



What Role for Emerging Markets After the Sell-Off?

“Is now the right time to buy?” This is the question that is – and should be – on the minds of investors after the sharp movements in financial markets that began in May. Virtually no sector of the global fixed income market was immune, and emerging markets (EM) was no exception, experiencing one of its worst periods of performance in the past decade. In the three months ending in July, local currency-denominated EM sovereign bonds fell 10.6%, U.S. dollar-denominated EM sovereign bonds declined 7.8%, and U.S. dollar-denominated EM corporate bonds dropped 5.8%. EM equities also fared poorly, falling 7.8%.

The past would suggest that periods of underperformance in EM ultimately could become buying opportunities. Over the past 10 years, quarters in which total returns were negative were followed by quarters of positive returns more than 70% of the time in local currency- and U.S. dollar-denominated EM bonds. This implies that in the past a certain amount of mean reversion has been the norm, in which selling during periods of stress overshoots and is followed by a bounce in prices after the stress subsides.

But it is dangerous to rely on simple historical patterns to form an investment thesis in the current environment. The past 10 years have seen an unprecedented decline in global yields. The recent sell-off of course was triggered by concerns that the tapering of large-scale asset purchases by the U.S. Federal Reserve would remove a key source of support for market valuations. Whether or not one believes that the market reaction to prospective tapering is overdone, it is clear that after unprecedented intervention in financial markets, the Fed at some point faces the challenge of unprecedented withdrawal. With all these “unprecedenteds” floating around, backward-looking analysis should be treated with caution.

Rather, in assessing value in EM bonds, or any asset class for that matter, it is important to anchor investment views within a macroeconomic outlook. The underlying strength of global economic activity ultimately acts as a source of gravity for global yields. Central bank policy rates and quantitative easing programs will be responsive to growth and inflation dynamics. The interest rates that generate equilibrium between savers and borrowers will be driven by whether those savers are opting to buckle down or spend, and whether those borrowers have appetite to take on additional debt to consume or invest. In short, you cannot answer a question about where yields are going without a view on where the global economy is going.

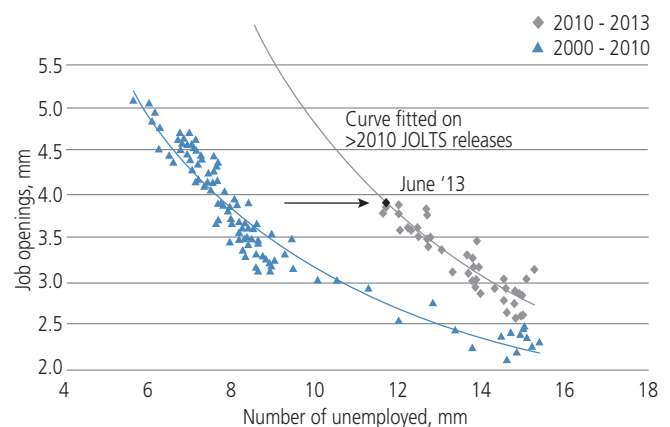
How strong is the global economy?

So what is the global macroeconomic outlook? There are definite pockets of strength, some of the most significant of which are in the United States. Housing prices rose 12.2% year-over-year in the Case-Schiller 20-city average index in May, and in July, consumer confidence as measured by the Thomson Reuters/University of Michigan index reached its highest level in six years, and the ISM purchasing managers index for manufacturing reached a two-year high.

But the U.S. economy continues to confront structural challenges that have made sustainable growth elusive. An enduring weakness continues to be what appear to be structural dislocations in the labor market, evident not only in the continuing high rate of total unemployment (7.4% as of July) and long-term unemployment (37% of those unemployed) but also in the apparent inability of the labor market to successfully match job-seekers with sectors of the economy that are hiring. Figure 1, known as the Beveridge Curve and prepared by PIMCO portfolio manager Ivan Skobtsov, depicts the relationship between the number of unemployed persons and the number of job openings. It shows an increase in the number of unemployed persons for any given level of job openings – for example, prior to 2008,

the 4 million job openings that employers were looking to fill would have been associated with around 8 million unemployed persons, whereas today's number is almost 12 million. Those 4 million additional unemployed people – representing 2.5% of the U.S. labor force – mean lower household incomes and consequently less ability to support household consumption growth.

FIGURE 1: U.S. JOB OPENINGS VERSUS NUMBER OF UNEMPLOYED



As of 30 June 2013

Source: Job Openings and Labor Turnover Survey (JOLTS), PIMCO

Globally, there are some positive economic indicators, but the overall picture looks tenuous. Industrial indicators, such as sentiment of European purchasing managers, have recovered from the extremely depressed levels of a year ago, but are still hovering around neutral, reflecting the continued squeeze of austerity in Europe, which has bounced off of the bottom but remains mired in a very slow growth regime. Japan is benefiting from the expansionary monetary and fiscal policies of Prime Minister Shinzo Abe, but the outlook is clouded by the prospect of a significant fiscal contraction in 2014 when a hike in the value-added tax is due to be implemented. Finally, the large emerging markets are either decelerating or stabilizing at substantially slower rates of growth than 12 months ago, as Figure 2 shows.

FIGURE 2: EMERGING MARKETS INDUSTRIAL PRODUCTION

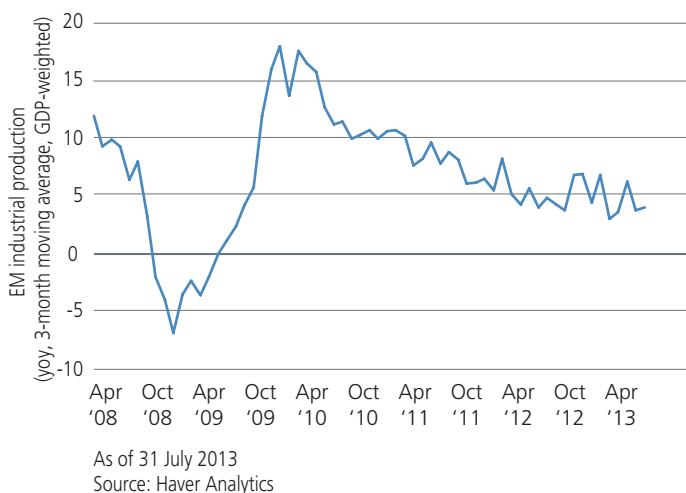
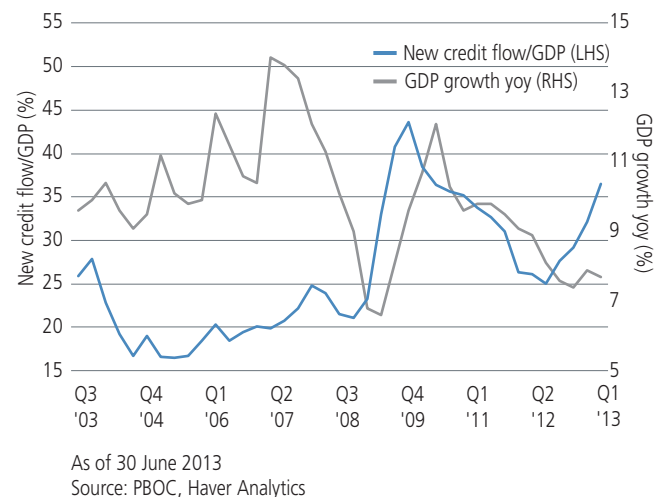


FIGURE 3: CHINA: GDP GROWTH AND CREDIT GROWTH



Of particular importance: China is facing its most significant structural growth slowdown since the late 1990s. Cyclical policy tools to boost growth are losing traction, illustrated vividly in Figure 3. Following the global financial crisis, the Chinese authorities deployed a massive fiscal and credit stimulus which achieved the objective of boosting GDP growth – observe the rise in the credit growth line, followed by the rise in the GDP growth line during 2008-2009. But when Chinese authorities implicitly did the same thing last year, the rise in credit growth did not produce the same boost to GDP. Instead, China’s GDP growth continued to decelerate to 7.5% year-over-year in the second quarter of 2013 – an indication that the credit- and investment-driven economic model is reaching its limits.

A pivot away from investment-led, credit-fuelled growth in China and toward household demand powered by rising incomes is a needed change, but achieving that involves difficult domestic reforms and also entails slower growth versus recent years when countries from Australia to Brazil piggybacked on ever-expanding Chinese demand.

Emerging market central banks in a low-growth environment

Amid these challenges to global growth, central banks throughout the world are likely to remain accommodative despite the pockets of improvement in the economy. In the U.S., tapering may suggest reduced asset purchases, but that is very different from interest rate hikes, which are unlikely for an extended period amid the still-slow rate of recovery. In Europe and the U.K., the European Central Bank (ECB) and Bank of England (BOE) surprised the market with commentary aimed at guiding forward interest rate expectations downward. In Japan, the BOJ continues to implement its expanded asset purchase program. In EM – with a few notable exceptions for countries with weaker balance sheets seeking to defend their currencies – interest rates are likely to remain on hold, and some may even be looking to ease policy.

Against this, the sell-off in global bond markets has now embedded expectations of sometimes significant interest rate hikes in yield curves for some EM countries. Figure 4 shows the changes in the policy rate embedded in various EM local

bond curves through the end of 2014. Moreover, the term premiums across most EM curves (the slope between the two-year government and 10-year government bond yields) have increased significantly in the past three months, reflecting the increased stress in global markets.

FIGURE 4: EMERGING MARKETS: CHANGES IN CENTRAL BANK POLICY RATES REFLECTED IN YIELD CURVES

Market implied policy rates changes through year end 2014 (bps)

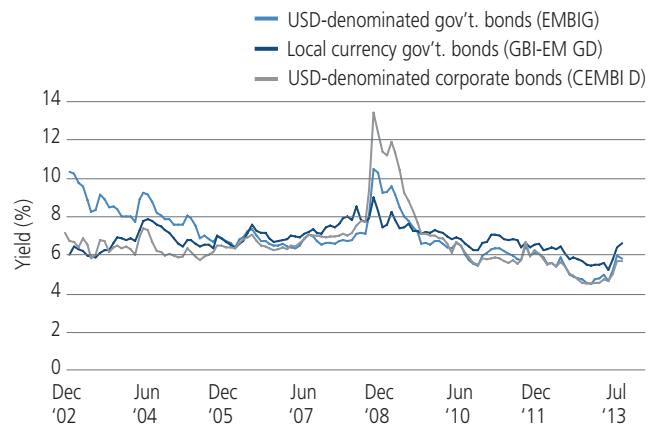
Latin America		Eastern Europe/Africa		Asia	
Brazil	262	Hungary	28	Indonesia	178
Colombia	150	Poland	65	Malaysia	22
Mexico	50	Russia	-51	Thailand	34
Peru	-26	South Africa	146		
		Turkey	88		

As of 8 August 2013
Source: HSBC, PIMCO

Buying bonds is all about locking in yields. If the global growth environment remains tentative, it is likely that the interest rate increases priced in most EM local curves will not materialize, making it advantageous for the bond investor to lock in yields now and position to benefit from the carry as well as potential capital appreciation if a revised lower interest rate path compresses yields. As Figure 5 shows, yields on EM local currency sovereign bonds – as well as their U.S. dollar-denominated sovereign and corporate counterparts – are at levels that have not been seen for some time. Figure 6 shows the difference in real yields on EM local bonds versus U.S. Treasury real yields is at the higher end of the range of the past 10 years.

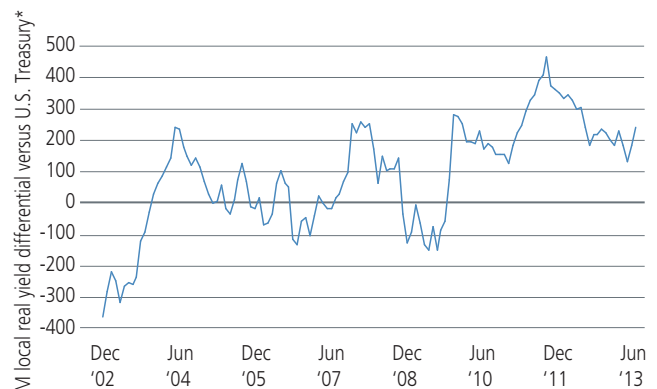
The message from both graphs is that valuations in EM bonds have improved – they are by no means at the cheapest levels they have been historically, but value to investors has increased.

FIGURE 5: EMERGING MARKETS: HISTORICAL YIELDS



As of 31 July 2013
Source: JPMorgan Securities, Inc.

FIGURE 6: EMERGING MARKETS: LOCAL REAL YIELDS RELATIVE TO U.S. TREASURY REAL YIELDS



As of 30 June 2013
Source: JP Morgan, Bloomberg, PIMCO.
*Yield of GBI EM deflated by weighted CPI of the constituents in the index vs. UST 5-year deflated by U.S. inflation

Brazil is a good example. Brazil is one of the few EM countries that is hiking interest rates. Responding to headline inflation at the top end of its 4.5% +/- 2.0% target, Banco Central do Brasil (BCB) has already increased policy rates from 7.25% to 8.50% since the beginning of the year. The Brazilian yield curve anticipates that the policy rate will rise another 262 bps to 10.86% by the end of 2014 (as seen in Figure 4).

Will Brazil hike policy rates by this much? Brazil's economy remains tepid, with GDP running at around 2% and industrial production growing around 4% yoy. Add the fact that slower Chinese growth is likely to impart a contractionary impulse to Brazil's economy, which is heavily dependent upon the export of mining and agricultural commodities. While the 15% depreciation of the exchange rate since early May will support some foreign demand for Brazilian exports and boost inflationary pressures that the central bank is seeking to combat, it is unlikely that these would overwhelm other disinflationary factors, unless the global economic picture improves.

Buying a Brazilian 10-year government bond that (as of 13 August) yielded 11.43% in local currency terms would have locked in an annual yield differential of 871 basis points (bps) versus a 2.72% yielding 10-year U.S. Treasury, if held to maturity. In thumbnail terms, that would mean that for a Brazilian bond to underperform a U.S. Treasury, the Brazilian real would have to depreciate more than 871 bps per year for the next 10 years (a total depreciation of almost 60%) – illustrating the attractiveness of the EM local bond.

The alternative case

How might the preceding analysis be wrong? That is a question that we are asking ourselves constantly, particularly in the context of a fluid economic and financial market environment. There are three main risks.

First, the call on tepid global growth could prove to be too pessimistic. If actual growth is more robust than we expect, then global yields could continue to increase. In particular, if the U.S. economy surprises on the upside, that could produce further increases in U.S. Treasury yields or more rapid Fed tapering, both of which could push global yields higher and produce further strength in the U.S. dollar to the detriment of EM currencies. It certainly helps that the starting point of higher yields on EM bonds means that there is more cushion from carry to absorb increases in yields (and losses from currency in the case of local bonds), but cushion is not the same as immunity.

Second, it may be possible that more emerging markets than previously recognized have financial vulnerabilities that prevent them from smoothly navigating a more hostile global growth environment. In fact, this was the “old normal” in emerging markets, where heavily indebted EM countries in the 1990s and early 2000s were compelled to hike interest rates despite sharp economic contractions, in efforts to stem capital flight and avert further currency depreciation that threatened to make foreign currency-denominated debts unsustainable. A critical thesis for investing in EM today – in particular in local currency-denominated bonds – is that most countries have the ability to cut interest rates in a slower global growth environment, because their basic economic stability is not at risk even amid currency depreciation.

Clearly, there are some countries that have felt compelled to tighten monetary conditions in an attempt to prevent further currency depreciation. Particularly vulnerable here are countries with large or growing current account deficits, foreign currency mismatches in their assets and liabilities, or relatively thin reserve cushions. Both Turkey and Indonesia have hiked interest rates recently in an attempt to keep foreign capital from withdrawing. India has implemented a variety of new

measures affecting the foreign exchange market, targeted at limiting pressure on the rupee. For the most part, however, the major systemically important EM countries fit the profile of “New Normal” flexibility in which policymakers have the freedom to ease monetary conditions into economic weakness.

Third, it may be the case that technical factors like the unwinding of large EM positions that were put on with an expectation of continued Fed asset purchases – or an increase in redemptions from EM mutual funds – could cause EM bond prices to continue decreasing in the near term. That is, even if eventually the fundamentals of slower growth were to reassert themselves over EM yields, investors in EM assets could absorb some significant bruises before that happens.

This risk is inherently difficult to analyze. Based on our observations, there has been a significant technical element to the sell-off in EM, as well as other asset classes. Positions that were owned by foreign investors tended to be positions that were sold. Positions that were less widely owned by foreign investors tended to perform better, even when those countries had fundamentals that were arguably more precarious.

In an environment where many trades – including in EM – are premised on the idea of clipping carry in a world where the Fed continued to provide an unlimited backstop, financial markets will remain vulnerable to the ongoing reassessment of Fed intentions and are liable to lurch on each piece of data or Fed-speak that implies a move in one direction or another. This calls for discretion in the scaling of positions in the face of inherent unknowns about market technicals.

Emerging markets assets after the sell-off

So, is now the right time to buy?

From a fundamental point of view, we see value in the higher yields available on many EM bonds, both in local currency and U.S. dollars. In a global environment characterized by

continued concerns about growth – even amid firmer economic indicators – policy interest rates in both developed and emerging countries are poised to stay low. In that context, yields (as of 13 August) of 6.54% on EM local currency government bonds, 5.95% on U.S. dollar-denominated EM sovereign bonds, and 5.73% on U.S. dollar-denominated EM corporate bonds offer advantages to cash and a defined income stream in a world of questionable corporate profit growth. Moreover, we continue to expect a reallocation by global investors away from lopsided allocations to developed countries and into emerging markets to provide support for EM asset prices in the years ahead.

On the negative side, we expect that there will be continued volatility in EM assets alongside the continued reconciliation of market positioning with expectations about Fed actions. Even if our view on weaker global growth is correct, it could be negative for EM currencies as softer economic conditions produce less appetite for investors to go abroad. In other words, what is good for EM yields might not be good for EM currencies in the short term.

This is especially true of countries with weaker fundamentals (current account deficits, mismatched currency denomination of assets and liabilities, unorthodox policy regimes, and low foreign reserve coverage). These countries are vulnerable on both the interest rate and foreign exchange fronts.

Adding this all together, we think that investors should consider using the valuations in EM bonds after the sell-off as an attractive entry point to build positions toward a long-term strategic target, emphasizing strategies with a higher-quality bias. This is premised on the observation that the starting point for most investors is very low exposures to EM bonds – which represent only about 7% of total U.S. mutual fund investments in bonds (and therefore an even lower proportion of overall U.S. investor portfolios), according to ETFR. In a world where large global investors are rotating into EM assets, periods of

market weakness provide an opportunity for smaller retail and institutional investors to build toward their strategic allocations, while retaining dry powder for additional purchases should market volatility persist.

All emerging markets performance and yield information in this article, unless otherwise noted, is based on index performance as of 31 July 2013: JP Morgan's Government Bond Index – Emerging Markets Global Diversified (for local currency-denominated emerging market sovereign bonds); JP Morgan's Emerging Markets Bond Index Global (for U.S. dollar-denominated emerging market sovereign bonds); JP Morgan's Corporate Emerging Market Bond Index Diversified (for U.S. dollar-denominated corporate emerging market bonds); and the MSCI Emerging Markets Index (for local currency-denominated emerging market equities).

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The JPMorgan Corporate Emerging Markets Bond Index (JPM CEMBI) is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities.

The JPMorgan Emerging Markets Bond Index Global is an unmanaged index which tracks the total return of U.S.-dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady Bonds, loans, Eurobonds, and local market instruments.

The JPMorgan Government Bond Index-Emerging Markets (GBI-EM) indices are comprehensive emerging markets debt benchmarks that track local currency bonds issued by Emerging Market governments. The index was launched in June 2005 and is the first comprehensive global local Emerging Markets index.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

It is not possible to invest directly in an unmanaged index.

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