Emerging Markets Grab Exchanges' Attention . . .

COMMODITIES C1

By SUZANNE MCGEE
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK – Far from quelling enthusiasm for new emerging-market derivatives, the fallout from Mexico's financial crisis has made these products more popular than ever at futures and options exchanges.

Only a handful of listed options and futures are available on emerging-nation stocks and bonds. But those few contracts have been surging. Hoping to build on that trend, exchanges are moving rapidly to expand their roster of offerings.

At the Chicago Board Options Exchange, the leading Mexican stock-index contract registered average daily trading volume of 3,948 contracts last month, up steadily from only 732 contracts daily at its launch in July. The index options got a shot in the arm late last year, as money managers scrambled to hedge the risks that the peso devaluation suddenly highlighted.

In the next year, the CBOE hopes to launch two broader stock-index contracts on emerging markets. One, already approved by the Securities and Exchange Commission, is linked to emerging-markets stocks in Asia, while the second, based on Latin American stocks, awaits regulators' go-ahead. "We're also still playing with the idea of a general emerging-market index that would combine these two products in some way," said Richard DuFour, executive vice president of business development at the exchange.

Nearby, the Chicago Mercantile Exchange plans a splashy debut for its long-awaited peso futures contract April 25, with a Latin American mystery celebrity set to cut the ribbon. Behind the scenes at the exchange, a special panel of industry representatives is working to develop new currency, stock and bond futures contracts based on Latin American markets. Within a year or two, they expect to launch new contracts based on emerging markets in Asia.

The trend isn't confined to Chicago: In New York, the Finex, the financial-futures trading unit of the Cotton Exchange, is seeking approval to introduce options and futures on its new "Brady bond" index. That would allow investors to gain exposure to, or hedge risks related to, a range of Mexican, Brazilian, Argentine and Venezuelan bonds. (Brady bonds are created from defaulted or devalued sovereign debt under guidelines set up by former U.S.

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. . . And Attract Bond Investors After Being Shunned for Months

CREDIT MARKETS C1

By THOMAS T. VOGEL JR.
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NEW YORK – Investors are moving back into "emerging markets" after a very long winter.

It's hardly a stampede—more like a few weeks' trickle into the bond and stock markets of developing nations from Mexico to India. But a number of money-management firms sense the renewed interest; already they are making plans to launch new funds to invest in the world's exotic young markets.

Inflows to existing funds are "gaining strength," says Frank Fernandez, who heads Global Emerging Markets Advisors, a New York money-management firm. The return to emerging-market funds "is in its beginning stages."

It's a turnaround from just a few months ago, when Mexico's peso devaluation in December sparked a world-wide sell-off in the stock and bond markets of developing nations, which had been pulling in massive amounts of capital from foreign investors since 1990.

Now investors are coming back, albeit much more cautiously than before. Many seem to have decided that despite all the risks, they want to put at least a small portion of their savings into the markets of exotic realms such as Russia, Argentina or Indonesia.

Further fueling the trend are declining long-term interest rates in the U.S. The yield on the benchmark 30-year Treasury bond has dropped more than ½ percentage point since the start of the year to 7.33% on Thursday. (The U.S. bond market was closed Friday ahead of the Easter and Passover holidays.)

Falling U.S. interest rates helped spark a frenzy of emerging-market investments from 1990 through February 1994, when the U.S. Federal Reserve started raising interest rates. U.S. investors, dissatisfied with low U.S. interest rates and an often-lackluster stock market, turned to emerging markets in an effort to earn more.

According to the Institute of International Finance, more than $166 billion poured into emerging markets in 1994, down sharply from $204 billion the previous year but still an impressive sum considering how the Fed raised interest rates in the U.S. and sparked a world-wide bond-mar-

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Exchanges Seek New Products To Catch Emerging Markets' Rise

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Treasury Secretary Nicholas Brady.)

"There's been no real diminution of interest in these markets from serious institutional investors," said Gary Brinson, president of Brinson Partners Inc., an asset allocation firm in Chicago with some $37 billion under management that makes heavy use of listed derivatives. He argues that the broad rout in emerging markets this year has resulted in a more informed client base. Come June, Mr. Brinson plans to tap into that continuing interest by launching a stock fund that will specialize in emerging markets.

"To the extent that there are viable, liquid derivatives products out there, we'll be delighted," he said. "That kind of product tends to improve the liquidity and efficiency of the underlying markets, and even can smooth out some volatility."

Mr. Brinson has joined the CME's panel of emerging-markets experts. Jack Sandner, the exchange's chairman, said the group has been "given a green light" to do whatever's needed to make the CME "the emerging-market exchange for the world."

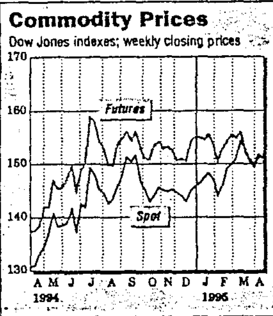
In the cards: new stock-index futures, which Mr. Sandner said would be based on a broader index than that used by the CBOE, as well as a series of Latin American bond futures. "But we'd do it country by country, which would allow people to make arbitrage plays between them," he said.

But all the exchanges mulling these initiatives acknowledge that they face tough odds. "The peso should take off, but not everything will be an instant hit," Mr. Sandner said. "If you're looking for the holy grail, a pot of gold" like the CME's hugely successful Eurodollar contract, "you certainly can't be sure of finding it in emerging markets."

But he notes that the costs of launching the products are minimal, mostly linked to marketing. "Just because a product might be small doesn't mean we won't do it," he said. "Instead of trading it in a pit, we'll just list it on Globex," the after-hours electronic-trading system of which the CME is a founding member.

Institutional investors and pension-fund advisers generally support the exchanges' efforts. Gregory C. Allan, senior vice president of Callan Associates Inc., a San Francisco investment advisory firm, said healthy, liquid futures and options markets would help increase liquidity in the underlying markets. That could solve many of the problems that have plagued emerging markets since their popularity began to soar at the beginning of the decade.

"The typical size of an investment made by a pension fund is going to be large in relation to the size of any of these markets as a whole," Mr. Allan said. "So just building up a position can have a significant impact on the price of the stocks." Mr. Allan said many of the astronomic gains in these stock markets in recent years had more to do with a sudden influx of cash from U.S. mutual funds than it did with the fundamentals of each marketplace.



"If you gain exposure through a futures contract, you can solve this problem," he said. "You don't have to leave a big footprint showing where you've been." Using futures, a manager can gain exposure to the market immediately. These holdings can then be liquidated slowly, and the proceeds used to buy stocks and bonds directly in the country concerned. Other investors will be more able to implement short-term trading strategies, or significantly reduce the high costs involved in dealing directly in stock markets such as Argentina's, he said.

Currency products may be less successful, Mr. Allan said. Even so, currency derivatives may still have a place in portfolios of managers who want to reduce the risk that a sudden swing in exchange rates might erase their emerging-markets gains.

Some skeptical traders and managers dismiss emerging markets as a fad that's had its 15 minutes of fame. They warn that many of the new products the exchanges are developing could wither from lack of interest.

"I've never had a customer ask for a liquid hedge on Brady bonds," said Paul Masco, head trader of emerging-market debt at Salomon Brothers in New York. "There's rarely any risk in that market that I can't lay off in the cash market."

Mr. Masco also said many speculators like the extra risk involved in emerging-markets trading because it translates into the possibility of higher rewards. "Most people who have the currency risk want that currency risk," he said.

"If it's useful and liquid, people will use it to some extent, I suppose," said another skeptical New York trader. "But they're going to have to prove to me that I need it and that it adds liquidity and stability to the markets. We'll wait and see."

Emerging Markets Regain Allure After Months of Being Shunned

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ket sell-off.

After the Fed raised rates, the flows to emerging markets slowed because many investors decided they could lock in higher rates of return in the U.S. without the kinds of huge risks associated with emerging-market investments. To be sure, the withdrawal of funds from emerging markets didn't become a stampede until Mexico devalued its currency.

Signs of a Turnaround

Union Bank of Switzerland estimates that in the three weeks ended April 5 there was a net inflow of more than $100 million into U.S.-based funds that specialize in emerging markets. It's not a lot. But it's a sharp reversal from the huge outflows that plagued the sector for most of last year and especially since the end of December.

AMG Data Services, an Arcata, Calif., firm that tracks mutual-fund cash flows, reports that net inflows to stock funds with the words "emerging market" in their names have totaled more than $110 million in the past month, compared with sharp outflows in the months after Mexico devalued the peso. There has also been a sharp jump in net inflows into Latin American stock funds, with more than $60 million coming in over the past four weeks compared with net outflows of more than $80 million for the prior five weeks.

Among stock funds that measure their returns according to Morgan Stanley's popular benchmarks for funds specializing in emerging markets, there has been nearly half a billion dollars of net inflows over the past four weeks, according to AMG.

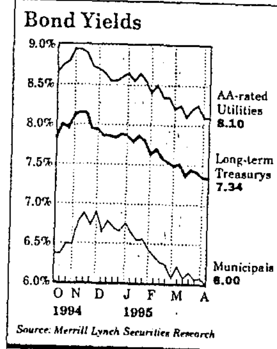
Emphasis on Eurobonds

In the bond market there is plenty of action as well, according to Craig Blessing, a money manager at Serfin Securities Inc., a subsidiary of Mexico's Grupo Financiero Serfin. "The first big money we've been seeing going back into the market has been going into Eurobonds," he says. "It's simple – investors see these companies trading cheap." Eurobonds are securities sold in European markets by foreign issuers in currencies other than their own.

The Eurobond sector of the Latin bond market was probably the most battered portion of emerging markets in the wake of the Mexican devaluation. Until late March, the market was extremely illiquid, and many investors who wanted to sell their holdings were forced to offer sharp discounts in order to get rid of bonds in companies including Cementos Mexicanos SA, one of Mexico's largest corporations. The price of Cemex bonds dropped below 50, so that the debt traded at below 50 cents on the dollar earlier this year. But the bonds but have since rebounded more than 20 points, or more than $200 for a bond with $1,000 face value, to trade in the mid-70s.

Mr. Blessing manages a $200 million offshore Latin America bond fund for mainly Mexican investors and says he has started to get net inflows over the past few weeks. "That's the first time we've seen that situation in a year," Mr. Blessing says.

A number of firms looking to launch investments have sensed the change in sentiment and are bringing their products to market now. T. Rowe Price Associates Inc. last week announced the launch of a new international stock fund that would invest in the emerging markets of Asia, Europe, Africa and Latin America. Calvert Group recently unveiled the Calvert New Africa Fund, which will be managed by New Africa Advisers, a division of Sloan Financial Group. According to Calvert, the fund will look for investments throughout Africa and not just on the Johannesburg Stock Exchange.



Source: Merrill Lynch Securities Research

Another company that says it's reviving plans for a new emerging-market fund is Hermes Capital Management Ltd. of New York. Late last year, Hermes was close to launching the Russian Renaissance Fund, but held off. Now it again is planning a private fund to be registered on the Irish Stock Exchange that would specialize in Russian companies other than the 20 most popular with foreign investors, says Marc Cohen, a managing director.

"After what happened in Mexico and in emerging markets around the globe and the Chechnya conflict, we purposely dragged our feet," Mr. Cohen says. "You don't want to be the lonely voice" launching a new emerging-market fund "when everybody is still under the table counting their quarters."

But in promoting his fund last week in Europe, Mr. Cohen said he encountered a number of large institutional investors that are "starting to tiptoe back into Brazil and Mexico" and other emerging markets.