

Bond Basics

July 2007

Bond Basics: Emerging Market Bonds (External and Local Markets)

Developing economies around the world, known to investors as emerging markets (EM), are rapidly maturing into key players in the global economy and financial markets. This maturation process continues to expand the opportunity set for bond investors seeking the benefits of emerging market exposure, which can include potentially attractive yields, rising credit quality and diversification.

What are the Emerging Markets?

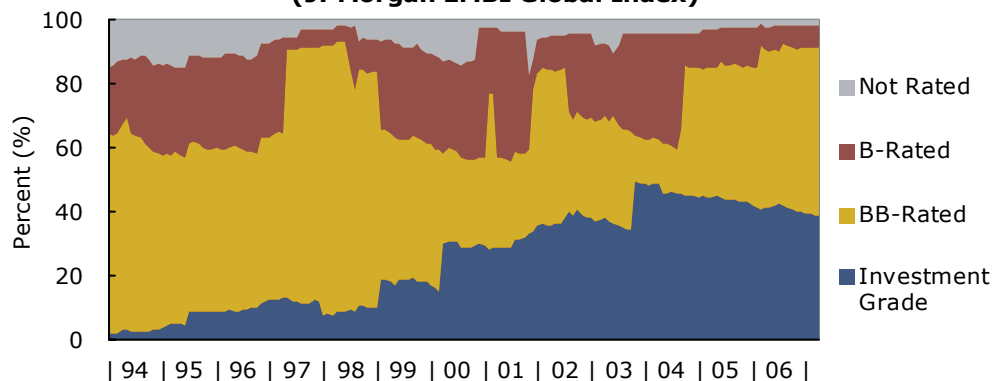
The emerging markets comprise those nations whose economies are considered to be developing—or emerging from underdevelopment—and usually include most or all of Africa, Eastern Europe, Latin America, Russia, the Middle East and Asia excluding Japan (see appendix for countries included in three major EM market indexes). Some are heavily dependent on commodity exports while others have extensive service and manufacturing sectors.

The Emerging Market Evolution

Until the 1990s, the emerging markets were a fairly limited fixed income asset class consisting primarily of government bonds issued in major currencies such as the U.S. dollar. Over time, the EM asset class has developed and matured to include a wide variety of government and corporate bonds, issued in local currency (often referred to as “emerging local market bonds”) and other major external currencies, as well as a deep array of derivative instruments.

Today’s diverse EM asset class is the result of fundamental changes in many emerging market countries. Many EM countries now run disciplined fiscal and monetary policies, rejecting the unorthodox policies of the past that caused investors concern about the potential for inflation, currency devaluation or bond defaults. These policies have produced a steady increase in the credit quality of EM bond issuers, with more than 40% of external debt now rated investment grade, as shown below.

**Market Capitalization Share Across Credit Ratings
(JPMorgan EMBI Global Index)**



Source: JP Morgan

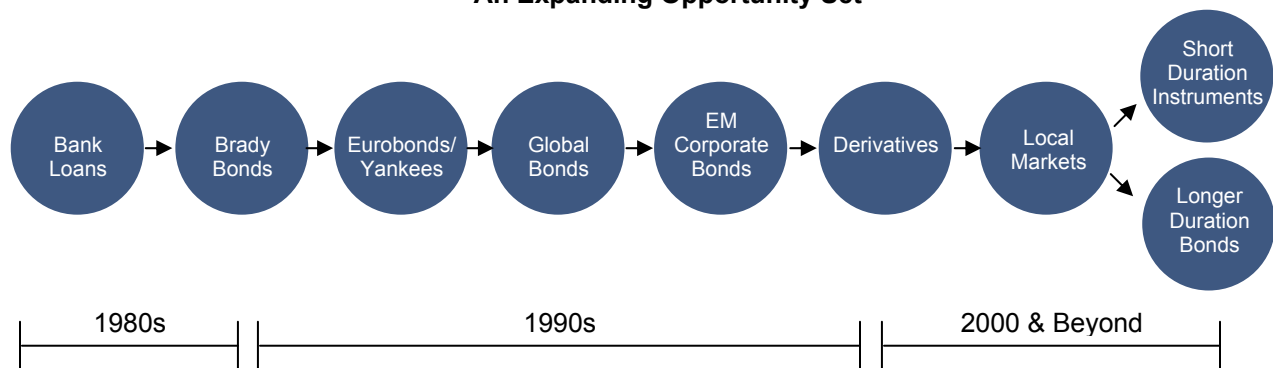
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In another important structural change, most EM countries have shifted from policies in which the value of their local currency was fixed relative to the U.S. dollar, to policies that allow the value of the local currency to change (or “float”) relative to the U.S. dollar. In 1996, more than 70% of developing countries pegged their currency to the U.S. dollar or ran fully dollarized economies. Today, 85% of EM countries allow their currency to float with little or no management. A floating currency provides a natural shock absorber that allows EM countries to better cope with periods of volatility in the global financial system. For example, weaker growth in a country will typically lead to a decline in the domestic currency, which in turn makes that country’s exports cheaper for foreign buyers and stimulates growth. The fixed currency regimes of the past provided no way to adjust to shocks and restore competitiveness, aside from tax hikes or other difficult fiscal measures likely to exacerbate already weak growth.

The combination of rising credit quality and fundamental improvements in emerging market countries has attracted new investors to the asset class, creating new borrowing options for EM governments and corporations. As the EM asset class has evolved, the opportunity set for fixed income investors seeking emerging market exposure has steadily expanded, as illustrated below. The ongoing expansion of local currency bond markets is the natural next step in this evolutionary process.

Emerging Markets Fixed Income: An Expanding Opportunity Set



Source: PIMCO

Local Currency Bonds: The Next Step in the EM Evolution

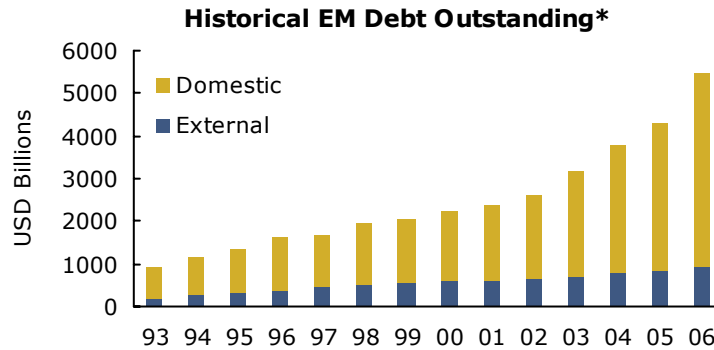
The emerging market maturation process is driving the expansion of the local currency bond market from both a supply perspective and a demand perspective.

On the supply side, emerging market governments are seeking to eliminate areas of vulnerability in their economies. Issuing debt in foreign currencies leaves EM countries more dependent on foreign investors and vulnerable to a mismatch between revenues denominated in the local currency and debt denominated in a foreign currency. To reduce these vulnerabilities, EM governments are steadily paying off external debt and issuing new debt in local currency. Thus, the local currency bond market has surged in

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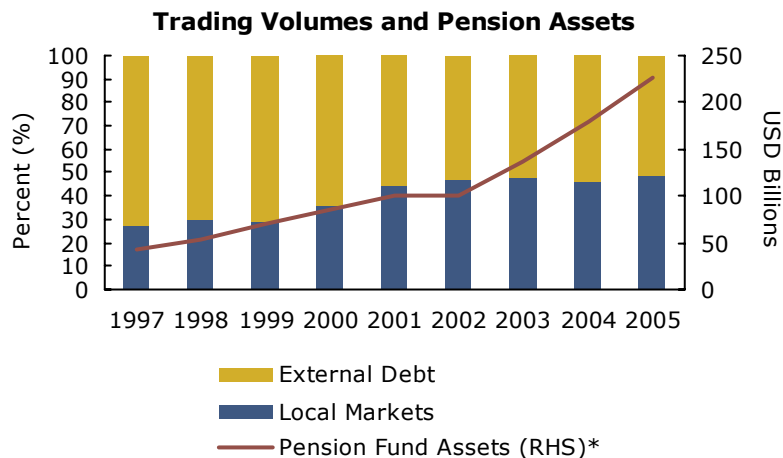
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size, as the chart below shows, and now makes up approximately 80% of all EM bonds outstanding in the market.



Source: Merrill Lynch, Bank for International Settlements
* Yearly survey

From a demand perspective, bond investors around the world are more comfortable with the EM asset class and are moving into local currency bonds in search of higher yields. In addition, domestic demand for local currency bonds is also growing. As part of the ongoing maturation process, many EM countries have implemented pension reforms, which are increasing demand among local pensions for local market bonds as a hedge against long-term liabilities. Today, local currency bonds account for nearly half of the trading volume in EM bonds, fueled in part by pension plan buying, as shown in the chart below.



Source: Trade Association for the Emerging Markets, JP Morgan
* EM countries with mandatory pension plans

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Why Invest in Emerging Market Fixed Income?

The emerging market asset class offers fixed income investors a number of potential benefits.

First, emerging market bonds (both external and local currency instruments) tend to offer potentially attractive yields on a risk-adjusted basis as compared to other global fixed income sectors. The table below shows yields for three major EM market indexes, as well as their average credit quality.

As of 6/30/07 Index	External EM Debt JP Morgan Emerging Markets Bond Index-Global	EM Local Currency JP Morgan Emerging Local Markets Index Plus	EM Local Debt JP Morgan Global Bond Index-Emerging Market Global Diversified
Yield	6.86% (in U.S. Dollars)	6.60% (in EM local currency)	7.12% (in EM local currency)
Average Credit Quality	BB+	A-	A-

Source: JP Morgan

As the table shows, yields on EM bonds and currency instruments may be well above those on government bonds in developed markets, considering that the yield on the Lehman Brothers Global Aggregate Bond Index, which measures developed country government bonds, was 4.65% as of June 30, 2007. Thus, on a risk-adjusted basis, EM yields may be attractive given historically low default rates on EM bonds and low price volatility.

Second, rising credit quality and an inflow of new investors into the EM sector raises the potential for a decline in yields that could lead to capital gains. Local currency bonds may also benefit from a rise in the value of these currencies relative to the U.S. dollar and other global currencies, which could increase the potential for capital gains.

Third, the EM asset class is very diverse, both regionally (as shown in the table below) and in terms of the instruments available in the market.

As of 6/30/07	# of Countries	Regional Composition (% of Benchmark)			
		Latin America	EM Europe	Asia	Africa/ Middle East
JPM Government Bond Index-Emerging Market Global Diversified	14	27	45	18	10
JPM Emerging Local Markets Index Plus*	23	20	38	34	9
JPM Emerging Markets Bond Index-Global	34	53	25	17	5

Source: JP Morgan

* Total adds to more than 100% due to rounding

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The diversity within the emerging markets asset class can help to contain volatility because the various regions and countries do not all tend to rise and fall at the same time. Diversity in the EM asset class also can provide active investors with a variety of ways to express their views in terms of which regions, countries, currencies and bonds of various maturities are likely to outperform based on macroeconomic forecasts and credit analysis.

Finally, emerging market bonds have the potential to reduce the volatility of a diversified fixed income portfolio, because the returns on emerging market debt are not closely correlated with those of many traditional asset classes. Within the emerging markets, investing in local-currency bonds offers both additional diversification and potential currency appreciation as these economies mature.

Assessing Risk in EM Requires Thorough Analysis

Although it may be convenient to lump emerging market debt together into a single broad category, it is far from a homogeneous asset class. Individual markets may have dramatically different growth prospects and risk factors. In the short run, that means one emerging country's or region's bonds may be performing poorly, while another's may be doing relatively well. Therefore, profiting from emerging market investments requires extensive analysis of the risk-versus-return profiles of individual emerging nation markets and issuers.

Conclusion

The emerging market asset class continues to evolve, expanding the opportunity set for fixed income investors. The growth of local currency bonds represents the next step in this evolutionary process. As the EM opportunity set expands and credit quality improves, more investors may be attracted to the benefits of the asset class, which can include the potential for attractive yields, the potential for capital gains and enhanced portfolio diversification. However, given the growing number of securities and the broad range of countries that make up the EM asset class, extensive analysis of risk and potential returns is required to identify the most attractive opportunities.

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Each sector of the bond market entails risk. Investing in emerging markets is more volatile than an investment in U.S. securities. The securities of emerging markets may be less liquid and subject to the risks of currency fluctuations and political developments. Diversification does not ensure against loss. Currency rates in non-U.S. countries may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

The use of derivative instruments for hedging purposes or as part of the investment strategy may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a portfolio could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested.

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Appendix: Three Major Emerging Market Indexes

As of: 6/30/07	EMBI Global J.P. Morgan Emerging Markets Bond Index Global	ELMI+ J.P. Morgan Emerging Local Markets Index Plus	GBI-EM Global Diversified J.P. Morgan Government Bond Index-Emerging Markets Global Diversified
Summary	EM external debt bonds denominated in U.S. dollars	EM currency money market securities denominated in local currencies	EM local debt longer-term securities denominated in local currencies
Countries	Argentina Belize Brazil Bulgaria Chile China Colombia Cote d'Ivoire Dominican Republic Ecuador Egypt El Salvador Hungary Indonesia Iraq Kazakhstan Lebanon Malaysia Mexico Pakistan Panama Peru The Philippines Poland Russia Serbia South Africa Trinidad & Tobago Tunisia Turkey Ukraine Uruguay Venezuela Vietnam	Argentina Brazil Chile China Colombia Czech Republic Hong Kong Hungary India Indonesia Israel Malaysia Mexico Peru The Philippines Poland Romania Russia Singapore Slovak Republic South Africa Taiwan Turkey	Brazil Chile Colombia Czech Republic Hungary Indonesia Malaysia Mexico Peru Poland Russia Slovakia South Africa Turkey

Source: JP Morgan