



The Best Offense Is a Good Defense (and Vice Versa)

Much has been written and discussed about the global financial crisis, most often focused on the short-term, or picking the “bottom” of the crisis. At PIMCO, we take a longer-term perspective: in his April *Investment Outlook*, Bill Gross laid out some of PIMCO’s thoughts regarding the future of the global economy – a preview of the secular themes we’ll be discussing in detail at our annual May forum. Among the trends Bill highlighted is a lower level of long-term growth for the global economy as it experiences 1) Delevering, 2) Deglobalization and 3) Reregulation.

Clearly, an environment of lower-trend developed world growth coupled with shrinking cross-border capital flows presents a difficult backdrop for emerging market (EM) economies and EM investors. Fortunately, the asset class has developed and matured enough over the past five years that investors are able to tailor exposures in EM to such environments, and even to potentially benefit from them. Indeed, investors who express suitable “defense” in EM now have ample opportunity to produce total returns that are commonly associated with significant “offense” in portfolios.

Original Sin, Version 2.0

Emerging market countries generally entered the current crisis on solid footing. As a group, EM sovereigns ran enormous balance of payments surpluses (leading to ballooning international reserve cushions), diversified their funding sources away from the

U.S. dollar (USD) and deepened local currency markets. In fact, some key EM countries – such as Brazil – had so internalized the Original Sin¹ lessons of the past that they entered the crisis with debt dynamics that were actually set to benefit from moderate depreciation of the local currency relative to the USD.

To be sure, the large imbalances that characterized the global economy overall were not sustainable, and had to adjust. And up until September 15, 2008, they were closing in a relatively orderly fashion. U.S. growth was slowing, the USD was depreciating and many saw burgeoning U.S. export sectors as a silver lining to the G-3 downturn. Then the Lehman debacle changed the closing of those imbalances from an orderly to a disorderly adjustment: the worldwide system for clearing basic financial transactions didn’t just malfunction, but essentially stopped in its tracks. The global flow of credit and capital ground to a halt seemingly overnight, leading to a massive forced spike in U.S. savings and a drop in consumption. The spillover to EM was swift, enormous, and perhaps best illustrated in Q4 2008 by the shocking drop in industrial production from Asia (see Chart 1 on the next page), the region most reliant on U.S. consumption as a driver of its own growth.

The other huge negative externality of the Lehman debacle on emerging markets was the tremendous increase in the demand for USD as credit formation disappeared. Entities

around the world could no longer count on functioning capital markets to roll credit coming due, sparking a global run to acquire USD for debt repayment. This destructive technical reverberated throughout the emerging world as the global private sector suddenly found itself massively short USD. The damage was amplified because so many corporate treasuries had decided – prior to the crisis – to sell deep-out-of-the-money USD call options that quickly moved in-the-money

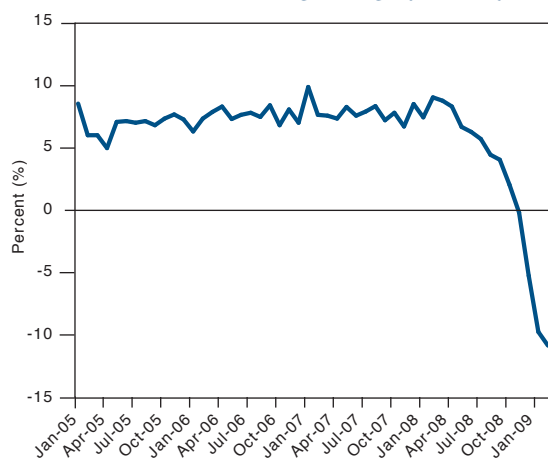
amid the USD squeeze. Thus, while sovereign balance sheets were mostly, and initially, isolated from the crisis, private sector balance sheets exhibited vicious debt cycle dynamics similar to the ones that plagued sovereigns in Original Sin crises past.

Mitigating the Left Tail

The danger with such explosive technicals is that otherwise sound sovereign fundamentals can get contaminated, spreading and deepening the crisis to the point where the solvency of sovereign balance sheets themselves becomes questionable. In Mexico, for example, fears of corporate sector vulnerabilities in the foreign exchange markets weakened the peso (MXN), leading to concerns that the Bank of Mexico would not be able to pursue counter-cyclical monetary policy. This deepened fears that the recession would worsen locally, calling into question the sovereign's creditworthiness as international reserves dropped, leading to more selling of the currency, and so on (see Chart 2).

This self-reinforcing dynamic has been seen in one form or another across EM, though it was most pronounced in Mexico given its size,

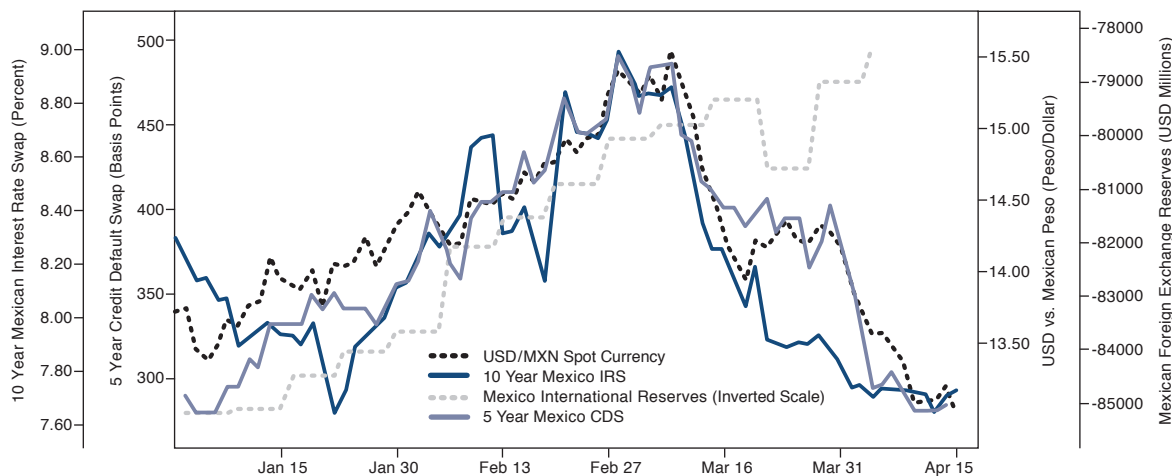
Emerging Asia Industrial Production (Three-month moving average, year-on-year)



Source: Haver Analytics

Chart 1

Challenges to Mexico's Currency, Credit and Local Rate Markets as Reserves Fall



Source: Bloomberg

Chart 2

liquidity, strong credit history and importance as a bellwether credit in emerging markets. To the dismay of EM investors, this dynamic also pushed Mexico's Finance Ministry and Central Bank to make policy decisions that were designed to bolster markets, but panicked them instead. In February, Mexico failed to place a poorly timed long-tenor external bond deal, and a week later cut interest rates less than the market expected – the latter in particular signaling that financial turmoil was adversely impacting policymakers' ability to implement counter-cyclical policy.

The International Monetary Fund (IMF) moved into this void with a new Flexible Credit Line (FCL) program aimed at countries with very strong fundamentals and proven track records of designing and implementing sound economic policies. The FCL switched conditionality from *ex post* to *ex ante*, lifted loan access limits and eased monitoring, all aimed at increasing financing availability and removing the stigma associated with IMF programs of the past. The FCL program also represented a breakthrough for the IMF in its relationship with these higher credit quality countries; it offered significant and front-loaded assistance with high degrees of flexibility, so participants could view it as a credit line or insurance policy to be drawn when needed. Importantly, in early April the G-20's major recapitalization commitment gave teeth to the FCL by pledging to boost the IMF's lending resources to \$750 billion.

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Unsurprisingly, Mexico announced its intention to be the first user of the FCL, signaling a new approach to mitigating the effects of the global credit crisis and sparking an across-the-board rally in its financial markets. The one-year program makes \$47 billion available to Mexico, more than enough money to put to rest any concerns about its credit

standing or the adequacy of its international reserves. Markets applauded the shift from a policy stance that was hesitant and defensive to one that was bold, aggressive and looking to stay ahead of the crisis. Concurrent with its decision to participate in the FCL, Mexico has cut policy rates by 150 basis points, further fueling rallies in its currency and credit markets thanks to the strong message that authorities would use all tools available to help alleviate the crisis.

Following the success in Mexico, Poland announced it too would apply to tap the FCL program. Its currency promptly rallied, while its local rates fell and credit default swap spreads tightened to the lowest levels in 2009. Fitch affirmed Poland's credit rating, and the country's prospects for adopting the euro received a boost from expectations of lower levels of financial market volatility. Though the IMF has been careful not to disclose which countries qualify for the FCL, by applying for the program Poland has signaled to investors that it stands out among the Central European countries in its ability to navigate this crisis.

Both Poland and Mexico are prime examples of countries realizing that in this immensely difficult global macroeconomic environment, there is *no* stigma attached to multilateral support through the FCL. In fact, countries should take *every* possible step to ensure economic stability. Indeed, after initially balking at the program, Colombia has now wisely formally requested an FCL credit line as well. Countries like South Africa and Peru that likely would qualify for the FCL should also take advantage of the program's embedded optionality to strongly signal to investors their capacity to secure scarce funding even amid the most volatile markets.² This way, it becomes even less likely that these countries would ever have to tap the program for funds in the first place.

Debasement in the G-7

In many ways, emerging market policymakers are following the examples set in the developed world, particularly the U.S., where policymakers have pulled out all the stops to mitigate the crisis. Quantitative easing (QE) is the latest tool to be employed in Japan, Switzerland, the U.K. and the U.S. Among major developed central banks, only the European Central Bank has resisted QE, and the markets have responded by pushing the euro weaker versus the USD since the Fed's decision,³ thereby rewarding aggressive action, and punishing policy laggards.

What about the longer-term unintended consequences of such aggressive policies? The Fed is rightly concentrating on fighting the deflation fire, which is closest and burning brightest amid the inferno of challenges facing U.S. policymakers. As a result, large holders of USD, and principally China, have openly begun to question the long-term impact of the Fed's policies on the value of their USD holdings, particularly as China is aggressively promoting internal drivers of growth amid the fall in G-3 demand. Indeed, doubts regarding the USD's reserve currency status have repeatedly surfaced, with the U.S. Treasury itself suggesting it was open to the idea of a larger global-finance role for IMF SDRs (Special Drawing Rights). If it makes sense for China to question the value of its USD holdings, perhaps you should too.

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How should one invest in EM with these trends in mind? Recognizing that the current crisis marks a long-term sea change to the global growth environment, PIMCO thinks it

makes sense to position portfolios overall to play "defense" by moving EM exposures into higher-quality credits to provide a greater level of principal preservation and still offer reasonable carry. At the same time, it is possible to make investments that can play "offense" as policymakers in select countries, armed with ample policy tool war chests augmented by the firepower from the IMF's FCL program, respond to the crisis by cutting rates aggressively. Brazil and Mexico in particular still have nominal local rates well in excess of their developed world counterparts and have just started what appear to be long and aggressive monetary policy easing cycles. Finally, investors should revisit secular USD diversification strategies as cyclical tailwinds for USD strength abate. This includes a structural long-term allocation to the Chinese renminbi, which currently has positive carry, and may offer optionality should the crisis deepen and lead to a collapse in confidence in the USD as a store of value.

Michael Gomez
Executive Vice President

¹ Refers to the historical inability of emerging economies to meet borrowing needs by issuing debt in their domestic currency, leading to currency mismatches as borrowing is done instead in "hard" foreign currency.

² Select Asian countries also would seem to qualify for the FCL program, but may be less likely to participate given that the trend in the region following the 1997 Asian crisis has been to move away from multilateral aid and focus more on intra-regional bilateral initiatives.

³ The EUR gained versus the USD immediately after the Fed decision was announced, on March 18, 2009, but sold off roughly 4% from the close of that day's trading to the time of writing (April 21, 2009).

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P I M C O

PIMCO Japan Ltd

Toranomon Towers Office 18F

4-1-28, Toranomon, Minato-ku

Tokyo, Japan 105-0001

813-5777-8150

Financial Instruments Business

Registration Number:

Director of Kanto Local Finance

Bureau (Financial Instruments

Firm) No.382

Member of Japan Securities

Investment Advisers

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Trusts Association.