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THE RISE AND RISE OF EMERGING MARKET DEBT

Introduction

Over the past two decades, we have seen much development in emerging market debt (EMD). Significant increases in issuance levels and improvements in the level of transparency mean that three components of EMD – external debt, local currency debt and corporate bonds – have now become asset classes in their own right. This demarcation into three distinct sub-groups warrants a study into what might be an optimal portfolio within this overall EMD asset class.

A Rapidly Developing Market

In the 1980s and early 1990s, the tradeable market for EMD was largely denominated in USD. Local markets began to develop in the 1990s so that, by 2003, market sizes were estimated at US \$250bn for sovereign and quasi-sovereign external debt, US \$250bn for EM local currency debt and US \$100bn for EM corporate bonds.¹

The next few years saw a major expansion of local currency debt issuance as domestic financial institutions developed. By the end of 2007, the corporate bond market had expanded to nearly US \$500bn outstanding, while sovereign and quasi-sovereign debt totaled around US \$300bn. At the same time, the local currency debt market had more than tripled to US \$900bn.¹

Despite the financial crisis of 2008, the growth of EMD markets continued. Indeed, the capital markets re-opened in 2009 and corporate issuance grew to more than two times that of sovereigns, while 2010 was a record year for eurobond issuance, reaching almost US \$300bn². By the end of 2010, market capitalization of traded bonds stood at US \$2.1 trillion³.

Inflation-linked bonds have also seen significant development, with the market now worth approximately US \$300bn³. Although we do not believe they can be seen as a standalone asset class just yet, they are nevertheless developing into an interesting addition to the opportunity set in emerging market bonds.

¹ JP Morgan, EM Debt as an Asset Class, January 2004, JP Morgan DataQuery, December 2010.

² Bond Radar, Bloomberg, December 2010.

³ JP Morgan DataQuery, December 2010.

Increasing Allocations

In addition to the growth in value of the EMD asset class, the proportion of total assets that investors are allocating to it has also been on the increase.

Overall, investors tend to allocate most heavily to local currency debt markets. Between January and October 2010, the figure was close to 60%: US \$35bn was allocated to local currency, with US \$26bn into external debt⁴. In addition to traditional EM investment managers and cross-over investors, two new investor types – foreign exchange (FX) overlay funds and EM bond ETFs totaling around US \$4-5bn in size – have helped drive demand for EM bonds. (Figures 1 & 2)

No Signs of a Slowdown

Despite these massive inflows, we are not seeing signs that emerging markets are in a bubble. First, fundamentals are positive: more sustainable debt dynamics and stronger institutions support the view that the EMD asset class is not as vulnerable as it used to be. (Figure 3)

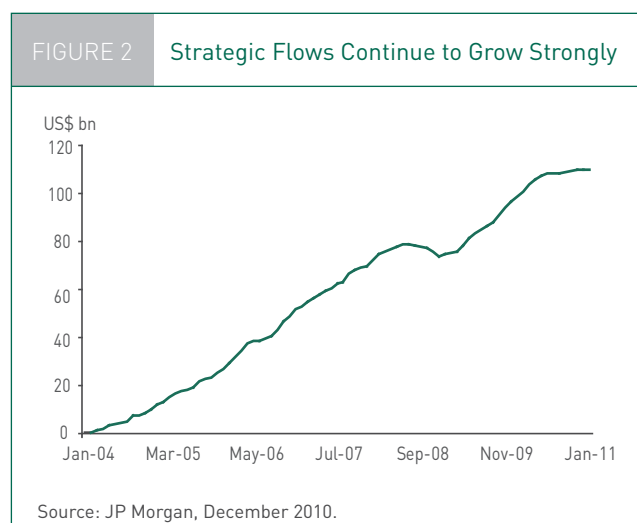
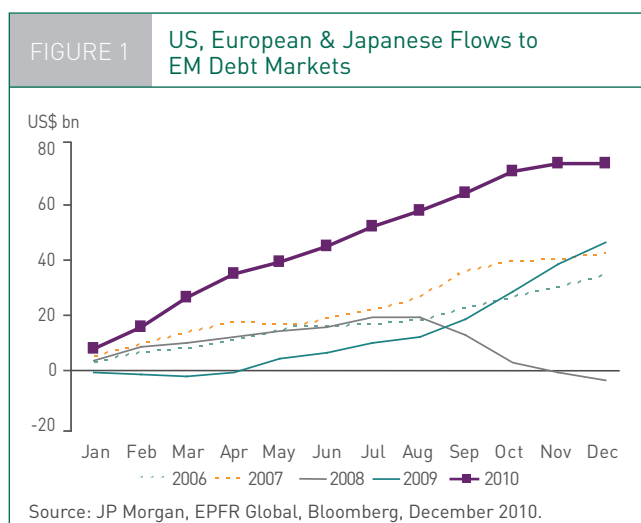
Secondly, the participation of foreign investors in the local debt of these markets is modest. On average, foreign investors own about 25% of local market cap, ranging from around 30% in Indonesia, the Philippines, Mexico and EMEA, to 10% or less in the remaining EM countries. This is despite a substantial recovery in the markets from the lows of the 2008 financial crisis, when it dropped to the low teens. (Figure 4)

Thirdly, banking sector indicators reveal solid numbers, consistent with the pace of the recent recovery. Private credit growth is at, or below, 10% year on year in the majority of EM countries and, with the exception of some Baltic and CIS countries, non-performing loans are typically below 5%.⁵ Though we have already seen positive growth in EMD, these are strong signs that the asset class still has plenty of room to expand before we see any sign of a slowdown. So long as policy mistakes can be avoided, either at the central bank or government level, i.e., inflation is kept under control and the fiscal outlook is positive, we believe there is no reason to be concerned.

Solid Fundamentals

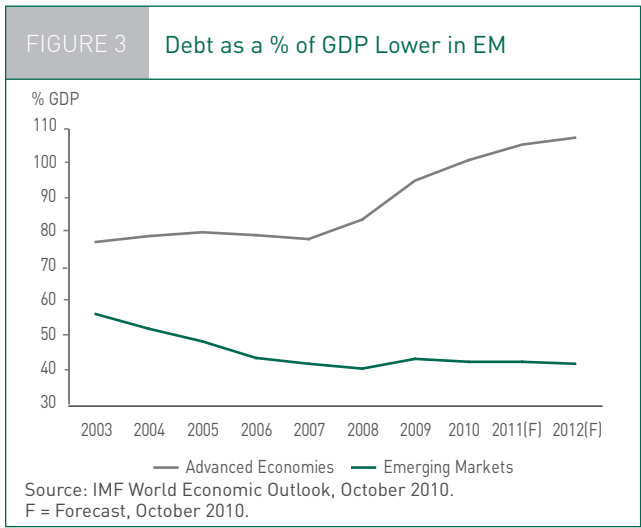
With unemployment rates very low, credit expansion strong and the commodity cycle benefiting the commodity producing economies, EMD is expected to fare far better than any other asset class. The resilience of domestic consumption against the uncertainties of the external markets, in addition to the record level of investment that is expected in the markets, should help push GDP growth to pre-2008 crisis levels. (Figure 5)

With favorable demographics, a stable and growing consumer market will demand a greater variety and sophistication of products, from basic food to financial services. Therefore, the urbanization and development of cities are expected to be the priority for these governments. As a result, projects focusing on basic infrastructure, transportation and construction will likely dominate the pipeline of around US \$6 trillion of projects



⁴ JP Morgan, EM Moves into the Mainstream as an Asset Class, 23 November 2010.

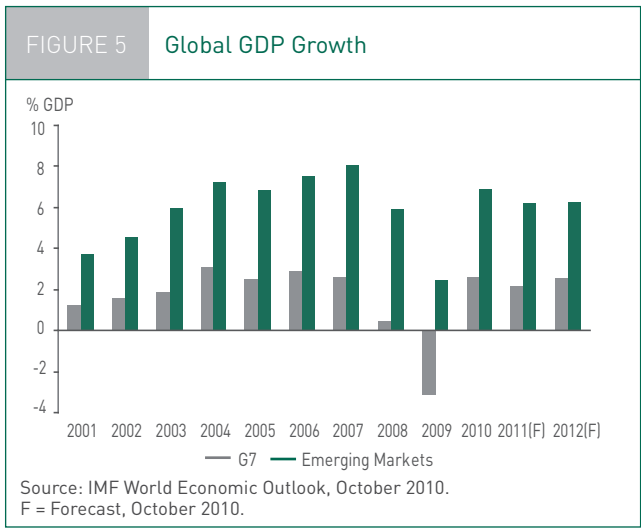
⁵ Bank of America Merrill Lynch, September 2010.



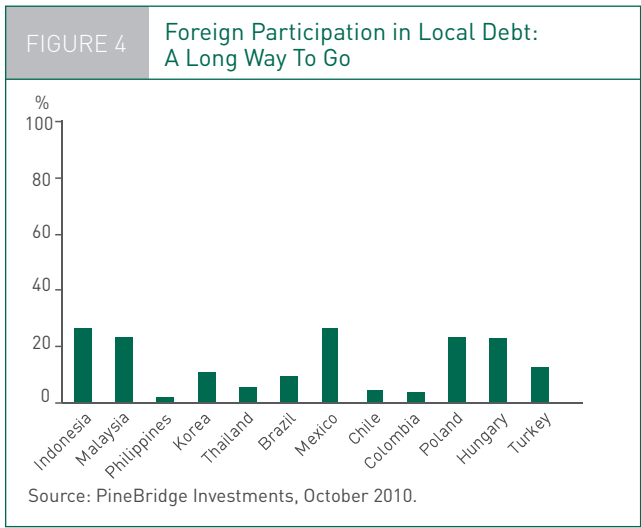
and investments expected to be pumped into EM over the next three years.⁶ (Figure 6)

With sound and sustainable growth, EM should continue to attract flows from international investors in search of more attractive returns. Foreign direct investment inflows have been more than adequate to cover current account deficits and should remain robust as growth prospects are positive for EM. Portfolio inflows into local currency debt markets are likely to continue unabated, as higher yields in EM attract investors seeking higher returns in the relatively low interest rates environment of the developed world.

As this wall of money floods into EM, several of these countries' monetary authorities are imposing barriers to prevent their currencies from fast and abrupt short-term



⁶ Bank of America Merrill Lynch September 2010, please note estimates may vary.



appreciation. This could potentially jeopardize external accounts, given the strong domestic demand and import growth. Although daily US dollar purchases in the FX markets, or the implementation of taxes on dollar inflows, may have some impact, they are unlikely to be sufficient to stem the appreciation of these currencies against the USD in the longer term. The reason being that fundamentals and long-term flows are factors that ultimately determine the fair value of the currencies.

Strong growth in EM is pushing commodity prices higher in the international markets, which is expected to exert strong pressure on domestic prices globally. Central banks will therefore have to maintain a vigilant stance in order to avoid the secondary effects of rising food and oil prices. (Figure 7)

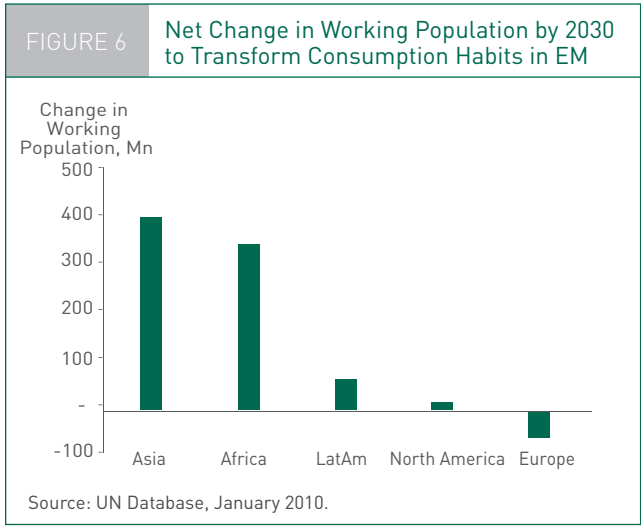
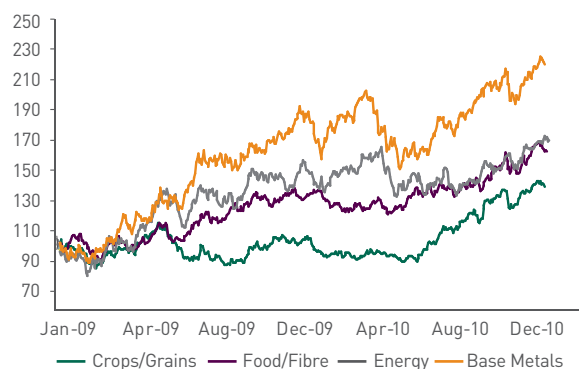


FIGURE 7 Food Prices On the Increase



Source: Bloomberg, January 2011.

FIGURE 8 Real Effective Exchange Rates



Source: BIS, November 2010.

Countries with solid central bank credibility and no fiscal slippage will outperform the most in local markets. The theme for 2011 so far has been inflation and the fear that higher commodity prices in the international markets, coupled with strong domestic growth in EM, would trigger a supply shock in food prices.

Can local markets perform well in an environment of higher inflation and interest rates? We believe that they can, particularly if rates in the developed world remain subdued and liquidity in emerging markets is abundant. We expect investors looking for higher returns with strong fundamentals to continue to participate in the EMD markets.

Additionally, as local yield curves have been pricing in excessive fears of rising inflation, attractive yields will lure investors to receive higher returns in countries with strong fundamentals.

Finally, debt dynamics remain very positive in EM, as strong growth generates higher budget revenues. Flows and fundamentals will drive EM currencies stronger in the medium to long term which, in conjunction with tighter monetary policy, will anchor inflation expectations going forward and support sustainable long-term growth.

(Figure 8)

An Optimal Portfolio

The three main asset classes within EMD each have their own strengths. Whilst exact allocations naturally depend on each investor's preferences and constraints, our fundamental and quantitative analysis shows that a relatively heavy allocation to local currency debt and corporate bonds will likely provide the best mix going forward.

The table below shows a breakdown of sizes and yields within the EMD asset class⁷.

	EM External Bonds	EM Local Currency	EM Corporate Bonds
Market cap US \$bn	404	1,433	344
Yield	5.97	6.69	5.94
	EMBI GD	GBI-EM Global Div	CEMBI Broad Div
Annualised monthly mean return	11.5	13.5	8.7
Annualised volatility	9.5	11.6	9.2
Correlations (historic)	1.00	0.79	0.93
		1.00	0.70
			1.00

⁷ Market capitalization calculated using EMBI Global, GBI-EM Broad and CEMBI Broad. Yields are historical, returns/volatilities are for the benchmarks.

Date Range for Indices: 31 December 2002 - 31 December 2010.

Sources: JP Morgan, Bloomberg, PineBridge Investments, 31 December 2010.

The following calculations are based on our in-house view of possible economic scenarios and the likely performance of various asset classes.

A standard mean-variance framework is used to plot the opportunity set using historic/expected returns and volatilities. We believe it is most useful to analyze this on a forward-looking basis. Our expectations for the three classes are as follows:

12-18 Month Time Horizon Returns %

Scenario	Probability	EM	EM	EM
		External Bonds	Local Currency	Corporate Bonds
Double Dip	10%	5	11	3.5
Muddle Through	85%	9	13.5	11
Fast Growth	5%	-3	-4	3.5
		8.0	12.4	9.9

5 Year Time Horizon Returns %

Scenario	Probability	EM	EM	EM	EM
		External Bonds	Local Currency	Corporate Bonds	Equities
Gradual Recovery	100%	5.5	7	6.5	20
Volatility		5.5	8	7	20

One clear conclusion is that we expect higher returns in the near term. We see the main downside risk as a fast G3 recovery, although we believe this to be an unlikely scenario due to the large, and still unresolved, structural issues these nations are facing. We also forecast correlations to remain high, though we expect them to ease slightly from the crisis/post-crisis levels.

Based on these assumptions, **Figure 9** shows a portfolio heavily weighted to EM local currency bonds and EM equities, which should provide the best Sharpe Ratio. However, this means taking a significant equity position, together with a large FX exposure. Without equities, the opportunity set would be smaller and provide somewhat lower returns, as shown in **Figure 10**. However, we still expect returns to be much higher than those available in other fixed income classes.

One theme common to both approaches is that a significant allocation to both local currency and corporate bonds shows the best risk-adjusted returns. Such allocations are consistent with the fundamental view of solid and sustainable growth in EM.

FIGURE 9 Optimal EM Asset Allocation - 5 Year Outlook

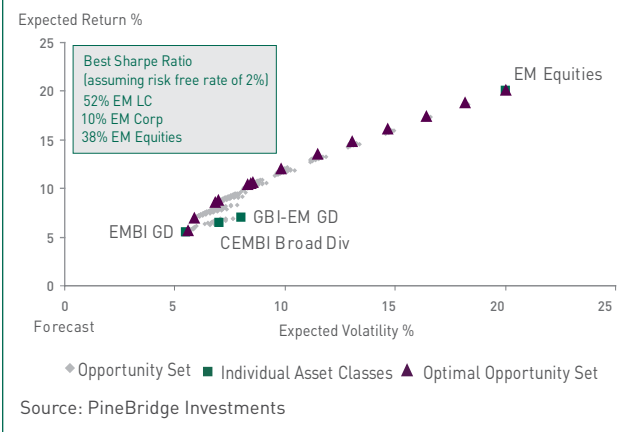
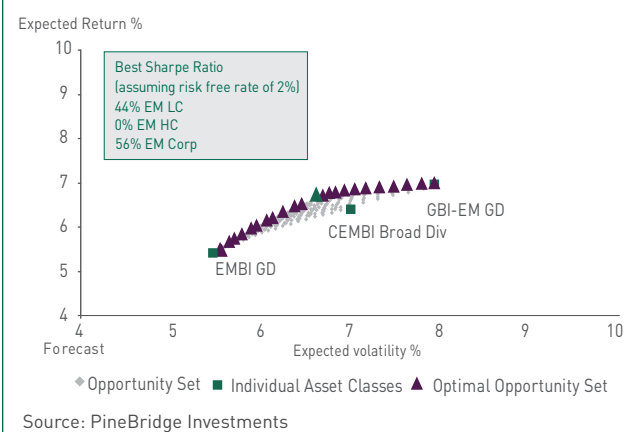


FIGURE 10 Optimal EM Asset Allocation - 5 Year Outlook



Conclusion

Overall, the investment case for EM remains compelling. As we have indicated in our analysis, we believe the case is particularly strong when looking at allocations to local currency debt and corporate bonds as the best way to capture alpha in this market.

All the signs point towards another bright year for emerging markets. The fundamental outlook for EM remains very positive, with strong growth driven by both consumption and investment. We believe there will continue to be a gradual recovery of the global economy, with all three main EMD asset classes performing well both in the near and longer-term ■

BIOGRAPHIES



Rajeev Mittal
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Mr. Mittal joined the firm in 1992 and is Head of Emerging Markets Fixed Income and International Fixed Income. He is responsible for all aspects of portfolio management, research and trading of emerging market strategies in hard and local currencies and credit default swaps. In March 2009, he took on the responsibility of International Fixed Income, including Global Sovereign strategies and various country specific strategies focused in Asia. Prior to his current position at PineBridge Investments, his responsibilities included portfolio management of single currency US Dollar, Sterling, and Irish Punt portfolios, as well as global bond portfolios. Mr. Mittal is a member of the Fixed Income Asset Allocation Team and also represents fixed income in the Global Asset Allocation Committee meetings. He received a BSc (Hons) in Mathematics and Statistics from the University of Bradford.



Dmitri Savin, CFA
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Mr. Savin joined the firm in 2000 and is a Senior Analyst for the Emerging Markets Fixed Income Team where he focuses on sovereigns in the EMEA region. He is also responsible for development of various quantitative strategies and applications of technical analysis. Mr. Savin was previously Head of Research with Fleming UCB in Moscow providing equity coverage on Russian companies as well as macroeconomic research and equity strategy. Prior to that, he worked in Equity Research for Deutsche Morgan Grenfell and was Head of Operations with United City Bank. Mr. Savin received a BSc with honors in Mathematics from Moscow State University and an MBA from Indiana University. He holds the Investment Management Certificate (IMC) and is a CFA charterholder. Mr. Savin is an Associate of the CFA Institute, The CFA Society of the UK and is a member of the Society of Technical Analysts.



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Ms. Tezine joined the firm in 2005 as a Senior Analyst for Latin America. She is responsible for the coverage of Latin American sovereign credits and market analysis. In 2008 she became Head of Research for the Emerging Markets team. Prior to joining PineBridge Investments, she was a Senior Analyst at ABN Amro Bank Brazil and also Dresdner Bank Lateinamerika. Ms Tezine began her investment career in 1993 at Unibanco. She received a degree in Economics from the University of Sao Paulo and an MSc in Economics from the Universitat Pompeu Fabra, Barcelona.

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