EMERGING MARKETS DEBT

Coming of Age

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A CHALLENGING OUTLOOK in the developed markets, alongside positive prospects in the emerging markets, seems likely to provide a constructive backdrop for emerging market debt. The Federal Reserve’s determination to keep rates low for an “extended period” and the quantitative easing program in effect until June suggest that 2010’s backup in yields was more an anomaly than a trend. Yearend data from the U.S., indicating stubbornly high unemployment and unprecedentedly low inflation, further support our view.

The reallocation of capital away from developed bond markets into emerging market debt also reflects investors’ search for countries with strong fiscal discipline, attractive yields and diversification of their interest rate and currency exposure. The current fiscal dynamics in the U.S., Europe and Japan look increasingly unsustainable. In light of the fiscal crisis that has been spreading throughout the eurozone, investors will likely focus more intently on countries’ fiscal policies as a discriminating factor between various bond markets. This focus reflects the progress EM debt has made over the past decade as the emerging nations have significantly cut back their borrowing and reduced their reliance on foreign lenders to fund it. While most
emerging nations have debt to GDP\(^1\) ratios ranging between 45% and 55%, for rich nations this statistic is typically between 65% and 90%. Exhibit 1 illustrates the diverging fiscal dynamics between the developed markets and emerging nations.

**Pressure Cooker**

The surging capital inflow into emerging economies is putting upward pressures on emerging currencies. A number of countries have resisted these pressures by accumulating reserves through foreign exchange interventions. This strategy has raised inflation worries—growing FX reserves make it harder for central banks to contain credit creation in their domestic economies. This transmission mechanism is forcing many central banks in emerging nations either to let their currencies appreciate or prevent investment from flowing in by enforcing stricter control of the capital account. While capital control measures can appear appealing on a short-term basis, we believe that many countries understand the medium-term risks in such policies. As a result, we expect emerging market currencies to be allowed to appreciate further in 2011.

We believe that this trend will be particularly strong in Asia due to the region’s traditional U.S. dollar link. In contrast to the Asian crisis of the 1990s, monetary authorities in the region have allowed their currencies to recover swiftly from distressed valuations after the recent credit crisis. While that adds a hurdle for exports in a challenging global environment, the primary objective of preventing excessive credit creation prevailed.

Furthermore, the fact that Chinese authorities have allowed the renminbi to appreciate again should facilitate a broader appreciation of Asian currencies. The government’s announcement last June 19 that it would allow the renminbi to start fluctuating again reinforces the case for other regional currencies to appreciate. The 2005 to 2008 experience, when China

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\(^1\) A debt to GDP ratio is a measure of a country’s federal debt in relation to its gross domestic product (GDP).
first allowed its currency to appreciate gradually relative to the U.S. dollar, is instructive. Exhibit 2 shows that the correlation between the renminbi and other major emerging Asian currencies was significantly positive, with regional currencies appreciating markedly, given their greater flexibility versus the renminbi. It is also noteworthy that over the last five years Asian currencies have depreciated significantly relative to the renminbi. The Korean won has fallen by 26% relative to the currency, the Indian rupee by over 20% and the Indonesian rupiah by close to 11%. That leaves significant appreciation potential for the broader basket of Asian currencies in an environment where the renminbi may well resume its upward tendency.

Factors to Watch and Risks to Our View

Inflation risks will likely be an ongoing theme within both developed and emerging markets. Partially as a result of quantitative easing from developed markets, we expect commodity prices to rise further in 2011, which should push food and energy prices higher. The price hikes should benefit net exporters of commodities, such as Venezuela and the Middle East. On the other hand, many emerging countries are further along in their recoveries, output gaps are closing and increases in their food and energy costs could push their core inflation higher as well. At the same time, countries with large output gaps, such as South Africa and Colombia, should not have to increase interest rates or normalize monetary policy to the same degree as those, like Indonesia or Brazil, operating closer to capacity.

Inflation aside, another risk that we will be monitoring closely is the fiscal situation in the eurozone and its impact on the mood across global markets. While the vast majority of emerging market countries do not have the fiscal deficit issues of their developed market peers, risk aversion in the face of more unwelcome news from peripheral Europe may pose risks to weaker balance sheets and parts of eastern Europe. This fiscal vulnerability could pose a risk, but may also present an opportunity throughout 2011 from which investments in countries with strong balance sheet positions could benefit. Since emerging Europe fiscal positions have been improving, despite the eurozone’s difficulties, a rotational strategy could gain from exploiting unwarranted upward yield movements.

A Rising Tide

Emerging market debt has developed into a mature asset class since the recent financial crisis, as emerging market nations demonstrated their ability to maintain fiscal responsibility while promoting both economic growth and price stability (Exhibit 3). We expect emerging market countries to drive global growth throughout 2011. Credit ratings for all three...
sub-sectors—local currency debt, corporate debt and external debt—are today, on average, investment grade and we anticipate further upgrades in 2011. Combined with ongoing strong growth, an improving fiscal balance and a spread over developed market bonds, emerging market debt presents an appealing investment proposition. In this environment, we expect global rebalancing to continue to drive capital flows toward emerging markets.

The leading risks to our 2011 outlook stem from the developed world, not the emerging nations themselves. The U.S. economy, while improving, remains dangerously close to deflationary territory and still struggles to create jobs. Peripheral European debt continues to unsettle the markets and will continue to do so periodically throughout 2011, especially during the first half of the year.

Rising inflationary pressures in emerging markets are also a focus going into 2011. We note, however, that policy normalization to curb inflation concerns has been well underway for many emerging countries. We would consequently view an inflationary scare as providing an attractive entry point for long-term investors looking to increase their allocation to the asset class.
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Investments in emerging markets can be more volatile. The normal risks of investing in foreign countries are heightened when investing in emerging markets. In addition, the small size of securities markets and the low trading volume may lead to a lack of liquidity, which leads to increased volatility. Also, emerging markets may not provide adequate legal protection for private or foreign investment or private property.

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