Opportunities and Challenges in Emerging Markets

10/16/2008—Guillermo Ossés, a member of PIMCO's emerging markets team, shares his analysis of this asset class in light of the unprecedented changes in the global financial system.

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Performance
It has been difficult for any asset class not to be affected by what happened in the credit markets in the developed world. But while emerging markets currencies are down year-to-date, this asset class has performed better than other, more inflationary asset classes.

- In developed markets—both globally and in the U.S.—equities are down about 38% or 39% year-to-date.
- In emerging markets, equities are down 49% year-to-date, common equities are down 22% year-to-date.
- U.S. high yield and U.S. investment grade are down 20% and 30%, respectively.

Two transmission channels for crisis
We are positioning our portfolios to improve this performance going forward, although it is important to remember that current and future portfolio holdings are subject to risk. That said, it's useful to look first at the two transmission channels that have helped this crisis develop.

- *Leverage unwinding.* For much of this year, emerging market currencies and emerging-market fixed income were among the most liquid asset classes in the world. As levered market participants were forced to meet margin calls payable in hard currency, they unwound those assets where they had liquidity and were up on the year. We saw extra pressure on emerging market local fixed income and local currencies, which triggered the sharp drop that we've seen in some currencies, such as the Brazilian real, Mexican peso and South African rand.
- *Corporates.* After the initial impact of the unwinding from levered foreign participants, we saw many corporates in these countries—particularly exporters who have been hedging future revenues by selling dollars forward—being forced to meet margin costs with international banks, which requires them to get funding in dollars. And in some cases, the only way for emerging market corporates to get this funding was to obtain it from their local markets, which entailed borrowing locally, selling their currency and buying dollars to meet their obligations abroad.

These two events—the leverage unwinding and the corporates—actually happened in sequence. After the unwinding, we saw a reaction from emerging market central banks. However, we've started to see these banks coming into the market, selling reserves directly or providing liquidity. This has helped the markets start to stabilize.

Country segmentation
Going forward, it is extremely important to identify those countries that have done their homework for the last 5-10 years and have been able to maintain high levels of savings, surpluses and reserves. These are the countries that are now going to have the ability to smooth out this volatility and bring their currencies into levels that make more sense from a valuation perspective.

This universe of emerging market countries can be divided into three groups.

1. *Very large domestic economies—China, Brazil, Mexico, Poland, and Russia.* They have been running responsible fiscal policies and accumulated large amounts of reserves; they can now help their economies pick up speed as external demand weakens.
2. *Smaller countries where exports are a large part of GDP.* In these countries, exports to developed economies are slowing, which has a significant impact both in local activity and in the value of their currencies. Examples include Hungary and Romania; they run very large current account deficits and will not have room to maneuver. We believe that these types of countries are going to perform very poorly going forward.

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3. *Countries that fall somewhere in the middle.* India, South Africa and Turkey have large domestic economies but run large current account deficits. There are also small countries that have large export sectors and have been extraordinarily well managed—such as Singapore, where we have huge amounts of reserves. Behind Singapore, we have other small Asian economies such as Malaysia, Taiwan and Thailand, where we are managing the exposure more tactically.

PIMCO's current positioning
We tend to be overweighted in currencies such as the Chinese renminbi and the Singapore dollar, because we believe that those two currencies are aligned to continue to outperform in the medium term. China in particular has the size and fiscal situation that will allow the economy to maintain its strong growth even if there are external demand increases.

Behind that, we have the large economies that have been properly managed, to which we maintain a neutral or slightly underweight level; this includes the Mexican peso, the Brazilian real and the Russian ruble.

And in third place are those economies where we are maintaining very large underweightings, such as Hungary, Romania and Argentina. Argentina is an extraordinary example of a country that is very poorly managed; we maintain zero weights in their currency.

Over the last couple of weeks, as we saw liability increasing, we took all of our overweights in those large economies to neutral positions and brought our investments in the better-managed smaller economies to neutral or even overweight.

Looking ahead
As we become convinced that the demand for U.S. dollars generated by speculative investors who need to raise cash nears its end, we will increase our exposure to those currencies of large countries with good macroeconomic management.

Why? Because yields are very, very high right now, and the currencies have reached levels—from a valuation perspective—where they are extraordinarily cheap.

We still believe that most Asian countries are going to be able to get through this problem without much impact, and this will help large emerging market economies recover.

Finally, we will maintain very aggressive underweight positions in these countries where we believe the significant need for financing puts them at risk of a blowout.

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