CHIA-LIANG LIAN
Co-Head of Investment Management, Asia (ex-Japan)/
Co-Head of Emerging Markets Debt

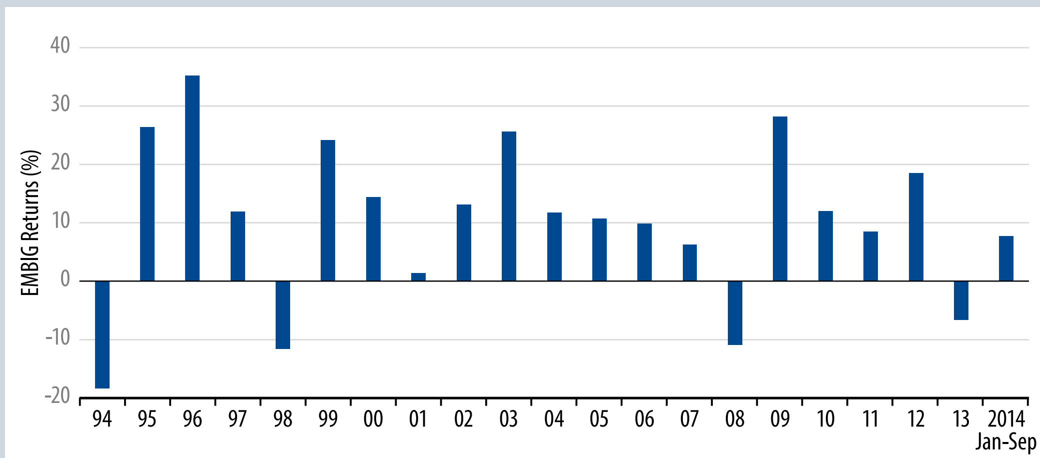

# Rethinking Emerging Markets


## Executive Summary

- The heterogeneity of EM debt is a feature and not a flaw of the asset class, as it creates a dynamic set of opportunities over different market cycles.
- Despite EM's improved credit quality and rising influence on global growth, it is still subject to fear-selling spurred by broad market and country-specific concerns alike.
- Investing in the asset class therefore requires differentiation of long-term credit stories and management of transitory shifts in risk sentiment.
- Post-Fed taper periods of market dislocation may present attractive opportunities to long-term investors seeking exposure to high-quality EM countries.


Following a wobbly start to the year, emerging market (EM) external sovereign debt has rebounded markedly to outperform most major asset classes. Total return—as measured by the JPMorgan Emerging Market Bond Index Global (EMBIG)—is up approximately 8% for the year through September 26, reversing last year's weakness induced by the Federal Reserve's (Fed's) stated intent to trim bond purchases. Notably, EM debt pared 6.1% during the April–June period of 2013. This was the worst quarterly drawdown for the asset class since the Russian default 15 years ago, and matched a similar drop in the fourth quarter of 2008. That said, and as tumultuous as the market tone has been in more recent trading sessions, the retrenchment of 6.6% for the whole of 2013 represented only the fourth decline since the Index's inception 20 years ago (Exhibit 1).

Exhibit 1
Emerging Markets External Sovereign Debt




*Source: Bloomberg. As of 26 Sep 14*

## Secular Changes to the Asset Class

Importantly, any historical analysis of EMBIG returns ought to be considered alongside profound changes to index constituents over the past two decades. There have been at least three distinct shifts in the underlying characteristics of the asset class of note: regional composition, country choice and credit quality.

By geography, EM countries are distinctly more global than they used to be. In 1993, the EMBIG market was narrowly concentrated in Latin America, which accounted for 83% of total capitalization. While still retaining its dominance, the region's current share has more than halved to 41%. All other regions—Africa, Asia, Europe and the Middle East—have witnessed increases in market share. One implication of this change for managing EM, as we at Western Asset have witnessed, is the growing need for a "boots on the ground" perspective to be successful.

Even more strikingly, the number of countries has risen over four-fold since the EMBIG's inception, from 14 countries two decades ago to 62 presently. Importantly, there has recently been a sharp rise in the inclusion of the so-called frontier nations. There are now 30 such countries that have tapped the international bond market for funding, which comprise around one-tenth of the market value of the EMBIG.

Finally, despite a slew of inaugural and lower-rated issuers, the credit quality of the asset class has improved dramatically. The average rating of the EMBIG migrated to investment-grade for the first time in October 2008, and has remained there ever since. Investment-grade countries now constitute a whopping 72% of market capitalization, a far cry from a paltry 1.7% when the Index was incepted.

## High Quality, Yet High Beta

Indeed, the familiar narrative of improving creditworthiness in EM countries—external surpluses, fiscal prudence and monetary discipline does not need elaboration—neither does their rising influence on global growth. Annual GDP growth in EM outpaced that in developed markets (DM) in all but two of the last 20 years, a trend that has turned up the heat on the alphabet soup of EM acronyms. The recent unfolding of structural cracks in DM economies is reinforcing a broader conviction of an EM-DM convergence in credit standing going into future years, as reflected by sovereign credit rating trajectories since the late 1990s (Exhibit 2). By extension, the catch-up phase of EM should present crossover opportunities for investors seeking to reflect the future realities of the global economy, particularly as more EM countries become eligible for inclusion in the broader global bond indices.

Exhibit 2
Sovereign Credit Rating Trajectories

| Emerging Markets | 1998 | 2014 | Developed Markets | 1998 | 2014 |
|---|---|---|---|---|---|
| Brazil | BB- | BBB- | Canada | AA+ | AAA |
| Colombia | BBB- | BBB | France | AAA | AA |
| China | BBB+ | AA- | Germany | AAA | AAA |
| India | BB | BBB- | Greece | BBB | B |
| Indonesia | CCC+ | BB+ | Ireland | AA+ | A- |
| Mexico | BB | BBB+ | Italy | AA | BBB |
| Philippines | BB+ | BBB | Japan | AAA | AA- |
| Poland | BBB- | A- | Portugal | AA | BB |
| Russia | CCC- | BBB- | Spain | AA | BBB |
| South Africa | BB+ | BBB- | UK | AAA | AAA |
| Turkey | B | BB+ | USA | AAA | AA+ |

*Source: Bloomberg, based on S&P ratings. Light blue=Upgrade from 1998 Grey=Downgrade from 1998*

Yet, the vulnerability of EM debt to a pullback in generalized risk appetite highlights the issue of market contrariety. As illustrated by the indiscriminate selloff during the summer months of 2013, market fears tend to be amplified during tough times—precisely when investor confidence is critical. Additionally, country-specific investor worries that surface from time to time, such as the recent headlines on Argentina and Venezuela, serve to propagate negative publicity for the asset class as a whole. Despite their fundamental strengths as a group, EM simply have not been able to shrug off the high beta label.

## Evolution, not Revolution

One plausible way of reconciling the apparent contradiction between improving credit fundamentals and observed market volatility is to consider EM from a viewpoint of *evolution* rather than *revolution*. In aggregate, EM countries are conceptually dynamic. Rather than undergoing a single, complete shift, the development process for EM—economic, market and political—is continuously in progress for EM countries. Although the rates of growth vary, and are, at times unsteady, the critical distinguishing factor is that, for the most part, they are all heading in the right direction.

To be sure, the maturation process has been an arduous undertaking. One traditional notion of EM that distinguishes them from DM is the absence of systemic importance in the global context. Historically operating under far greater constraints, many EM countries were drafted into "sovereign boot camps" in response to domestic economic crises. Over time and as a result, many EM countries have developed an internal built-in mechanism of economic resilience. This was particularly apparent following the Lehman Brothers' bankruptcy in the fall of 2008, when various EM countries acted swiftly and decisively to contain the fallout on their domestic economies.

EM now constitute a radically different asset class than it used to in the early 1990s. Countries such as Brazil, Mexico, Poland and the Philippines, developed over time and matured as anchor EM members. China leap-frogged onto the league table of the world's ultra-large economies, and Korea actually managed to graduate from the EMBIG in April 2004. We highlight two countries—Korea and Mexico—where the structural transformation has been nothing short of spectacular.

## No Pain, No Gain

Korea entered the EMBIG with BB rated credit in 1998, and exited six years later as an A rated issuer. It is currently rated Aa3/AA- by Moody's and Fitch, while S&P in mid-September raised its outlook on the A+ rating to positive. Korea is now the world's eighth largest holder of foreign reserves, marking a contrast with the situation in late-1997 when it nearly exhausted its war chest. Its manufacturers have moved up the value-add chain to become industry leaders. Importantly, these achievements came with substantive economic adjustments during the interim years; the country's GDP shrank at a record rate of -5.7% in 1998. As the experience of Korea suggests, there are no short cuts to achieving long-term economic resilience.

In the case of Mexico, the sovereign rating reached "A" territory for the first time ever in 2014, a year that also marks the 20th anniversary of the Tequila Crisis. A key aspect of the renewed optimism was the recent passage of broad-based productivity-enhancing reforms, which will boost the country's long-term potential growth. While the recent high-frequency data suggest that the growth trajectory has yet to shift to a higher gear, the economic benefits will nonetheless be felt over the medium term. Of note is the growing appeal of Mexico as a destination for foreign direct investments, the oil and automobile industries in particular.

## Be Wary of Animal Spirits

Admittedly, the experiences of Korea and Mexico are not necessarily the rule. Tempting as it might be, we would caution against adopting a cavalier approach with unbridled enthusiasm toward the asset class as a whole. Not only has the pace of progress among EM countries been extraordinarily uneven, some countries have even seen a regression in national development as a result of years of unorthodox policies, while others have had persistently subpar economic activity because of policy inertia. Consequently, what is valid at the asset class level may not be applicable to every country. The diverse range of sovereign ratings, between AA and CCC, reflects the inherent complexity of the asset class.

In turn, the heterogeneity of EM would suggest that one should avoid either extremes of eternal optimism or perpetual pessimism when evaluating the asset class's appeal. Instead, in considering the rationale for investing in the asset class, we see a need to balance the twin objectives of differentiating long-term credit stories and managing transitory shifts in risk sentiment.

The first objective necessitates a disciplined approach to fundamental analysis. Central to our investment philosophy is the preservation of capital. At its core, investments should be focused on anchor EM countries with the highest degree of self-insurance against the vagaries of the global economic cycle. Given the dynamism of the asset class, we would keep a keen eye on potential crossover candidates in the sub-investment-grade space. At the periphery, the goal is to zero in on a select group of frontier nations that possess the ingredients to emulate the success stories of Korea and Mexico in the years ahead.

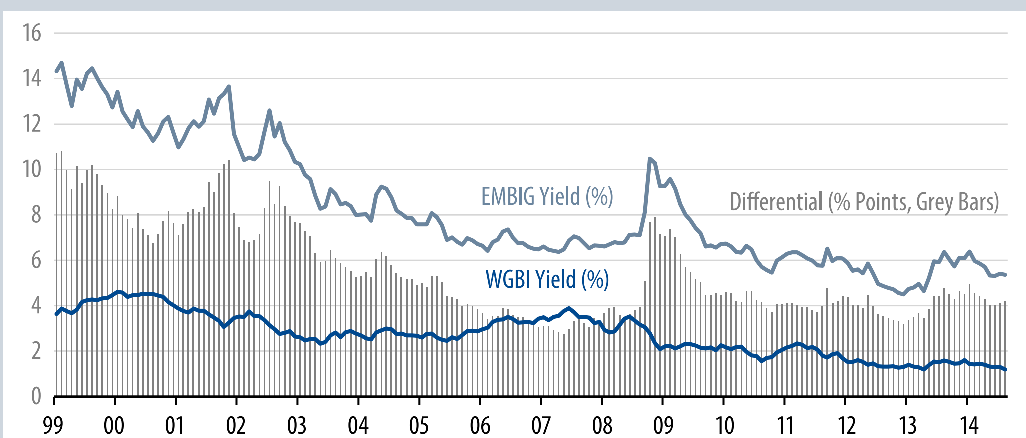
The second objective requires the ability to navigate the technical factors that impact short-term valuations. Notwithstanding the dependence on easy money with seven years of Fed-driven liquidity, new bank regulations have capped the growth of short-term players with significant leverage. On the other hand, the benefits of diversification will likely prompt greater participation from the real-money community, official institutions, pension funds and insurers in particular. Reduced reliance on short-term funding among EM investors today suggests that the risk of a major bubble burst is much lower.

## Pockets of Value in EM Debt

Just as the asset class has transformed itself over the years, investors need to reconsider their approach to EM. The "low hanging" trades that rode on the coattails of the liquidity-induced super-cycle are behind us. That said, the expansive universe—which includes corporate bonds and domestic securities—creates new opportunities for a total return approach with specific targets in credit rating, duration and sectors. Indeed, there has been growing demand from crossover investors with global investment-grade credit mandates.

For investors with a longer investment horizon, attractive opportunities should present themselves in periods of market dislocation. For yield-hungry investors, the still-considerable yield premium of EM bonds versus their DM counterparts should attract attention. Despite the narrowing gap in credit quality since the global financial crisis, the differential in yield between the EMBIG and the Citi World Government Bond Index has remained wide versus pre-crisis levels (Exhibit 3).

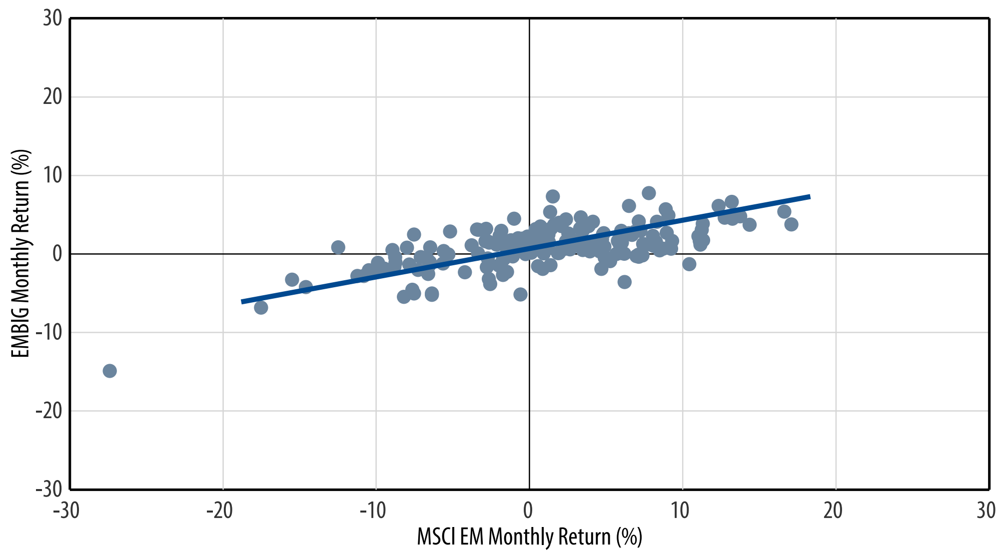
Exhibit 3
Emerging Market Sovereign Bond Yields




*Source: Bloomberg*

We are cognizant of the beneficial impact on asset valuations being temporarily obfuscated by the onset of Fed rate normalization. However, the current de-synchronization of G3 monetary cycles with the European Central Bank and the Bank of Japan firmly in accommodative mode is significant. Our belief is that fundamental improvements in many EM countries will prove more lasting than current pricing would suggest. Contrary to the "great rotation" proposition, the empirical support for a negative debt-equity relationship is not strong, based on monthly returns since 1999 (Exhibit 4). This is not surprising though, given the credit risk component embedded in EM sovereign bonds.

Exhibit 4
Emerging Markets: Debt Versus Equities




*Source: Bloomberg. As of 01 Jan 99 to 31 Aug 14*

Our fundamental conviction is that the rising gravitational force of EM economies is a secular trend, not an aberration. Given the under-representation of EM in global asset allocation, an inordinate and persistent trend of strategic flows out of the asset class appears to be a low-probability outcome in a post-Fed taper environment. The heterogeneity of EM debt is a feature and not a flaw, as it presents a dynamic set of opportunities to customize around or rotate into the appealing segments of the market at different market cycles. Properly calibrated, EM bonds should navigate the threat of exogenous turbulence relatively well, meaning investors should still be amply rewarded on a risk-adjusted basis over the medium term. In the current tug of war between constructive fundamentals and shifty technicals, our belief is that the former will ultimately prevail.