PIMCO's Emerging Markets Watch

Michael Gomez
Executive VP,
Portfolio Manager
PIMCO

"Because things are the way they are, things will not stay the way they are."

—Bertolt Brecht

PIMCO believes the crisis of 2008–2009 will have a widespread and long-lasting impact on global economic growth, government policy and the interplay between developed and developing economies. This New Normal implies lower growth, greater regulation and higher savings rates in the developed world, as well as relatively higher growth and a more prominent role in influencing global economic policy for the developing world. Along the way, lower global investment returns are likely to track slower aggregate global GDP growth. Yet investors seem to be shrugging off the systemic implications of the financial crisis and pricing many markets for an "old normal" recovery.

The damage from leverage-driven bubbles in equities, real estate and credit markets that characterized the pre-crisis period should not be easily forgotten. But has it?

Stocks and high yield bonds are strong performers on the back of rosy earnings predictions, even as the U.S. economy sheds jobs for the 20th month in a row. Many banks seem to have recovered from the near-death experiences of last year to report robust profits, but loan growth numbers suggest credit continues to contract. Finally, Asian policymakers continue to use U.S. policy, particularly the fed funds rate, as an anchor when growth and inflation trajectories between the two regions have never been more disparate.

Positioning portfolios for secular changes can be disconcerting when short-term market moves contrast so sharply with long-term expectations. Nevertheless, given the magnitude of the shifts implied by the New Normal, investors who fail to account for them may be worse off when the cyclical and secular forces intersect. Witness the example last week in Dubai—the emirate's investment holding company Dubai World revealed that it was seeking to extend maturities of its debt—a good reminder that high levels of country and credit differentiation will be critical in managing emerging markets (EM) assets successfully ahead.

With that in mind, let's move around the EM universe and look at areas we believe are misinterpreting "normalcy" and maintaining emphasis on the old, rather than the new. Based on these observations, we can draw some useful conclusions for portfolio strategy.

Go East, Young Man

Asia was initially the emerging market region most acutely affected by the credit crunch. But thanks to large-scale policy stimulus and the supportive initial conditions that existed in many Asian countries going into the crisis, including healthy fiscal and current accounts, the massive drops in growth and industrial production in 2008 have given way to a recovery.

Free-floating exchange rates have also played a part in helping Asia weather the crisis. They served as an effective release valve for capital account stress and helped restore competitiveness quickly, without threatening the region with a vicious debt spiral.

Throughout emerging Asia, governments allowed their currencies to adjust during the crisis, with one notable exception: China. As in the Asian financial crisis of 1997, China has kept its nominal exchange rate steady and thus re-entered a peg with the U.S.

dollar that it had effectively exited in July 2005. This policy initially provided a source of stability to global financial markets amid severe volatility. However, as Asia and China lead global growth in the New Normal, China will need to be as nimble with its exchange rate policy in the future as it was unwavering in the past in order to sustain growth.

China's resounding recovery this year has been driven by a surge in fixed asset investment targeted at infrastructure and developing the Chinese Finterland. Indeed, this increased focus on infrastructure investment across the emerging markets is critical to maintaining high levels of productivity and higher trend growth rates. It has also provided some attractive secular investment opportunities, as described in **Figure 1**.

While the markets have applauded the investment-led approach in China, its efficacy in the long run will depend on how well Chinese leadership has allocated this capital. As more projects come online, the lack of a true market-based pricing system that efficiently allocates capital makes it increasingly likely that problems of excess capacity and resource waste will occur.

A flexible exchange rate policy in China would benefit the global economy in many ways, but perhaps most importantly, it would increase the chances that China more effectively allocates its long-term resources. Market-based currency levels would increasingly shift investment emphasis away from exports and toward domestic sources of growth in China—a necessary adjustment given lower U.S. consumption in the New Normal. Without a more flexible currency policy, growing distortions and asset bubbles that result from monetary policy inappropriately tied to the Fed could derail Chinese growth over the long term.

Out with the Old and In with the New

As in China, the consequences of pegs and quasi-pegs plague emerging Europe. For a decade, the promise of euro zone accession has led to a massive build-up in foreign exchange–denominated debt in central European and Baltic countries. The expectation, of course, was that convergence-fueled growth and adoption of the euro would ease that debt-servicing burden. Instead, in the New Normal scenario, Europe will face below-trend long-term growth over the coming years. An overvalued euro, bearing the burden of U.S. dollar weakness as the world waits for China to adjust its exchange rate, will exacerbate the situation in the near term.

With competitive currency adjustment in many European countries limited or not feasible, the fiscal channel bears the stimulus burden. The 3% deficit requirement for eurozone entry is turning out to be more theoretical than practical. Indeed, none of the current eurozone members themselves will come close to that marker in 2010—fiscal deficits in Greece and Ireland are forecasted to top 12% next year, while public debt-to-GDP ratios will likely

Figure 1

Investors who recognized early on the underlying trend of improving fundamentals in emerging markets had the opportunity to benefit from the strong returns delivered by the fixed income asset class: in excess of 10% annualized since 1994 with only three years of negative performance, according to the JPMorgan Emerging Markets Bond Index as of October 31, 2009. As the sovereign portion of the asset class continues to mature, we find increasingly compelling opportunities in bonds issued by state-owned and private sector emerging market entities.

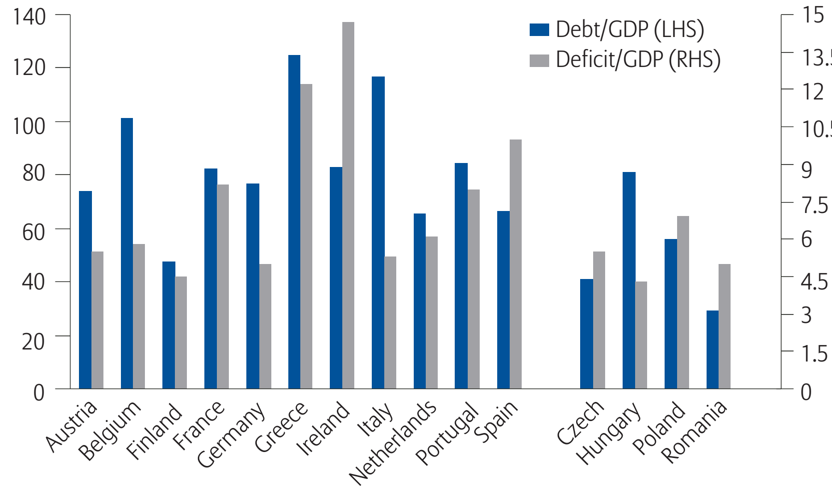
This handoff of return generation relates, in part, to the robust initial conditions, including strong sovereign balance sheets and very manageable public debt burdens, particularly in comparison to the developed economies of the U.S. and the eurozone. Additionally, the desire of emerging market governments to set their economies on a sustainably higher growth trajectory is an important supporting pillar. Achieving the ambitious goals of many EM governments requires continued investment in areas such as energy, transportation, telecommunication, and metals and mining. While governments implicitly support these infrastructure sectors, they have generally left the financing to private—and in some cases government-sponsored—entities. Yields on these securities are generally quite attractive relative to sovereign risk. In addition, many of the entities operating in these sectors are global leaders in their industries. Nonetheless, they generally pay more for their financing relative to what their fundamentals justify, simply because they are domiciled within an EM country.

We believe many EM infrastructure investments are attractive not only relative to what sovereigns offer, but also relative to what investors can earn in developed country credit, particularly given even explicit support we have seen from EM sovereigns for many of these sectors. Today, we find considerable opportunities to participate in the higher costs of capital paid by these entities and view them as a powerful way to play the continued appeal of emerging markets fixed income investing.

surge above 100% in Belgium, Greece and Italy (**see Figure 2**). The markets have mostly shrugged off these numbers for now, taking comfort in the almost unlimited short-term financing available to eurozone members through the Long Term Refinancing Operation (LTRO) from the European Central Bank (ECB).[1]

For emerging European countries that aspire to eurozone heaven, these days are purgatory. They have avoided short-term disaster with EU and IMF bridge financing and through capital markets that have thawed sufficiently to allow limited external financing. Nevertheless, the New Normal looms, and these countries must have a plan for generating sustainable, long-term growth before investment—and spreads that imply old normal conditions—can be justified.

Figure 2 | Eurozone Debt Dynamics



Source: European Commission 2010 forecast, Morgan Stanley

The Price Is Right?

In many ways, Latin America has proved to be a middle ground in the crisis and recovery, suffering less than emerging Europe but bouncing more moderately than Asia. Much of the region entered the crisis with strong initial conditions, including high international reserves; ample monetary and fiscal policy flexibility; and strong ties with the multilaterals, which allowed quick access to emergency financing. Ironically, because these countries suffered so many crises in the past, they had ample experience in navigating shocks, both exogenous and endogenous.

The credit rating agencies have rewarded Peru and Brazil with well-deserved upgrades, rarities in these times. But the region's resilience raises important questions: Has the market already fully priced secular credit improvements? Is there a more compelling way to invest in Latam under a New Normal secular view that couples a difficult external, or global, environment with a favorable regional environment?

The case of Brazil illustrates these issues well. Recently, Brazil's BBB- rated U.S. dollar debt traded in the secondary market at a significantly tighter level than single A rated "Build America Bonds" issued on the same day with a similar maturity (138 basis points versus 230 basis points over the 30-year U.S. Treasury bond). However, valuations on Brazilian real–denominated local debt, offering nominal yields close to 13% for seven-year maturities, compare favorably with those of U.S. high yield credits. That level of compensation far exceeds current consumer price inflation (4.2%) and expected future inflation in Brazil. It also provides ample cushion to offset currency volatility that may increase as risk sentiment changes or as Brazilian policy radicalizes to try to contain BRL appreciation. At current differences in like maturity nominal yields between U.S. dollar- and Brazilian real–denominated debt, the U.S. dollar would have to appreciate by 70% versus the real over the life of the investment for U.S. dollar debt to outperform.[2]

Investment Implications

Based on our analysis, we believe investment portfolios should express a secular tilt to benefit from eventual flexibility in the Chinese currency. That flexibility should, in turn, loosen what has been an implicit constraint on the ability of Asian currencies to appreciate versus those of the developed world. More autonomous monetary policy in Asia as it moves away from the "lower-for-longer" Fed means a more defensive stance regarding Asian local interest rates.

Accommodating the New Normal through more policy flexibility will be painful for emerging Europe, however. Pegs and quasi-pegs are likely to be tested again as stagnant Euroland growth dashes hopes that emerging Europe can "grow its way out of it." An overvalued euro threatens to tighten financial conditions further.

Investors looking for exposure to local market investments in emerging Europe may want to focus on Poland. It is the only country in Europe (old or emerging) that is expected to register full-year positive real GDP growth in 2009, due to its strong domestic orientation, credible institutions and flexible exchange rate. Despite a stronger balance sheet, better growth prospects, and more effective policy in navigating the crisis, the Polish zloty has cheapened versus both the euro and other regional emerging European currencies over the past year. Hungary, Romania and the Baltics, on the other hand, continue to suffer severe recessions and we think exposure there should be minimized. These countries have high levels of foreign exchange–denominated debt, creating potentially explosive debt dynamics and hindering adjustments through the currency channel. While multilateral and bilateral aid has been abundant, these countries also lack the immediate access to financing in periods of stress that their eurozone member cousins have through the LTRO.

In Latin America, valuations on sovereign external debt reflect the progress many countries in the region have made over the past decade in reducing their vulnerability to external shocks and developing closer ties to Asia through commodity trade. Given the low absolute level of yields, total returns on sovereign external debt will likely be lower than investors expect from emerging market debt. However, opportunities for higher total returns abound in Latin America's local markets; real yields in Brazil are by far the highest in the world, and currency valuations in Mexico are significantly cheaper than historical averages. We find investments in Brazil and Mexican local bond markets attractive.

Finally, investors can find opportunity for significant yield pickup in infrastructure-based investments around the emerging world, without sacrificing credit quality. This segment of the market should increase in importance in the New Normal, as countries lay the foundation for long-term gains in productivity and real growth.

1. *The ECB's Long Term Refinancing Operations provide liquidity to eurozone banks (and, by extension, governments) in exchange for acceptable collateral. Acceptable collateral is published on the ECB website and was expanded greatly during the peak of the crisis.*

2. *On October 19, 2009, the Brazilian government announced measures aimed at containing appreciation of the nominal BRL exchange rate, including the introduction of a 2% tax on capital inflow for both fixed income and equities. Breakeven BRL depreciation assuming all else held constant for life of investment, and with yield on Brazil NTNF 2017 local bonds of 13.15% and Brazil USD 2017s of 4.42% on November 18th, 2009.*

Allianz Global Investors Distributors LLC, 1345 Avenue of the Americas, New York NY, 10105-4800 www.allianzinvestors.com, 1-888-877-4626.

27465