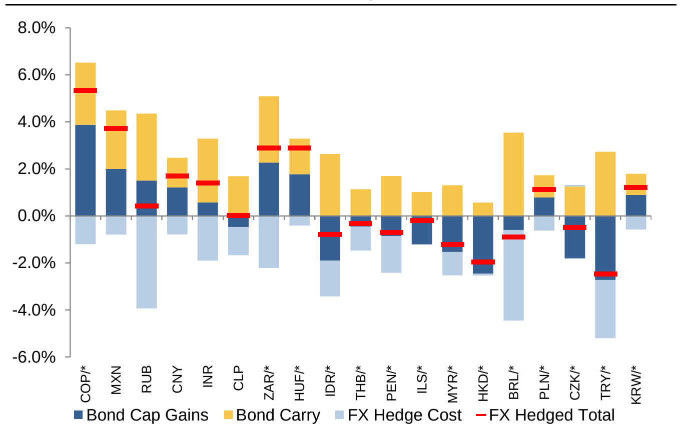
We recommend staying selective, with a preference for China, India, Poland, Hungary, South Africa, Colombia and Mexico, as these markets look set to benefit from their strong idiosyncratic dynamics.

Despite the positive macro backdrop in Mexico, its reliance on portfolio flows makes it particularly vulnerable to higher US rates, and we expect yields to move higher in 2015, though still outperforming the forwards. Nevertheless, signs of MXN resilience should help tighten the Mexican-US 10y spread to 300bp. We explained in *Mbonos – Attractive Investment in Firm(er) Hands* (November 13, 2014) that Mbonos are more resilient than some may perceive since, despite its high level of foreign ownership, more than a third of Mbono foreign ownership could be considered 'sticky'. The local Afores are able to stabilise the local market in the event of market disruptions as well, in our view.

We remain very mindful of the impact of slowing growth on the availability of credit locally. Brazil, Turkey and Russia, in particular, stand out as vulnerable on this basis, as tightening domestic financial conditions may in fact exacerbate the scope for steepening caused by increasing concerns over domestic risks and may boost long-end risk premiums.

Exhibit 6

Local Rates Returns Until 1Q15



Source: Bloomberg, Morgan Stanley Research
*Total return with FX hedged

Constructive on EM credit: A benign external environment keeps our stance at Accumulate for EM *sovereign credit* going into 2015, and we expect the EM sovereign benchmark spread to tighten towards 340bp by 1Q15. However, a strong USD and rising rates later in the year are likely to push spreads wider. We expect the benchmark to widen to 375bp by end-2015. Rising core rates also weigh on total return that we see at 0.6%, which means a 2.5% excess return versus US Treasuries.

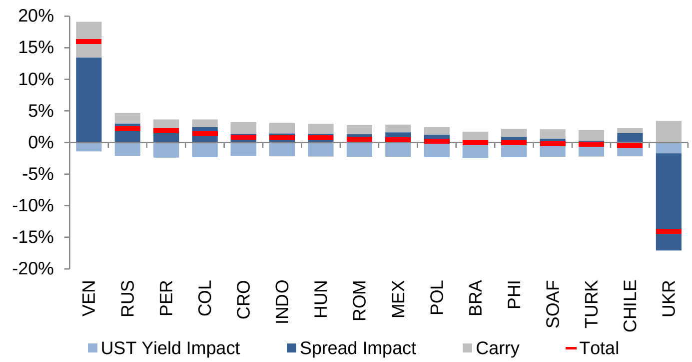
With an overall uninspiring total return outlook, our focus is more on differentiation to generate excess return. We continue to like the long end in low-beta LatAm. We also shift back to a constructive view on CEE, given that the region is more resilient to higher US rates and it can also benefit from potential European QE. On the other hand, we remain underweight the double deficit countries of Turkey and South Africa.

Among the high-yielding idiosyncratic credits, we maintain our market-weight in Argentina, given already high expectations of a settlement with holdouts early next year. With the dramatic fall in oil prices, Venezuela's challenges are growing to deal with its USD deficit, but with spreads already at very elevated levels, we remain market-weight and look for a better entry level to increase exposure. We stay underweight Ukraine, where we expect further deterioration while the extent of external financing remains somewhat unclear.

In *corporate credit*, the weakening fundamental trend, potential US rates volatility and commodities weakness as well as still somewhat rich valuations versus the sovereign keep us cautious on the asset class. We maintain a Hold stance versus our Accumulate stance in sovereign credit. Our strategic preference remains with lower-beta (i.e., Mexico, Peru) and defensive (i.e., utilities and consumer products) corporate credits.

Exhibit 7

Sovereign Credit Returns Until 1Q15



Source: Bloomberg, Morgan Stanley Research

Global EM Cross-Asset Compass

Currencies

Tailwinds

- Selective evidence of macro rebalancing – particularly for oil-importing economies, such as Turkey and India.
- Improved valuations following several years of EMFX weakness versus the USD.

Headwinds

- Durable USD strength supported by divergences in growth between the US and rest of the world.
- EUR and JPY weakness pressures EM competitiveness.
- Increased disinflationary risks amidst high debt levels, with FX being used as a policy tool to reflate inflation in several cases.

Outperform MXN, INR

We see scope for MXN and INR to outperform other EM currencies on the back of improved reform prospects and growth. INR will also benefit from a continued decline in energy prices.

Underperform BRL,COP,KRW,SGD,ZAR,ILS

There are two groups of underperforming currencies. First are those exposed to falling commodity prices and low productivity – BRL, COP and ZAR. Second are those at risk of low inflation and EUR or JPY weakness - KRW and ILS. SGD is also exposed to China risks.

Local Rates

Tailwinds

- Sovereign QE from ECB.
- Lower inflation due to weakening commodity prices.
- Dovish EM central banks.
- Neutral market positioning and institutional inflows.

Headwinds

- Higher and more volatile DM rates.
- Currency weakness.
- Risks of fiscal slippage.

Outperform INR, CNY, ZAR, COL

We like countries with scope for additional policy easing and less sensitivity to currency weakness. India, China and Colombia are in this camp. The SARB is likely to postpone tightening cycle given lower oil prices.

Underperform IDR, MYR

Rich valuation, IndoGB's high sensitivity to USD/IDR and our forecasts for USD strength make IndoGB unattractive, in our view, while MGSs are exposed to external risks due to unattractive valuations and little risk premium in the curve.

Sovereign Credit

Tailwinds

- Supportive external funding environment, at least until 2H15.
- Still positive technicals: EM-dedicated investors currently underweight exposure versus benchmark, reasonable cash balances and high amortisations in 1Q15.
- Valuations are no longer expensive.

Headwinds

- Stronger US dollar and higher UST yields in 2H15.
- Fundamentals remain weak: Lacklustre growth and absence of structural reforms to correct imbalances.

Outperform MEX, COL, PER, CEE region

Strong fundamentals favour low-beta LatAm. CEE should benefit from lower oil prices and also prove resilient against China weakness and higher US yields.

Underperform UKR, SOAF, TURK, CHILE

There is no easy resolution in sight in Ukraine. Turkey and South Africa remain vulnerable, particularly to higher core rates, due to large CAD, lacklustre growth and increasing debt levels (government in South Africa, private sector in Turkey).

Corporate Credit

Tailwinds

- External funding environment remains favourable.
- Fundamentals in IG are not deteriorating as rapidly as HY.

Headwinds

- Little evidence of balance sheet improvement, and leverage remains elevated, especially in HY.
- Large banking sectors are vulnerable to macro shocks, with asset quality deterioration as a key risk.
- Domestic financial conditions are tight, and could lead to rising NPLs.

Outperform BBB rated and QS credits, with preference for defensive sectors: We maintain our preference for higher-quality, given our cautious view of the asset class. Mexican corporates should benefit from reforms and an improving outlook.

Underperform Brazilian, Russian and Turkish banks: Excess credit growth, high private sector leverage and asset quality are key concerns. Brazil faces domestic risks from a slowing labour market, while Turkey remains vulnerable to TRY deterioration. In our view, Russia faces an increasingly bleak economic outlook that will weigh on banks.

Study #1: Deflation Risks and Currency Conflict

FX plays a key role in the global trade of deflation. In this note we take a look at which currencies risk getting caught up in the struggle against 'lowflation', in light of the deflationary spillover that results from EUR and JPY weakness, which we expect to continue.

Our framework considers several variables for thinking about these trends: i) **Current inflation,** as measured by the deviation of CPI from the targeted rate; ii) **The openness of the economy,** as a proxy for whether the currency can be a useful tool to import inflation; iii) **Existing policy space through rate cuts.** Some central banks have used FX as a policy lever as space to use the interest rate lever diminished; and iv) **Recent REER performance,** as currencies that have been on an appreciating trend could be hindering attempts to bring inflation back to target (For more, See *Global EM Investor: Deflating Currencies*, *November 18, 2014*.)

Moreover, the currencies of economies that face 'lowflation', and also suffer from high debt, could be more at risk. This is because the negative macroeconomic implications of failing to address deflation are higher for countries with excessive debt, and thus these currencies could face more pressure to weaken in order to prevent low inflation expectations becoming entrenched.

The currencies that are most at risk from these trends are EUR, SGD, HUF, CHF, KRW, SEK, ILS, PLN, GBP and THB. This is because these economies not only face existing low inflation, but are also exposed to a deflationary spillover from further EUR and JPY weakness, due to trade linkages reflected in trade-weighted exchange rates.

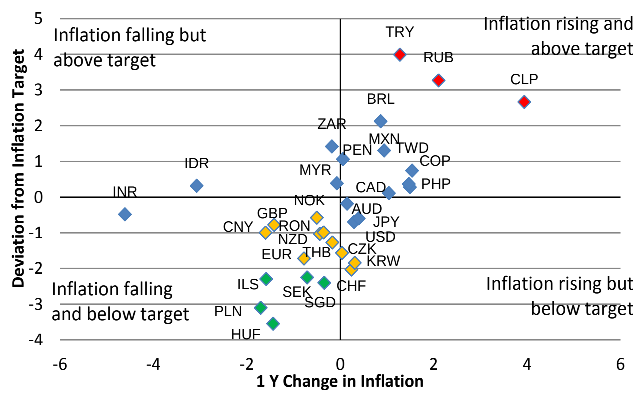
Ways to position for low inflation risks: Long USD/SGD, long MXN/KRW, short EUR/INR, short EUR/USD, long USD/THB, long USD/HUF, long USD/PLN and long USD/ILS.

Which Currencies Are Most Exposed?

At a global level, inflation is falling and consensus inflation expectations for 2015 remain subdued. Falling oil prices and still-weak growth in parts of the world are helping to keep inflation expectations at bay. This has different implications for currency markets, depending on context and the starting point for inflation rates.

Exhibit 1

Where Is Inflation Falling and Below Target?



Source: Haver Analytics, Morgan Stanley Research

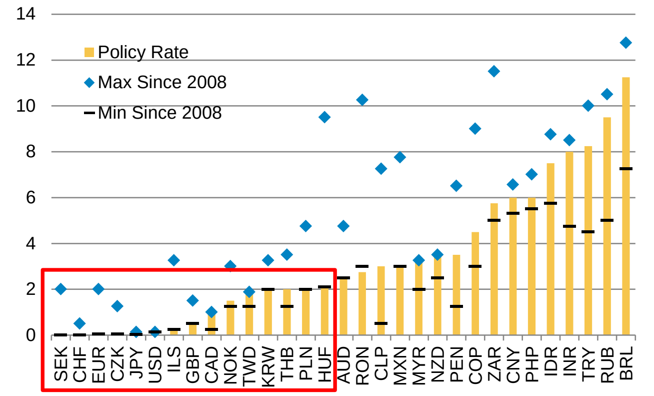
A growing number of economies are starting to see inflation undershoot inflation targets – with the largest margin in Europe. The eurozone, Central and Eastern Europe, Sweden, Switzerland and Israel are on the frontline. EUR, ILS, CHF, SEK and CZK have already entered into the policy debate and have weakened accordingly as central banks have encouraged their currencies to weaken.

Many economies still have high and above-target levels of inflation. For these markets, the global disinflation trends are a positive dynamic, particularly for net oil importers like Turkey, India and South Africa. High inflation in these markets is a macro vulnerability and convergence towards target is FX-positive, provided central banks do not ease prematurely. The RBI is taking a prudent approach, emphasising the need to bring down inflation expectations.

More open economies, more FX risk: Currencies of more open economies are potentially more exposed to global disinflationary trends, particularly if they are already suffering from low inflation. With JPY and EUR weakness exporting deflation to trading partners, markets could start to push currencies weaker where there are strong trading links with these economies. Markets could anticipate that more currencies of open, lowflation economies enter the policy debate, should global disinflationary trends persist.

Exhibit 2

Shrinking Policy Space



Source: Haver Analytics, Morgan Stanley Research

This is particularly the case for those markets where policy space for reflating via lower interest rates is shrinking. This has clearly been the case in SEK, CHF, EUR, CZK, JPY and ILS. Of the currencies of other lowflation and open economies, KRW and THB have shrinking policy space, and central banks in these economies have a track record of currency intervention.

Currencies could potentially be more at risk if the recent performance of their real exchange rates is hindering inflation dynamics. Many of the lowflation economies mentioned have seen large REER depreciation of their currencies already over the past year, but some, such as KRW and THB, are still up on a year-on-year basis.

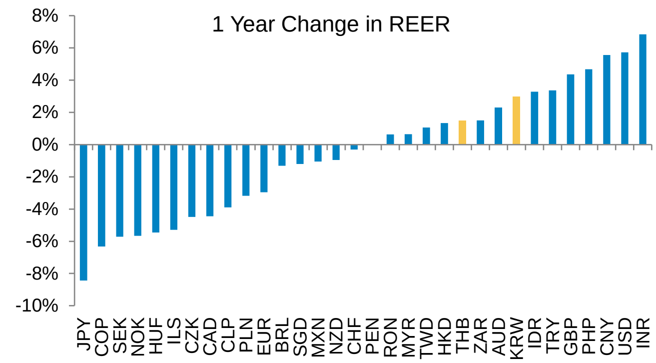
Noting the existing high leverage faced by Thailand's households and corporates, the BoT may refrain from embarking on aggressive rate cuts, while allowing for THB weakness as another channel to balance economic growth and inflation. As such, we expect to see THB weaken to adjust for the recent appreciation in Thailand's NEER. The main risk to our view is that BoJ easing could encourage FDI inflows from Japan to Thailand, supporting THB.

High leverage is also a concern in Korea, where already high debt levels mean there are risks associated with rate cuts that encourage more borrowing. However, as our chief Asia economist Chetan Ahya highlights, there are clear dangers of letting inflation expectations fall for highly leveraged economies that are facing broader regional growth risks (see *Asia Pacific Economics: Disinflation Entrenched – A Challenge for Debt Management*, November 10, 2014).

For high inflation economies such as India and Turkey, a year-on-year rise in their REERs is helpful to bring down inflation to healthier levels, while growth is strong in the case of India, which means the economy is likely to be able to tolerate a stronger REER. In the US, strength in the REER is a reflection of the start of the secular USD bull trend we have long expected, and is unlikely to derail the US recovery (see *US Economics: USD Sensitivity*, September 19, 2014).

Exhibit 3

KRW and THB REERs Rising amid JPY Weakness



Source: Morgan Stanley Research, BIS, Haver Analytics

The CEEMEA region can be split into two camps: the low-yielders, where inflation is well below target, and with potentially dovish policy – i.e., CZK, HUF, ILS and PLN; and the high-yielders, where falling inflation from above-target levels and lower oil prices may be a more welcome development – i.e., TRY and ZAR. RUB fits into neither category, with inflation rising and above target, and RUB weakness related to declining oil prices may add further upward pressure on inflation. In addition, competitiveness challenges that may result from a depreciating EUR are high across the region. We think a good way to position for the deflation and EUR weakness theme in the CEEMEA region is via long USD/ILS, USD/PLN and USD/HUF positions

In LatAm inflation is running above the target in all countries, and although inflation expectations are well-anchored in most of the region, central banks have less scope for further currency-weakening interest rate cuts, particularly when considering that sharp exchange rate depreciation in the last two years is at least partially responsible for current high inflation prints. Global disinflation thus seems at least initially less likely to result in policy adjustments and potential currency weakness in this region. We believe that COP could be most at risk of additional weakening pressure from lower inflation. Inflation and inflation expectations are in line with the target, and after the end of the tightening cycle earlier this year, there is scope for cuts. Additionally, both the central bank and the government maintain an FX-weakening bias, with the central bank buying dollars.

Study #2: China: RMB Depreciation – Will It, Can It?

While several economies appear to be joining the currency race to the bottom in this global trade of deflation, China remains an exception. Weakening the renminbi is, indeed, not a clear-cut choice for China's policy-makers.

Although a weaker RMB can play a supportive role in the management of debt dynamics, we believe that the management of real rates versus real GDP growth is more critical. While a mild depreciation of RMB would not provide much support in terms of export growth, material depreciation could increase the likelihood of substantial outflows significantly.

Engineering a weaker currency and a potentially unstable macro environment may not abet the broader structural reform and rebalancing story under way in China. We therefore expect policy-makers to hold USDCNY central parity close to its current level before year-end, with our Chief China Economist Helen Qiao maintaining her USDCNY forecast at 6.14 for 2014, 6.09 for 2015 and 6.07 for 2016.

In the scenario that the PBOC weakens FX as a policy tool, which is not our base case, we would expect global disinflationary currents to come further to the fore. **Under such an outcome, EUR, CHF, SEK and JPY within G10 and SGD, KRW, THB and, indirectly, ILS, PLN and HUF within EM would be most vulnerable.**

The Role of FX in the Deleveraging Cycle

Since the credit crisis, the rise in debt-fuelled investment in China has been taking place against a background of slowing additions to the workforce and also structurally weaker export growth, hence lacking the productivity dynamic. Reflecting the excess capacity issues in the industrial sector, producer prices have been in deflation for the past 32 months while consumer price trends have also been subdued. These disinflationary pressures have resulted in slower nominal GDP growth and higher real rates, posing challenges for policy-makers to manage debt dynamics. Against this backdrop, a crucial debate has been raised as to whether policy-makers in China should engineer a sustained depreciation in RMB in order to aid deleveraging efforts.

Our Chief China Economist, Helen Qiao, maintains her USDCNY year-end forecast, leaving it unchanged at 6.14 for 2014, 6.09 for 2015 and 6.07 for 2016. She expects a gradual appreciation of CNY due to export growth stabilisation and a likely rising trade surplus in the coming quarters. Yet she notes that the path could be more volatile, with temporary depreciation likely down the road (see *2015 China Economic Outlook: Policy flexibility to help stabilization and reform*, November 30, 2014).

Despite the clear loosening bias in domestic monetary policy, the CNY exchange rate has yet to embark on a visible depreciation trend. Some observers have been expecting Chinese policy-makers to use currency weakening to add to the easing policy mix, but so far, there is little evidence of this. Since USD strengthened against major currencies from last July, CNY has appreciated gradually but persistently against USD, as guided by the central parity rate the PBOC set on a daily basis.

We expect the monetary authority to keep the CNY exchange rate on a slow appreciation path. It is possible that Chinese policy-makers tend to think currency appreciation will serve the purpose of attracting more liquidity into China from overseas, where funding costs are lower. Meanwhile, a stronger CNY is also in the interests of outward direct investment (ODI) and renminbi internationalisation.

In view of weak domestic demand growth and growing deflationary pressure, we have reservations about such a strategy that tightens monetary policy and skews more resources away the external sector (dominated by private companies of smaller scale). Nonetheless, the wide trade surplus caused by weak imports would still leave China vulnerable to criticism if the renminbi weakens.

Furthermore, the experience of the US deleveraging cycle, during which USD held relatively stable (as opposed to a sustained depreciation trend) as the US economy successfully achieved a stabilisation in its debt dynamics, suggests otherwise. To be sure, a weaker currency can play a supportive role in the management of debt dynamics, particularly if most of the external debt of the economy is denominated in local currency; however, we argue that the management of real rates versus real GDP growth is more critical.

In addition, we see challenges for policy-makers in engineering a sustained depreciation. Real rate differentials are supportive of RMB and, as per our forecasts, real rate differentials are unlikely to narrow significantly in the coming 12-18 months. With the onset of disinflation pushing up real rates and policy-makers' ongoing attempts to reduce misallocation of financial resources, fixed asset investment growth has been weak. If disinflationary pressures were to persist, high real rates would weigh on domestic demand growth and, in this scenario, current account surpluses, as represented by the savings-investment gap, would likely increase. This would make it even more difficult to engineer a meaningful, sustained depreciation in the trade-weighted exchange rate.

Putting RMB Under the Microscope

Given the strong USD backdrop, China's monetary conditions have been tightening due to tight credit lending, high real interest rates and a strong REER. China will likely focus on reforms and continue to promote the critical transition of its growth model away exports and investments towards domestic consumption. Furthermore, a weaker RMB could lead to significant outflow risks and consequent hedging demand in FX, additionally resulting in an adverse monetary impact on the domestic economy. This would also not align with China's ambitious plans for RMB internationalisation. Helen Qiao does not expect China to devalue RMB. Her forecast for the RMB central parity implies a slow appreciation path over the next year.

Global FX Implications of RMB Policy

The impact on the global economy from the path the PBOC takes cannot be emphasised enough. With global disinflation very much at the fore of macroeconomic concerns, a policy adopting the weakening of RMB, allowing China to export deflation abroad, would only add to existing issues. While China's policy-makers look to provide some support to domestic growth to eschew a disorderly rebalancing, using FX weakness as the policy tool could have substantial negative implications for disinflationary currencies, especially within Asia, we argue. SGD, KRW and THB would be most vulnerable, given large trade linkages with China and already low inflation.

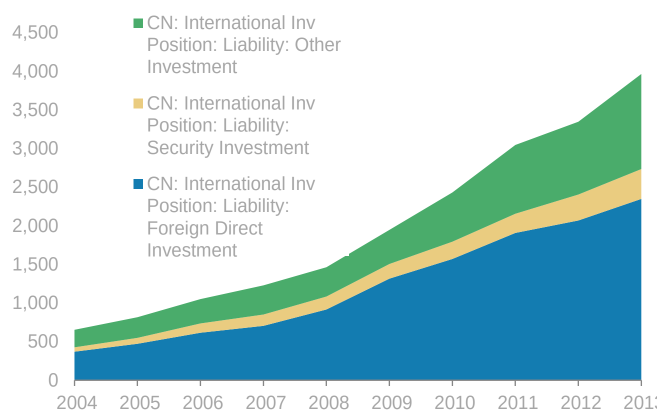
In addition, China joining the global trade of deflation would increase pressure on other central banks to take further dovish action in order to support dangerously low inflation expectations. In the case that the ECB takes further action to counter the PBOC's RMB-weakening policy and weakens EUR, we also see an indirect negative impact on other 'lowflation' currencies against USD. As such, this outcome could be potentially negative for EUR, CHF, SEK and JPY within G10, and ILS, PLN and HUF within EM.

We also evaluate the broad global FX implications of three separate scenarios: i) Our base case in which the PBOC stays neutral on RMB and no active changes are made to FX reserves; ii) The PBOC fixes USDCNY higher to weaken the currency while keeping FX reserves stable; and iii) The PBOC buys USD reserves to weaken RMB in order to support domestic growth and inflation, similar to 1Q this year (for full details, see *Economics and Strategy Insights: China: RMB Depreciation - Will it, Can it?* November 26, 2014).

In summary, our base case remains that the PBOC will not use FX as a policy tool to buttress domestic growth. In the event that it does, we see potentially negative implications for disinflationary currencies, as well as commodity currencies, depending on the policy adopted on FX reserves.

Exhibit 1

Substantial Unhedged Positions Built Up, Increasing the Risk of Outflows



Source: Bloomberg, CEIC, Morgan Stanley Research

Study #3: Navigating EM FI in the DM Rates Waves

The direction of US Treasury (UST) and Bund yields are key factors that shape our view on EM local rates and sovereign credit for 2015. Below, we therefore look at risks to our calls caused by alternative DM rates scenarios, including ECB government bond QE.

Our work shows that lower Bund yields would positively impact EM, as it has in 2014 – in particular CEEMEA local bonds – and can provide an offsetting effect to rising UST yields.

Which rates matter most? USTs, Bunds or JGBs? Using Granger causality tests, we try to identify the main driver for EM local and external debt.

Exhibit 1 illustrates our main findings: While USTs were the predominant driver for EM local and external bonds before 2014, **Bunds have become a more prominent driver –** especially for EM credit – in 2014. Indeed, looking first at the periods prior to 2014, the Treasury-EM yield relationships were the strongest and on average statistically significant (i.e., above 4), especially in the summer of 2013 as the 'taper tantrum' began. This is particularly evident for EM local yields as EM currency weakness exacerbated the sell-off in EM local bonds.

Starting in February 2014, USTs moved mainly sideways and EM yields were better supported by lower Bund yields. We suspect that declining rate (and FX) volatility had a role to play as well, allowing EM yields to rally further thanks to their relatively attractive vol-adjusted carry (see *Global EM Investor: Technically Speaking*, April 7, 2014).

During the period we have tested, JGBs have rarely been an important driver, let alone the main driver (relative to USTs and Bunds) for EM local and external rates.

Why have Bunds become a more important driver? Lower Bund yields have been a sign of increased chances of ECB QE, which could prompt important capital flows to EM to continue. Also, while the USD funding channel is still the most important to EM, EUR is also increasingly becoming a funding currency.

We use our global interest rate strategists' bull/bear scenarios to gauge impacts from lower/higher Bund yields or higher UST yields. In addition to our base case, we look at three other distinct scenarios:

In our base case, we expect a mixed performance in the EM fixed income market in 2015 as both UST and Bund yields slowly rise.

In the Bund bull case, where they rally by 20bp on the back of 2016 ECB QE expectations, we expect EM local rates to see most upside, whereas EM credit will be more dependent on UST yields remaining contained. We would expect the CEEMEA region to see the most benefit.

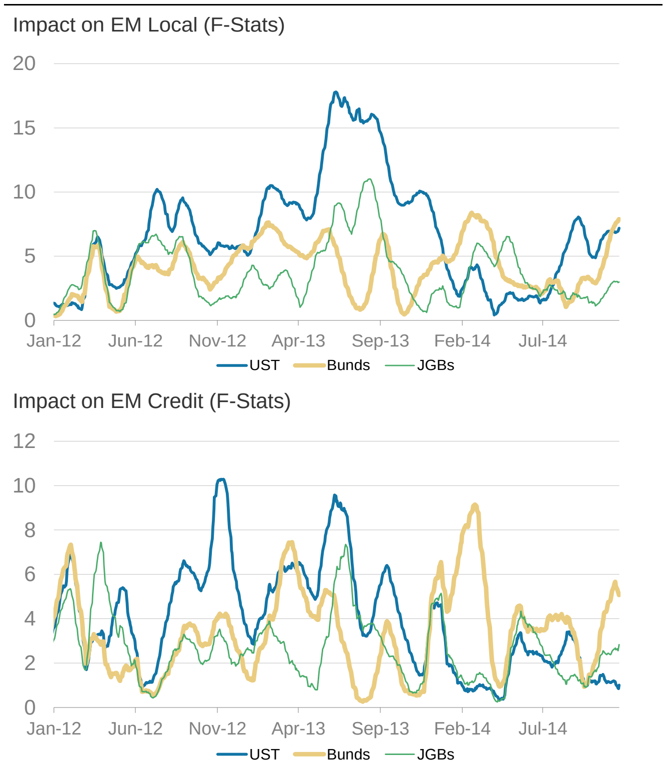
In the Bund bear case, with ECB government bond QE in 2015 but Bund yields higher, we believe that the excess liquidity from balance sheet expansion should offset the higher Bund yields. LatAm and MEA should benefit the most while CEE would likely underperform.

In the UST bear case, EM will again feel a negative impact, and we expect double deficits countries to suffer the most.

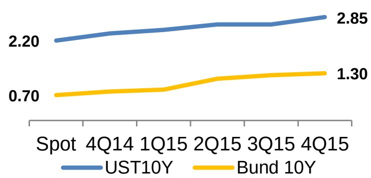
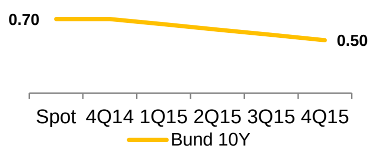
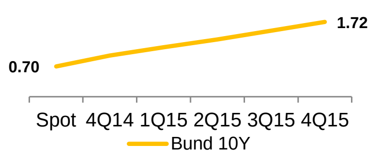
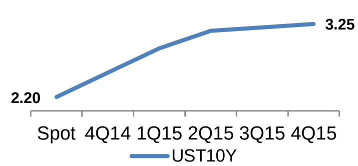
See the table on the following page for more specific takeaways in each scenario, both on the local rates side and the EM credit side. For the complete analysis, see EM Strategy Update: Navigating EM Fixed Income in the DM Rates Waves (01 Dec 2014).

Exhibit 1

F-Statistics from Rolling Granger Causality Tests Show that Bunds Have Had an Increasingly Large Impact on EM Rates and Credit



Source: Bloomberg, Morgan Stanley Research

<table>
<tr><th>Scenario</th><th>Details</th><th>EM Local Rates Impact</th><th>EM Credit Impact</th></tr>
<tr><td>Base Case</td><td>Both UST and Bund yields rise slowly, with 10Y US Treasuries (USTs) ending 2015 at 2.85% and 10Y Bunds at 1.30%

</td><td>Outright: Bullish in 1Q but cautious into year-end.
Allocation: OW China, Korea, India, Poland, Hungary, South Africa, Colombia, Mexico. EW: Russia, Turkey. UW: Indonesia, Malaysia
Comments: Downside risk in growth and lower inflation support EM local bonds in 1Q. But local bond market will underperform in 2Q when core rates move higher.</td><td>Outright: Bullish in 1Q but cautious into year-end.
Allocation: OW low-beta LatAm and the CEE region. EW: Russia, Brazil, Venezuela. UW: Turkey, South Africa, Ukraine.
Comments: While spreads can compress in 1Q15, higher UST and Bund yields throughout 2015 will also see spreads move wider. We forecast 12m excess return of 2.4% and total returns of 0.6%.</td></tr>
<tr><td>Bund Bull Case</td><td>ECB implementation of government bond QE is slow; weak growth and low inflation lead the market to price in a greater probability of the ‘Japanification’ of the eurozone.

</td><td>Outright: Bullish
Allocation: CEEMEA over Asia and LatAm
Comments: We expect 2% return in local bonds for 1% rally in Bunds price. We see CEEMEA as having the most upside, driven by high yielders such as South Africa. LatAm (Mexico and Brazil) and Asia will benefit as well but with smaller beta.</td><td>Outright: Moderately Bullish
Allocation: Favour CEEMEA and LatAm over Asia
Comments: While Bunds rallying further in 2015 would be a positive for EM credit, it is likely more important that UST yields remain contained. Current tighter valuations are also likely to mean that betas will be smaller than back in February 2014</td></tr>
<tr><td>Bund Bear Case</td><td>ECB implements government bond QE in early 2015 and the program effectively supports growth and sees inflation pick up, boosting future rate hike expectations.

</td><td>Outright: Bullish ex-CEE
Allocation: LatAm over CEEMEA over Asia.
Comments: LatAm will benefit the most, given its high yield and inflow from Europe. Performance in CEEMEA is mixed as CEE will suffer due to high economic and market linkage with the eurozone, while MEA should be supported. Asia is unlikely to benefit as euro area investors’ allocation to the region is relatively small.</td><td>Outright: Supportive
Allocation: OW the CEE region.
Comments: EM credit will be less impacted than local rates due to the smaller investment universe, higher dependence on UST yields and overall tighter spreads. Still, if peripheral spreads rally then it also increases the potential upside for the CEE. Increased liquidity could also reduce funding pressure on the double deficits, South Africa and Turkey in particular, although higher UST yields need to be watched.</td></tr>
<tr><td>UST Bear Case</td><td>US recovery gathers pace and market expectations of the first rate hike is brought forward. This sees a much quicker rise in UST yields

</td><td>Outright: Bearish
Allocation: UW double deficit countries such as Turkey and Brazil. OW CEE region (EUR-hedged).
Comments: Similar to the selloff in late 2013. Turkey and Brazil will underperform the most. Mexico should also underperform due to high foreign ownership, although we note that large part of Mexican local bonds are owned by long-term investors.</td><td>Outright: Bearish
Portfolio Allocation: UW double deficit (DD) credits and low-beta LatAm. OW CEE region.
Comments: High funding needs cause DD credits to underperform while the tight spreads make it hard for low-beta LatAm to absorb the UST yield widening. The CEE region stands as the least sensitive to UST yields</td></tr>
</table>

Study #4: What Do Lower Oil Prices Mean for EM Assets?

Lack of OPEC action could lead to a new paradigm for oil prices: Our oil analysts believe that without a cut in the OPEC production quota and any supporting language, the 'OPEC put' is effectively removed for now. While lower production is still possible without a change in quota, the risk that oil prices will move lower going into 2015 is now significantly higher (see *OPEC Shifting the Path of Oil Prices*, November 27, 2014).

Lower oil price is good for global growth… Our economists' forecasts assume Brent averaging US$88 in 2015, based on the mid-November futures curve. If instead oil stays at the current spot price of US$70 during all of 2015, global GDP growth could be lifted by about 0.3pp and headline inflation could be some 0.3pp lower (see *2015 Global Macro Outlook: The Battle Against Lowflation*, November 30, 2014).

…but there are winners and losers: As our global EM economists have highlighted, oil exporters face a demand shock on aggregate with a more permanent drop in oil prices, leading to, all else equal, higher inflation and lower growth. Conversely, oil importers benefit from a favourable supply-side shock with improving growth and falling inflation (see *Emerging Issues: When Oil Meets an Out-of-Sync EM Cycle*, October 13, 2014).

However, starting points also matter. Therefore, it is important to consider where each economy is in its growth and inflation cycle. Those who are still near the bottom of the growth cycle benefit more. Overall, this leaves India, Thailand and Chile as the main beneficiaries while Russia is among those most adversely affected.

Implications for EM Fixed Income and Currencies

Further lowflation risks for FX: In line with Study #1, further disinflationary/deflationary pressures could add to the headwinds many EM currencies are already facing from the deflationary pressures Europe and Japan are exporting to the rest of the world.

Rates: Lower inflation should support local rates. It is a welcome development for those countries with inflationary pressures, while for others it could mean further monetary policy easing as inflation continues to drop below target.

For the overall path of local rates, we do need to factor in the FX implications, too. The positive impact of further disinflation could be offset by more marked FX weakness (see "Staying Selective," page 20).

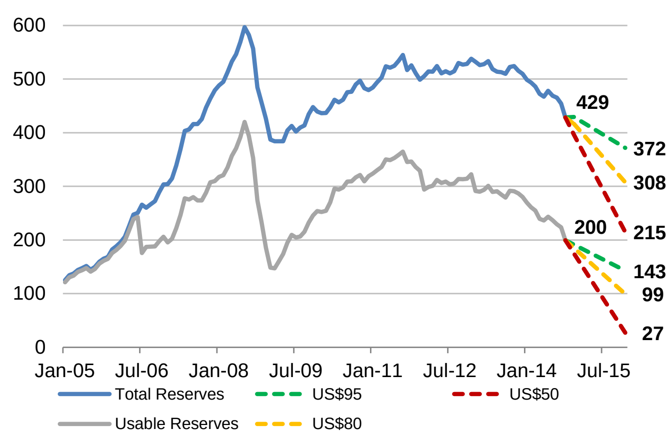
Mixed bag in credit: The EM credit benchmark is split roughly 50/50 between countries gaining and losing from lower oil prices and, as such, the overall impact on benchmark performance is more muted, in our view.

While there are some large oil importers in the benchmark, such as Turkey and Indonesia, many oil importers are smaller countries. Oil producers, on the other hand, are more concentrated in the benchmark, for example, Mexico, Russia, Colombia and Venezuela.

Focus on Russia… Russia would normally be able to manage a drop in oil prices to recent levels, since it's exactly what the oil reserve fund (around US$90 billion) has been set up to cover. However, a lower oil price is far from the only drain on reserves at the moment. The sanctions by the West on new financing and the much weaker RUB have led to a dollar shortage and capital outflows. The CBR has stepped in to provide dollars through interventions and liquidity provisions to the banking sector. The result has been rapidly falling reserves in 2014 (from US$510 billion to currently US$420 billion).

Exhibit 1

Sanction and Lower Oil Prices Weigh on Russian FX Reserves



Source: Haver Analytics, Morgan Stanley Research

Our economists' base case is that sanctions remain in place throughout 2015, meaning that capital outflows continue (see *2015 Global Macro Outlook: The Battle Against Lowflation*, November 30, 2014). With oil lower, the current account is no longer able to offset these outflows (i.e., at a price of US$80/bbl, the current account surplus is only 1%. At US$70, it would be around 0%). So, even if oil prices rise, we still expect reserves to fall as sanctions remain in place. If oil prices fall, it would worsen the problem. For now, reserves are still at reasonable levels compared to other credits. However, as shown in Exhibit 1, at the end of 2015, levels are no longer as comfortable (see *Economics & Strategy: Russia: Oil Risk Returns*, October 22, 2014).

…and Venezuela: In *Venezuela: When is it Time to Buy?* October 14, 2014, we estimated a US$8 billion deficit for 2014 with an average oil price of US$92/bbl. However, with the Venezuelan basket at US$62/bbl (assuming a 10% discount to current Brent prices), we see the USD deficit at US$27 billion for 2015 without adjustments (see Exhibit 2).

Exhibit 2

USD Deficit in Venezuela Could Reach US$27 Billion in 2015

Cash-generating oil exports (tbpd)	
+ Production	2,623
- Domestic consumption	703
= Exports	1,920
- China debt service	375
- Energy agreements financed	232
= Adjusted Exports (tbpd)	**1,313**
Oil price (USD/bbl)	
Brent	69
Venezuelan basket	62
(US$ bn)	
Exports	43.5
China debt service	8.5
Energy agreements financed	5.3
Adjusted exports	29.8
Funding sources	**35.8**
Oil and gas exports (excl. non-cash)	32.8
Other exports	3.0
Funding needs	**63.0**
PDVSA and gov't ext debt service	12.0
Imports	40.0
Net services balance	16.0
- Imports paid from Petrocaribe financing	5.0
USD balance	**-27.2**

Source: BP, PDVSA, Morgan Stanley Research estimates

In the absence of any increase in oil prices and production as well as market access, we believe that Venezuela needs policy adjustments to correct imbalances and also measures to buy time in order to close the USD deficit.

Potential policy adjustments to correct imbalances include:

- **Reducing the amount of oil delivered under the Energy Agreements (e.g., Petrocaribe) at favourable terms:** Anecdotal evidence suggests this is already happening, although as Foreign Minister Ramirez highlighted, a complete unwinding of these agreements seems unlikely at this point. We estimate that at the current oil price, a complete unwind of the programme would improve the USD balance by US$5.3 billion.
- **Increase in domestic fuel prices:** While higher domestic fuel prices would reduce the budget deficit, they would stay well below market prices, suggesting to us that consumption is unlikely to drop meaningfully. As such, this is unlikely to contribute to higher oil export volumes generating more USD.
- **Devaluation:** Following an already significant import compression in the past two years, we think that remaining imports are likely to be more inelastic to any currency depreciation while a further drop in imports would run the risk of increased social discontent. Given parliamentary elections next year, we see risks of imports picking up again.

Potential measures to buy time include:

- **Sale of Citgo:** Revenues from the sale of the US refinery could amount to US$7 billion. According to a report from Reuters last week, Venezuela set December as a deadline for bids on the company. We note that this report is unconfirmed, and that Venezuela's finance minister has recently ruled out the sale of the refinery.
- **Drawing down on other liquid external assets:** FX reserves amount to US$22.5 billion, including US$4 billion from the joint Chinese-Venezuelan Fund and about US$15 billion gold, while Ecoanalitica reports the government's extra-budget resources at US$7.9 billion as of the end of October.

In summary, should oil prices remain low, the government would likely be forced to make long-delayed and politically difficult adjustments and possibly draw down on its shrinking external asset base.

Currencies: Lowflation Risks for FX

Sell | **Reduce** | Hold | Accumulate | Buy

- **We stick to our Reduce stance for EM currencies, as we expect the long-running adjustment process to continue.**
- **A strong USD, downward revisions to EM growth, more dovish policy rate forecasts and risks of lowflation contribute to the anticipated adjustments.**

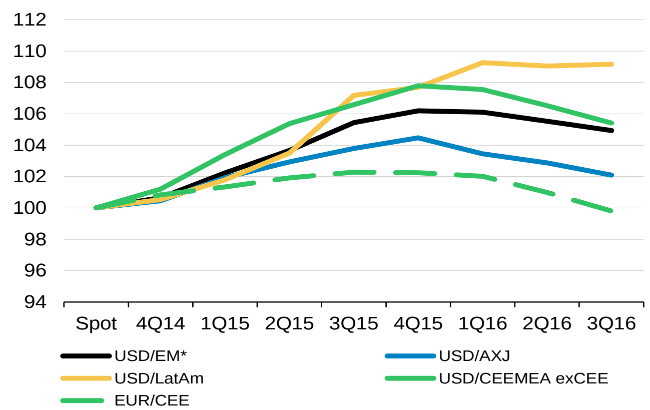
EM currency adjustments to continue: EM currencies have been in a bear market versus USD for several years, with nominal exchange rates adjusting significantly. Real exchange rates have seen less of an adjustment, particularly on a trade-weighted basis, and there is limited evidence that so far the valuation improvement has led to an improvement in the growth outlooks. To some extent, current account deficits have started to narrow, but importantly EM export market share has not increased in response to the decline seen in REERs in recent years.

Lowflation exacerbating debt risks: A key theme in our *Global Macro Outlook* is the battle that central banks have against lowflation, and FX markets play a key role in passing disinflationary pressure around the world. With more and more EM countries seeing headline inflation drop below target, there is a risk that more central banks will view FX as an important policy tool to stave off deflation risks – particularly in light of recent and expected further large declines in EUR and JPY, which will export deflationary pressure to other regions. The risks are heightened by the large quantities of debt that exist in the world, with EM no exception, particularly in the AXJ region. The stakes are high, and policy-makers will want to do their utmost to prevent disinflationary risks from inflating their debt burdens.

Growth divergences remain: A key pillar of our strong USD, weak EM currency view hinges on the expected continued divergence in growth between the US and the rest of the world, and EM in particular. Growth forecasts have been revised lower in most EM economies, but up in the US.

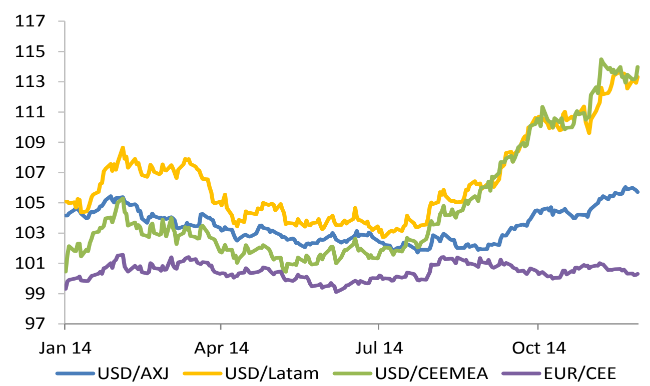
Risks around the USD, growth: There are sizeable risks associated with our strong USD and bearish EM currency view. Given the extent to which the market is long USD, and expecting the US economy to outperform, the biggest and most plausible risk to our call is that we enter into a period of softer-than-expected growth in the US, which would undermine the case for USD strength. Alternatively, stronger-than-expected growth in the EM world would be a second risk. This would offset the need for additional easing and potentially strengthen EM currencies as capital flows returned to EM.

Exhibit 1
EM Currency Forecasts



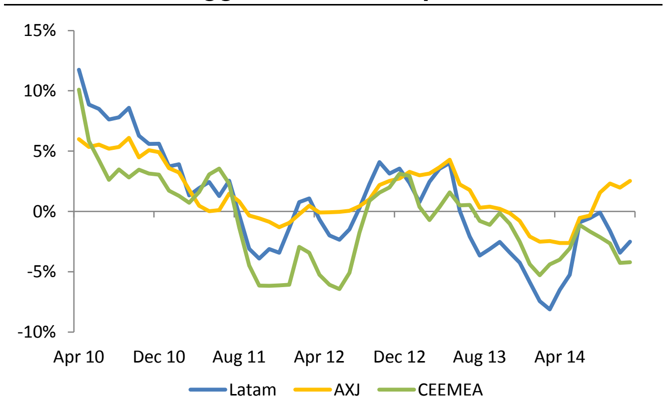
*Excluding CEE currencies, which we measure versus EUR
Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 2
Adjustment to Continue across EMFX



Source: Bloomberg, Morgan Stanley Research

Exhibit 3
Asia REERs Suggest USD/AXJ Upside

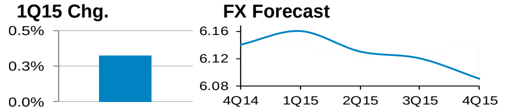


Source: Bloomberg, Morgan Stanley Research

Currencies Snapshots

1Q15 Chg. | FX Forecast | Outlook

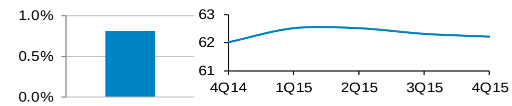
CNY



FX Change: .33% — Forecast

We do not think a weaker CNY will be used as a tool to support export growth, given the focus on rebalancing the economy towards a consumption-driven growth model. We expect mild appreciation for CNY in 2015 – our 2015 year-end target for the RMB fixing is 6.09.

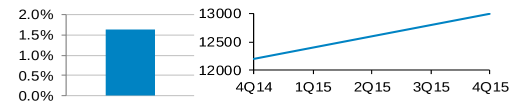
INR



FX Change: .81% — Forecast

INR remains our favourite buy in the region as it benefits from ongoing structural reforms as well as the decline in commodity prices that are helping narrow India's current account deficit and rein in high inflation. INR is attractive in carry to vol terms, given the policy-driven stability in the currency. We expect USD/INR to move broadly sideways in 2015 and outperform the rest of the region.

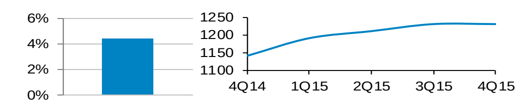
IDR



FX Change: 1.64% — Forecast

Jokowi has made the first move in the reform process by cutting retail fuel subsidies, and diverting the subsidy savings towards infrastructure development. However, reforms in Indonesia remain difficult, given the government's parliamentary minority, while the decline in commodity prices also hurts Indonesia's trade balance. We expect a gradual upward grind in USD/IDR through 2015.

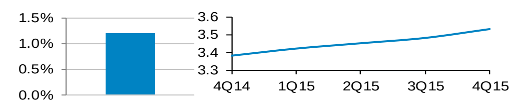
KRW



FX Change: 4.39% — Forecast

We expect KRW to weaken in line with JPY, given the direct competition with Japanese exports. Korea also faces disinflation risks from the slowdown in China, given its high export exposure to China, in addition to the challenges of high household debt and weakening demographics. Our 2015 year-end target for USD/KRW is 1230, in line with a sideways move in JPY/KRW.

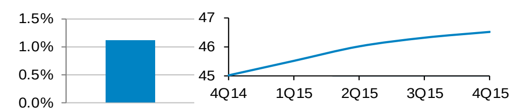
MYR



FX Change: 1.18% — Forecast

The fundamental outlook for MYR remains challenging, given Malaysia's dependence on commodity exports and its export exposure to China, which are putting pressure on the current account surplus. Domestic growth will also be challenged by the government's fiscal consolidation efforts. Meanwhile, BNM has switched from a hawkish to neutral bias, reducing carry support for the currency.

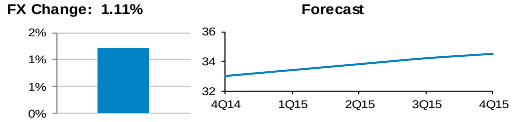
PHP



FX Change: 1.11% — Forecast

The Philippines' structural current account surplus and stable political and macroeconomic outlook are favourable for PHP. However, we expect a gradual depreciation in the currency next year in line with broader USD strength. PHP is also exposed to broader risk sentiment on AXJ and has low carry support.

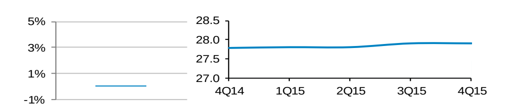
THB



FX Change: 1.21% — Forecast

THB is likely to face headwinds from slow growth, high leverage, declining inflation and uncertain politics in 2015. We expect BoT to remain accommodative in 1H15 and believe that the focus on THB REER appreciation could increase next year, given the sharp depreciation in currencies of Thailand's major export partners.

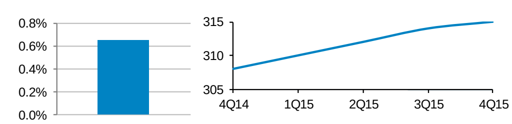
CZK



FX Change: .% — Forecast

We expect the CNB to keep its FX regime in place well into 2016, with the 27-level acting as a floor for EUR/CZK. This leaves our forecasts above 27 over the forecast horizon. EUR weakness and some signs of inflation picking up should put downward pressure on the cross. However, better domestic demand dynamics may also limit CZK strength as imports rise. The CNB's interventionist stance should keep volatility subdued and it is still too soon to position for a change in the FX regime.

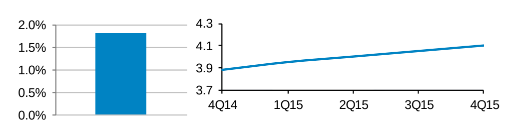
HUF



FX Change: .65% — Forecast

We look more or less for a sideways path in EUR/HUF with some skew towards HUF weakness in 2015. Depreciation pressure may come from improvements in domestic demand (driving imports) versus a backdrop of potentially subdued external demand (euro area/Russia), while external disinflationary pressures increase the risks of more dovish NBH policy. On the other hand, the risk of a more dovish ECB should keep HUF weakness versus EUR well contained. Also, as the domestic risk picture improves with the passing of the FX mortgage conversions, we think there are upside risks to financial flows which could add support to the balance of payments. HUF should outperform PLN and stay stable versus EUR.

ILS



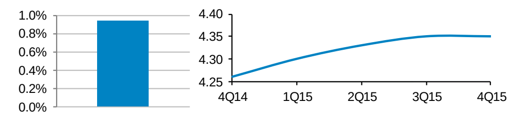
FX Change: 1.8% — Forecast

We look for USD/ILS to head towards 4.10 over 2015. Disinflationary pressures amid weak domestic and external growth dynamics should keep the BoI dovish, and with the policy rate already low, we expect the bias for a weaker ILS to remain in place. A falling EUR will mean USD/ILS will need to adjust even higher for ILS to stay competitive on a trade-weighted basis. The BoI will announce a new USD purchase plan for 2015 and we expect discretionary interventions will also be utilised to support the upward trend in USD/ILS. Also supporting USD/ILS has been increased expectation among local investors for more ILS weakness, which has resulted in a reduction of previous FX hedges on their foreign investments.

Charts show 1M performance against USD, as normally quoted

1Q15 Chg. | **FX Forecast** | **Outlook**

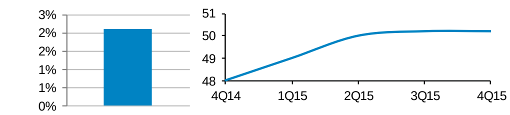
PLN



FX Change: .94% Forecast

We forecast a modest move higher in EUR/PLN over 2015 before the cross starts to fall back lower over 2016. Weak external demand versus signs of domestic recovery may keep PLN weak relative to trading partners. In addition, our economist expects normalisation of policy in Poland to be pushed out into 2016, delaying the scope for PLN to recover; while the risk of more dovish NBP policy presents increased downside risk for the currency. Transferring of EU flows into PLN will act as a natural buffer during periods of excessive market volatility.

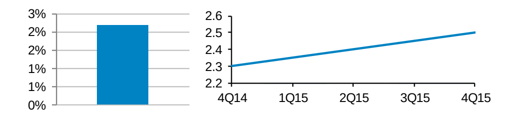
RUB



FX Change: 2.08% Forecast

RUB faces mounting domestic and external challenges over 2015, though we are mindful of the significant trade-weighted weakness already seen in the currency over the past four months. With the CBR no longer intervening on a formalised basis, we expect volatility to remain high for a prolonged period of time and RUB sensitivity to oil prices to be higher than usual. With oil prices remaining weak and little expectation of sanctions to be removed over the coming year, we continue to forecast moves higher in USD/RUB. Continued hawkish policy helps alleviate some of the risks for RUB, but will not reduce the risk of continued capital outflow.

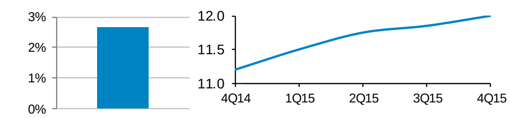
TRY



FX Change: 2.17% Forecast

The continued decline in energy prices has had a positive impact on Turkey's external balance – which has shown signs of rebalancing – and may also help lower market expectations for inflation. That said, the extent to which this allows for durable TRY strength will depend heavily on the policy response, with less defensive monetary policy leaving TRY as exposed to an eventual rise in UST yields, given Turkey's still heavy external funding requirements. In addition, the political backdrop may present challenges with general elections set to take place in June 2015.

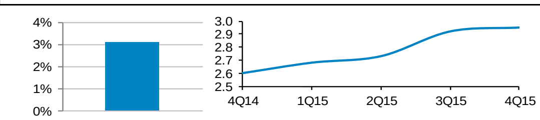
ZAR



FX Change: 2.68% Forecast

We forecast continuation of the multi-year trend higher in USD/ZAR, allowing for moves in the cross to 12 in 2015, before recovering in 2016. The main drivers of weakness include terms of trade deterioration and widening productivity growth divergences with the US economy. Downside risks related to a more fragmented union landscape may also weigh on productivity and output in key exporting sectors. Lower oil prices and contained inflation are supportive offsetting factors, but to the extent that this allows for the SARB to be less hawkish – and rate differentials versus the US to stay flat – means the currency may not benefit materially. An eventual rebalancing of the current account and the significant REER adjustment already seen over the past few years should allow for a modest recovery in ZAR over 2016.

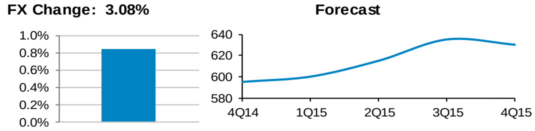
BRL



FX Change: 3.08% Forecast

Higher interest rates and macro adjustments support BRL in the short term, but we are sceptical about the official long-term commitment to rebalancing efforts and expect USD/BRL to climb to 2.95 by end-2015. High inflation, low growth and unattractive REER valuations also point to the need for further adjustment. The potential unwinding of central bank intervention could also add pressure.

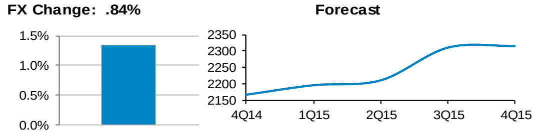
CLP



FX Change: .84% Forecast

Attractive REER valuations reflect a sharp adjustment already and more limited room for currency depreciation. We expect USD/CLP to rise at a more moderate pace and reach 630 by end-2015, as weak economic activity and lower inflation supports expectations for more interest rate cuts. Uncertainty about growth in China and potential lower copper prices remain important downside risks.

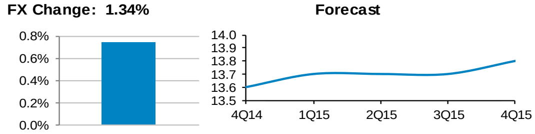
COP



FX Change: 1.34% Forecast

Seasonal capital inflows could provide relative support early next year, but we still expect USD/COP to continue weakening and climb to 2,315 by end-2015. REER valuations have not yet adjusted to lower oil prices that should also weigh on terms of trade and domestic demand. Our forecast is also consistent with a reiterated official weakening bias and scope for more dovish monetary policy.

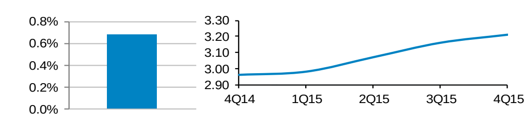
MXN



FX Change: .74% Forecast

We expect USD/MXN to be close to 13.80 next year and continue to outperform peers in the region, as it benefits the most from positive US growth and suffers the least from weaker demand from China and lower commodity prices. MXN also gets support from increasing productivity and capital inflows following the reforms last year and expectations for interest rate hikes in 2015.

PEN



FX Change: .68% Forecast

We expect economic growth to rebound next year, but in the short term, lower activity and monetary policy easing should put weakening pressure on PEN. The central bank keeps actively intervening to moderate volatility while allowing the currency to adjust. A large current account deficit, unattractive valuations and uncertainty about China and commodity prices can also help to drive USD/PEN higher.

Local Rates: Staying Selective

Sell Reduce Hold **Accumulate** Buy

- **In EM, we expect the asset class to perform well in 1Q15 but weaken in the rest of the year. We recommend hedging FX exposure tactically throughout the year. Local bonds should average 1.2% gains (in USD) at the end of 1Q15, with China, India, Korea, Poland, Hungary, South Africa, Colombia and Mexico outperforming and Indonesia and Malaysia underperforming.**

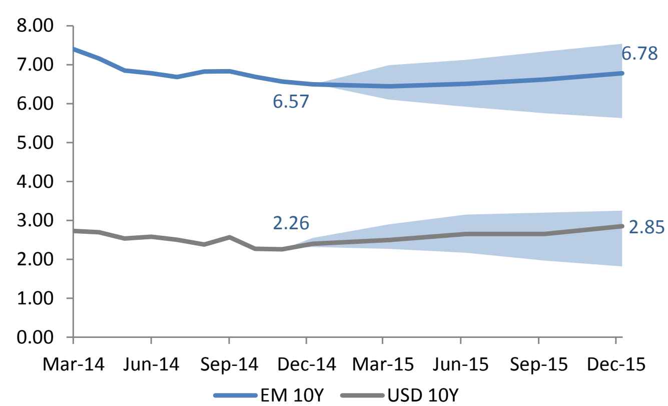
In **EM**, we are constructive on local rates in 1Q 15 as additional downside risks to growth provide scope for more policy easing. We expect the yield to move higher thereafter, in line with the move in Bunds and UST. We forecast the benchmark yield will move 20bp higher to 6.78% at the end of 2015 and recommend hedging EMFX weakness. In **LatAm**, we see NTNF'25 above the forwards at 12.0% and Mbono'24 below them at 6.0% for end-2015 respectively. In **CEEMEA**, we expect R186 to outperform the forwards next year with yields at 7.80%. We also maintain a cautious stance on TURKGBs, while disinflation risks should support yields in CEE. In **AXJ**, we forecast bonds in China and India to outperform, with 10y yields at 3.20% and 7.50% respectively.

CEEMEA should benefit from the market pricing additional ECB stimulus in the near term, but higher bund yields and increasing medium-term inflation expectations are likely to challenge **Poland**, **Hungary** and **Czech** in the second part of 2015. The possibility of additional monetary policy easing in **Turkey** despite heightened inflation expectations could support the front-end of the curve in Q1, though we suspect this could be reversed later in the year when UST yield moves higher. **South Africa** local bonds should outperform in the region as the SARB postpones hikes, while **Russia** OFZs yield should remain high as long as the CBR maintains the tightening monetary policy and lower oil prices keep the RUB volatile.

There is scope for differentiation in **LatAm**. As long as inflationary expectations remain well-contained, **Colombia** and **Peru** bonds could gain from a lower equilibrium growth rate and the possibility for additional rate cuts, despite their deteriorating fiscal balance due to lower commodity prices. Since **Mexico** monetary policy is tied to that of the US, the Mbono curve is likely to flatten, supported as well by institutional flows given the country's positive reform backdrop. **Brazil** on the other hand could see its curve steepen if inflation expectations deteriorate and fiscal policy remains very loose. However, we expect the new government will pursue some of the necessary macro adjustment supporting the local bond curve in H1. If the BCB becomes more dovish and unwinds its hiking cycle as we expect, this will also help the front-end of the curve in Q2.

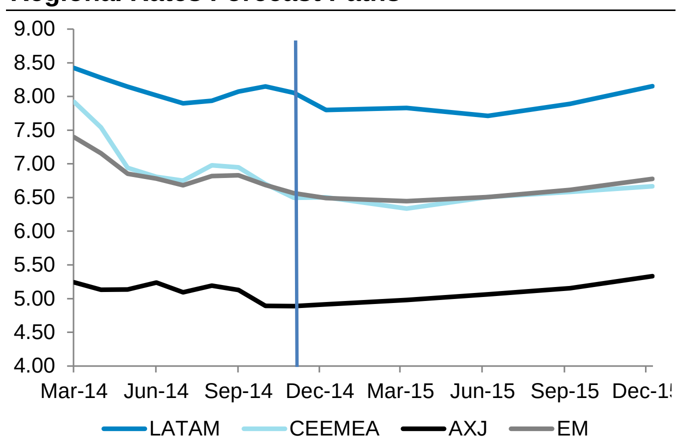
In **AXJ**, the external backdrop remains positive for bonds, particularly for those countries with scope for additional policy easing and that are less sensitive to currency weakness. We expect **India, Korea** and **China** bonds to outperform on this basis, while, given **Indonesia** bonds are highly sensitive to FX weakness, we are neutral despite prospects for reforms possibly supporting the local market. Lastly, **Malaysia** bonds have little risk premium embedded into the curve and are exposed to external risks. Hence, we expect the short-end to outperform.

Exhibit 1
EM Local Rates Bull/Bear Fan Forecast (%)



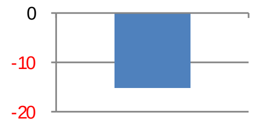
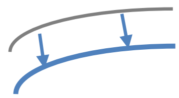
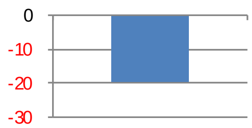
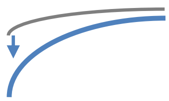
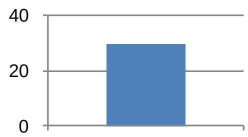
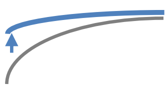
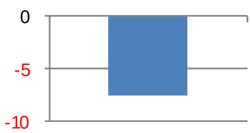
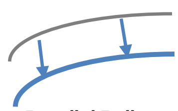
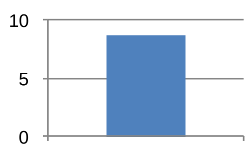
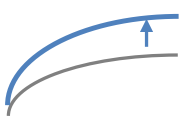
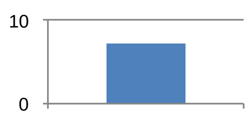
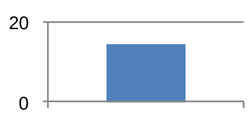
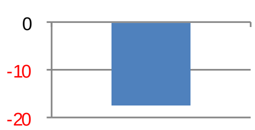
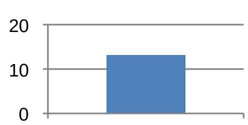
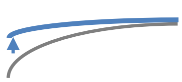
Source: Bloomberg, Morgan Stanley Research forecasts; GBI Weighted EM 10yr Yield

Exhibit 2
Regional Rates Forecast Paths

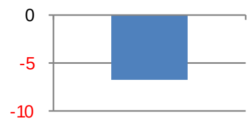


Source: Bloomberg, Morgan Stanley Research forecasts; GBI weighted averages

Rates Snapshots

	1Q15 Change (bp)			Outlook
CNY	 5y Yield Change	 Parallel Rally	**Buy 2019** **Asset Preference**	We maintain our bias to receive China front-end IRS in anticipation of the PBOC providing further monetary easing in 1H15. While the recent rate cut and property sector easing measures have reduced the downside risk for the economy, we think the policymakers will continue to push for lower borrowing costs to complement the ongoing structural reforms.
INR	 5y Yield Change	 Bull Steepening	**Buy IGB '24** **Asset**	The steep fall in global oil prices have had a positive impact on inflation, current account and the fiscal balance. With the sharp decline in inflation, we expect the RBI to start cutting rates in 1Q15. In addition the we think the INR will remain stable, and the high FX carry implies that Indian government bonds should outperform on duration as well as on a total return basis.
IDR	 5y Yield Change	 Bear Flattening	**Buy IndoGB '24** **Asset Preference**	Neutral: The new government took a decisive step in terms of cutting the fuel subsidies, which has raised expectations on more structural reforms to come. The fuel subsidy cuts should also help fiscal consolidation to some extent. However, rich valuations, IndoGBs' high sensitivity to USD/IDR, and our forecasts for USD strength next year mean we stay neutral on Indonesia bonds.
KRW	 5y Yield Change	 Parallel Rally	**Buy NDFB '16** **Asset Preference**	Korea's growth outlook is likely to remain subdued, on the back of a China slowdown and weak growth in the Eurozone. This leaves room for further BoK rate cuts in early 2015. Meanwhile the back-end of the curve should also rise gradually with US rates. We expect the curve to steepen and the 5y to underperform the short and long end of the curve.
MYR	 5y Yield Change	 Bear Steepening	**Buy MGS '17** **Asset Preference**	We expect BNM to remain on hold, although GST implementation and subsidy adjustments may put some pressure on inflation in 2015. However, exposure to FX and sensitivity to bond flows makes us cautious about bond performance. The risk premium along the curve has compressed substantially. Our bearish stance on MYR also makes bonds less attractive on a total return basis.
THB	 5y Yield Change	 Parallel Selloff	**Buy THAIGB '16** **Asset Preference**	We expect moderate performance in Thailand government bonds in 1H2015 as we look for a moderate growth recovery next year while rising global disinflation risks provide space for the market to price in more BOT rate cuts. The current low vol environment also makes Thai bonds attractive from a carry perspective.
CZK	 5y Yield Change	 Bear Steepening	**Buy CZGB '18** **Asset Preference**	The central bank still sees inflation risks as tilted to the downside and is likely to delay rate hikes until 2016. As such, we expect a gradual rise in long-end bond yields, a reflection of higher European rates and better growth into 2015. Low carry makes the bonds relatively unattractive.
HUF	 5y Yield Change	 Bull Flattening	**Buy HGB '19** **Asset Preference**	We continue to be bullish on HGBs – with a dovish NBH set to keep rates at 2.1%. The removal of the uncertainty from FX loan conversion could open the door for rate cut in 2015, supporting HGB curve. We also like the 5yr asset swap given the attractive value, in anticipation of outperformance in bonds
ILS	 5y Yield Change	 Bear Steepening	**Buy ILGOV '24** **Asset Preference**	Economic weakness is fully priced in, in our view, and unless there are additional geopolitical risks, we expect local bond yields to rise, though more slowly than US rates in 2015. The BoI is likely to keep rates on hold for some time, a dynamic which should bear-steepen the curve.

PLN



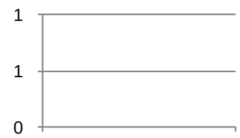
5y Yield Change


Bull Flattening

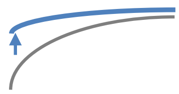
Buy POLGB '25
Asset Preference

A decent GDP print in 3Q raised the risk of no rate cut in the near term but we expect the NBP to eventually continue its easing policy given that inflation will deviate from the target for a prolonged period. We expect POLGBs to outperform in 1Q15 but to gradually move higher in the rest of 2015 as bunds yields rise.

RUB



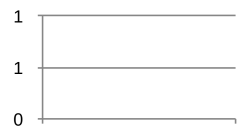
5y Yield Change


Bear Flattening

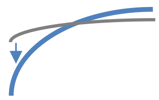
Buy OFZ '23
Asset Preference

We expect the CBR to keep interest rates on hold in 1H15 with the risk of more rate hikes, keeping downside pressure on OFZs. The deterioration of fiscal balance should prompt the FinMin to tap the primary market more regularly in 2015. A combination of weak fundamentals and increasing supply does not bode well for the OFZs market. However, the valuation is more balanced after the recent selloff, which keeps us neutral.

TRY



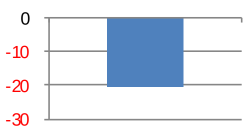
5y Yield Change


Bull Steepening

Buy TURKGB '19
Asset Preference

The fast drop in the inflation outlook and stable TRY will support TURKGBs in the near term. However, we believe continued currency vulnerability to higher funding costs and domestic political uncertainty will likely put renewed pressure on TURKGBs, particularly given the slightly negative carry and unattractive roll.

ZAR



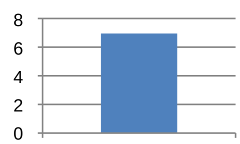
5y Yield Change


Bull Flattening

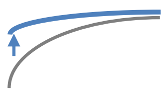
Buy SAGBs 2037
Asset Preference

We expect the SARB to delay its tightening cycle as inflation remains below the target throughout 2015. South Africa's inflation is sticky due to the rigidity in the labor market. However, given that inflation is expected to drop and inflation expectations are backward-looking, SAGBs can rally further from the compression of inflation expectations.

BRL



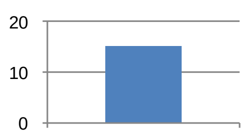
5y Yield Change


Bear Flattening

Buy NTNF '25
Asset Preference

The new administration should continue to signal willingness to fix the deteriorating fiscal balance. Combined with the BCB's decision to hike the policy rate, this should help re-build market credibility and remove risk premium in the long end, associated with the risk that Brazil may lose IG status. As such, we suspect the NTN-F could flatten at the beginning of next year.

CLP



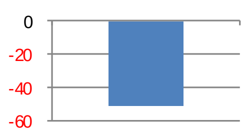
5y Yield Change


Bear Steepening

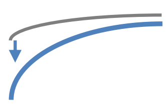
Buy Chile 2020
Asset Preference

Bearish local sentiment, a high liquidity premium and little carry to compensate for higher funding costs make Chile's Global 2020 bond unattractive. The fiscal stimulus package is unlikely to have a material impact, and we suspect the possibility of additional easing could steepen the curve.

COP



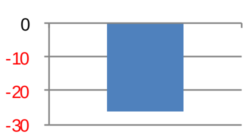
5y Yield Change


Bull-Steepening

Buy Coltes '24
Asset Preference

Lower oil prices is likely to be an important strain for Colombia's fiscal balance. Further downside risks suggest the market may price a reversal of the tightening in 2014, which makes us position in the belly this quarter.

MXN



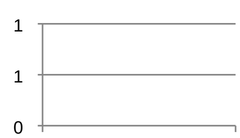
5y Yield Change


Bull Flattening

Buy Mbono '24
Asset Preference

Despite the positive macro backdrop in Mexico, its reliance on portfolio flows makes it particularly vulnerable to higher US rates, and we expect yields will move higher in 2015, though still outperforming the forwards. Nevertheless, signs of MXN resilience should help tighten the Mexican-US 10y spread to 300bp.

PEN



5y Yield Change


Bear Steepening

Buy Soberano '23
Asset Preference

We are neutral Soberanos. Downside risks to growth should support front-end rates as they will likely spur additional easing getting priced in, while high foreign ownership and political risks domestically make the long end more vulnerable.

Sovereign Credit: Diverging Destinies

Sell Reduce Hold **Accumulate** Buy

- **While spreads can compress in 1Q15, higher UST yields throughout 2015 should see spreads move wider by end-2015. We favour low-beta LatAm and CEE and remain cautious on UKR, TURK and SOAF**

A constructive start to 2015… While fundamentals have not improved over the past quarter, with the exception of a few countries, we expect the external environment to remain supportive early next year. This, combined with favourable technicals and valuations that are no longer expensive, should allow for some spread compression in the near term. However, in the absence of any improvement in EM fundamentals, a stronger dollar and risks for rate hikes materialising next year (versus our expectations for the first rate hike in 2016) will lead to wider spreads later in the year, in our view. On balance, we see spreads for the asset class widening by 20bp over the next 12 months (see Exhibit 1).

…leads to positive returns despite higher US rates: Although both spreads and US rates are likely to be headwinds to total returns, we expect carry to offset these factors, leading to 0.6% total return until the end of 2015. This translates into 2.5% excess return versus US Treasuries and is especially strong in 1Q15 (see Exhibit 2).

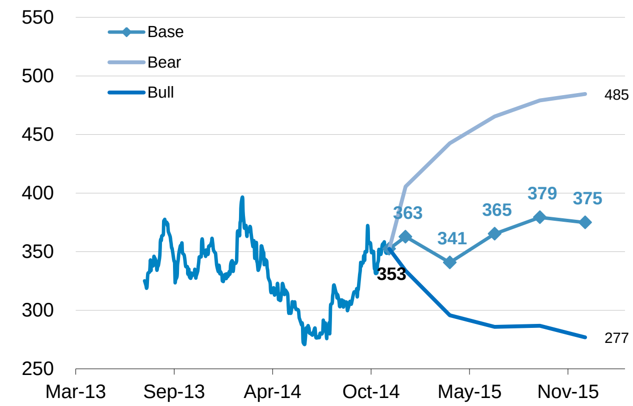
Balanced skew, some binary stories: The majority of the asset class, comprising of the IG credits, has limited room to tighten while their downside in an adverse scenario is larger. However, Venezuela and, to a lesser extent, Argentina and Ukraine represent binary outcomes where already a lot of the risks are in the price. Given Venezuela's large weight in the index, its positive skew leaves the index skew balanced.

Pick your stories and stick with them: Differentiation remains the prevailing theme to generate excess return. We continue to like low-beta LatAm. We also shift back to a constructive view on CEE, given the region is more resilient to higher US rates and can also benefit from potential European QE. While the FY return for Venezuela is high due to carry, the fall in oil poses high risks to our base case. We remain market-weight and look for a better entry point. Argentina is likely to resolve the holdout saga some time next year, opening up the way to unlocking its long-term growth potential. On the other hand, we expect further weakness in Ukraine and remain underweight in the double deficit countries of Turkey and South Africa.

Long duration in strong credits: Expectations for further UST flattening keep us favouring the long end of strong credits.

Exhibit 1

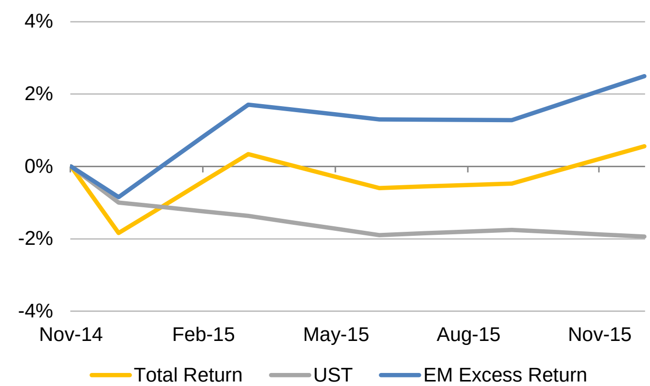
EM Sovereign Spread Bull/Bear Fan Forecast (bp)



Source: Bloomberg, Morgan Stanley Research forecasts; based on EMBIG spread index

Exhibit 2

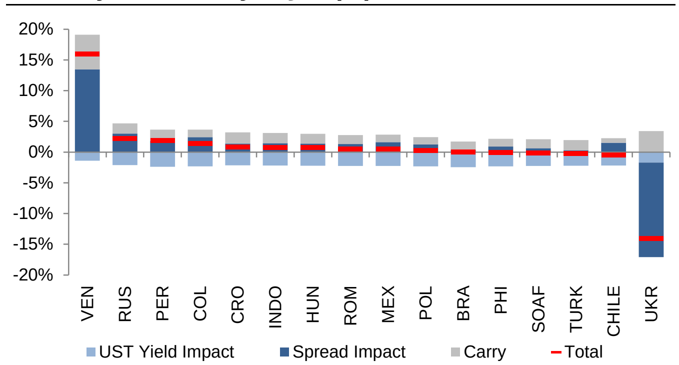
Decent Excess Returns but Due to UST Widening the Total Return Is Only Just Positive at 0.6% over 12m



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 3

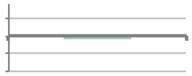
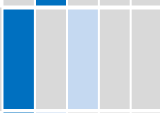
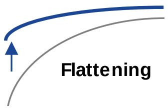
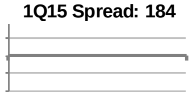
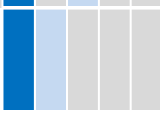
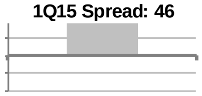
Country Returns by 1Q15 (%)



Source: Morgan Stanley Research forecasts

Credit Snapshots

	Allocations	10s30s Curve (or 5s10s if N/A)	1Q15 Spread	Outlook
MEX		Flattening	1Q15 Spread: 90	Technicals have improved as large fund overweights have declined. While spreads are tight, we believe Mexico can perform well due to reform and growth momentum. We like the long end.
COL		Flattening	1Q15 Spread: 105	Improving growth, no excessive build-up of private sector leverage and lower China exposure put Colombia in a good position. Lower oil is a risk but the country can navigate it, in our view. Demand for the 30y UST and a flatter 10s30s UST curve should also support the long end of Colombia.
PER		Flattening	1Q15 Spread: 108	A wider current account deficit, on the back of lower metal prices, and growth that may settle at 4-5% provide a weaker macro backdrop. Yet still decent fundamentals and positioning that is not yet stretched mean we still see Peru as attractive.
HUN		Flattening	1Q15 Spread: 175	While valuations are no longer cheap, several factors favour the CEE region and Hungary: benefits from lower oil and other commodity prices, higher resilience to UST yields, and also the fact that it stands to benefit indirectly from potential ECB QE. We therefore move Hungary to a moderate overweight.
ROM		Flattening	1Q15 Spread: 131	Romania, together with Hungary, is our preferred credit in the CEE region and we move them to moderate overweights. We favour the region due to its resilience to both a China slowdown and/or lower oil and commodity prices in addition to higher UST yields.
VEN			1Q15 Spread: 1627	While willingness to pay is strong, ability to service debt is eroding, especially as oil prices keep falling. While we do not expect a credit event over the next 12 months, the outlook beyond is becoming very challenging. As prices fall, we remain marketweight and look to increase exposure at better levels.
ARG				We keep Argentina at neutral. While bond prices still don't reflect near-term fundamental risks, strong technical support from investors with longer investment horizons has offset this. Seasonal factors and the approaching expiry of the RUFO clause provide additional support into year-end.
BRA		Belly Outperforming	1Q15 Spread: 163	Brazil needs a tighter fiscal policy due to the recent deterioration. However, once it affects already-weak growth, chances are that the much-needed tightening is unwound and debt continues to rise. Investors are however likely to give Brazil the benefit of doubt in the near term before spreads widen in 2H15.
CRO		Steepening	1Q15 Spread: 244	Fiscal risks remain, growth is sluggish, there is a strong need for structural reforms, which are currently lacking, and public debt levels keep rising. These issues keep us from upgrading to overweight as we have for Hungary and Romania, despite our favourable view of the CEE region.
INDO		Flattening	1Q15 Spread: 148	Given relatively low government debt and already favourable signs of structural reforms, we favour Indonesia over other high CAD countries. However, YTD outperformance by double-deficit credits and a still-wide CAD that is unlikely to correct materially given low commodity prices keep us market-weight.
PHI		Flattening	1Q15 Spread: 75	Strong fundamentals, namely resilient inflows due to remittances and the service industry, and favourable technicals due to high local ownership, position the Philippines as one of the more resilient credits. However, we move back to market-weight, given that valuations are now fully pricing this in.
POL		Steepening	1Q15 Spread: 84	We expect Poland to remain among the most resilient credits on the back of fund exposure that remains underweight, solid macro fundamentals and being in the generally more resilient CEE region. However, spreads are still very tight and this keeps our allocation to Poland at market-weight.
RUS		Belly Outperforming	1Q15 Spread: 289	With oil prices now much lower, RUB wider and lack of progress with Ukraine, we no longer expect a tactical rebound, despite wide spreads. Instead, we revert to our more cautious long-term view, where unless we see a durable move towards de-escalation, the reserve drain will become a problem.
SOAF		Belly Outperforming	1Q15 Spread: 168	While the budget was overall positive, we believe that current spreads justify an underweight allocation due to the weak growth, wide double deficits and rising government debt levels, most of which are unlikely to correct in the near term.

	Allocations	Curve	4Q14 Spread	Outlook
TURK		 **Steepening**	 **1Q15 Spread: 184**	Although Turkey largely benefits from lower oil prices and technical support from the Russia situation, structural challenges are not being addressed. A weak lira and rising core rates can put pressure on spreads, which are at the tightest level of the year.
CHI		 **Flattening**	 **1Q15 Spread: 46**	Generally sound macro policies and low debt levels leave Chile very resilient. However, spreads are very tight and leave very little cushion to absorb any rise in UST yields, which means we favour the other low-beta LatAm credits instead and move Chile to underweight.
UKR			 **1Q15 Spread: 1382**	It is unclear when and how the Eastern Ukrainian conflict will get resolved. Meanwhile, the economic fallout from the crisis leaves a significant funding gap for 2015. While donor funding is expected, the situation remains fragile, and that is not reflected in current prices. We stay underweight.

Corporate Credit: Don't Fight the Fundamentals

Sell Reduce **Hold** Accumulate Buy

- **Valuations have improved, but fundamentals are trending in the wrong direction. Our base case is not for an unravelling, but we continue to believe that risk/reward in the medium term is not attractive due to fundamentals, lack of growth, potential US rates volatility and commodities weakness.**
- **We maintain a Hold recommendation, with an expectation for further volatility in 1H15. Our strategic preference remains with lower-beta and defensive corporate credits.**

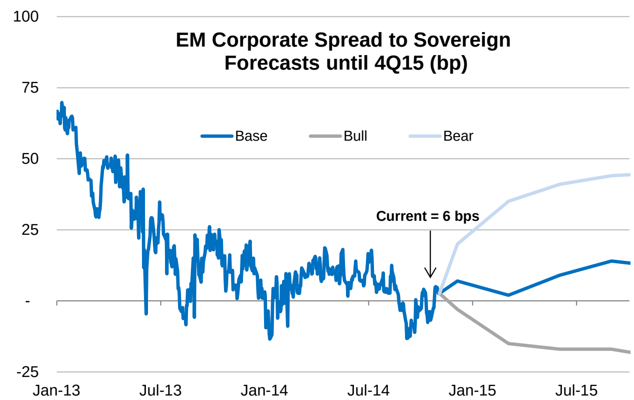
Over the medium term we continue to maintain a cautious view on corporate credit. Fundamentals are weakening more sharply in lower-quality credits, with the differential between IG and HY leverage the widest we have seen post-crisis. Spreads have increased to account for this, and in our view, compensate adequately for risk in select credits, providing some opportunity in the near term. However, relative to sovereign, we think they still look somewhat rich. And on a longer-term horizon, we maintain our belief that most EMs are entering into a downturn phase of their financial cycles, which typically coincides with strongly negative total returns. In our view, credit conditions are the key indicator to watch in monitoring this situation.

Regional allocation – Favor higher quality: YTD, lower-beta countries in the LatAm region have outperformed, while Turkey has been the best within the CEEMEA region. We think this is due to a combination of positive technicals and favourable external dynamics, counter-balanced by weaker fundamentals. In our view, this trend will continue, and we prefer regions with higher growth, lower stocks of private sector debt, further progress with reforms and fewer fundamental imbalances.

In LatAm, we believe that these factors favour Mexico, Peru and Colombia over Brazil, and to a lesser extent, Chile. For CEE, we think the focus will be increasingly on the deteriorating economic situation in Russia and Ukraine. In Turkey, while some of the data has been better than expected, our currency strategists are expecting further lira weakness in 2015, and we retain caution due to FX vulnerability in the banks.

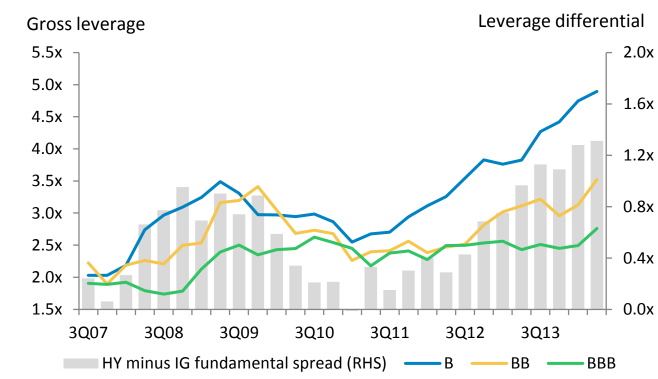
Sector allocation – stay defensive: We retain an underweight view on the banking sector, as we see significant downside risk due to end-of-financial cycle dynamics. We are starting to see a pick-up in NPLs in more stressed regions such as Russia, while we expect slower growth in Brazil to weigh on currently benign NPLs. We bring the energy sector down to neutral, given commodity weakness, and have a similarly cautious view on mining. Our preference is for defensive sectors such as utilities and consumer products, which, while somewhat rich, provide better downside protection.

Exhibit 1
Spread over Sovereign Forecast: Bull/Bear Skew Still Suggests More Downside Than Upside



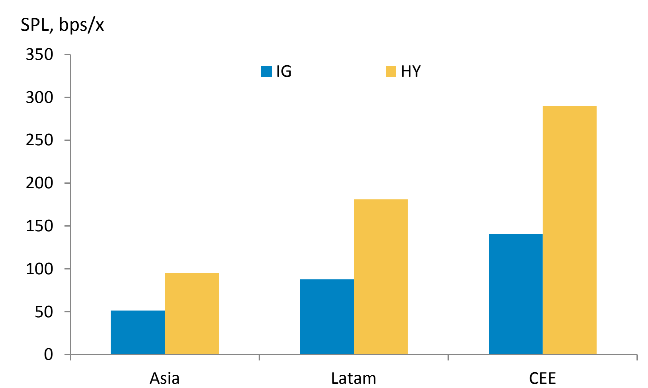
Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 2
Deteriorating Fundamentals in Lower-Quality Credit



Source: Markit iBoxx, S&P Capital IQ, Bloomberg, Morgan Stanley Research

Exhibit 3
LatAm and CEEMEA Offer Better Risk/Reward



Source: S&P Capital IQ, Bloomberg, Morgan Stanley Research

Corporate Credit Snapshots

	Allocation	Banks	O&G	M&M	Telecoms	Utilities	Other	Outlook
MEX		MW	MW	-	OW	-	MW	Mexican corporates are trading slightly rich, in our view. Corporates are benefitting from being perceived as the relative 'safe haven' within EM assets. However, we are starting to see further signs of a pick-up in economic activity, suggesting that rich valuations may be pricing in the better growth outlook.
PERU		MW	-	MW	-	OW	-	Valuations are underpinned by strong banking fundamentals. Overall SPL remains relatively attractive and credit metrics are robust across the sector. Activity seems to be firming after a first-half slump, and tax cuts (plus other measures) seem to be on the way. Continued weakness in metal prices remains one of the key risks to watch, but we think risk/reward is favourable, and raise to overweight.
COL		MW	MW	-	MW	OW	-	Generally, we like the fundamentals in the sector, and SPLs still look attractive compared to Chile and Mexico. However, while financial sector valuations look rich, Colombian banks performed well in our bank scoring model. Oil price weakness is a key concern for Colombia, where the oil and gas sector accounts for just over half of the investible credit universe. However, the USD revenue from the oil sector also shields it from some potential weakness due to FX depreciation.
CHI		UW	MW	UW	MW	MW	-	Chilean banks look vulnerable, based on our bank scoring model. High credit growth, low capital adequacy and FX funding reliance present an unfavourable risk/reward in the medium term, especially when compared to other low-beta LatAm countries. Commodities weakness is a key concern in the medium term, and FX depreciation could weigh on sectors with fewer sources of USD revenue. While we move to underweight, this highlights expensive valuations and limited upside, rather than a similar degree of challenges faced by other regions such as Russia, Brazil or Turkey.
RUS		UW	MW	MW	MW	-	MW	Valuations on an absolute basis are near YTD wides, and while optically attractive, corporates have been reporting that the operating environment is deteriorating and access to USD is dwindling. Fundamentals may soon overtake geopolitical risk premium as the key concern for Russian corporates. We expect a growing separation between corporates likely to receive support, and those that won't. The oil & gas sector is likely to face challenges due to a combination of sanctions and falling oil prices, but this sector is also composed primarily of quasi-sovereign names that are likely to receive sovereign support. We downgrade to underweight.
TURK		UW	-	-	-	-	MW	High dollar-based borrowing/lending remains a key risk for Turkish corporates and banks. In our view, however, it will take a large move in the lira to cause weakness, thanks to an accommodative CBT and improved fundamentals. However, our forecasts are for meaningful FX weakness over the next year, with the lira moving to 2.50 by 4Q15. Prior bouts of volatility in Turkish corporates have coincided with weaker FX, and should we hit these levels, we expect to see significant weakness in the space.
BRA		UW	UW	UW	-	MW	MW	SPLs are cheap relative to Mexico, but risk/reward is not attractive at present. The government has provided some indications that it will push through with reforms, but execution is a key factor. In addition, there is the potential for a sovereign downgrade, which could hit large quasi-sovereign credits such as Petrobras. Furthermore, corporate fundamentals are not attractive, and debt service ratios may come under scrutiny if the economy slows as we expect in 2015, due to both contraction on the revenue side, and also weakness on the FX side.
UKR		UW	UW	UW	-	-		Corporate fundamentals are offset by persistent sovereign concerns, and we expect that fundamentals could deteriorate further in 2015 like that of Russia. State banks are amongst the most vulnerable to sovereign performance. We stay underweight.

Morgan Stanley EM Forecasts

		Currencies					Local Rates 10y						Sovereign Bonds 10y					
		Current	1Q15	2Q15	3Q15	4Q15		Current	1Q15	2Q15	3Q15	4Q15		Current	1Q15	2Q15	3Q15	4Q15
Latin America	ARS	8.52	10.63	11.25	11.88	12.50												
	BRL	2.50	2.68	2.73	2.92	2.95	NTNF '25	11.85	12.00	11.25	11.50	12.00	BRAZIL '25	166	163	185	205	225
	CLP	599	600	615	635	630	CHILE 20*	4.30	4.50	4.70	4.90	5.10	CHILE '22	60	46	61	66	71
	COP	2163	2195	2210	2310	2315	Coltes '24	6.48	5.90	6.00	6.20	6.40	COLOM '24	132	105	120	125	130
	MXN	13.72	13.70	13.70	13.70	13.80	Mbono '24	5.78	5.50	5.80	5.90	6.00	MEX '23	108	90	105	110	115
	PEN	2.91	2.98	3.07	3.16	3.21	PERUGB '23	5.29	5.40	5.50	5.60	5.70	PERU '25	129	108	123	128	133
	VEF	6.29	12.00	14.00	14.00	14.00							VENZ '23	1,894	1,627	1,757	1,882	1,765
CEEMEA	CZK*	27.57	27.80	27.80	27.90	27.90	CZGB '24	0.72	0.95	1.30	1.45	1.60						
	HUF*	307	310	312	314	315	HGB '25	3.50	3.30	3.50	3.60	3.80	REPHUN '24	193	175	185	190	195
	ILS	3.87	3.95	4.00	4.05	4.10	ILGOV '24	2.14	2.30	2.40	2.50	2.60						
	PLN*	4.18	4.30	4.33	4.35	4.35	POLGB '25	2.37	2.30	2.50	2.60	2.70	POLAND '24	99	84	99	104	109
	RON*	4.42	4.46	4.48	4.50	4.50							ROMANI '24	148	131	141	146	151
	RUB	47.06	49.00	50.00	50.20	50.20	OFZ '23	10.30	10.30	10.20	10.00	9.80	RUSSIA '23	329	289	294	314	324
	ZAR	10.96	11.50	11.75	11.85	12.00	SAGB '26	7.60	7.30	7.50	7.70	7.80	SOAF '24	176	168	188	203	218
	TRY	2.21	2.35	2.40	2.45	2.50	TURKGB '24	7.90	8.10	8.40	8.50	8.70	TURKEY '24	187	184	204	224	239
													UKR '23	1070	1382	1557	1382	1232
Asia	CNY	6.14	6.16	6.13	6.12	6.09	CGB '4	3.50	3.35	3.25	3.15	3.20						
	HKD	7.75	7.80	7.80	7.80	7.80	HKGB '24	1.71	2.00	2.15	2.15	2.35						
	INR	61.9	62.5	62.5	62.3	62.2	IGB '24	8.09	8.00	7.70	7.60	7.50						
	IDR	12178	12400	12600	12800	13000	INDOGB '24	7.66	7.96	8.07	8.20	8.40	INDON '24	167	148	158	173	188
	KRW	1107	1190	1210	1230	1230	NDFB '24	2.61	2.50	2.60	2.70	2.85						
	MYR	3.35	3.42	3.45	3.48	3.53	MGS '24	3.86	4.05	4.15	4.20	4.35						
	PHP	44.9	45.5	46.0	46.3	46.5							PHILIP '24	85	75	83	88	93
	SGD	1.30	1.31	1.32	1.33	1.34	SIGB '24	2.18	2.45	2.58	2.60	2.75						
	TWD	30.93	30.80	31.00	31.10	31.20	TGB '24	1.59	1.69	1.75	1.76	1.85						
	THB	32.76	33.40	33.80	34.20	34.50	THAIGB '25	3.07	3.12	3.15	3.25	3.45						

Source: Morgan Stanley Research forecasts * All EUR pairs *CHILE 20 is 5yr bond.

Exhibit 1
Local Rates Markets Return Base Case Forecasts 1Q15

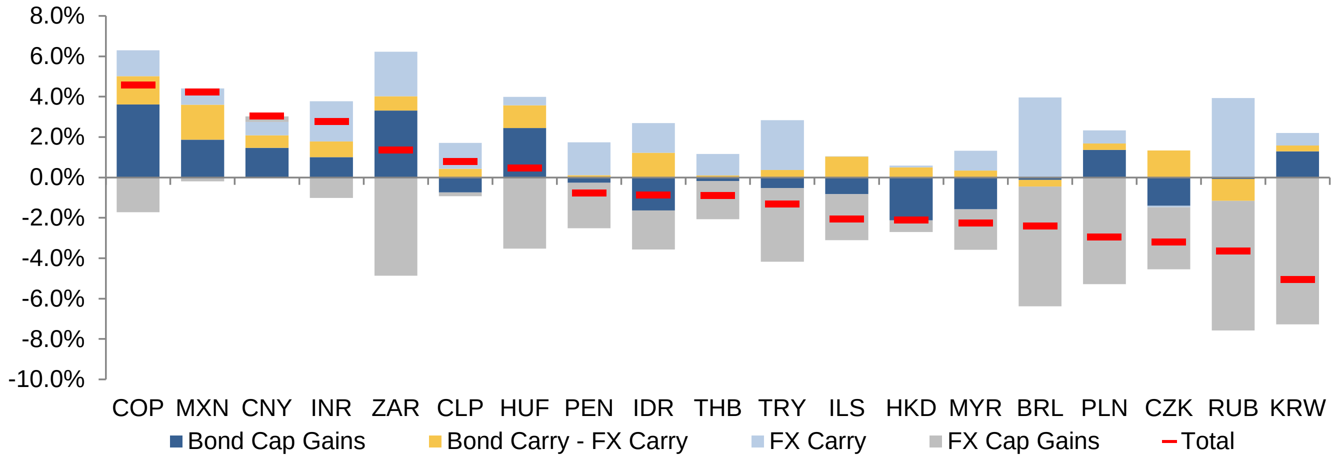


Exhibit 2
FX Markets Return Base Case Forecasts 1Q15

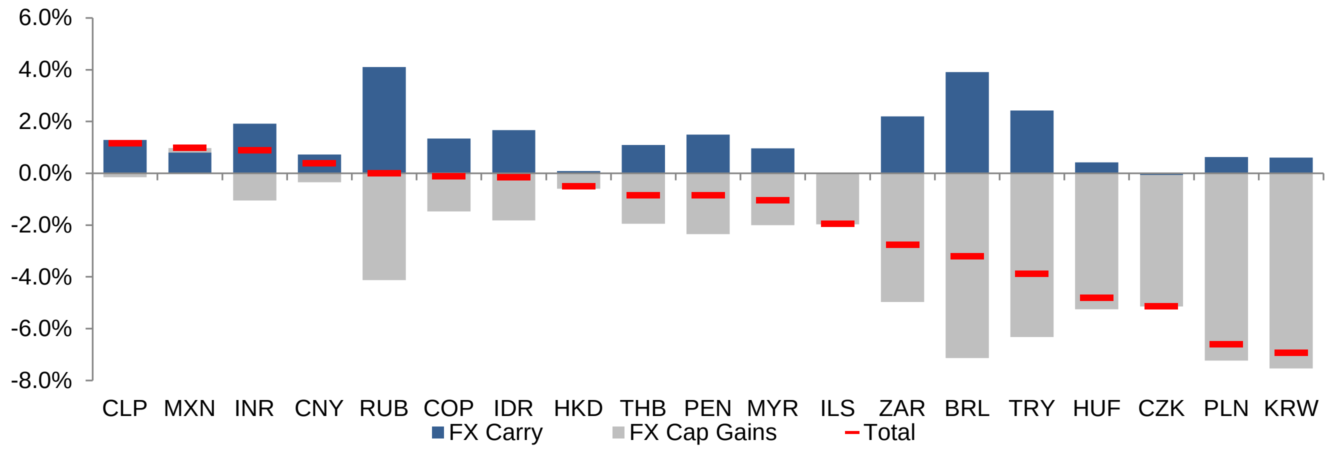
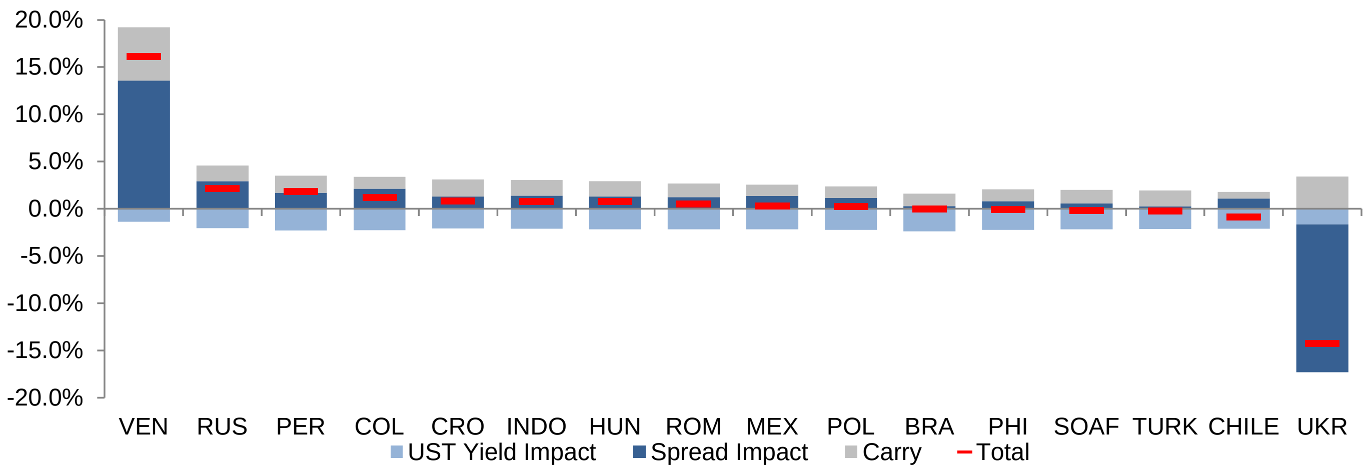


Exhibit 3
Sovereign Credit Return Base Case Forecasts 1Q15



Source for all charts: Morgan Stanley Research forecasts

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1159**	**35%**	**339**	**42%**	**29%**
Equal-weight/Hold	**1403**	**43%**	**355**	**44%**	**25%**
Not-Rated/Hold	**108**	**3%**	**20**	**2%**	**19%**
Underweight/Sell	**595**	**18%**	**87**	**11%**	**15%**
Total	**3,265**		**801**		

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.
Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.
Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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