

Emerging Market Debt: Improving Credit Quality

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HISTORICALLY PERCEIVED AS THE DOMAIN OF ONLY THE SPECULATIVE INVESTOR, EMERGING MARKET DEBT HAS EVOLVED TO REFLECT THE IMPROVED CREDITWORTHINESS OF DEVELOPING NATIONS, A RESULT OF GREATER FISCAL HEALTH, IMPROVED MONETARY POLICY, AND INCREASED CAPITAL MARKET DEPTH.

Despite strong inflows into emerging market debt (EMD) since 2009, many US investors currently have little or no exposure to the asset class. It is our view that investor allocations should be higher in light of the improved creditworthiness, attractive valuations and diversification potential of both sovereign and corporate emerging market debt. From a valuation perspective, current yield spreads over developed market debt do not fully reflect the favorable trends in EMD credit quality. This improved creditworthiness is the result of stronger balance sheets relative to developed market governments, greatly improved bond market depth, record foreign currency reserves and enhanced effectiveness of monetary policy. Furthermore, we believe that select emerging market currencies also have room to appreciate and present an additional potential source of alpha. Our research also shows that a relative lack of efficiency in EMD presents a compelling case for active management, and that the modest correlations between EMD and other asset classes provide the potential to enhance the risk-adjusted return of a diversified portfolio. The risk/return profile of EMD is therefore attractive and the diversification benefits substantial. As a result, EMD warrants an allocation in investor portfolios.

BACKGROUND OF EMERGING MARKET DEBT

A little more than a decade ago, a series of crises struck the emerging market world, perpetuating the notion of its acute vulnerability to external capital flows. During the late 1990s and early 2000s, investors were besieged with examples of emerging market sovereign debt defaults and currency devaluations. In 1997, the government of Thailand, after failed efforts to support its currency in the wake of heavy selling, ended the baht's peg to the US dollar. This unleashed a torrent of devalued currencies and crashing stock markets across the Asian continent, ultimately culminating with an IMF-led aid package of over \$100 billion.

Exacerbating the crises were the heavy external debt burdens and futile currency intervention efforts of emerging market countries at the time. In Southeast Asia, foreign debt-to-GNI ratios reached as high as 94% and

168% in Thailand and Indonesia, respectively, in 1998.¹ As currencies were devalued, these external debt loads would prove crippling to the region. Later that year, partly due to the fallout from the Asian crisis, the Russian government defaulted on its debt after unsuccessful attempts to defend its currency, the ruble. The resulting investor panic and outflow of speculative capital caused yields on local currency Russian bonds to rise rapidly. The financial crisis led to the collapse of the hedge fund Long-Term Capital Management, whose positions suffered immensely from the resulting contagion in the global bond markets. Additional crises saw Latin American countries issue staggering amounts of external debt in the late 1970s and early 1980s, eventually resulting in the issuance of Brady Bonds to replace the defaulted bonds of many of these nations, and Mexico's devaluation of its currency, the peso, in 1994. In all of these scenarios, investors that had been drawn in by high growth levels in emerging markets suffered significant losses, cementing EMD's reputation as an asset class with little appeal for the average US investor.

While these are but a few examples of emerging market debt crises, they serve to illustrate the perils faced by EMD investors in the past, including instances of hyperinflation, skyrocketing yields and default. The Asian, Russian, Latin American and Mexican financial crises, caused in part by high levels of debt, the withdrawal of speculative capital, currency policy which included strict pegs to the US dollar and monetary policy that exacerbated the calamities, saw EMD come to be viewed as far too perilous for all but the most risk tolerant of investors. However, emerging markets have advanced remarkably since that time, with enhancements in regulatory and capital market structure, as well as improved policy and fiscal sustainability, creating an environment for investing that has evolved greatly from the turn of the century.

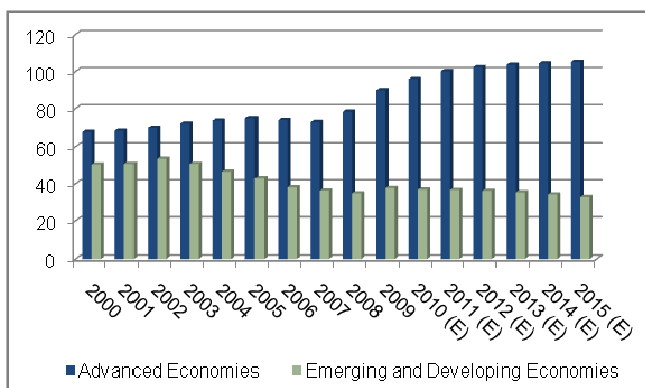
IMPROVED FISCAL HEALTH & MONETARY POLICY

As the last decade unfolded, developing nations experienced dramatic improvements in debt levels, foreign currency reserves and monetary policy that have combined to transform EMD from an almost entirely speculative asset class to one with vastly improved credit

¹Asian Development Bank

quality. Perhaps the most striking difference between the emerging market countries of the late 1990s and today is their improved fiscal health. In 2002, the gap between the general gross government debt-to-GDP ratios of developed countries and those of emerging countries was 16%, with developed nations at 70% and emerging nations at 54%.² By the end of 2010, the gap is expected to stand at 59%, with developed economies at 96% and emerging economies at 37%.² By the year 2015, the gap is projected to widen to 72%.² As a result, debt levels of emerging market nations are far more sustainable than those of developed countries, and much more manageable than they have been in the past. This has ultimately lessened both the chance of sovereign default and a sharp increase in debt financing costs from rising interest rates, both staples of past crises.

Chart 1: General Gross Government Debt as % of GDP²



Pari passu with the widening gulf in debt ratios between emerging and developed economies is the gap in terms of fiscal deficits, which will likely result in higher relative interest rates in emerging economies going forward. The IMF forecasts a fiscal deficit-to-GDP ratio of 3.7% for emerging markets in 2010 versus 8.0% for developed markets. This 4.3% difference represents a sharp increase from the 1.6% gap between the two as recently as 2007. As political pressures on developed nations to cut these fiscal deficits grow, and fiscal stimulus wanes as a result, it is likely that the central banks of these countries will keep interest rates lower for longer than they have in previous downturns in order to facilitate stronger growth. This should work to keep the gap in interest rates between developing and emerging economies wide, encouraging investors to borrow from lower-yielding countries and invest in the debt of higher-yielding countries in an attempt to earn a greater return. Thus, we should see this trend of capital flows continue as investors seek higher-yielding assets than what is available in developed fixed income markets.

²IMF

³Bloomberg, IMF

While abundant global liquidity can be a potentially destabilizing force for developing economies in times of monetary tightening, inflows of capital from abroad serve to increase their foreign currency reserves. This provides central banks with increased financial flexibility in the event of a withdrawal of liquidity. While the risk of liquidity withdrawal bears watching, it is our view that the risk of a massive flight of capital from emerging markets is lower relative to the past and is further mitigated by a high level of foreign currency reserves. Global reserves have increased to \$8.7 trillion from \$4 trillion in 2005, with \$5.5 trillion of these reserves in developing countries.³ These stockpiles allow a central bank to more nimbly defend its currency, protecting investors against extreme drops in its value and protecting exporters from sharp increases.

In addition, the sophistication and effectiveness of emerging market monetary policy has greatly improved since the crises of the late 1990s. During that period, central banks raised interest rates to prevent capital outflows, thus exacerbating investor panic. In contrast, the central banks of developing economies managed the financial crisis of 2008 with prudent monetary policy, cutting rates as the global economy weakened and as investors withdrew capital from risk assets in a massive flight to quality. In doing so, they limited the damage to their economies. As a result of their improved fiscal health, high level of foreign currency reserves and improved monetary policy, the credit quality of EMD has improved dramatically. As of 10/31/10, 58% of the market value of the Emerging Markets Bond Index Global (EMBIG) of sovereign bonds and 76% of the Corporate Emerging Markets Bond Index (CEMBI Broad) of corporate bonds was rated investment grade.⁴

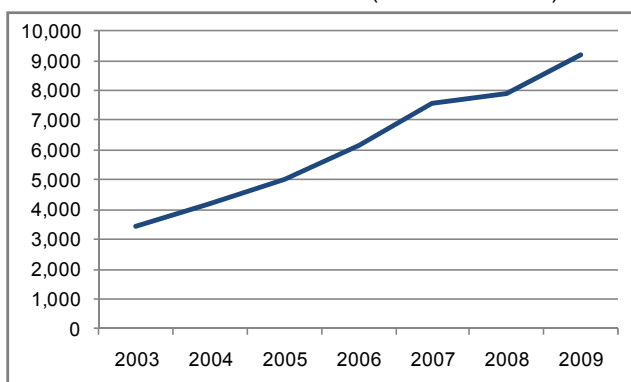
FINANCIAL INFRASTRUCTURE & MARKET DEPTH

Emerging market economies have made meaningful strides in improving the quality of their financial infrastructure and depth of their capital markets over the past 15 years. While not yet on the level of major advanced economies, these enhancements represent a significant upgrade over the past and present investors with greater transparency and more protection than ever before. Recent areas of improvement include stronger laws to protect creditors, overall improvements in legal systems, better trading platforms, clearing and settlement processes and stricter insider trading regulations. While developing nations still have room to improve their financial, legal and regulatory infrastructure, the trend is clearly towards a more advanced framework on all counts.

⁴JP Morgan Emerging Markets Bond Index Monitor

As financial and legal systems have improved over the past decade, the market for local currency EMD has grown markedly. The universe of domestic EMD stood at \$7.8 trillion in 2009, up from \$2.7 trillion in 2003, a growth rate nearly twice that of the external EMD market over the same time period.⁵ During this same interval, the overall tradable EMD universe (local currency and external debt combined) grew from \$3.5 trillion to \$9.2 trillion, with the local market comprising 85% of the universe in 2009, up from 79% in 2003.⁵ The deepening market for local currency EMD has worked to reduce issuer exposure to currency movements and therefore lessened the risk of spikes in debt service costs as well. In addition, this substantial increase in the local debt market has served to expand the EMD opportunity set available to foreign investors and improve liquidity, as secondary market local currency bond trading as a percentage of total EMD trading volume rose from 25% in 1997 to 65% in 2009.⁶

Chart 2: Tradable EMD Universe (in billions of USD)⁵



Emerging market companies are finding it easier to access the debt markets than ever before, expanding to meet increasing demand for exports as they evolve from strictly national companies into global entities. Corporate debt as a percentage of the tradable EMD universe increased from 34% in 2005 to 40% by 2009, a year in which corporate EMD debt grew by 26% overall.⁵ Moreover, liquidity has improved in the corporate EMD market, as annual corporate bond issuance grew over 600% between 2000 and 2009.⁷ A look at the five largest companies in the CEMBI Broad in Table 1 illustrates the increasingly global nature of emerging market corporations.

⁵Size and Structure of EM Debt, Bank of America Merrill Lynch, 6/24/10

⁶Emerging Markets Traders' Association (EMTA)

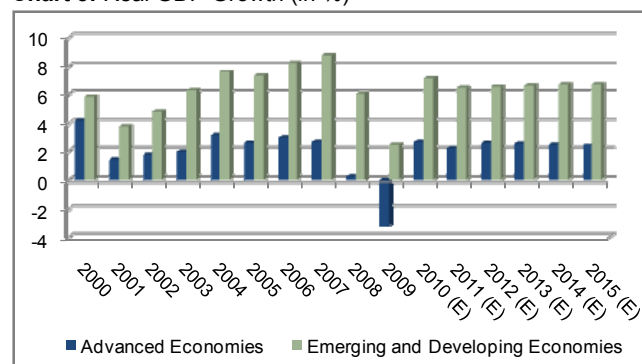
Table 1: 5 Largest Companies in the JP Morgan CEMBI⁸

Location	Company	Global Footprint
Russia	Gazprom	Supplies 30% of Europe's natural gas
Hong-Kong	Hutchison Whampoa	World's largest port operator
Brazil	Petrobras	Second largest market cap globally
Brazil	Vale	World's second largest mining company
Mexico	America Movil	Latin America's largest telecom company

GROWTH TRENDS INCREASINGLY FAVORABLE

While it is our view that the compelling nature of the EMD story lies primarily in the greatly improved credit quality of developing nations, it is impossible to ignore the robust economic growth of these countries, and resultant implications it will have for debt sustainability and creditworthiness going forward. A confluence of factors has made the picture for emerging market growth far more favorable than that of the developed world. Better demographics and a global financial crisis that more deeply affected advanced economies have combined to create conditions for more sustainable growth in developing nations than their developed counterparts. As evidenced by Chart 3, the gap in real GDP growth between emerging and developed nations, which had widened throughout the last decade, is expected to remain large well into the middle of this decade.

Chart 3: Real GDP Growth (in %)²



Aside from the global financial crisis, which impacted advanced economies more severely, emerging nations have structural advantages that should act as the impetus for higher secular growth relative to developed markets. These advantages include younger and faster growing populations with a greater potential for increased productivity, which should facilitate robust growth without stoking excessive inflation.

⁷JP Morgan

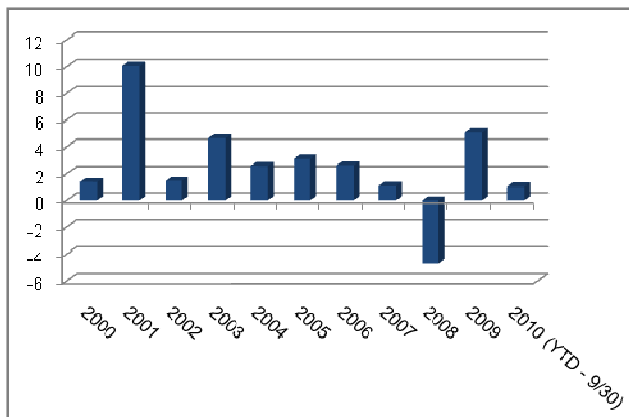
⁸Emerging Markets: Investment Opportunities in the New Normal, PIMCO, October 2010

In addition, abundant natural resources and the ability to export them should continue to act as key drivers of expansion for certain emerging market countries, specifically Latin American nations, as well as Russia. While these economies are indeed heavily reliant on energy and commodities with respect to exports, over the past decade the structure of these markets has evolved, driven in large part by the rising consumer classes in other emerging nations. For example, the emergence of India and China has created an entirely new, massive group of consumers, which should create sustainable demand for natural resources, supporting prices in the process.

THE BENEFITS OF ACTIVELY MANAGED EMD

The EMD asset class provides significant opportunity for active managers to add alpha over EMD indices, as informational asymmetry presents an advantage to managers with strong depth of research resources. As seen in Chart 4, the median manager in the EAI EMD Universe (comprised of 43 managers) consistently outperformed the JP Morgan EMBIG over the past decade, with the median manager trailing the benchmark in only 1 of the last 10 calendar years.

Chart 4: Excess Return of Median Manager in the EAI EMD Universe (in %)



Active managers in EMD have more potential sources of alpha relative to strictly domestic managers, as they can add value through country selection and currency management, in addition to the traditional avenues of duration management, yield curve positioning and sector/security selection. Traditional sovereign emerging market indices are heavily concentrated in Latin American debt, providing active managers with a meaningful opportunity to add alpha by overweighting the regions they deem more attractive at any given time. In addition, managers can express views on currencies in a number of ways, including by investing in US dollar-denominated

issues, or buying local currency debt and either hedging their currency exposure using derivatives or leaving the position unhedged. During the 2000 to 2009 period, the median manager in the EAI EMD Universe generated an average of 273 bps of alpha over the EMBIG per annum. Further, EMD offers attractive diversification benefits, as evidenced in Table 2, which displays the relatively low correlations between EM USD-denominated sovereign bonds (represented by the monthly returns of the EMBIG) vs. a number of other asset classes since 1994. Additionally, exploring the risk-adjusted monthly returns of various asset classes over the same time period in Table 3 illustrates the relative attractiveness of EMD. As a result, not only is the risk-adjusted profile of EMD attractive, but it also provides significant diversification benefits to a portfolio of other commonly held assets.

Table 2: EMD Sovereign Bond Correlations (1/94-10/10)⁹

S&P 500	BC Aggregate	ML HY Master II	MSCI EAFE	MSCI EM
0.54	0.34	0.52	0.50	0.66

Table 3: Risk-Adjusted Returns (1/94-10/10)⁹

Asset Class	Annualized Return (%)	Annualized Volatility (%)	Sharpe Ratio
BC Aggregate	6.35	3.81	0.71
JP Morgan EMBIG	10.56	14.06	0.54
ML HY Master II	7.56	9.33	0.45
S&P 500	7.70	15.72	0.33
MSCI EM	6.87	24.59	0.25
MSCI EAFE	5.13	16.75	0.17

THE RISKS OF EMERGING MARKET DEBT

Investing in EMD contains a different set of risks from developed markets and, as a result, those risks warrant extra attention from investors. For one, political uncertainty has historically been a key risk of emerging market investing. Despite advancements towards free-market oriented policies, the potential for excessive state interference in emerging economies remains. Capital constraints on foreign investors and increased state control of banking systems are two examples of issues which require particular investor attention. Secondly, regulatory and legal infrastructure in emerging economies, though improved, remains underdeveloped, with government oversight of securities markets less stringent than in advanced economies, and liquidity less abundant. Further, accounting, disclosure and covenant requirements may be less transparent, offering investors less protection. In addition, greater volatility may be caused by fluctuating capital flows into and out of

⁹Index Providers: JP Morgan, MSCI, Bank of America Merrill Lynch, S&P, Barclays Capital

emerging markets, such as in a flight to quality scenario during periods of high risk aversion.

Another source of risk is dependence on natural resources, as certain emerging nations are export-driven economies that are heavily reliant on commodities, such as copper or iron ore, and energy, including natural gas and crude oil. An adverse price movement in one or more resources, perhaps as a result of slowing global growth, could negatively impact the economic outlook in a given country. While a downturn in demand for natural resources would be a headwind for some nations, so would a rapid strengthening in EM currencies, which would raise the price of exports and have a potentially deleterious effect on economic growth. Additionally, currency exposure, if unhedged, presents another source of risk for investors, as depreciation of emerging market currencies detracts from return for unhedged foreign investors in local currency bonds. This risk is especially relevant today, as central banks are increasingly inclined to actively weaken their currencies to protect exports. Lastly, with higher growth comes the risk of higher inflation in developing nations relative to advanced economies. Higher inflation erodes the value of interest payments and can weaken currency values, negatively impacting unhedged investors in local market debt.

AN ATTRACTIVE RISK/RETURN PROFILE FOR EMD

Current yield spreads on EMD debt do not fully reflect the myriad improvements in fiscal health, capital market depth, regulatory structure and monetary policy that have greatly increased the credit quality of emerging market countries and corporations. With respect to the latter, as of 10/31/10, the average credit rating for CEMBI Broad Index of emerging market corporate debt was investment grade at Baa2 vs. A2/A3 for the Barclays US Corporate Investment Grade Index. As of 10/31/10, the EMBIG Index of emerging market sovereign debt yielded 321 bps over the Government Bond Index (GBI Global) of developed market government debt (vs. a monthly median of 505 bps since the end of 1997), while the CEMBI Broad Index yielded 190 bps over the Barclays US Corporate Investment Grade Index (vs. a monthly median of 195 bps since the end of 2001).⁴ In the past, the EMBIG has experienced spread levels that reached as high as 1,235 bps over the GBI Global in the summer of 1998, at the height of the Russian financial crisis, as well as nearly 1,000 bps again in the fall of 2001, just prior to the devaluation of the Argentinean peso.

While they have narrowed significantly, it is our belief that current spread levels do not fully reflect the improved credit quality of EMD or the ability of central banks to constrain the hyperinflation and rapid currency devaluations that plagued their economies in the past and, therefore, warrant further tightening. In addition, it is also our expectation that as the creditworthiness of EMD

continues to improve, additional credit rating upgrades will provide another source of spread tightening, as risk premiums narrow further.

Given that our view on the dollar is one of bearishness, due to quantitative easing, low interest rates, high unemployment and slow growth in the US, we currently favor local currency emerging market sovereign and corporate bonds for US investors. Despite less liquidity in the local corporate bond market relative to local sovereign debt, both of these markets are much deeper and more liquid than they were even a few years ago, and provide investors with an additional source of potential alpha in the form of currency appreciation. Emerging market central banks have managed the appreciation of their currencies, allowing them to increase at a measured pace in order to prevent a steep increase that would destabilize their export markets and potentially stunt economic growth. Therefore, it is our expectation that select emerging market currencies will continue to strengthen, though at a more deliberate pace than the volatile movements experienced in the past. In addition, as developed economies keep interest rates low and as an additional \$600 billion of quantitative easing is executed in the US over the next eight months, we do not see the backdrop of abundant global liquidity dissipating in the near term. In addition, institutional investors in the US remain significantly underweight the asset class, representing a substantial potential source of additional demand for EMD paper. As a result, capital flows into emerging markets should remain strong as investors seek higher-yielding assets.

CONCLUSION

Despite the more complex set of risks involved in EMD investing, we believe that the increased credit quality of the asset class is not fully reflected in current yield spreads, and that the potential for currency appreciation provides an additional source of alpha for investors. Therefore, we are particularly constructive on local currency sovereign and corporate bonds, which we believe present the most compelling opportunities for US investors to capitalize on the attractive valuations and increased credit quality of EMD. Such an allocation would enhance both the diversification and risk-adjusted return potential of their portfolios, while also allowing them to benefit from potential currency appreciation. We favor dedicated EMD managers, and believe that 5-7% of a total portfolio is an appropriate allocation range for clients, depending on their size and mandate.

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