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Emerging Markets Bonds

Developing economies around the world, known to investors as emerging markets (EM), are rapidly maturing into drivers of growth in the global economy and financial markets. As a result of this ongoing, secular transformation, emerging markets bonds have evolved from a high-yielding niche asset class into a fully integrated sector of the global bond markets that offers attractive total return potential. In the coming years, the emerging markets sector may also present fixed income investors with the opportunity for diversification away from developed economies that are likely to face continued fiscal challenges.

Investment Basics

What are the emerging markets?

The emerging markets comprise countries whose economies are considered to be developing – or emerging from underdevelopment – and usually include most or all of Africa, Eastern Europe, Latin America, Russia, the Middle East and Asia, excluding Japan. Some are heavily dependent on commodity exports while others have extensive service and manufacturing sectors.

The emerging markets evolution

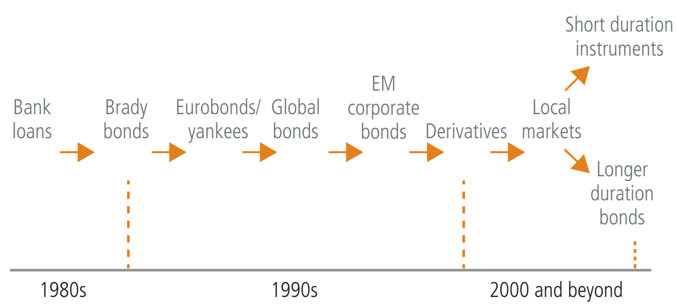
Until the 1990s, emerging markets were a fairly limited fixed income asset class consisting primarily of government bonds issued in major currencies such as the U.S. dollar. Over time, the EM asset class has developed and matured to include a wide variety of government and corporate bonds, issued in local currency (often referred to as "emerging local markets bonds") and major external currencies, as well as a deep array of derivative instruments.

Today's diverse EM asset class is the result of fundamental changes in many emerging markets countries. Many EM countries now run disciplined fiscal and monetary policies, rejecting the unorthodox policies of the past that caused many investors concern about the potential for inflation, currency devaluation or bond defaults. These policies have produced a steady increase in the credit quality of EM bond issuers, with many now rated investment grade.

In another important structural change, most EM countries have shifted from policies in which the value of the local currency was fixed relative to the U.S. dollar to policies that allow the value of the local currency to change (or "float") relative to the U.S. dollar. In 1996, more than 70% of developing countries pegged their currency to the U.S. dollar or ran fully dollarized economies. Now, most EM countries allow their currencies to float with little or no management.

A floating currency provides a natural shock absorber that may allow EM countries to better cope with periods of volatility in the global financial system. For example, weaker growth in a country will typically lead to a decline in the domestic currency, which in turn makes that country's exports cheaper for foreign buyers and stimulates growth. The fixed currency regimes of the past provided no way to adjust to shocks and restore competitiveness, aside from tax hikes or other difficult fiscal measures likely to exacerbate already weak growth.

Figure 1: Emerging markets fixed income: An expanding opportunity set



Source: PIMCO

The combination of rising credit quality and fundamental improvements in emerging markets countries has attracted new investors to the asset class, creating new borrowing options for EM governments and corporations. As the EM asset class has evolved, the opportunity set for fixed income investors seeking emerging markets exposure has steadily expanded, as illustrated below. The ongoing expansion of local currency bond markets has been a natural step in this evolutionary process. Also, we believe bonds from emerging markets companies, in particular, stand to benefit from these long-term trends in the years ahead as their prices may begin to reflect the improved growth prospects and credit quality of the emerging markets.

Local currency bonds: The latest step in the EM evolution

The emerging markets maturation process is driving the expansion of the local currency bond markets from both a supply perspective and a demand perspective.

On the supply side, emerging markets governments began issuing bonds in local currency in an effort to eliminate areas of vulnerability in their economies. Issuing debt in foreign currencies leaves EM countries more dependent on foreign investors and vulnerable to a mismatch between revenues denominated in the local currency and debt denominated in a foreign currency. To reduce these vulnerabilities, EM governments are steadily paying off external debt and issuing new debt in local currency. While governments paved the way for local currency bond markets by issuing different types of bonds with various maturities, in recent years, many corporations have become very active issuers as well.

From a demand perspective, global bond investors have generally become more comfortable with the EM asset class and began moving into local currency bonds several years ago in search of higher yields. In addition, domestic demand for local currency bonds has grown; as part of the ongoing maturation process, many EM countries have implemented pension reforms, which have increased demand among local pensions for local markets bonds as a hedge against long-term liabilities.

Why invest in emerging markets fixed income?

Investors have traditionally bought emerging markets bonds (both external and local currency instruments) for several reasons.

- **Attractive yields.** On a risk-adjusted basis, emerging markets bonds may offer higher yields than comparable bonds from more developed countries.
- **Price increases.** Improving credit quality and an inflow of new investors into the EM sector over the long term raises the potential for bond price increases, which can lead to capital gains.
- **Diversification.** Within the emerging markets asset class, the diversity by region and by security should help manage volatility because the various regions and countries do not all tend to rise and fall at the same time. It might also provide active investors with a variety of ways to express their views in terms of which

regions, countries, currencies and bonds of various maturities are likely to outperform based on economic forecasts and credit analysis.

- **Potential for lower portfolio volatility.** Historically, the returns on emerging markets debt have shown lower correlations with those of many traditional asset classes.
- **Currency appreciation.** Investing in emerging local markets bonds has offered both additional diversification and potential currency appreciation as those economies matured.

In recent years, the potential benefits of emerging markets bonds have become even more compelling. As many developed economies face lower growth prospects, several emerging markets countries – including Brazil, China, India and Russia – are expected to drive more growth in the global economy in the coming years, creating the potential for attractive returns on their bonds. In addition, emerging markets bonds may offer diversification away from developed economies that are struggling with heavy debt loads and lower revenues following the financial crisis in 2008. In this environment, emerging local markets bonds may be especially attractive for investors because emerging markets currencies could appreciate relative to major currencies such as the U.S. dollar.

Prices on many emerging markets sovereign bonds have risen over the past few years to reflect their improved credit quality and declining risk relative to developed markets bonds. In the years ahead, local currency bonds, as well as emerging markets sovereign and corporate bonds denominated in U.S. dollars, may continue to benefit from these secular trends.

Assessing risk and maximizing potential returns in EM

One of the primary risks in emerging markets bonds is a pullback in investors' risk appetites, which can cause bond prices to fall and yield spreads to rise. Historically, many investors have reduced their exposure to perceived risky assets, including emerging markets and developing local markets bonds, during significant economic slowdowns in the developed economies, which are major markets for the goods produced in emerging economies.

In addition, although it may be convenient to lump emerging markets debt together into a single broad category, it is far from a homogeneous asset class. Individual markets may have dramatically different growth prospects and risk factors. In the short run, that means one emerging country's or region's bonds may be performing poorly, while another's may be doing relatively well.

To limit exposure to the risks and maximize potential returns in emerging markets, investors should take into account the external environment, or macroeconomic factors; the fundamentals in individual emerging countries, including economic, political and financial factors; and technical factors that can influence the market, such as debt supply, liquidity and leverage, changes in the investor base, and fund flows.

Conclusion

As the emerging markets bond sector expands, with many emerging economies continuing to grow quickly and credit quality generally improving, more investors may be attracted to the asset class. The benefits of emerging markets bonds include the potential for attractive yields, capital gains, currency appreciation and portfolio diversification. Given the growing number of securities and the broad range of countries that make up the EM asset class, investors need to analyze risk and potential returns to identify the most attractive opportunities. Already, prices on many emerging markets sovereign bonds have risen to reflect the improving economic prospects and higher credit quality in certain developing countries; the EM corporate sector may follow this long-term repricing trend in the coming years. In addition, potentially attractive investment opportunities continue to expand in emerging local currency bonds.

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