

PIMCO's Emerging Markets Watch



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Emerging Markets in the New Normal

At PIMCO's most recent secular forum we analyzed the significant changes to the global economy and concluded we were entering a New Normal. This New Normal will mean lower potential growth for the global economy overall and especially so for the highly levered developed economies. For the emerging economies this presents a challenging environment, with lower export demand and a reversal of leverage induced global capital flows. But it also presents significant opportunities, not only to shift from export led growth to domestic demand but also to strengthen their position within the new economic order.

We believe that several key emerging economies are well advanced in the process of making that transition. While the U.S., Europe, and Japan are still economically the largest and most dominant economies, these economies are reaching the tipping point¹ of global economic impact. (see chart 1) This article will review the critical mass of this transformation and the implications this has for the valuation of the U.S. dollar and its role as the global reserve currency.

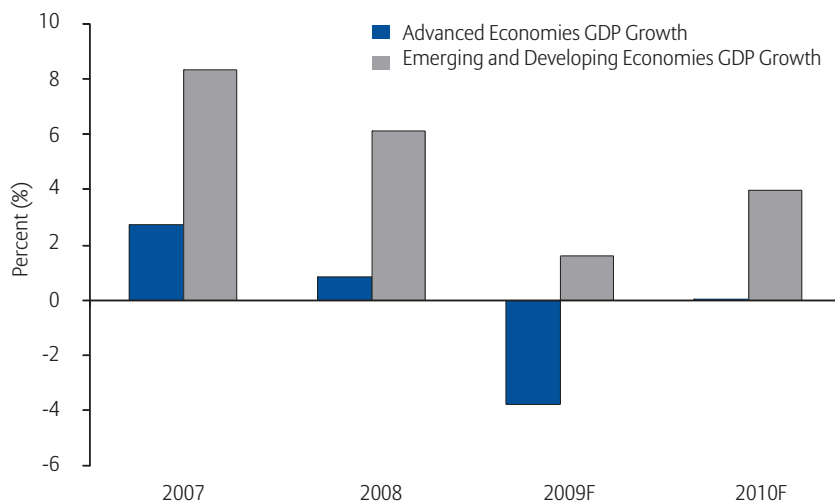
Voting or Weighing Machine?

Whether financial markets are voting machines or weighing machines² (see chart 2) is eye opening. China's stock market capitalization is now larger than that of Japan, the second largest economy in the world. Just three years ago, in 2006, Japan's market capitalization was 12 times the size of China's. In retrospect a buy China/sell Japan trade was about as close to a "no brainer" as financial markets offer. Four trillion dollars of profits were available for investors who stuck with this simple theme.

Some readers may perhaps fear that yet another asset bubble is forming, and that the growth in the Chinese market has come too far too fast, which of course is possible. At 25 times forward earnings and 3.8 times price-to-book, the Shanghai Stock Exchange Composite Index is far from cheap by traditional measures, and thus financial markets are likely reflecting more of a "voting machine" aspect of future expectations than a "weighing machine" measure of current value. But the fact is that we are witnessing real time indicators of significant changes in the global economy, with China clearly continuing its meteoric rise in terms of global economic importance. It is not surprising China's market capitalization is larger than Japan's, given that the Chinese economy will probably surpass Japan to become the second largest economy in the world next year, measured in current exchange rates.³

China is clearly the largest emerging economy, but by no means is the phenomenon limited to China. Indeed in terms of GDP, emerging market (EM) economies account for seven of the top twenty countries⁴, and represent the component that is

Chart 1 | Emerging Economies Becoming "Locomotive" of Global Growth

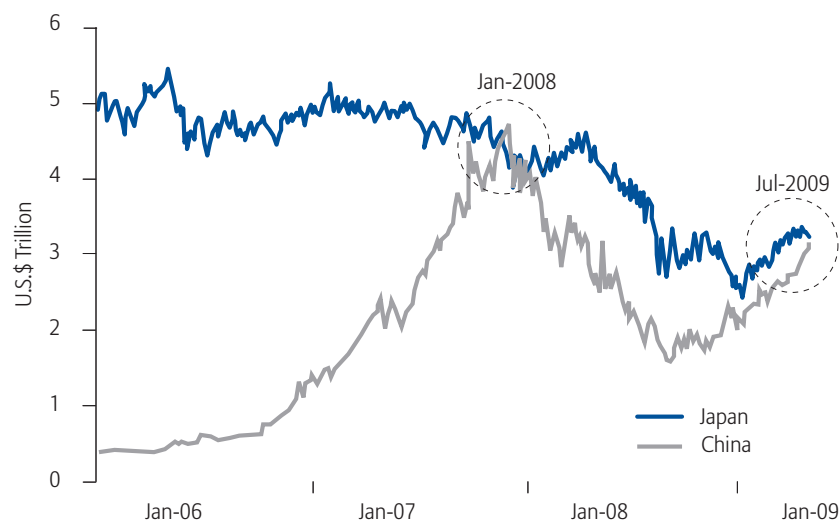


Source: IMF World Economic Outlook 2009



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Chart 2 | Stock Market Capitalization



Source: PIMCO

growing the fastest. The rest of the BRICs⁵ share some of the same characteristics that are significant comparative advantages in the New Normal, for example, low labor costs and extremely low levels of consumer debt. They also have large populations, so domestic demand can truly move the needle on a global scale.

Chart 3 | Global Share of Consumption

(% share of global consumption)	2007E	2008F	2009F	2010F	2015F	2020F
U.S.	20.2	29.3	28.3	27.4	23.5	20.8
Non-Japan Asia	12.1	13.6	15.5	17.1	25.8	32.3
China	5.3	6.4	8.0	9.3	16.4	21.1
Japan	8.2	7.9	7.7	7.4	6.5	5.8
Germany	5.6	5.5	5.3	5.1	4.3	3.8
U.K.	5.0	4.9	4.8	4.6	4.0	3.7
France	4.2	4.1	3.9	3.8	3.2	2.9
Italy	3.6	3.4	3.3	3.2	2.7	2.3
NIE 4*	2.9	3.0	3.0	3.0	3.1	3.1
India	2.0	2.2	2.4	2.6	3.9	5.3
Spain	2.4	2.3	2.2	2.2	1.9	1.8
ASEAN 4**	1.8	2.0	2.1	2.1	2.5	2.7
Canada	2.3	2.3	2.2	2.1	1.9	1.7

Source: Credit Suisse

Note: Data sorted by year 2010

*Includes Hong Kong, Korea, Taiwan and Singapore

**Includes Indonesia, Malaysia, the Philippines and Thailand

For countries to become and remain dominant in the global economy they must reduce their dependency on others (export demand) and develop their own sources of sustainable demand (particularly domestic consumption). Thus for large systemically important economies, export led growth is a means rather than an end, and the transition to domestic demand is underway. The large (~\$580 bn) government stimulus program in China has been a contributing factor, keeping GDP above 6%. But India too has been able to maintain growth around 5%, without such a large program. A recent analysis by Credit Suisse⁶ shows that Chinese consumption is already the second largest contributor to global consumption, and that China and India will be the first and fourth largest contributors by 2020.

Projections of Global Consumption Growth

One analogous way to think of an economy is as a company with four major divisions, namely, consumer, business (investment), government, and international (net exports). For a company with limited domestic customers (consumer, business, or government), a winning strategy can be to initially produce goods for the export markets, and look to grow the other divisions over time as demand picks up. As shown in chart 3 below domestic demand is now starting to pick up, with enabling conditions in place following years of structural reforms and balance sheet improvement.⁷

Following this simple construct, economies with large domestic consumer and business (investment) sectors—like in China and India with 30% of the world's population—may have a key advantage. Take for example the auto industry: Chinese auto sales are poised to exceed U.S. sales (chart 4). The BRICs have 10 times the population of the U.S. and less than 3% of the population own automobiles, so the potential for growth is simply huge.

One of the most powerful and potentially profitable investment implications likely to result from emerging economies reaching critical mass is the future value of the U.S. dollar, which has been the

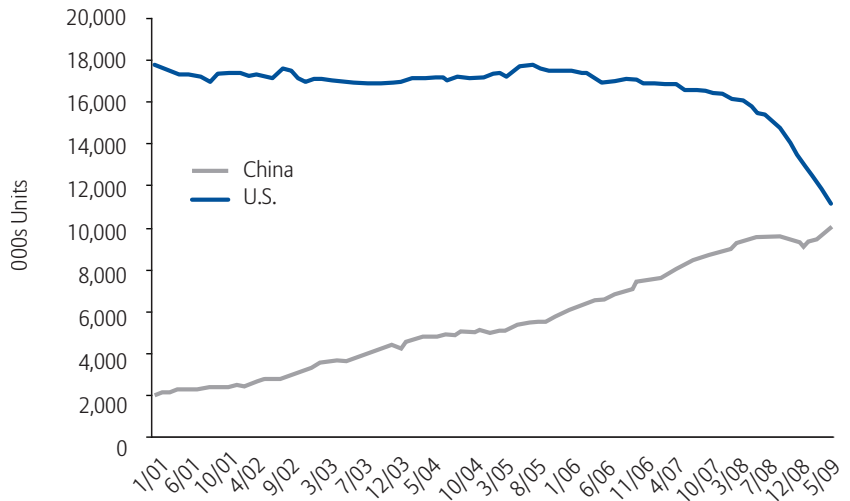
undisputed global reserve currency since the end of WWII. Many thoughtful and influential market participants expect the U.S. dollar to continue to play that role, if for no other reason that there are no viable alternatives. They will likely point to the euro (€)⁸ as suffering from a lack of political union among member states and the significant financial crises among peripheral countries. The British pound, notwithstanding the fact that it was the global reserve currency for most of the 18th and 19th centuries, is not a realistic contender given the small size of the U.K. economy. Nor is the yen, with the diminishing economic status of Japan, following two decades of economic stagnation.

Notably absent from the list of alternatives above are the currencies of the BRIC countries. Why? Because none of these currencies are freely convertible. Each of these countries has some system of capital controls that significantly limit foreign exchange transactions. Governments use capital controls to keep control of their currencies by not allowing currency to leave the country⁹ freely and by requiring foreign entities to exchange only with the central bank or its agents. On the trading floors of the large international banks you can trade U.S. dollars, Japanese yen, euros, British pounds, Mexican pesos and Polish zlotys and dozens of other currencies for delivery into your bank account, but if you want to buy or sell Chinese renminbi, Brazilian real, Indian rupees or Russian rubles you can only do so in the “offshore” derivative market, where buyers and sellers pair up with no physical currency changing hand, and all gains or losses are settled in a different agreed currency.¹⁰

So while it is true that no emerging currencies have yet reached critical mass as a viable replacement, there are many reasons to expect a secular decline in the value of the U.S. dollar.

As seen in chart 5, emerging countries hold the lion’s share of international reserves, mainly in the form of U.S. dollars and to a lesser extent euros. They appear to be increasingly concerned that the weakening U.S. economy and banking system,

Chart 4 | U.S. and China Automobile Sales

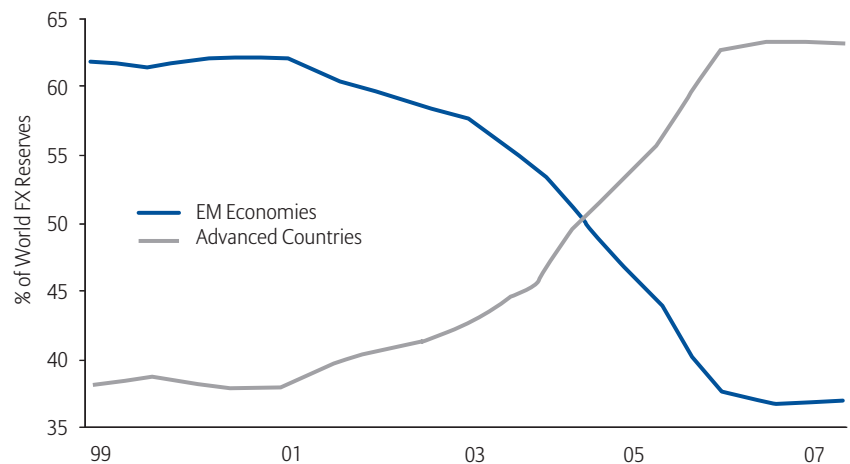


Source: PIMCO

the increase in money supply and other factors may reduce the value of the dollar over time. Notably, they have been voicing concerns in international forums like recent G8 meetings, and they have taken some (perhaps small) steps to reduce dependency on the U.S. dollar.

China for example has entered currency swap arrangements with a number of countries¹¹ so that trade financing can be negotiated in renminbi as opposed to dollar terms. In addition, several

Chart 5 | It May Be Our Currency, But It’s Your Problem¹²



Source: PIMCO, as of June 2009

countries have signed up to replace part of their foreign currency reserves with new bonds issued by the IMF and denominated in SDRs (Special Drawing Rights), a basket of currencies.

Capital must flow somewhere, and recent data suggest that the patterns of the previous decades, when capital flowed out of emerging countries and back into core countries has to some degree reversed. Clearly the U.S. dollar benefitted from a strong flight to quality bid during the global banking crisis. However, recently we have witnessed a reversal of those flows, arguably at least in part due to concerns that the massive amounts of U.S. dollar liquidity produced in response to the crisis. Indeed, in emerging countries we are seeing some central banks intervening to limit appreciation of their currencies as capital flows back into their

economies. These preliminary signs of a reversal in the traditional pattern of capital flows during a deleveraging cycle may well mark an important shift in currency preferences.

And while we have not yet reached the point where a new global reserve currency will arise, we are clearly seeing a loss of status for the U.S. dollar as a store of value even in the absence of a single viable alternative. In combination with other factors, that likely means a continuing devaluing of the U.S. dollars versus other currencies, especially the EM currencies. Accordingly investors should consider whether it makes sense to take advantage of any periods of U.S. dollar strength to diversify their currency exposure.

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1. In his book of the same name, Malcolm Gladwell says a "Tipping Point is the moment of critical mass, the threshold, the boiling point."
2. To paraphrase, in the short term, the stock market behaves like a voting machine, but in the long term it acts like a weighing machine, Graham and Dodd, *Security Analysis* (McGraw-Hill, 1934), page 23.
3. IMF forecasts of nominal GDP measured in \$U.S. at current exchange rates, *World Economic Outlook April 2009*. China became the second largest economy in the world in purchase power parity (PPP) terms in 2001 according to IMF data.
4. China, Russia, Brazil, India, Mexico, Korea, Turkey per IMF *World Economic Outlook 2009*.
5. BRICs include Brazil, Russia, India, and China.
6. Credit Suisse, "China's Economic Outlook," Dong Tao, Chief Economist, Non-Japan Asia Economics Research, July 16, 2009.
7. See previous EM Watch articles for analysis of structural and institutional reforms across EM countries at
8. The € was introduced as an accounting currency on 1/1/1999 with coins and bills entering circulation 1/1/2002.
9. Small amounts of notes and coins are tolerated but foreign individuals and companies cannot, for example, exchange those currencies or deposit them into a bank account.
10. The Non Deliverable Forward (NDF) market under ISDA agreements.
11. Brazil, Hong Kong, Indonesia, Korea, Malaysia, Belarus and Argentina.
12. John Connally, Treasury Secretary under Nixon.

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Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

Price-to-book is a ratio of the current stock price to the book value. This is used to identify undervalued stocks. Price-to-earnings is a ratio of security price to earnings per share. Typically, an undervalued security is characterized by a low P/E ratio, while an overvalued security is characterized by a high P/E ratio. BRIC is an acronym for the economies of Brazil, Russia, India and China combined. Gross Domestic Product (GDP) is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance.

The Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. It is not possible to invest directly in an unmanaged index.

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