



Never Send to Know For Whom the Bell Tolls; It Tolls For Thee.

– John Donne, *Meditation XVII*

They don't ring a bell at the top of the market, according to an old trader's adage. But it sure sounds like warning bells ringing across financial markets, with credit spreads across most sectors more or less doubling and global equity markets experiencing their sharpest sell off in many years.

Given the secular improvements in Emerging Markets credit fundamentals that we have repeatedly written about in *EM Watch*, it would be understandable for EM investors to think those bells were not meant for them. After all, what do Asset Backed Securities (ABS), Collateralized Debt Obligations (CDOs), Collateralized Loan Obligations (CLOs), and Leveraged Buyouts (LBOs) have to do with Emerging Market bonds? Well – with apologies to John Donne – no *financial market* is an island in today's highly integrated global financial system. The question is not for whom the bell tolls, but rather what the future holds for thee.

Credit Crunch

Much has been written recently about the causes and the linkages at the root of the

current credit crunch, so I will limit a recap to a single sentence. The large private equity/LBO pipeline creates significant demand for credit while some of the suppliers of credit (such as leveraged players and derivative structures) have been margin-called.

For EM investors there are two important considerations to keep in mind. First, the current credit crunch is driven by an increase in the cost of capital as opposed to actual defaults across credit instruments. Global default rates for corporate bonds are at historic lows of around 1.4% and Emerging Market sovereigns have had ZERO defaults for several years.¹ Even in the case of subprime mortgages, over 85% of borrowers are still making timely payments and actual defaults so far have been below 5%, though rising delinquencies point to increased losses in the future.

Second, increases in the cost of capital are the result of the withdrawal of levered players from capital markets (hedge funds, CDOs, CLOs, etc.) These types of investors and instruments had been a powerful force behind the compression of credit spreads.

Take, for example, the CLO market which barely existed 10 years ago, but grew in importance to account for over 60% of the demand for all new issuance in bank loans for the past several years.² Following record issuance of new CLOs in the first half of 2007, CLO creation ground to a halt in July as investors disappeared. A shuttered CLO market is very problematic for private equity firms, who finance the purchase of companies with bank loans, and especially for the banks that have made over \$200 billion of bridge loan commitments to finance those purchases. The commercial and investment banks made these loans with the intention of quickly syndicating (selling) to other investors, especially CLOs, but demand has all but disappeared.

Linkage of Fundamentals and Technicals

One of the critical and often overlooked characteristics of previous financial crises is that problems often start with the lenders, not the borrowers. This is the self-fulfilling or “reflexive”³ element in credit markets: the contraction of liquidity from lenders often results in the deterioration in credit quality of the borrowers, as higher interest rates undermine those borrowers’ ability to roll-over at affordable costs.

From this perspective, the benchmark higher-quality countries in the Emerging Markets fixed income asset class are less vulnerable to a higher cost of capital than in previous cycles, thanks to a dramatic reduction in

external debt levels, improved current account balances, lower gross financing requirements, and FX reserve accumulation. Further, there are only a handful of Emerging Markets CDOs and CLOs, so the contractions in those markets should have little direct impact on the spreads. This contrasts with many lower-rated U.S. and European corporate credits that are arguably much more vulnerable, given their higher leverage, need for roll over financing, and the reduced capacity of the banking sector to provide financing. Moreover, leveraged structures have been a large source of demand for these corporate credits, especially bank loans, and hence an important driver of the pre-crunch spread compression.

At the same time, emerging market investors do need to be aware of how the shift in risk perceptions will affect different countries within the EM universe. Prior to the current credit crunch, benign global conditions were perceived to be very supportive to EM countries and companies across the board, even those that needed to borrow large amounts of capital. In the midst of the current crunch, perceptions have shifted such that those credits are now perceived to be the most vulnerable to tighter financial conditions. Risk has increased for countries with large financing needs, weaker policy fundamentals, and large current account deficits, as well as companies with large near-term financing requirements or with highly leveraged capital structures. In a world in which credit is more scarce, differentiation and sophisticated credit

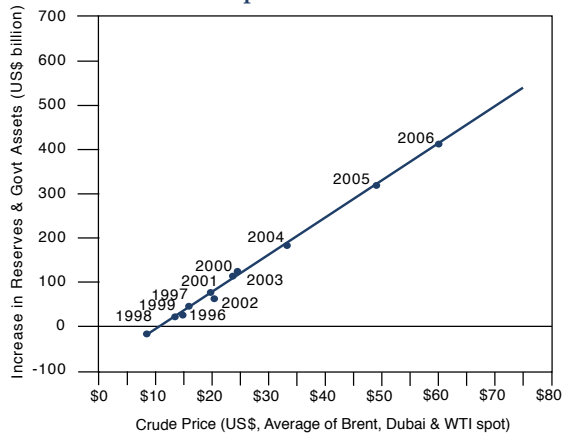
selection become much more important and credits with a lack of policy transparency and/or unorthodox policies become more vulnerable.

Global Savings and EM Credit Markets

At PIMCO, our secular outlook is for continued strong global economic growth and an incremental unwinding of existing global imbalances in current accounts over time mainly through a weaker U.S. dollar. In terms of credit fundamentals, this secular outlook and current strong performance elsewhere in the global economy should further strengthen the capacity of Emerging Markets to service their debt.

This secular outlook is also positive from a technical perspective. Two of the largest sources of global savings continue to grow – namely the sovereign wealth funds of the oil-exporting countries (Chart 1) and the foreign exchange reserves of the BRICs (Brazil, Russia, India, China) (Chart 2) and other Emerging Market countries. In fact, these two sources of global savings have increased almost as much in the first half of 2007 as they did for the entire year in 2006 (Chart 3). These large pools of capital will likely play a very important role in normalizing the current credit crunch – directly through expanded purchases of riskier assets; indirectly through the relentless supply of savings generally to international capital markets which are then intermediated into riskier asset categories, or some combination of these.

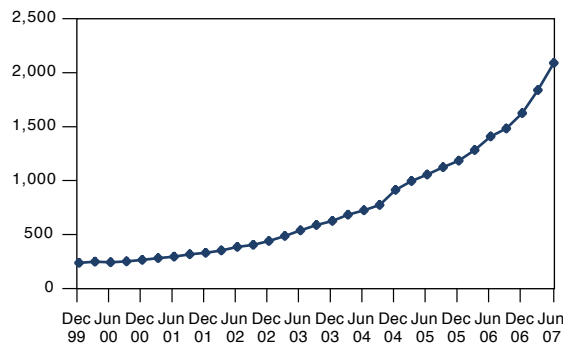
Official Asset Accumulation by Oil Exporters vs. Oil Prices



Source: PIMCO

Chart 1

BRIC International Reserves (US\$ Billions)



Source: Bloomberg

Chart 2

Tracking Global Savings

US\$ Billion	H1/2007	All of 2006
China	266	247
Oil Exporters*	132	287
Russia	111	120
Brazil	60	32
India	34	39
	603	725

* Excludes Russia and Norway. Does not include investment returns.

Source: PIMCO estimates

Chart 3

High levels of savings within Emerging Markets also give rise to another important support factor for higher-quality emerging market countries: the debt buyback. During periods of market turbulence, debtor countries can benefit by buying back their own debt at lower prices. We have already seen some countries and even companies take advantage of the recent sell off to purchase their own debt. With foreign exchange reserve accumulation running at such high levels we would anticipate continued buyback activity if markets remain volatile.

Emerging Markets Investing in a Credit Crunch

The breadth and depth of the current dislocations suggest that financial markets will likely remain quite volatile, perhaps for several months. Further margin calls and forced selling and hedging could continue to increase credit spreads across various sectors, while any significant allocation of capital will likely lead to sharp short-covering rallies. Even if strong global growth and large pools of savings ultimately contain the damage from the current credit crunch, near-term uncertainty remains as to what spread level will clear supply and demand as markets move to equilibrium levels. Credit spreads

in EM will be affected by relative valuations with competing assets classes, a phenomenon that will likely have the sharpest impact on the lower-quality credits where temporary disruptions of access to financing could lead to a fundamental deterioration in credit quality.

Volatility creates opportunities, especially where the underlying fundamentals are strong. At moments like this, EM investors must chart a course that takes advantage of the improved fundamentals in many EM countries and long-term supportive backdrop of the global growth and savings environment, while recognizing the potential for increased volatility. This means avoiding credits that are vulnerable to higher financing costs or volatility in financial markets like Argentina, Ecuador, Hungary, Lebanon, and Turkey and concentrating in credits that have ample liquidity reserves like Brazil, Mexico, Russia.

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¹ Moody's Monthly Default Report, June 2007

² Standard & Poor's Leveraged Lending Review 2Q07

³ George Soros' concept that "financial markets can affect the so-called fundamentals which they are supposed to reflect"

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