

## Emerging Markets Corporate Bonds: Seizing Opportunities in the 21st Century

### Executive Summary

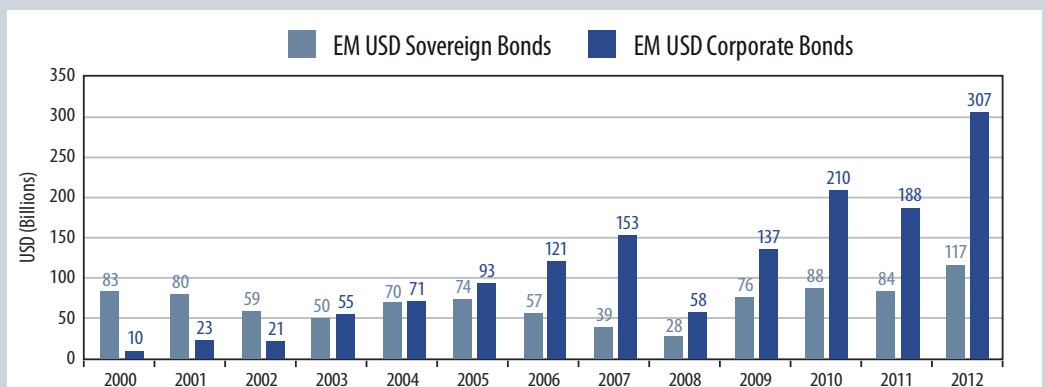
A significant reduction in sovereign risk in many EM countries has allowed a deep, robust and liquid local government debt market to develop. Accordingly, many of these countries have increasingly financed themselves in their own currencies rather than in US dollars. Therefore, the external hard-currency (USD) borrowing space has opened dramatically for EM corporate issuers. This paper addresses the following themes driving our investment thesis for EM corporate bonds:

- EM corporate bonds allow investors to tap into the next stage of EM economic growth and development by investing in the debt of corporations that appear best positioned to take advantage of positive secular trends.
- EM corporate bonds present a unique credit alternative to bridge the gap between existing developed economy investment-grade and high-yield corporate credit products.
- The EM corporate bond asset class is expected to become a popular “emerging mandate” within global fixed-income investor portfolios. There is strong potential for new and increasing allocations among sophisticated investors as the market grows and liquidity continues to improve.

Due to a number of positive economic and political factors, a significant reduction in sovereign risk in many emerging market (EM) countries over the last 15 years has allowed a deep, robust and liquid local government debt market to develop. Thanks to years of increasingly transparent monetary policy coupled with fiscal discipline, many of these countries have increasingly financed themselves in their own currencies rather than in US dollars, the historical norm. This has been an extremely important development because as a result, the external hard-currency (USD-denominated) borrowing space, which was once dominated by sovereign debtors, has opened dramatically for EM corporate issuers. In fact, in 2003, EM hard-currency-denominated corporate issuance outpaced that of sovereign issuance for the first time. This has remained the case every year since (see Exhibit 1). Moreover, and as defined by the benchmark corporate and sovereign bond indices, EM USD-denominated corporate bond stock surpassed EM USD-denominated sovereign bond stock in both par amount and market capitalization for the first time in history. For the foreseeable future, we expect that EM corporate bonds will increasingly dominate the market for USD-denominated EM debt as the go-to option for global bond investors seeking to capitalize on the positive long-term secular investment story offered by EM countries.

### Exhibit 1 EM Corporate Issuance vs. Sovereign Issuance

*EM corporate bond primary issuance is now more than double the level of sovereign issuance.*



*Source: JPMorgan. As of 31 Dec 12. EM USD Sovereign Bonds represented by JPMorgan EMBI Global Index. EM USD Corporate Bonds represented by JPMorgan CEMBI Broad Index*

The investment implication of the aforementioned developments in EM countries is that the recent history of improvement in credit fundamentals for EM issuers—both governments and corporates—offers a compelling counterpoint to the deterioration in government balance sheets in many developed markets. With income valued at a premium by many global investors, investments in EM corporate bonds can offer high levels of current income with prospects for total return enhancement through spread compression as the market continues to evolve and improve.

The remainder of this paper addresses the following positive long-term themes driving our investment thesis for EM corporate bonds, as well as our investment approach for the asset class:

- EM corporate bonds allow investors to tap into the next stage of EM economic growth and development by investing in the debt of corporations that appear best positioned to take advantage of positive secular trends.
- EM corporate bonds present a unique credit alternative to bridge the gap between existing developed economy investment-grade and high-yield corporate credit product. This is the case because there is virtually no overlap among the issuers in the indices that define the respective asset classes. Thus, traditional developed economy credit investors have little to no direct exposure to this important and growing asset class.
- The EM corporate bond asset class is expected to become a popular “emerging mandate” within global fixed-income portfolios. There is strong potential for new and increasing allocations among sophisticated investors as the market grows and liquidity continues to improve.

### EM Corporate Bonds Allow Investors to Tap into the Growth Potential of Emerging Markets

New investment opportunities in EM corporate bonds are evolving rapidly with recent and continuing GDP growth in emerging markets. Real GDP growth in the emerging world has outpaced growth in the advanced world every year since 1990, and has grown three times as fast since 2000. The gap in living standards, while still wide, is narrowing. Nominal EM GDP now comprises close to 40% of the world's total, up from 20% only a decade ago. It now significantly exceeds the 25% share held by the United States (US). Moreover, EM countries also hold over 60% of the world's foreign exchange reserves (in US dollar terms), which reflects a shift in global purchasing power away from US and European consumers at the margin, and toward EM corporations and consumers<sup>1</sup>.

Many EM countries are expected to continue empowering the corporate/private sector as the engine of future economic growth. Companies in these countries are encouraged to expand their businesses, hire workers and thus increasingly bolster government revenue streams via a growing and deepening tax base. What's more, industries and entire economic structures should continue to change and develop. Economies that had once been more traditionally focused on supply-side activity that encouraged rapid industrialization by developing the oil and gas, basic materials, and metals and mining sectors, will continue to evolve by further developing industries such as telecommunications, banking, homebuilding and water and electrical utilities needed to avoid bottlenecks and provide for millions of new city dwellers.

Exhibit 2 presents an overview of the investable universe for EM corporate bonds as represented by the JPMorgan Corporate Emerging Market Bond Index Broad. The EM corporate bond universe includes large concentrations in issuers from both export-driven and the aforementioned essential industries. Moreover, issuers from strong investment-grade-rated countries such as Brazil, Mexico and Russia, as well as from many important Asian countries, comprise a significant portion of the overall investable universe. Reflective of the solid sovereign credit quality of these countries, the credit quality of the corporate index is also strong, as illustrated by the 3:1 split between investment- and non-investment-grade rated issues within the index.

<sup>1</sup>Moody's and Western Asset calculations

**Exhibit 2**  
**JPMorgan Corporate Emerging Markets Bond Index Broad**  
*Overview of the investable universe for EM corporate bonds.*

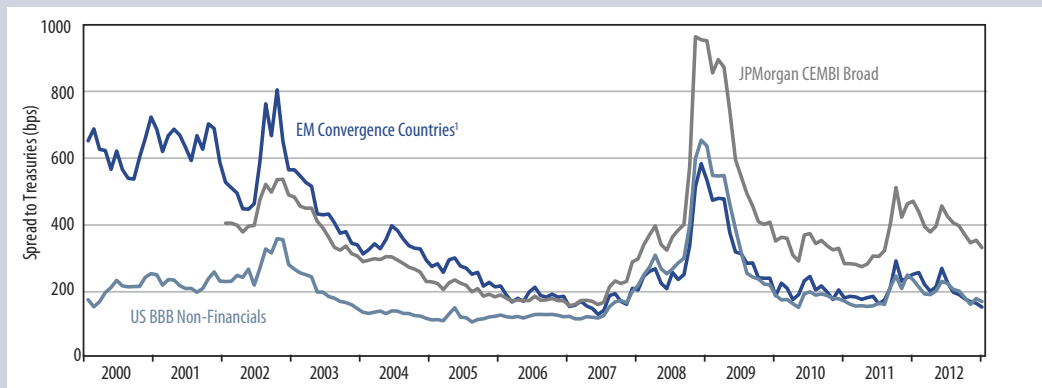
Characteristics	JPM CEMBI Broad	Sector Breakdown	JPM CEMBI Broad
Number of Issues	824	Financial	32.9%
Market Value	\$620 Bn	Oil & Gas	17.4%
YTM	4.71	TMT	9.9%
Duration	5.66	Metals & Mining	9.2%
Credit Profile	JPM CEMBI Broad	Utilities	6.8%
Investment Grade	73.65%	Real Estate	5.9%
Non-Investment Grade	22.63%	Diversified	5.6%
NR	3.72%	Consumer	5.3%
Top 5 Country	JPM CEMBI Broad	Industrial	4.2%
Brazil	21.8%	Pulp & Paper	1.3%
Russia	14.4%	Infrastructure	0.8%
Hong Kong	8.1%	Transport	0.7%
China	7.9%		
Mexico	7.8%		
Regional Breakdown	JPM CEMBI Broad		
Latin America	36.9%		
EMEA	28.6%		
Asia	34.4%		

Source: JPMorgan. As of 31 Dec 12

**EM Corporate Bonds Present a Unique Credit Alternative**

In conjunction with the robust EM corporate bond issuance of the last half decade, the spread convergence of investment-grade-rated EM sovereign bonds (the benchmark of 20th century EM fixed-income investors) to generic US investment-grade-rated nonfinancial credits has eliminated most of the total return potential due to spread tightening from the bulk of that asset class. Meanwhile, EM corporate bonds in many of the same countries still offer considerable spread pick-up (Exhibit 3). Further, as Exhibit 4 illustrates, EM corporate bonds across the rating spectrum have offered significant spread pick-up with less exposure to rising interest rates due to their lower duration—specifically relative to either EM hard currency-denominated sovereign bonds or developed world alternatives.

**Exhibit 3**  
**EM Convergence Countries vs. US BBB Non-Financial Corporates**  
*EM sovereign spread convergence has run its course.*

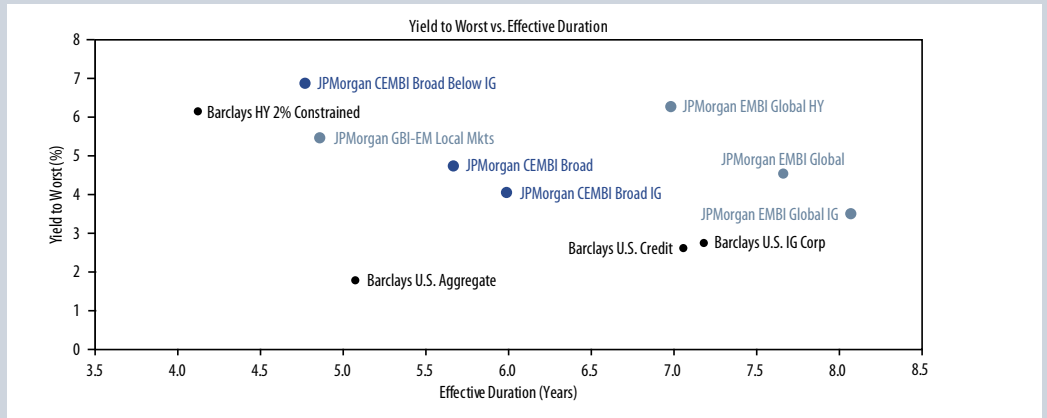


Source: JPMorgan, Western Asset. As of 31 Dec 12

<sup>1</sup>Convergence countries spread defined as the average of EMBI+ subcomponents Brazil, Colombia, Mexico, Panama, Peru, Indonesia, Philippines, Russia, Turkey and South Africa

**Exhibit 4**  
Yield to Worst vs. Effective Duration

*EM corporate credit offers an attractive risk/reward profile.*



Source: JPMorgan, Barclays Capital. As of 31 Dec 12

**Yield-to-Worst** is the yield generated assuming a bond is redeemed by the issuer on the least desirable date for the investor. Yield-to-Worst for the asset class is calculated as the weighted average yield to worst of the individual constituent bonds.

**Effective Duration** provides a measure of sensitivity of a bond's price to changes in interest rates and recognizes that changes in interest rates may also change expected cash flows generated by bonds with embedded options. Effective duration for an index is calculated as the weighted average of the effective durations of its individual bond constituents.

Given the sharp moves in US Treasury (UST) rates in recent years, duration differences among fixed-income spread sectors have had a pronounced impact on relative spread sector performance. As illustrated in Exhibit 5, EM USD-denominated sovereign bonds have historically exhibited greater sensitivity to movements in interest rates than have EM corporate bonds due to their longer duration. Sharp declines in UST yields during the 2008 and 2011 crisis years propelled EM USD-denominated sovereigns to superior performance. However, EM USD-denominated sovereigns lagged significantly when 10-year UST yields rose 163 basis points (bps) to 3.84% in 2009. Rates remain near historically low levels and leave USD-denominated sovereigns vulnerable to any measured increase in UST yields.

Over the past few years, EM corporate issuers took advantage of low absolute yields to refinance older, more expensive debt, term out shorter-tenor debt, execute expansionary business plans and expand balance sheets

**Exhibit 5**  
Return Decomposition of EM USD Corporate and EM USD Sovereign Bonds, 2008-2011

	2008	2009	2010	2011	2008-2011
<b>CEMBI Broad Index Total Return</b>	<b>-16.81%</b>	<b>37.49%</b>	<b>12.46%</b>	<b>2.96%</b>	<b>7.27%</b>
Treasury Return	13.12%	-4.72%	4.56%	10.48%	5.64%
Credit Return	-26.47%	44.29%	7.56%	-6.81%	1.55%
<b>EMBI Global Index Total Return</b>	<b>-10.91%</b>	<b>28.18%</b>	<b>12.04%</b>	<b>8.46%</b>	<b>8.48%</b>
Treasury Return	18.01%	-8.37%	6.71%	13.49%	6.72%
Credit Return	-24.51%	39.88%	4.99%	-4.43%	1.64%

Source: JPMorgan, WisdomTree, Western Asset Management 2012

while also improving financial flexibility. We expect heavy issuance from the EM bank and finance sector to continue as EM banks extend credit to small and medium enterprises (SMEs) and individuals through an ongoing process of financial intermediation bolstered by economic growth and stability. Industrial borrowers also accessed the international capital markets extensively over the past couple of years to refinance existing debt and for ongoing capital expenditure. Issuance was particularly strong in the commodity sectors as deep global demand for commodities encouraged issuers to build out operations to meet incremental demand. We expect robust issuance in this space to continue over the long term as hard-currency issuance is seen as a good financial “hedge” for EM-based global commodity producers.

Heavy EM corporate issuance over the past couple of years has been met with strong investor demand as higher relative spreads, improving fundamentals and ever-improving liquidity attracted a global investor base. Higher spreads relative to similarly rated developed-country issues attracted traditional EM investors expanding their former sovereign-dominated mandates. It also attracted nontraditional participants—mainly global investment-grade buyers—as some EM corporate issuance met the requirements for inclusion in both JPMorgan’s family of EM corporate bond benchmarks and the Barclays Aggregate and related family of indices. The broad reach of these global bond indices has allowed larger issuance sizes along multiple tranches from EM debtors. During 2012, the typical benchmark size issue for EM corporates was USD 500 million to USD 1.0 billion, well within the range of developed-economy benchmark-sized issues. Finally, with volume and tradable issuance size, liquidity across the EM corporate credit sector has improved dramatically.

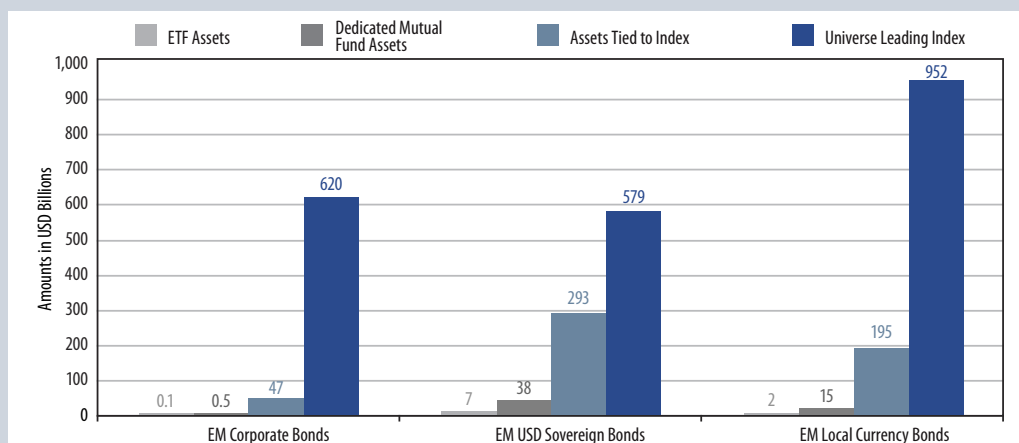
### **EM Corporate Bonds Expected to Become a Popular “Emerging Mandate”**

While adoption of the asset class has grown in recent years, EM corporate bonds remain underinvested relative to other EM and developed market fixed-income sectors, despite the relatively large size of the market. Exhibit 6 profiles the sponsorship of the three sectors of EMD.

Dedicated exposures to EM corporates are still in their infancy among fund structures. While JPMorgan reported a 60% increase in assets tied to its CEMBI family of indices over calendar 2012, the level of assets is still only at US\$47.5 billion, less than 8% of the EM corporate bond investable universe. Similar numbers for local currency debt are slightly higher at 20% of the investable universe, while figures for EM USD sovereign debt approximate 51% of the investable universe.

Given the attractive attributes of the asset class, we believe there is significant potential for increased sponsorship of the asset class in the coming years.

**Exhibit 6**  
Investor Sponsorship of Emerging Markets Debt Sectors



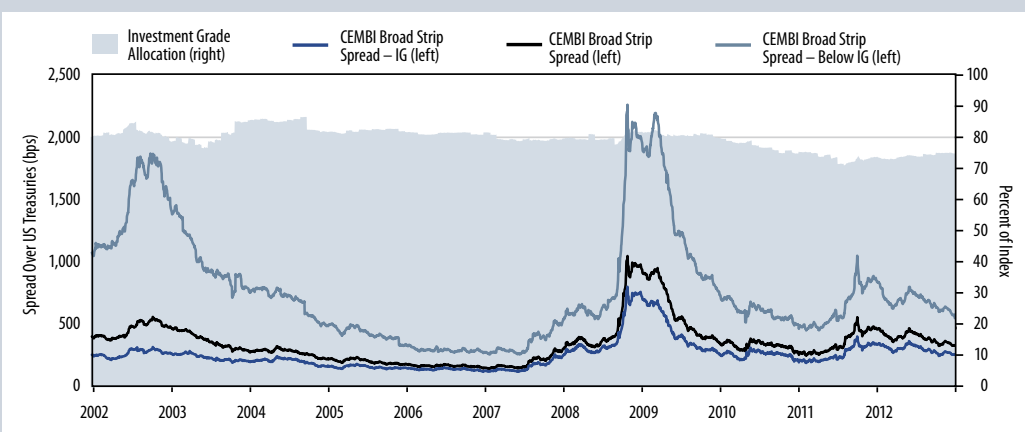
Source: JPMorgan. As of 31 Dec 12. EM Corporate Bonds, EM USD Sovereign Bonds and EM Local Currency Bonds are represented by the JPMorgan CEMBI Broad, JPMorgan Emerging Markets Bond Index Global, JPMorgan Government Bond Index-Emerging Markets Global Diversified, respectively.

**Robust New Issuance Growth Offers Increasing Numbers of Opportunities for Active Global Bond Managers**

Following 2010's new high watermark for EM corporate bond issuance, 2011 issuance dipped a bit and the 2012 calendar year was a very strong year for EM hard-currency corporate issuance. Approximately US \$188 billion of new issues priced during 2011 with US \$307 billion pricing during 2012 (Exhibit 1). Following the trend of previous years, approximately 63% of the 2011 issuance and 72% of the 2012 issuance was rated investment-grade, but the window for strong EM issuers rated below-investment-grade was also very robust during both years. Although many EM issuers (both sovereign and corporate) will likely continue their migration up the ratings spectrum, we expect future issuance in the EM corporate debt space to include an increasing number of below-investment-grade rated issuers (Exhibit 7). Finally, the geographic breakdown of issuance was relatively uniform in recent years. Latin American issuers dominated the primary market in the late 1990s and early 2000s, but no longer dominate the league tables. For example, in recent years, Latin American issuers accounted for 33% of the primary market, while Eastern Europe, the Mid-East and Africa (EEMEA) accounted for 41% and Asian issuers accounted for 26%. We expect a well-diversified regional issuance pattern to continue over the coming years.

**Exhibit 7**  
JPMorgan CEMBI Broad Spread and Investment Grade Allocation

As the EM corporate credit market grows, index credit quality should become more balanced.



Source: JPMorgan. As of 31 Dec 12

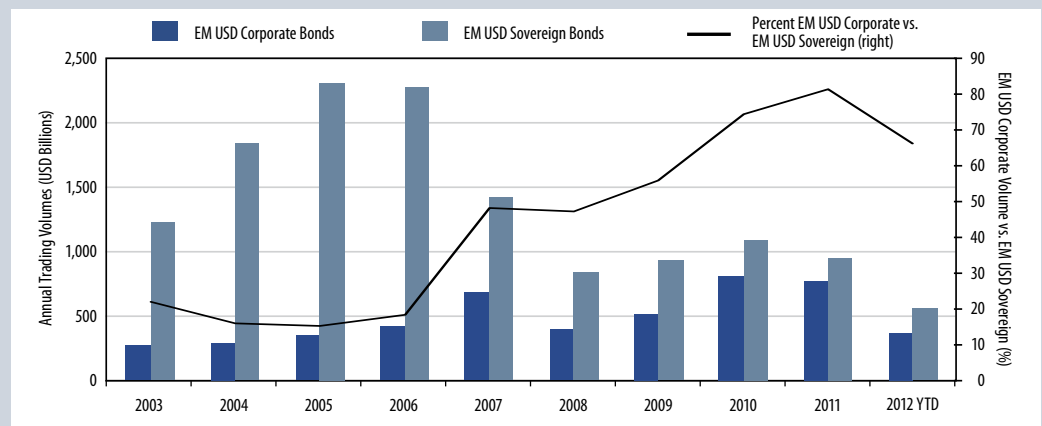
### Trading Volume and Liquidity Have Continued to Improve

Investor interest in the EM corporate credit sector continues to grow and many investors are surprised to find the market characterized by a vibrant and increasingly liquid secondary market. According to the Emerging Market Traders Association (EMTA), a trade forum for EM investors and dealers, trading in EM corporate debt set a new high watermark in calendar year 2010 on a USD basis and has generally continued at a robust pace ever since.

Secondary market volumes are expanding at a faster pace than at any time since the global credit crisis, and staffing on both broker-dealers' and investment managers' EM desks has mirrored the growth and global acceptance of this asset class. With record-setting secondary market trading turnover of more than US \$800 billion (Exhibit 8), corporate debt continued to constitute an increasingly higher percentage of the overall secondary market trading volume for all EM external debt.

In 2005, EM corporate debt volumes accounted for less than 15% of total EM external debt volumes. Several years later, corporate volumes are nearly 50% of total volumes, and we expect these trading volumes to surpass USD-denominated sovereign trading volumes in the near future (Exhibit 8). As EM sovereign balance sheets continue to improve and as domestic capital markets deepen, USD-denominated sovereign issuance will continue to be replaced by local-currency-denominated issuance. In addition, the corporate market will see more first-time issuers and higher total issuance.

**Exhibit 8**  
Ratio of EM USD Corporate to EM USD Sovereign Volumes



Source: EMTA, Western Asset. As of 30 Jun 12. EM USD Corporate Bonds represented by JPMorgan CEMBI Broad Index, EM USD Sovereign Bonds represented by JPMorgan EMBI Global Index.

### Western Asset's Investment Approach and Capabilities

Given EM corporations' increasing global presence and EM governments' increasing economic and political responsibility, "transfer risk" (or the risk of a government impeding the ability of an otherwise creditworthy private sector borrower from paying its debt) has naturally plummeted in recent years. Over the same period of time the overall level of country risk in many EM countries has fallen dramatically. The implication for investors is that the analysis of idiosyncratic, or pure credit risk, is increasing in importance, with the overall investment process shifting toward the bottom-up from the more historically skewed top-down. An assessment of variables such as managerial competence, reliability of supply chains, volatility of cash flow, and other firm-specific variables is increasingly overshadowing more macro-level variables such as GDP growth, political accountability and other factors.

As fixed income investors at Western Asset, we do not necessarily focus on the “earnings” upside, but rather on the downside risks; in other words, does a company have the ability to generate sufficient operating cash flow to consistently make coupon and principal payments? In this regard, we believe in focusing on industries such as oil and gas, metals and mining, and telecommunications that are essential to ongoing industrialization and urbanization in the emerging world. These are the corporations that issue bonds to expand capacity and unclog bottlenecks in the ongoing growth process currently transforming the world.

We believe EM corporate bond prices will be increasingly determined by firm-specific (as opposed to country-specific) factors as general EM sovereign risk trends down. While the investment process begins with an assessment of the global economy and country-specific risks, the bottom-up issue selection process receives more than equal attention.

Western Asset will continue to leverage its comparative advantage in credit analysis by applying it to a much larger universe that now includes EM corporate bonds. While the US still has the world’s largest corporate bond market, this may not last much longer; both outstanding market capitalization and trading volumes are growing much faster in the emerging world.

Western Asset’s EMD effort can best be described as a “boutique with the benefits and leverage of a global firm.” The EMD Team headquartered in the Firm’s Pasadena office has a large team of credit analysts in every industry, located in local markets around the globe. The Team coordinates analysis with a focus on identifying undervalued industries, companies and securities relative to their long-run fundamental value. The focus on value has been the backbone of Western Asset’s corporate credit investment process since the Firm’s inception, and it has delivered strong results in dedicated EM corporate mandates. As an innovator in EMD asset management, the EM corporate credit effort at Western Asset is one of the longest running in the industry. The Firm began investing in EM corporate credit in 2001 and began managing a dedicated EM corporate credit mandate in 2008. The Firm is a member of the JPM CEMBI Index Advisory Committee. The Firm is also the sub-advisor to the first-ever actively managed EMD Corporate Credit exchange-traded fund (ticker: EMCB). Western Asset’s thorough understanding of the EMD universe gives it the unique ability to provide customized solutions that seek to meet client objectives.

*Note: Western Asset has published whitepapers on the topic of EM corporate bonds since 2008. Specifically “Emerging Market Corporate Bonds: Leading the Charge” was published in April 2008. This whitepaper is an update to the whitepaper published in February 2012.*

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