WESTERN ASSET

OCTOBER 2013

Valuations in Emerging Markets Have Become More Attractive

Executive Summary

- The attractive fundamentals of many EM countries should continue to support EM assets over the longer term.
- However, the recent selloff in EM bonds and currencies highlights the fact that these markets are not immune to global economic and market forces.
- The EM team at Western Asset believes recent market volatility has created an opportune moment for value investors to initiate or add to their EM exposures.
- In local EM markets we favor exposures to countries where we have seen a significant upward adjustment in yields and where carry and rolldown remain attractive.
- Western Asset's view of slow but steady growth in the DM world combined with continued supportive monetary policy globally is, we believe, a supportive backdrop for EM growth and asset prices.

Introduction

The attractive fundamentals of many emerging market (EM) countries—including stronger relative growth, demographics, productivity catch-up and healthy balance sheets—are well known and, we believe, should continue to support EM assets over the longer term. However, the sharp selloff in EM bonds and currencies since May highlights that this is not a one-way trend and that these markets are not immune to global economic and market forces.

In our view, concerns over the normalization of US Federal Reserve (Fed) monetary policy caught the EM sector at a vulnerable time. Declining growth expectations throughout the sector (and in particular fears over a Chinese hard landing) served to further unnerve investors who were already concerned with valuations in the context of higher US rates. And while some of the structural vulnerabilities among certain EM countries are nothing new, selling pressure exacerbated by recent outflows from the asset class has brought these back into sharp focus. As long-term value investors, we are interested in whether current pricing in EM bonds and currencies correctly reflects underlying fundamentals and whether they offer attractive opportunities to generate returns.

Fundamental Backdrop

Underpinning our assessment of valuations is our central view that while the eventual "tapering" of asset purchases by the Fed will remove an important element of support for developed market (DM) bond yields, the broad backdrop of moderate (but improving) growth, continued policy accommodation by the major central banks, benign developed world inflation and some evidence that Chinese growth is stabilizing should be broadly supportive of risk markets. This includes EM at these current "cheaper" levels. In addition, EM-specific factors such as flexible exchange rate regimes, large foreign exchange reserves, generally low levels of external debt (particularly short-term external debt), lower levels of inflation and monetary policy flexibility bring comfort to EM investors that 2013 is not a replay of the balance of payments crises seen in the 1990s.

External Debt (USD-denominated Sovereign and Corporate Debt)

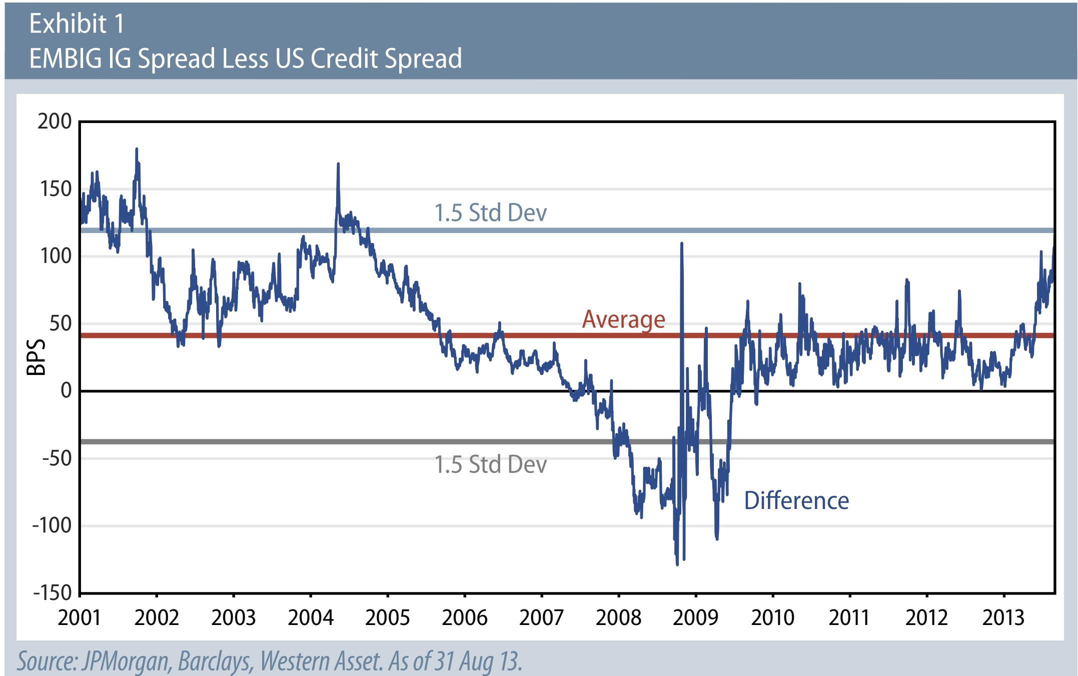
Although the future normalization of US monetary policy brings new challenges to EM policymakers, particularly with respect to the impact of capital flows on bond yields and currency levels, we believe sovereigns are generally well positioned to weather the storm and have plenty of policy levers to ease the transition. Very few EM countries are default candidates, and although there may be some ratings pressure among more vulnerable countries, we do not see downgrades to speculative grade; in fact, we still forecast ratings upgrades over the coming year, e.g., in the Philippines.

EM external debt, like other spread sectors, is valued as a spread over US Treasuries. There is a US rates component and a spread/credit risk component to the all-in yield. In our view—particularly as we are not forecasting negative ratings actions—the back-up in external debt spreads relative to comparables makes valuations attractive at current levels.

© Western Asset Management Company 2013. This publication is the property of Western Asset Management Company and is intended for the sole use of its clients, consultants, and other intended recipients. It should not be forwarded to any other person. Contents herein should be treated as confidential and proprietary information. This material may not be reproduced or used in any form or medium without express written permission.

Exhibit 1 illustrates the widening in investment-grade-rated EM sovereign bonds relative to similarly-rated US corporate bonds. Although EM spreads on an absolute basis are far from the highs seen during past crises, we haven't seen current relative spread levels since 2004. A discount of approximately 125 basis points (bps) to the US Credit Index seems to offer good value given our view that the market is correctly discounting a low probability of severe sovereign strain.

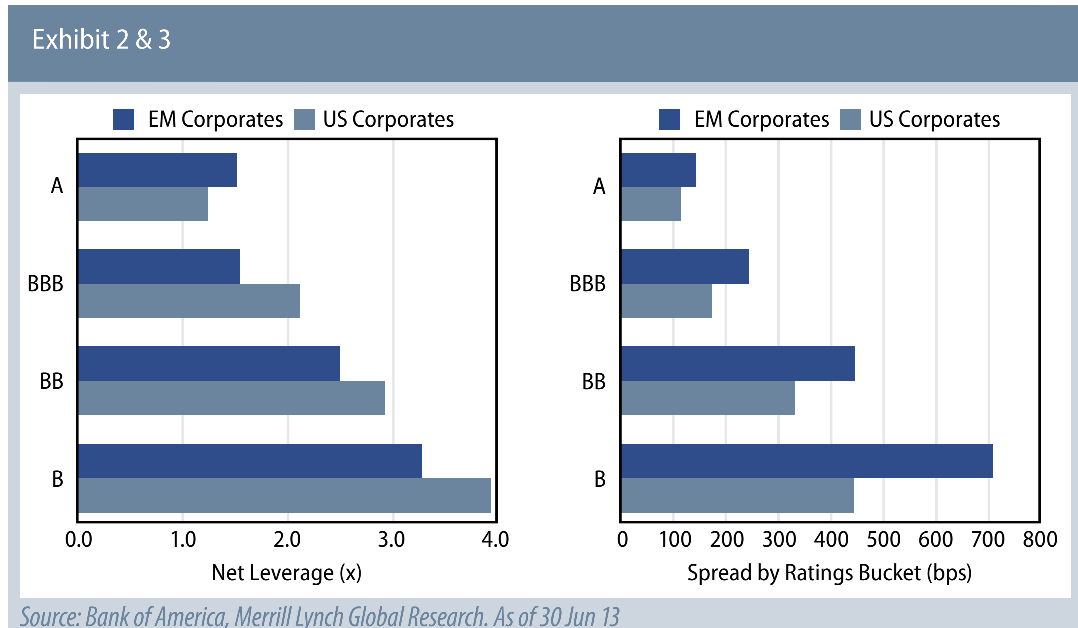
Exhibit 1
EMBIG IG Spread Less US Credit Spread



Source: JPMorgan, Barclays, Western Asset. As of 31 Aug 13.

We also believe that recent market volatility has created attractive opportunities within EM corporate bonds. When rating EM corporate credit issuers, ratings agencies rightly take into consideration country risk. However, typically a "strong" corporate issuer will receive a lower rating than a comparable DM bond due to the domicile of issuance. In addition, despite many EM companies being "under-rated" for the standalone strength of their balance sheets (Exhibit 2), EM corporate bonds trade wide to DM comparables on a ratings basis (Exhibit 3). A nimble manager will be able to pick through credits using top-down and bottom-up expertise to discern those credits that may benefit from the recent local currency weakness and those that may be more vulnerable.

Exhibit 2 & 3

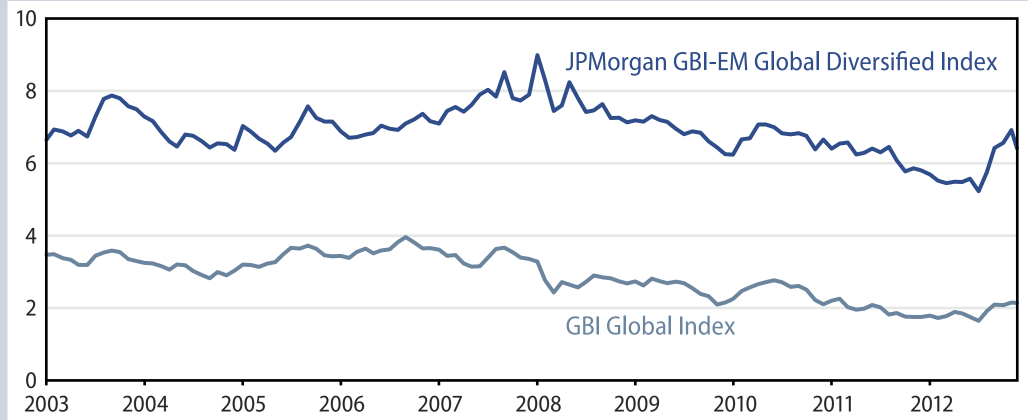


Source: Bank of America, Merrill Lynch Global Research. As of 30 Jun 13

Local Currency and Bond Markets

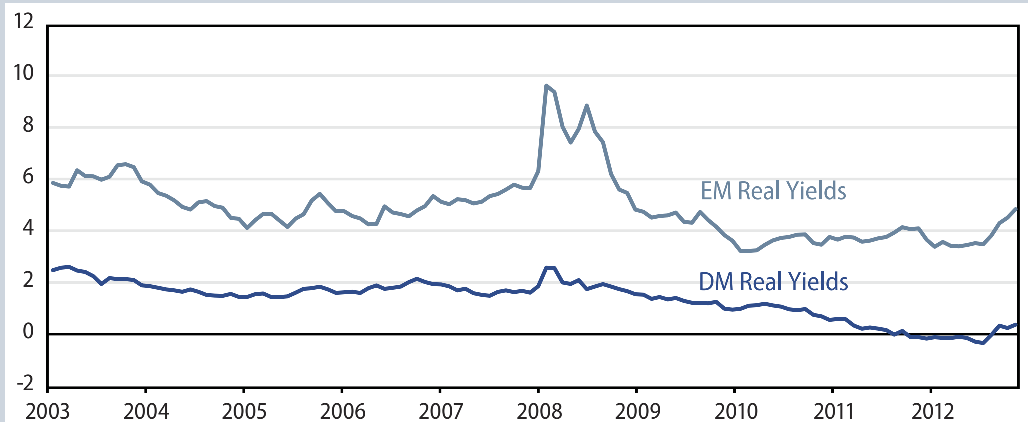
Local bond yields (both in nominal and real yield terms—Exhibits 4 and 5, respectively) and EM currencies (Exhibit 6) in particular have borne the brunt of the recent selloff. In the short run, we recognize that currency weakness and higher local bond yields are necessary "pressure valves" as slower EM growth and a normalization of US monetary policy are priced in. However, with the Fed's intention to taper asset purchases now discounted by the market and with EM growth recently showing signs of stabilizing, we believe the dramatic selloff of local currencies and rates merits a closer look.

Exhibit 4
Nominal Yield Gap Between EM Local Currency-Denominated Sovereign Bonds and DM Bonds Remains Wide



Source: Bloomberg, JPMorgan. As of 20 Sep 13.

Exhibit 5
The Real Yield Gap Between EM Local Currency-Denominated Sovereign and DM Bonds Also Remains Wide

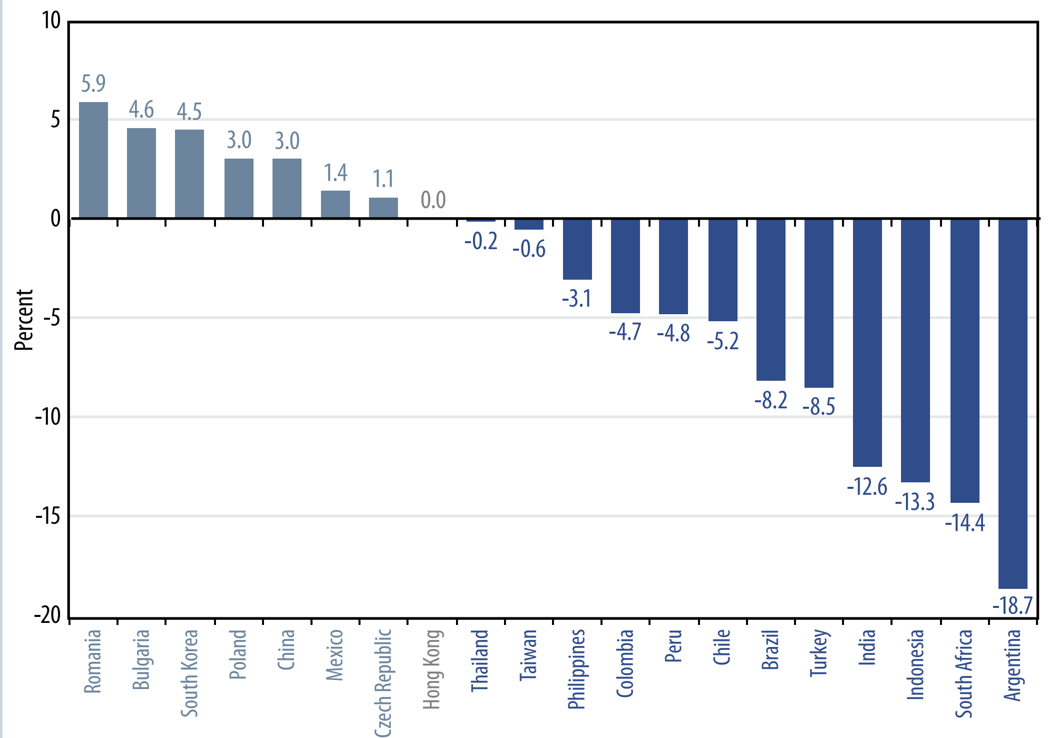


Source: Haver Analytics, Barclays. As of 31 Aug 13.
- *EM real yield was calculated by taking an equally-weighted average of the real yields on the inflation-linked bond indices of Brazil, Poland, Turkey, Argentina, Colombia, Israel, Mexico, South Korea, Chile and Thailand.*
- *DM real yield was calculated by taking an equally-weighted average of the real yields of the countries comprising the Citi World Government Bond Index.*

Although the current environment is challenging for policymakers, we take some comfort in the fact that a number of central banks such as Indonesia and Brazil "get it" and have already responded by tightening policy. Over the medium term, weaker currencies and higher bond yields, combined in some cases with more

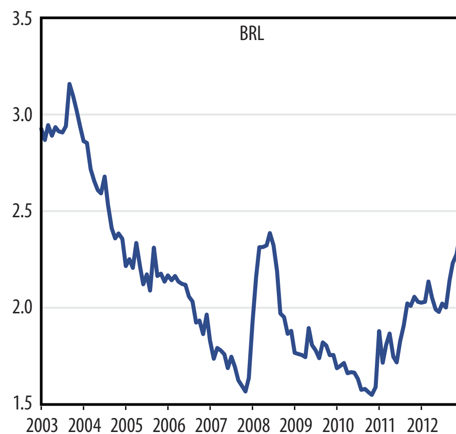
sound fiscal policies should help to address imbalances and stabilize exchange rates. In those countries where policymakers think their currencies and rates have moved disproportionately to fundamentals, central banks have moved into action. The Brazilian central bank, for example, is implementing a plan to supply dollars to the market via swaps/credit lines to try to ease liquidity pressures. By potentially offering up approximately a quarter of their foreign exchange (FX) reserves, Brazilian authorities are sending a powerful message to investors who try to short the currency as well as reducing volatility. As a result, negative positioning in Brazil is much more expensive in light of central bank action.

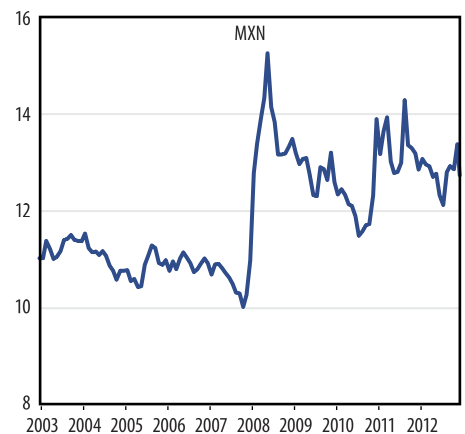
Exhibit 6
The Selloff of EM Currencies Has Been Severe

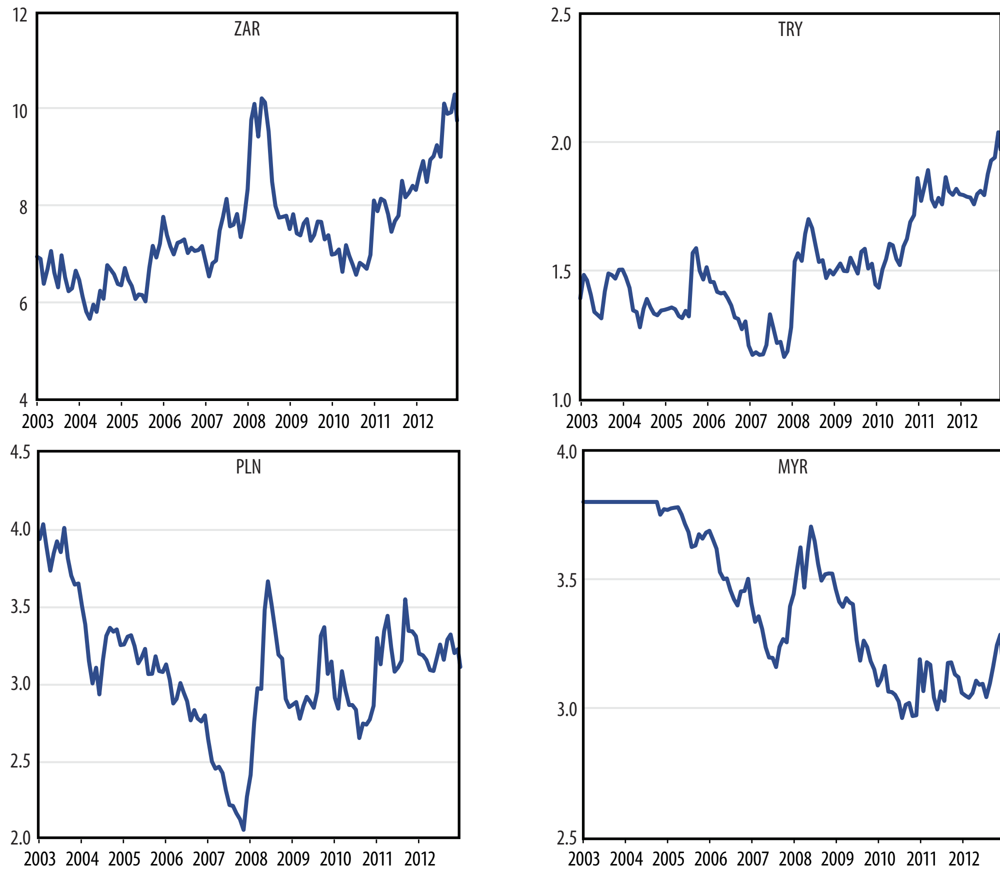


Source: Bloomberg . 20 Sep 12–20 Sep 13

The exhibits below show the 10-year history of selected currencies versus the US dollar. In the cases of the Brazilian real, South African rand and the Turkish lira, currencies have moved close to or beyond levels seen during the global financial crisis in 2008.





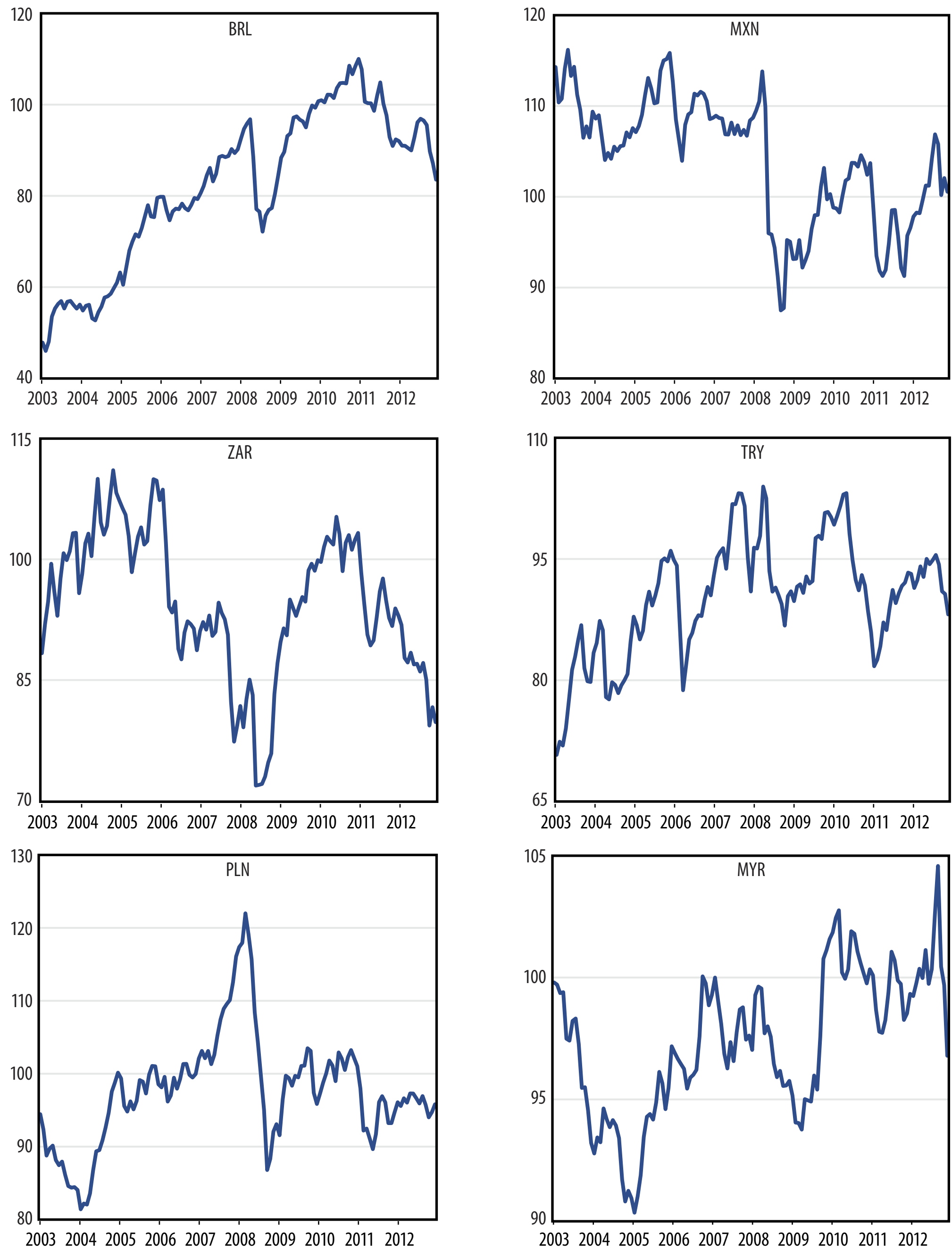


Source: Bloomberg. As of 20 Sept 13

Even under "normal" market conditions, trying to estimate the fair value of a currency can be a complex and imprecise exercise, but one simple metric we can look at to try to ascertain whether a currency has moved out of line with its long-term fundamentals is to look at changes in that country's real effective exchange rate (REER).

Economic theory supports the idea that faster-growing EM countries, where productivity levels are playing "catch up" with DM countries, should see their currencies appreciate over the long term. One of the best-known theories is the "Balassa-Samuelson" effect, which states that countries with higher productivity in the tradeable sector of the economy (e.g., manufactured goods) will have higher wages in that sector than a country with lower levels of productivity. This should put upward pressure on wages in the non-tradeable sector (e.g., local services) by more than the tradeable sector where prices adjust through international competition. This raises the overall price level relative to the country with lower productivity, resulting in an appreciation in the real exchange rate.

A rise in a country's real exchange rate was a feature of a number of EM currencies prior to the 2008 financial crisis (see exhibits below). In most cases the real exchange rate started to recover after a significant downward adjustment.



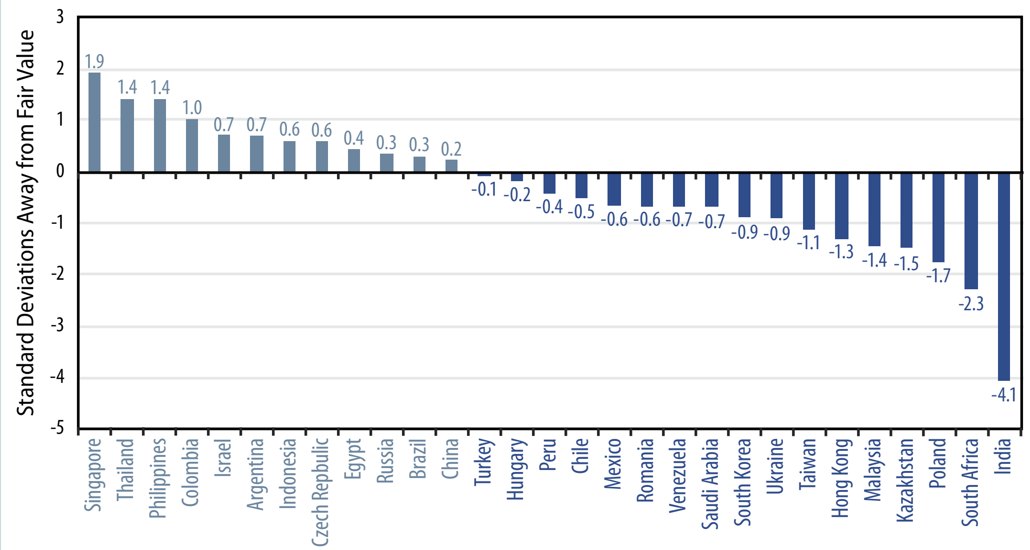
Source: Haver Analytics, Bank for International Settlements. As of 31 Aug 13

In the cases of South Africa and Turkey (and to a lesser extent Brazil), a common trend has been that they have run persistent current account deficits (a country's net position in trade, services and income) suggesting that their exchange rates were "overvalued" prior to the recent weakness. Such "overvaluation" can often be sustained if the current account deficit is funded by long-term foreign direct investment. However, if the deficit has mainly been funded primarily by short-term portfolio flows (as is the case in both South Africa and Turkey) then this "overvaluation" is difficult to sustain.

The country that has seen the largest adjustment in its REER is South Africa, a decline which started in 2011 and has continued since. The sharp fall in South Africa's REER should start to help restore competitiveness within the country's export sector, and over time, help correct the current account deficit. By contrast, the declines in the REERs in Turkey and Brazil have been more modest. The REERs in both Poland and Mexico have never really recovered post the financial crisis and remain below 2008 levels.

A recent study of EM REER valuations (Exhibit 7) highlights that the South African rand, Polish zloty and Mexican peso are "undervalued." Other currencies that stand out as "cheap" on this measure include the Indian rupee and Malaysian ringgit.

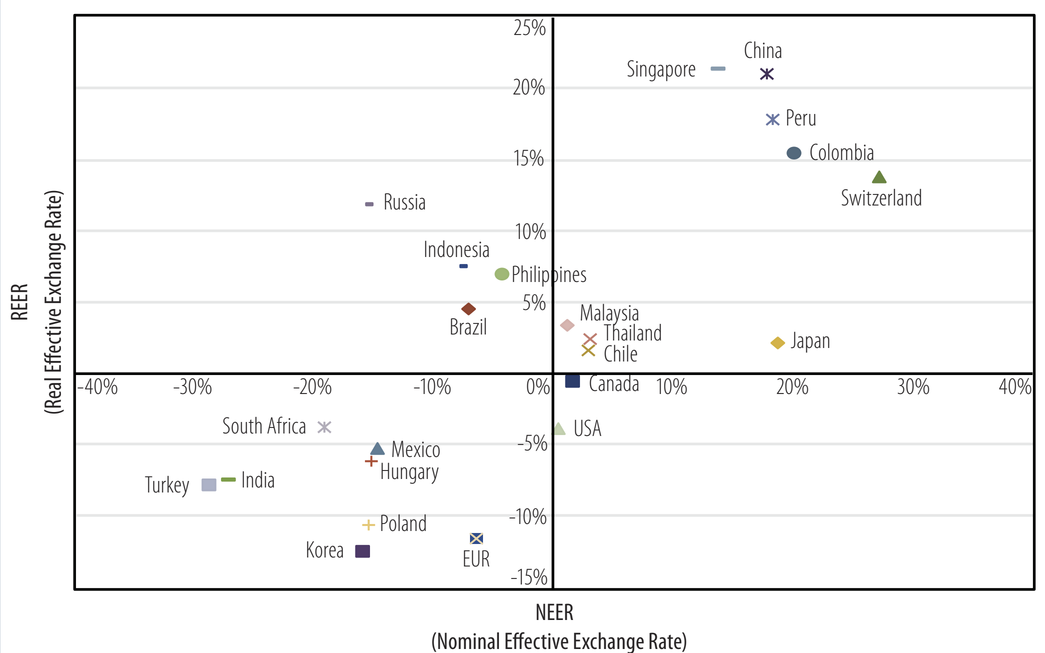
Exhibit 7
Valuations of REERs Reveal Undervalued Currencies



Source: Credit Suisse, Western Asset. As of 30 June 13

Similarly, comparing changes in a country's REER (Exhibit 8) with changes in their nominal effective exchange rate (NEER) highlights that a number of EM currencies appear to be undervalued.

Exhibit 8
Five-Year Rolling NEER and REER Changes (%)



Source: Bank for International Settlements, Western Asset calculations. As of Jan 2013

In local EM markets, we favor exposure to countries where we have seen a significant upward adjustment in yields and where carry and rolldown remain attractive. In currencies, we favor "quality" EM currencies which have suffered during the indiscriminate recent selloff in EM FX and which still appear undervalued on a REER basis, such as the Mexican peso. The table below is a summary of various scenarios for a US dollar-based investor looking to take a position today in 10-year maturity Mexican bonds (current yield 5.75%) and the peso (i.e., an unhedged bond position) over a 12-month horizon.

Change in Yield	Bond Return*	FX Return	Total
-100	12.8%	+10%	22.8%
-50	9.3%	+5%	14.3%
0	5.9%	0	5.9%
50	2.8%	-5%	-2.2%
100	-0.3%	-10%	-10.3%

*Source: Western Asset. *Analysis assumes rolldown*

Investor Positioning Remains Supportive

With uncertainty over Fed policy and the global growth outlook subsiding, headwinds to positioning in local EM bonds should start to abate. Western Asset's view of a slow but steady recovery in the US and in other major DM economies, and a gradual retreat from quantitative easing, combined with improving data from China, should all generally be supportive of EM currencies and local bonds.

Despite increased volatility, foreign investors have not reduced their EM local market exposures (Exhibit 8). Although some pundits point to the dangers of offshore positioning within domestic bond markets, we believe this positioning reflects broader positive trends. The fact that offshore investors have not materially reduced local positioning (despite ample opportunity) likely reflects their ongoing belief in the long-term fundamentals of the assets class and suggests they are not concerned about a repeat of previous EM crises. In addition, investors are likely finding local EM investments still attractive within their wider opportunity set. We also believe many investors are still structurally "underweight" EM fixed-income and therefore are less inclined to unwind positions.

Foreign Ownership of EM Domestic Securities Has Doubled Since 2007

Foreign Ownership of Debt Stock (%)

	2007	2008	2009	2010	2011	2012	Latest Available
Peru	30%	30%	21%	46%	49%	60%	60%
Malaysia	15%	14%	17%	28%	37%	44%	43%
Hungary	30%	22%	20%	23%	35%	40%	39%
Poland	20%	14%	18%	26%	30%	36%	38%
Mexico	11%	12%	12%	20%	26%	37%	37%
Indonesia	16%	17%	19%	31%	31%	32%	31%
Turkey	17%	15%	13%	18%	23%	29%	31%
South Africa	11%	13%	14%	22%	29%	32%	31%
Romania			7%	10%	12%	14%	23%
Russia						7%	20%
Thailand	1%	3%	3%	6%	10%	11%	18%

South Korea	10%	8%	10%	15%	18%	16%	16%
Brazil	3%	4%	5%	9%	9%	10%	14%
Czech Republic	16%	11%	11%	14%	14%	12%	13%
Colombia				2%	3%	4%	7%
Israel*	3%	2%	3%	10%	8%	5%	5%
Debt stock wtd. avg.	**8.7%**	**8.2%**	**9.0%**	**14.5%**	**17.1%**	**20.0%**	**22.4%**
Simple average	**14.1%**	**12.7%**	**12.4%**	**18.7%**	**22.3%**	**24.3%**	**26.6%**

*Source: JPMorgan and official sources. *Israel includes bonds and Makam*

Conclusion

EM assets have experienced a significant selloff since early May. For a long-term investor, this re-pricing has created attractive value opportunities across the EM bond and currency universe. Western Asset's view of slow but steady growth in the DM world combined with continued supportive monetary policy globally is, we believe, a supportive backdrop for EM growth and asset prices. The recent indiscriminate selloff in USD-denominated EM sovereign and corporate bonds has, we believe, made yield spreads compared to similarly-rated DM bonds look attractive. Local currency-denominated EM bonds, which combine the potential for both lower yields and stronger currencies also, in our opinion, represent an attractive opportunity for those investors who have a constructive long-term view and are able and willing to accept shorter-term volatility. The EM Team at Western Asset believes recent market volatility has created an opportune moment for value investors to initiate or add to their EM exposures.

Past results are not indicative of future investment results. Investments are not guaranteed and you may lose money. 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. Potential investors in emerging markets should be aware that investment in these markets can involve a higher degree of risk.

Western Asset Management Company Distribuidora de Títulos e Valores Limitada is authorised 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 KLFB (FID) No. 427, and members of JIAA (membership number 011-01319) and JITA. Western Asset Management Company Limited ("WAMCL") is authorised and regulated by the Financial Conduct Authority ("FCA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FCA Handbook and has been approved by WAMCL.