

How Would a US Downgrade Impact Emerging Markets?

Executive Summary

- A US technical default that results in a US credit rating downgrade will have a negligible impact on emerging markets. We believe that a US default on Treasuries is unlikely, although any political process carries a risk of mistakes due to political brinksmanship.
- Emerging markets have “graduated” on the global capital structure of risk. The result is a new order of tiers reflecting the maturation of the emerging market asset class into three distinct fixed-income subsectors, which co-exist alongside their more volatile sister, emerging market equities.

Moody’s warning on Wednesday, July 13, that the US might lose its AAA rating as a result of the debt ceiling issue has prompted some questions regarding the impact of such a development on emerging markets. We believe that this “noise” has been with us for quite some time. Moreover, major structural problems exist not only in the US, but elsewhere in the developed world; these problems are widely known and reflect serious global imbalances that are challenging countries on the economic offensive and defensive fronts.

So, in the grand scheme of things, what is the relevance of a US downgrade that has been telegraphed for some time, given that the US is in “less worse” shape from a fundamental and political perspective than its developed world peers?

We believe that a US default on Treasuries is unlikely, although any political process carries a risk of mistakes due to political brinksmanship.¹ But assuming that a technical default occurs and the US is downgraded as a result, what will be the impact on emerging markets? The short answer to the question is: While emerging market (EM) debt may widen due to increased uncertainty—like any other risk asset—the fundamentals of these markets are not likely to change appreciably.

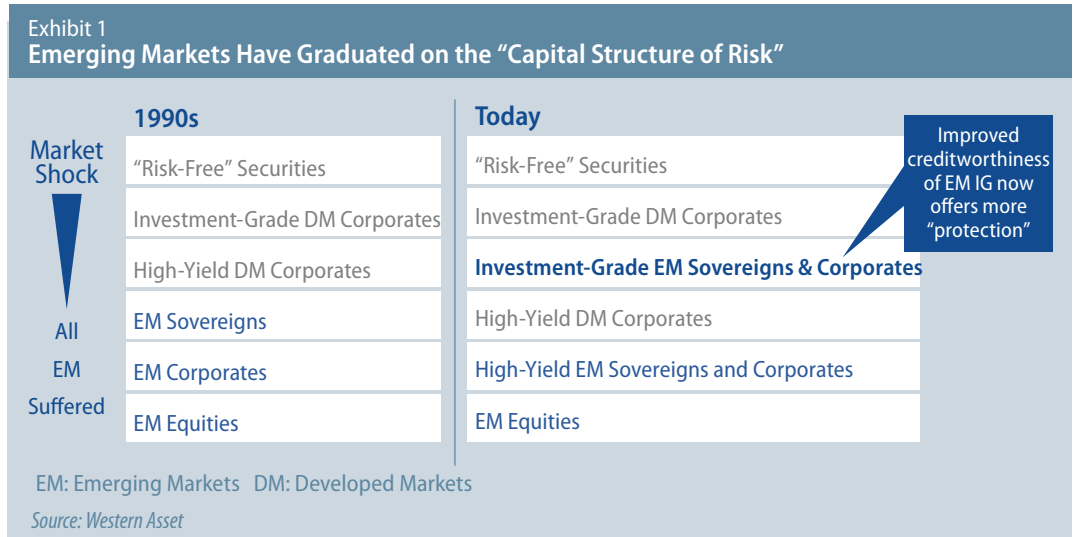
A snapshot of today’s market environment shows risky assets continuing their upward march in the face of escalating global risks—the S&P 500, a key barometer of market sentiment, still hovers near its pre-2008 crisis level. Some argue that valuations in US markets are justified because of the record cash positions held by US corporations and banks. Conversely, some argue that EM countries’ valuations are justified because EM countries hold more than 80% of the world’s foreign exchange reserves. The bottom line is that the accumulation of these war chests of cash by both parties spells uncertainty about the future. With investor sentiment on a knife-edge, we would not be surprised if a US downgrade unsettles financial markets worldwide, effectively sending shockwaves throughout an already fragile global capital structure that has never fully healed from the 2008 crisis.

The question, as always, is this: Which markets or asset classes will be most impacted by such an event? In the past, the investment community would have collectively answered, “emerging markets!” However, that argument—especially when studied through the lens of the 2008 crisis—no longer holds true.

Exhibit 1 is a very simple rendition of how emerging markets have “graduated” on the global capital structure of risk. As a primarily sub-investment-grade asset class throughout the 1990s, emerging markets (both debt and equity) behaved like a highly levered entity prone to liquidity and solvency crises as a result of sharp capital flow volatility during that period.² During that decade, shocks stemming from the developed world via the interest rate or G3 FX channels ripped

¹ In a recent white paper—*Will the US Government Default on Its Debt?*—we describe the impact of a possible US default and discuss the likelihood of such an event. This paper, along with previous Western Asset white papers, can be found on our website, www.westernasset.com

² In a November 2010 white paper—*Emerging Markets: Navigating the Rising Tide of Global Liquidity*—we argue that the factors driving capital flows into emerging markets this time are structural in nature, which represents a distinct change from past episodes of strong inflows.



apart EM sovereign balance sheets. Today, the EM asset class is much more resilient, with about 60% of investable EM countries and 70% of investable EM corporations rated investment-grade (supported by a formidable stock of “collateral” in the form of foreign exchange reserves).³ The result is a new order of tiers reflecting the maturation of the EM asset class into three distinct fixed-income subsectors, which coexist alongside their more volatile sister, EM equities.

In our view, the EM investment-grade tier—comprised of select sovereigns, quasi-sovereigns (state-owned corporations) and blue chip EM corporations—has earned a higher ranking on today’s global capital structure because of its continued strong US-dollar earnings power (supporting the tier’s ability to pay) and its desire to preserve its newfound geopolitical status and access to the capital markets (supporting the tier’s willingness to pay). The 2008 crisis supports this argument: EM investment-grade and the rest of the asset class rallied hard from the initial depths of the crisis as investors began to fully accept that the old economic world order—dominated by developed countries for almost a century—was now “upside down,” with cash-rich EM sovereigns and corporations leading the way.

None of these comments is meant to imply that EM “decoupling” is alive and well, that emerging markets face zero internal risks, or that emerging markets are fully immune to external shocks such as a US downgrade. Emerging markets are, have been, and always will be a price-taker of G3 interest rate and exchange rate risk. Indeed, if markets become unglued because of a greater probability assigned to a US downgrade—resulting in even greater global risk aversion (let’s not forget the risks percolating in peripheral Europe)—then we should expect increased volatility to once again test investors’ loyalty to the EM asset class. However, in our view, that possibility—in and of itself—is not an adequate reason to avoid the asset class. The implicit message coming out of the headlines announcing continued downgrades in the developed world is that the math continues to favor emerging markets.⁴

³ Data according to JP Morgan’s EMBI-Global and CEMBI Broad indices as of end-June 2011.

⁴ In a September 2010 white paper—*Emerging Markets: Revisiting the Investment Thesis in an Era of Debt*—we argue that in a market characterized by uncertainty and concern over rising sovereign debt risk, the more compelling rationale for investing in EM today centers on the improved debt sustainability metrics these nations now enjoy.

Exhibit 2
Select Data for JP Morgan’s Emerging Market Benchmark Indices

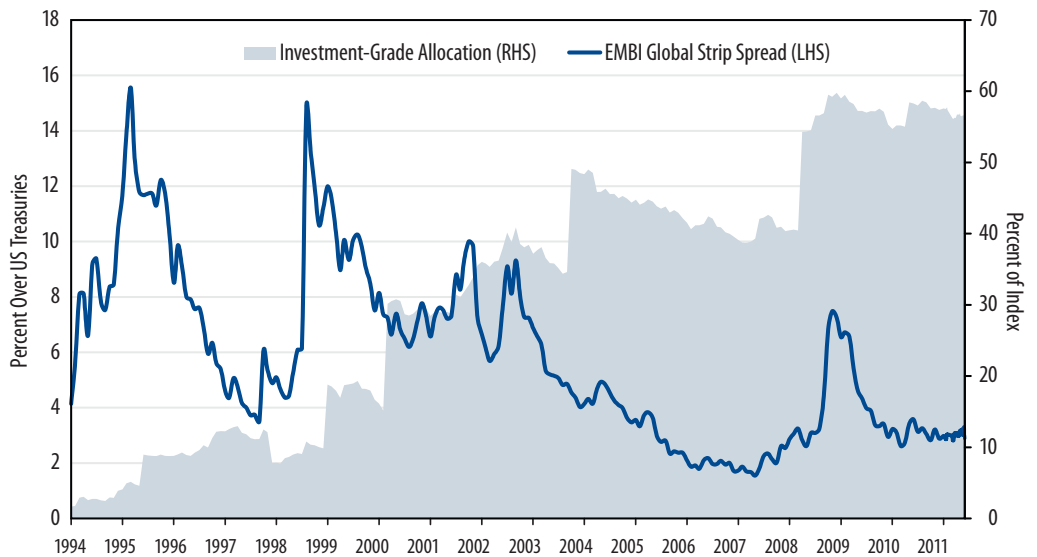
	Market Cap (US\$ BB)	Spread (%)	Duration	Sovereign Yield	Sovereign Spread	Return Total Return (% change) Volatility		
						3-mo	YTD	3-mo
EMBI-Global (1)	440	100	6.7	6.0	288	4.0	5.1	2.1
EMBI-Global Investment-Grade	248	56	6.8	4.9	169	3.8	5.4	1.7
EMBI-Global High-Yield	192	44	6.6	7.4	433	4.3	4.6	3.6
CEMBI Broad (2)	410	100	5.5	5.9	319	1.7	3.6	1.3
CEMBI Broad Investment-Grade	293	71	5.8	5.2	232	2.2	3.7	1.3
CEMBI Broad High-Yield	117	29	4.6	7.9	566	0.4	3.5	2.4

(1) Tracks total returns for USD debt instruments issued by emerging market sovereign and quasi-sovereign entities.

(2) The most comprehensive benchmark which tracks total returns for USD debt instruments issued by corporate entities in emerging market countries.

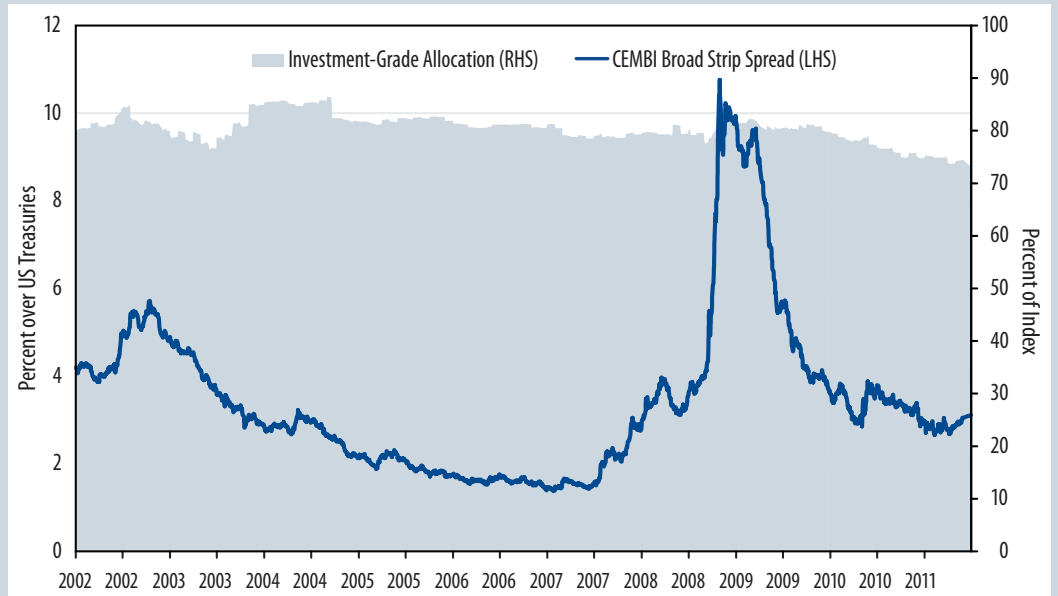
Source: JPMorgan. As of 30 Jun 11

Exhibit 3
JPMorgan EMBI Global Spread and Investment-Grade Allocation



Source: JPMorgan. As of 30 Jun 11

Exhibit 4
JPMorgan CEMBI Broad Spread and Investment-Grade Allocation



Source: JPMorgan. As of 30 Jun 11

Past results are not indicative of future investment results. This publication is for informational purposes only and reflects the current opinions of Western Asset Management. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice. Employees and/or clients of Western Asset Management may have a position in the securities mentioned. This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. It is your responsibility to be aware of and observe the applicable laws and regulations of your country of residence.

Western Asset Management Company Distribuidora de Títulos e Valores Limitada is authorized and regulated by Comissão de Valores Mobiliários and Banco Central do Brasil. Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services Licence 303160. Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services Licence for fund management and regulated by the Monetary Authority of Singapore. Western Asset Management Company Ltd is a registered financial instruments dealer whose business is investment advisory or agency business, investment management, and Type II Financial Instruments Dealing business with the registration number KLF B (FID) No. 427, and a member of JSIAA (membership number 011-01319). Western Asset Management Company Limited ("WAMCL") is authorized and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by WAMCL.