



Emerging Market Debt: Think Local, Trade Global

Executive Summary

- Emerging-market debt has outperformed most major asset classes on a risk-adjusted basis over the past 15 years, due primarily to favorable secular and demographic trends.
- Emerging-market debt performance over the recent crisis shows the extent to which the asset class has been positively shaped by structural change.
- The maturation of emerging market local currency debt and external corporate credit markets offers attractive opportunities versus more traditional benchmarks (such as the JPMorgan EMBI+).
- Emerging-market debt's weak correlation with developed world bond markets provides an opportunity for enhanced returns and reduced risk through diversification.

Emerging-market debt has outperformed many major asset classes on a risk-adjusted basis over the past 15 years (Exhibit 1). As illustrated by the historical Sharpe Ratios in Exhibit 1, hard currency sovereign debt (represented by the Emerging Markets Bond Index Global, or EMBI Global, and the Emerging Markets Bond Index Plus, or EMBI+), hard currency corporate debt (represented by the Corporate Emerging Markets Bond Index Broad, or CEMBI Broad) and local market debt (represented by the GBI-EM Global Diversified) all look favorable relative to the performance of high-yield debt, stocks (represented by the S&P 500) and US Treasuries. This has been due to several important factors, most notably fiscal and monetary reforms, and favorable secular and demographic trends. Although emerging-market debt is generally viewed as higher risk within much of the global fixed-income industry, the performance of the asset class over the full course of the most recent global credit crisis shows the extent to which structural change has shaped these markets in a positive way. We believe that emerging market debt's weak correlation with developed world bond markets offers investors a prime opportunity to enhance returns and reduce risk through diversification.

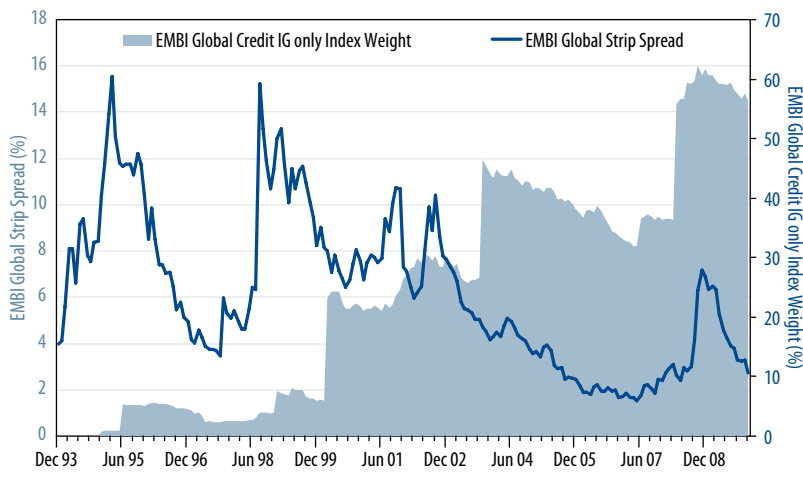
Exhibit 1
Total Return Analysis (%)

	EMBI Global	EMBI+	CEMBI Broad	GBI-EM Global Diversified	JPMorgan High Yield	S&P 500	JP Morgan US Treasury
1994	-18.35	-18.93	-	-	-1.55	1.32	-2.90
1995	26.38	26.78	-	-	19.52	37.58	17.34
1996	35.23	39.30	-	-	13.01	22.96	2.94
1997	11.95	13.02	-	-	12.39	33.36	10.00
1998	-11.54	-14.35	-	-	0.97	28.58	10.25
1999	24.18	25.97	-	-	3.13	21.02	-2.88
2000	14.41	15.66	-	-	-5.92	-8.13	13.93
2001	1.36	-0.79	-	-	5.48	-12.81	6.55
2002	13.11	14.24	11.06	-	2.17	-22.10	12.21
2003	25.66	28.82	15.67	16.92	27.90	28.68	2.44
2004	11.73	11.77	10.26	22.97	11.55	10.88	3.75
2005	10.73	11.86	6.35	6.27	3.07	4.91	2.94
2006	9.88	10.49	6.51	15.22	11.45	15.79	3.09
2007	6.28	6.45	3.93	18.10	2.88	5.49	9.20
2008	-10.91	-9.70	-16.81	-5.22	-26.83	-37.00	14.26
2009	28.18	25.95	37.49	21.98	58.90	26.46	-3.77
YTD 2010*	1.79	1.47	2.56	1.38	1.63	-0.61	2.02
Cumulative Return	374.93	400.34	95.59	143.69	214.40	221.41	160.04
Annualized Return	10.12	10.47	8.56	13.23	7.34	7.49	6.09
Annualized Volatility	14.30	15.04	9.84	11.56	8.86	15.47	4.91
Sharpe Ratio	0.41	0.41	0.57	0.88	0.35	0.21	0.40

Source: JPMorgan

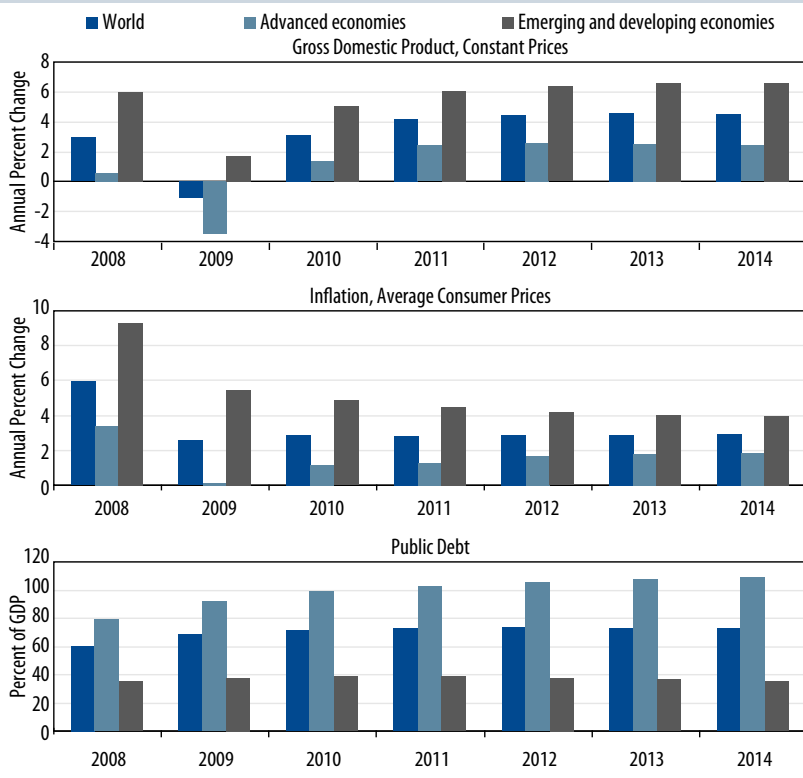
*YTD is through Feb 2010

Exhibit 2
JPMorgan EMBI Global Historical Rating and Spread



Source: JPMorgan

Exhibit 3
Select Economic Indicators: Emerging versus Advanced Economies



Source: International Monetary Fund. As of Oct 2009

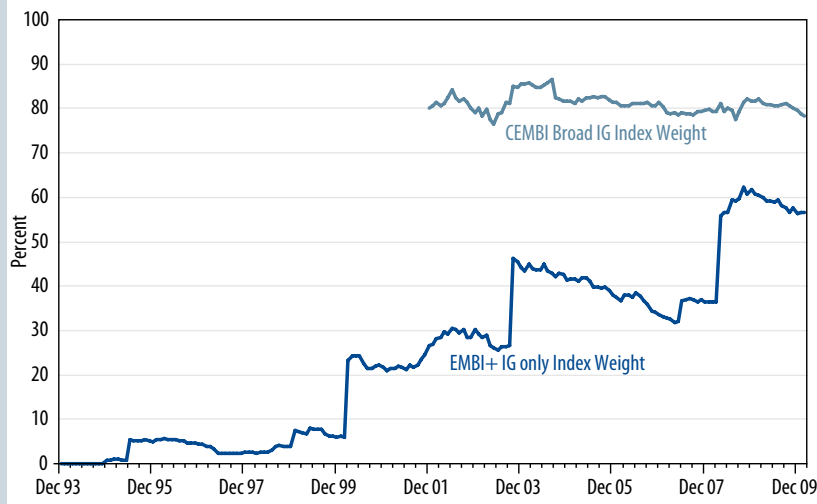
Emerging-market sovereign credit ratings have continued to be incredibly resilient both before and after the recent credit crisis, and numerous emerging-market sovereign ratings have been upgraded over the last few years, many to investment-grade (Exhibit 2). This contrasts sharply with advanced countries which are now being threatened with sovereign credit ratings downgrades due to persistent fiscal deficits, slower economic growth and growing debt stocks. A common theme backing the upgrades in emerging markets has been impressive crisis management via prudent fiscal and monetary responses. This policy flexibility, especially during the most recent credit crisis, was a direct product of increasing levels of central bank independence. The combination of more flexible exchange rate regimes and the growth of local debt markets as another important source of financing has helped to buoy reserve levels, improve the currency composition of government debt and stabilize emerging market currencies. Robust economic growth bolstered by real economic reform has made the emerging world significantly less vulnerable to external shocks than in past cycles (Exhibit 3).

Three Distinct Emerging-Market Subsectors

A market once characterized by sovereign hard currency issuance has evolved into one composed of three distinct investable subsectors, each with its own unique and important attributes. Today, the sovereign external bond market is complemented by its two larger counterparts: local currency denominated sovereign debt, (tracked by benchmarks such as the GBI-EM Global Diversified), and US dollar denominated debt issued by companies and tracked by benchmarks such as the CEMBI Broad. The local currency sovereign market is approximately three times the size of the hard currency external

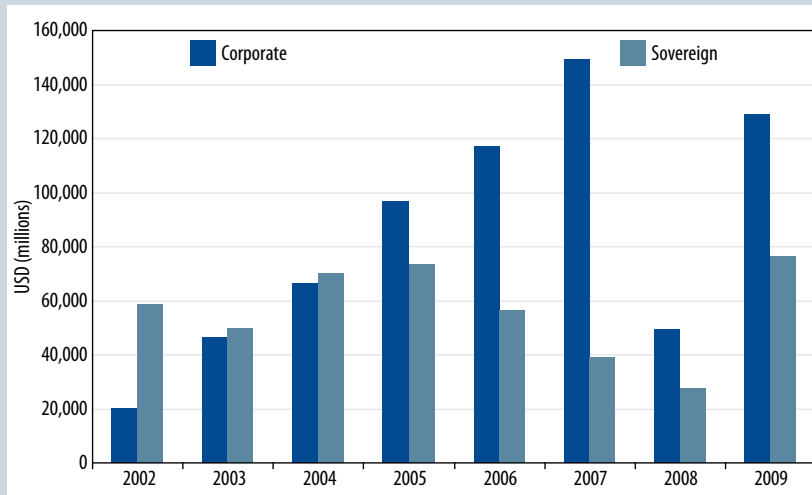
sovereign market and, within the hard currency external market, emerging-market corporate debt represents more than 50% of the market. It is worth noting that the CEMBI Broad is of even higher quality than its sovereign counterpart, the EMBI+. Approximately 80% of the CEMBI Broad is rated investment grade, compared to approximately 55% of the EMBI+ (Exhibit 4).

Exhibit 4
EMBI+ and CEMBI Broad Investment-Grade Percentage



Source: JPMorgan

Exhibit 5
Emerging Market US Dollar Denominated Issuance



Source: JPMorgan

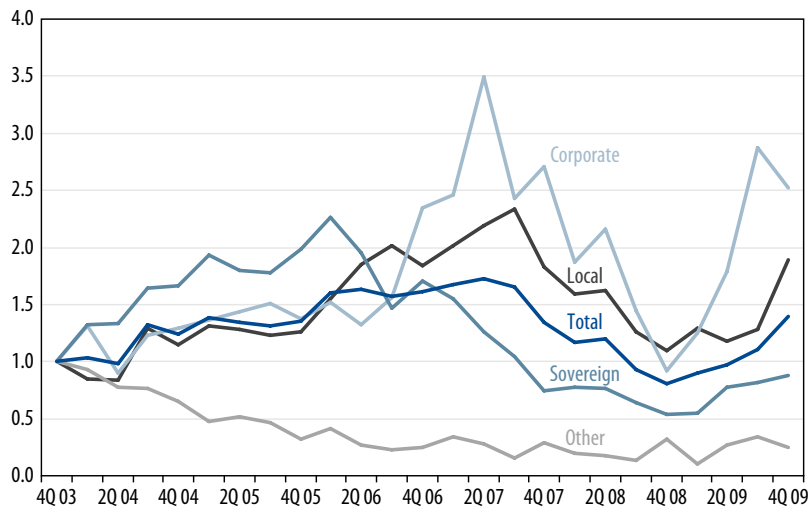
Taking exposure to emerging local markets allows an investor to benefit from a secular reduction in emerging market local interest rates relative to developed country rates as well as via potential nominal currency appreciation. Although we currently favor exposure to external over local markets due to expected near-term cyclical volatility in global currency markets, we are bullish about the long-term prospects for local markets' exposure (both rates and currency). Our view is motivated by the relative gains in productivity that contribute to strong economic growth in the emerging markets, along with increased central bank credibility via declining inflation expectations. Therefore, we believe in the likelihood of a long-term structural appreciation of many emerging market currencies compared to the US dollar and other hard currencies.

Stability at the sovereign level has paved the way for corporate issuers to begin to access external capital markets (Exhibit 5). These issuers have business models uniquely tailored to enable success in developing markets, and stand poised to take advantage of the future growth opportunities that economic development will naturally provide. The JPMorgan CEMBI family of indices reflects these trends and is dominated by industrial companies, metals and mining companies, energy companies, and banks. The above factors, combined with lower levels of net external debt issuance from sovereign entities and continued compression (improvement) in sovereign credit ratings, lead us to view a sector rotation strategy utilizing active allocations to

local market sovereign debt and hard currency corporate debt as offering a unique opportunity to enhance returns in broad emerging markets strategies, while also offering lower levels of risk.

Nevertheless, and despite higher average credit quality, valuations on corporate issues remain cheaper, on average, than similarly rated sovereign bonds. While wider spreads are partly attributable to incremental credit risk (corporates in almost all instances trade at a discount to sovereigns), other factors include liquidity conditions, lack of coverage by credit analysts and a general lack of familiarity with the asset class. As trading volumes grow, liquidity improves and credit analysts increase their coverage of the companies that comprise the subsector, we believe that this subsector of the emerging markets asset class should continue to offer

Exhibit 6
EM Bond Trading Volume Index*



Source: JPMorgan, Western Asset
* Fourth quarter 2003 equals 100

compelling value relative to developed market corporate and emerging market sovereign issuers (Exhibit 6).

Conclusion

Emerging market debt has outperformed many major asset classes on a risk-adjusted basis over the past 15 years (Exhibit 1). This has been due to several important factors, most notably fiscal and monetary reforms, and favorable secular and demographic trends. Although emerging market debt is generally viewed as higher risk within much of the global fixed-income industry, the performance of the asset class over the full course of the most recent global credit crisis shows the extent to which structural change has shaped these markets in a positive way. We believe that emerging market debt's weak correlation with developed world bond

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