MATTHEW C. DUDA
Portfolio Manager / Research Analyst

Emerging Market 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. Many of these countries have increasingly financed themselves in their own currencies rather than in US dollars. As a result, the external hard-currency (US$) 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 best positioned to take advantage of those 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, as well as a bulk of the traditional US$-denominated EM sovereign bond market.
- A 15-year history of solid and improving EM sovereign and corporate credit quality should continue to create attractive income and total return potential for investors in private sector EM companies.
- 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 (US$) borrowing space, which was once dominated by sovereign debtors, has opened dramatically for EM corporate issuers. In fact, in 2003, EM hard-currency-denominated corporate issuance outpaced that of sovereign issuance for the first time; furthermore, this has remained the case every year since (see Exhibit 1). Thus, we expect that for the foreseeable future, EM corporate bonds will increasingly dominate the market for US$-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.

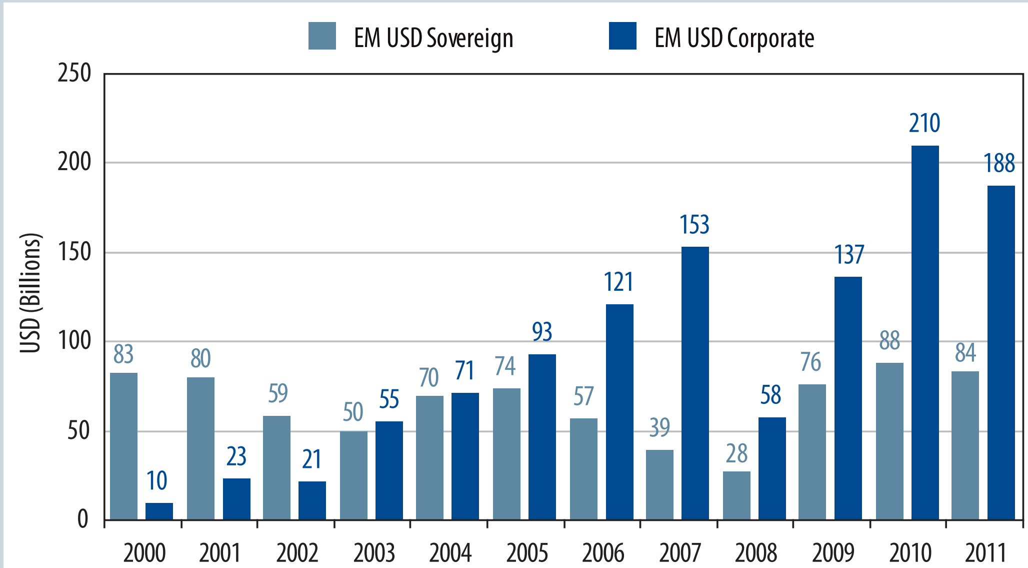
The investment implication of the aforementioned developments in EM countries is that consistent improvement in credit fundamentals for EM issuers—both governments and corporates—offers a compelling counterpoint to the deterioration in government balance sheets in many developed markets. With income 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 best positioned to take advantage of those 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, as well as a bulk of the traditional US$-denominated EM sovereign bond market 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.
- A 15-year history of solid and improving EM sovereign and corporate credit quality should continue to create attractive income and total return potential for investors in private sector EM companies.
- 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.

EM Corporate Bond Primary Issuance is Now More Than Double the Level of Sovereign Issuance

Exhibit 1
EM Corporate Bond Issuance vs. Level of Sovereign Issuance



Source: JPMorgan. As of 31 Dec 11

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

These new investment opportunities in EM corporate bonds are of course arising apace 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. Moreover, EM countries also hold over 60% of the world's foreign exchange reserves (in US$ terms), which reflects a shift in global purchasing power away from US and European consumers at the margin, and toward EM corporations and consumers[1].

Many EM countries are expected to continue to empower 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 is 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 sectors 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 sectors. Moreover, issuers from strong investment-grade rated countries such as Brazil, Mexico and Russia, as well as from many

[1] *Moody's and Western Asset calculations*

important Asian countries, represent a significant chunk 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.

Overview of the Investable Universe for EM Corporate Bonds

Exhibit 2
Decomposition of the JPMorgan Corporate Emerging Market Bond Index Broad

Index Statistics	
Number of Issues	625
Market Cap	$419 B
Yield to Maturity	6.28%
Duration	5.43

Credit Profile	
Investment Grade	70.6%
Non-Investment-Grade	23.9%
Not Rated	5.6%

Sector Breakdown	
Banks	29.8%
Industrials	19.7%
Oil	18.5%
Telecom	10.7%
Metals & Mining	9.2%
Utilities	7.8%
Consumer Products	4.4%

Top 5 Country Exposure	
Brazil	22.3%
Russia	14.7%
Hong Kong	9.2%
Mexico	7.4%
Korea	7.1%

Regional Breakdown	
Latin America	36.8%
EMEA	29.1%
Asia	34.2%

Source: JPMorgan, 2012. As of 31 Dec 11

EM Corporate Bond Investment Analysis is Increasingly Driven by Firm Specific Factors

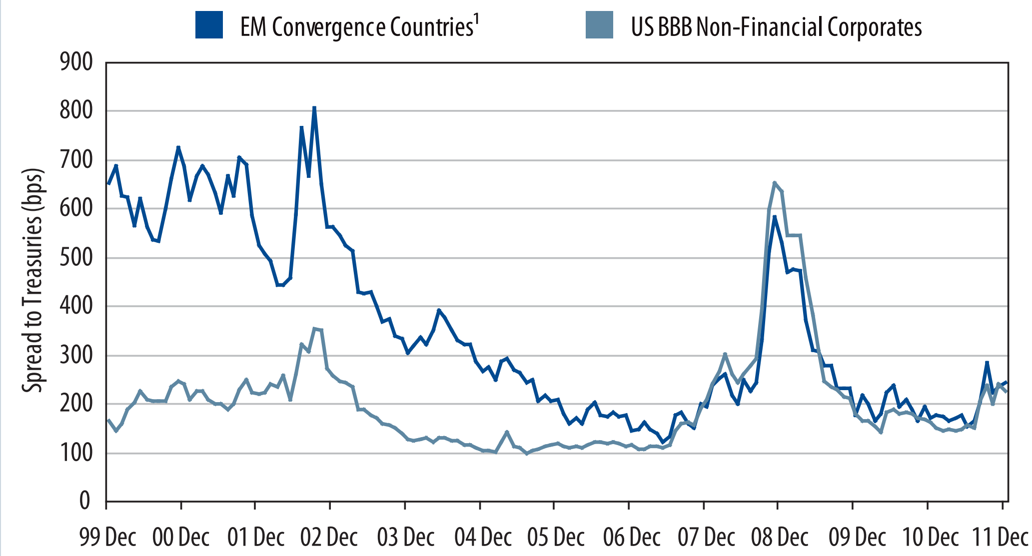
Given EM corporations' increasing global presence and EM governments' increasing economic and political responsibility, "transfer risk" (or the risk of a government impeding the ability of an otherwise creditworthy private sector borrower from paying its debt), has naturally plummeted in recent years. Therefore, over the same period of time the overall level of country risk in many EM countries has likewise fallen dramatically. The implication for investors, of course, 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.

EM Corporate Bonds Offer Value and Diversification Relative to EM and Developed World Alternatives

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 (Exhibit 3). Moreover, 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.

EM Sovereign Spread Convergence Has Run its Course

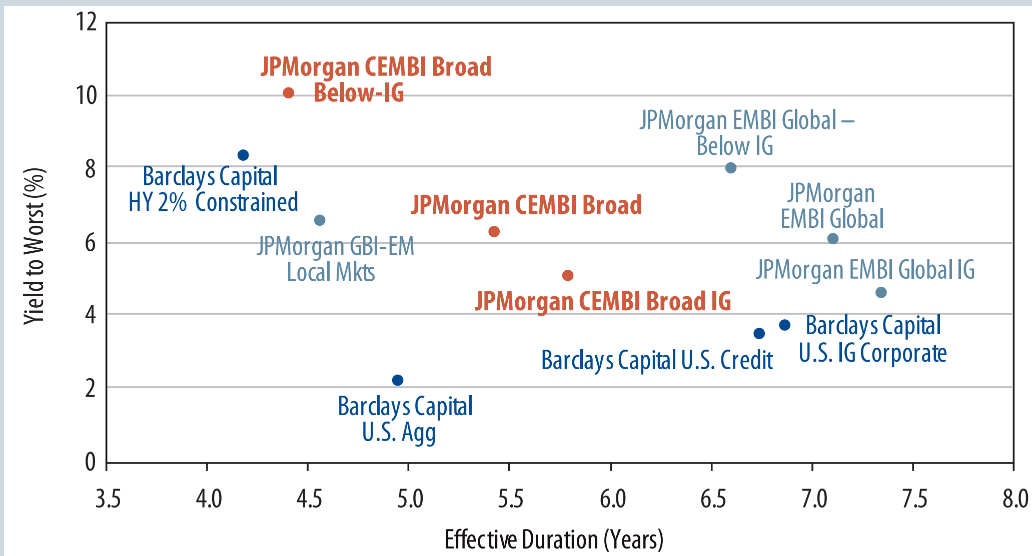
Exhibit 3
EM Convergence Countries vs. US BBB Non-Financial Corporates



Source: JPMorgan, Western Asset. As of 31 Dec 11
[1]Convergence countries spread defined as the average of EMBI+ subcomponents Brazil, Colombia, Mexico, Panama, Peru, Indonesia, Philippines, Russia, Turkey and South Africa

EM Corporate Credit Offers an Attractive Risk/Reward Profile

Exhibit 4
Yield to Worst vs. Effective Duration



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.

Source: JPMorgan, Barclays Capital. As of 31 Dec 11

Given the sharp moves in Treasury 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 US$ sovereign bonds, on average and due to their longer duration, have historically exhibited greater sensitivity to movements in interest rates than have EM Corporate Bonds. Sharp declines in Treasury yields during the 2008 and 2011 crisis years propelled EM US$ sovereigns to superior performance. EM US$ sovereigns lagged significantly, however, when 10-year Treasury yields rose 163 basis points (bps) to 3.84% in 2009. Rates remain near historically low levels and leave US$ sovereign vulnerable to any measured increase in Treasury yields.

Exhibit 5
Return Decomposition of EM Corporate and EM US$ Sovereign Bonds, 2008-2011

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

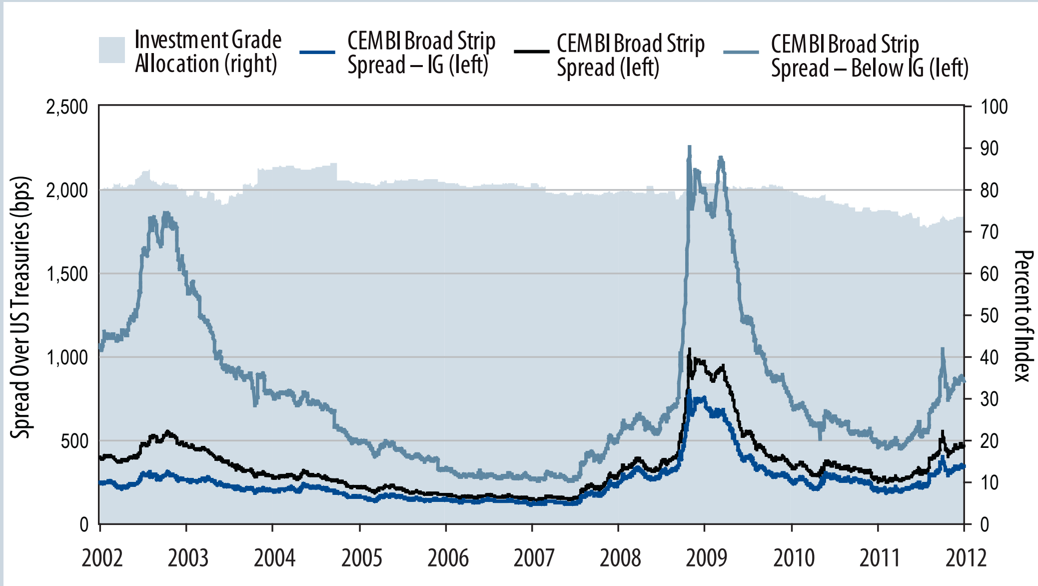
Source: JPMorgan, WisdomTree, Western Asset Management 2012

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, the 2011 calendar year was another very strong year for EM hard-currency corporate issuance. Approximately US$188 billion of new issues priced during the year, a slight decrease of approximately US$22 billion compared with 2010 (Exhibit 1). Following the trend of previous years, approximately 63% of the 2011 issuance was rated investment-grade, but the window for strong EM issuers rated below-investment-grade was also very robust during 2011. A very important trend to note in the EM corporate credit asset class is that even though 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 sub-investment-grade rated issuers (Exhibit 6). Finally, and in line with the trend of recent years, the geographic breakdown of issuance was relatively uniform in 2011. Latin American issuers, dominating the primary market in the late 1990s and early 2000s, no longer dominate the league tables. For example, in 2011, Latin American issuers accounted for 33% of the primary market, 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 throughout 2012.

As the EM Corporate Credit Market Grows, Index Credit Quality Should Become More Balanced

Exhibit 6
JPMorgan CEMBI Broad Spread and Investment Grade Allocation



Source: JPMorgan. As of 31 Dec 11

As was the case in 2010, during 2011 EM corporate issuers took advantage of low absolute yields (due to the rally in US Treasuries) to refinance older, more expensive debt, to term out shorter-tenor debt, to execute expansionary business plans and to expand balance sheets while also improving financial flexibility. We expect heavy issuance from the EM bank and finance sector to continue in 2012 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 during 2011 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 well, as hard-currency issuance is seen as a good financial "hedge" for EM-based global commodity producers.

Heavy EM corporate issuance in 2011 was met with strong investor demand as higher relative spreads, improving fundamentals and ever-improving liquidity attracted a global investor base. Higher spreads (compared with similarly rated developed-country issues) attracted traditional EM investors expanding their former sovereign-dominated mandates, but also attracted nontraditional participants—mainly global investment-grade buyers—as some EM corporate issuance met the requirements for inclusion in not only JPMorgan's benchmark family of EM corporate bond benchmarks but also in the Barclays Capital Aggregate and related family of indices. The broad reach of these truly global benchmark bond indices has thus allowed larger issuance sizes along multiple tranches from EM debtors. During 2011, the typical benchmark size issue for EM corporates was US$500 million to US$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 Debt Trading Volume and Liquidity Have Continued to Improve

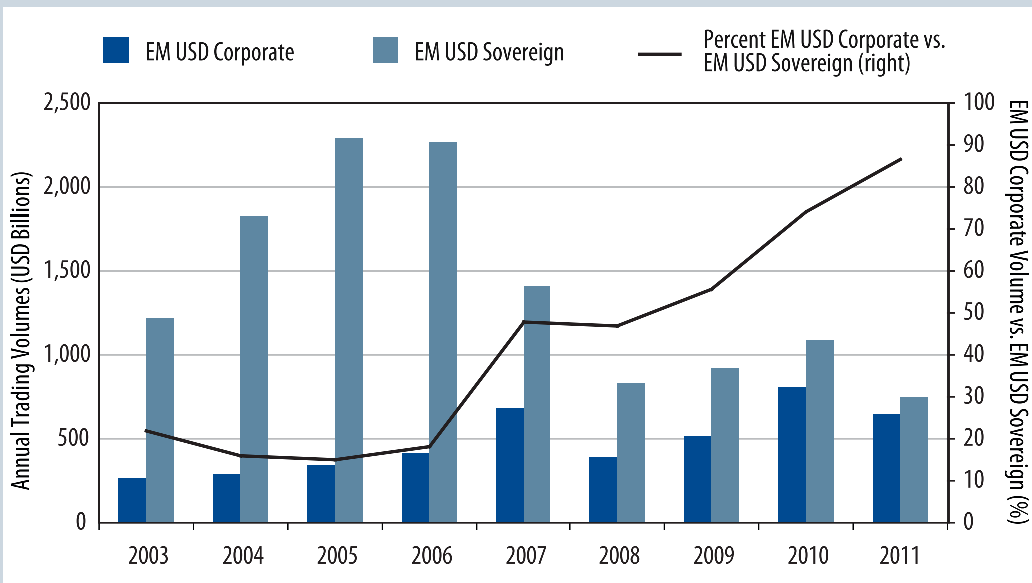
Investor interest in the EM corporate credit sector continues to grow, both for dedicated and opportunistic exposures, and many investors are surprised to find the market characterized by a vibrant and increasingly liquid secondary market. According to the Emerging Market Traders Association (EMTA), a trade forum for EM investors and dealers, EM corporate debt trading set a new high watermark in calendar year 2010 on a US-dollar basis and continued at a robust pace through the first three quarters of 2011.

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 7), 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. No more than five years later, corporate volumes are nearly 50% of total volumes, and we expect US$-denominated corporate debt trading volumes to surpass US$-denominated sovereign trading volumes in the near future (Exhibit 7). As EM sovereign balance sheets continue to improve and as domestic capital markets deepen, US$-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.

US$-Denominated Debt Trading Volumes

Exhibit 7
Ratio of Corporate to Sovereign Volumes



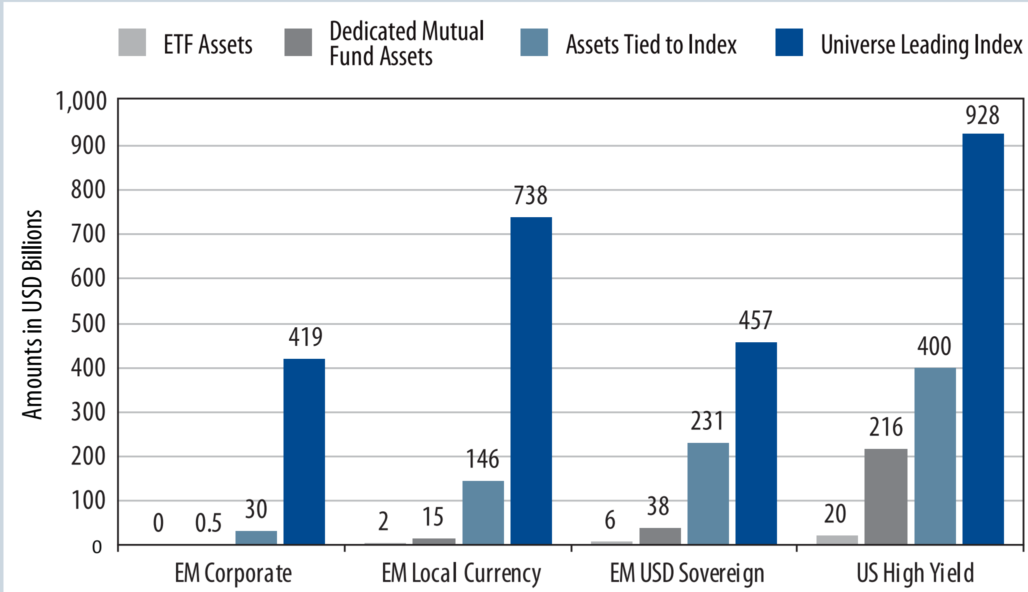
Source: EMTA, Western Asset.

Secondary liquidity will vary depending on credit and tenor. Some sections of the EM corporate market are more liquid than the US investment-grade market. On-the-wire liquidity for upward of US$25 million to US$35 million within a tight bid-ask spread is normal for benchmark credits such as Vale or Petrobras. Some segments of the market are less liquid and may display liquidity characteristics similar to those of the US high-yield market. Investors are able to construct diversified portfolios across the liquidity spectrum according to their risk-reward parameters.

Potential for New and Increasing Allocations as the Market Evolves

While adoption of and interest in the asset class has grown in recent years, EM corporate bonds remain underinvested relative to other EM and developed market fixed-income sectors, given the size of the market. Exhibit 8 profiles the sponsorship of the various emerging debt sectors.

Exhibit 8
Investor Sponsorship of Selected Emerging Market Sectors



Source: EM Corporate Bonds, EM Local Currency Bonds, and EM USD Sovereign are represented by the JPMorgan CEMBI Broad, JPMorgan Government Bond Index – Emerging Markets Global Diversified, JPMorgan Emerging Markets Bond Index - Global

Dedicated exposures to EM corporates are still in their infancy among fund structures. While in 2011 JPMorgan reports a 73% increase in assets tied to its CEMBI family of indices, the level of assets is still only at US$29.5 billion, less than 7% of the overall investable universe. Similar numbers for local currency debt are slightly higher at 23% of the investable universe, with the fund portion at 2%. Assets tied to the EMBI Global approximate over 50.5% of the investable universe and fund penetration is around 8.3%. In contrast, fund penetration for the domestic high-yield markets is over 23%.

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

Western Asset's Investment Approach for EM Corporate Bonds

As fixed-income investors, we focus not on "earnings" upside, but on the downside; not on profitability per se, but on a company's ability to generate sufficient operating cash flow to consistently make coupon and principal payments. In this regard, we believe it wise to focus on industries 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 as we know it: oil and gas companies, infrastructure developers, utilities, telecommunications, etc.

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. We have a large team of credit analysts in every industry, located in local markets around the globe. The portfolio management team in Pasadena coordinates analysis with a focus on identifying undervalued sectors, companies and securities relative to their long-run fundamental value. This has been the backbone of Western Asset's corporate credit investment process since the Firm's inception, and it has delivered strong performance in dedicated EM corporate mandates.

With the inclusion of debt issued by corporations across the globe, credit markets are beginning to truly represent the global production process. Western Asset looks forward to the opportunity to extend our comparative advantage in credit analysis to a much larger universe. 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.