

Product Focus

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Michael Gomez Discusses the Evolution of Emerging Markets and Growth of Developing Local Markets



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Mr. Gomez is an Executive Vice President, portfolio manager and Co-Head of the Emerging Markets portfolio management team. He joined PIMCO in 2003, previously having been associated with Goldman Sachs where he was responsible for market making and proprietary trading of Emerging Market bonds. Prior to that, he spent a year in Colombia serving as a financial consultant to the Ministry of Finance and Public Credit. Mr. Gomez has over eleven years of investment experience and holds a bachelor's degree from the University of Pennsylvania and an MBA from The Wharton School of Business.

Emerging Markets are in the midst of a significant evolution beginning with structural reforms and economic improvements in every region of the EM universe and leading to continued improvement in the sector's average credit quality. The latest step in the EM evolution is the growth of local-currency debt markets that offer investors new opportunities to potentially benefit from the sector's structural improvements. PIMCO believes EM local debt and currencies are among the most attractive opportunities available in the global fixed income markets over the next three to five years, as Bill Gross noted in his May/June Investment Outlook. In the interview below, Portfolio Manager Michael Gomez discusses the growth of developing local markets and describes this growth as the next step in the EM asset class' secular maturation process.

Q: How does the growth of local currency markets reflect the broader evolution of the emerging markets asset class?

Gomez: The maturation of EM economies has led to an evolution of the investment opportunity set. The EM market started with bank loans and collateralised Brady Bonds in the 1980's and early 1990's, and then expanded into more standardised Eurobonds and Global bonds in the mid-1990's as investors became more comfortable with the asset class and demanded more traditional, uncollateralised bullet bonds. The wide acceptance of EM sovereign risk and increasing credit quality then opened the door to the private sector and the development of a corporate bond market in EM. This was quickly followed by the growth of derivatives markets. The expansion of EM local markets is the natural next step in this evolutionary process for a number of reasons.

First, on the supply side, as EM countries have matured, policy makers increasingly look to eliminate vulnerabilities in their economies. One vulnerability is the historical mismatch between liabilities denominated in foreign currencies (largely U.S. dollars) and revenues denominated in local currency (i.e., taxes). To reduce this risk and lessen their dependence on foreign investors for funding, EM countries have increasingly looked to their own local capital markets as a source of funding.

On the demand side, international investors are comfortable with EM credits, which have been trading for nearly two decades now, and are eager to move into the newer local markets in search of further opportunities given the economic improvements and increase in credit quality within the asset class. Additionally, as EM economies have

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matured, local pension systems have been reformed and are growing at an impressive rate. With this growth has come strong demand for long duration, local currency denominated fixed income instruments as pension funds look to match their long duration liabilities, just as we see with pension funds in the developed world.

Q: How does EM local market debt compare to the EM external debt markets in terms of size and liquidity?

Gomez: Both the external and local bond markets in EM are very large and liquid. The total amount of EM debt outstanding is estimated to be over \$4 trillion with annual trading volumes of over \$5 trillion. Importantly, these figures do not include the sizable FX and derivatives (CDS) markets that increase markedly the opportunities for investors to gain exposure to the sector. Local currency denominated bonds make up approximately 80% of all EM debt outstanding, a fact that is often surprising to international investors. This proportion is likely to increase as EM issuers continue to tap the local markets versus external markets for their funding needs in the future.

Q: What are the current issuance trends? Looking forward five years, what will the EM market look like in terms of outstanding debt?

Gomez: PIMCO estimates that in 2006, net new issuance of sovereign external debt was actually negative, falling by approximately \$8 billion. This is due, in part, to massive international reserve accumulation. While a build up of reserves is a good thing in that it signals to investors a country's ability to insulate itself from shocks, there is such a thing as too much of a good thing. At a high enough level of reserves, the benefit of larger reserves is outweighed by the cost – namely the difference between the return that can be earned on those reserves and the country's foreign currency funding cost. Many countries are now reaching the point where this "negative carry" more than offsets the signalling benefit of accumulating more reserves. The result has been an increase in debt buybacks and/or a reduction in new external issuance. Thus, the negative net new issuance figures we have been seeing.

At the same time, the acceptance of EM sovereign issuers by the international financial markets has allowed EM corporates to access funding via the bond markets. As economic growth continues to be robust in EM countries, the private sector has increasingly funded its expansion by issuing corporate debt. As a result, corporates accounted for roughly 70% of external issuance in 2006, up from roughly a third only 5 years ago.

Because of the demand from local pension funds and international investors that we discussed earlier, EM countries continue to issue local currency instruments at a healthy pace. In fact, many countries (Mexico and South Africa are two good examples) can now fully fund themselves in local currency and no longer need to fund in U.S. dollars. If current trends continue, the EM market of the future is likely to be one dominated by local currency instruments and corporate debt. Sovereign external debt issuance will continue as countries strive to establish and maintain yield curves of benchmark bonds in U.S. dollars, but growth in this market will be muted as countries will not need to rely on foreigners for funding.

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Q: Earlier, you mentioned demand for EM local debt among international investors. How strong is this demand for local currency instruments, and are other factors driving this interest in addition to the fundamental improvements in EM countries?

Gomez: Market demand for EM fixed income products continues to be very strong. Emerging Portfolio Fund Research estimates that EM funds have attracted over \$4.5 billion in new assets so far this year with these flows increasingly favouring local market strategies. Of course, these estimates only measure a subset of the market so the total inflows are likely to be much larger than this figure. For example, at PIMCO alone, we have seen an increase in our total EM assets under management from approximately \$13 billion only three years ago to over \$40 billion today. Within that total, our exposure to local markets has increased from virtually zero three years ago to almost \$20 billion today. So you can see that the growth rate for local market strategies has been phenomenal.

Investors have been attracted by the many benefits of an exposure to EM local markets. These markets provide investors with additional opportunities to potentially benefit from the economic improvements in EM that we talked about earlier, but there are other factors driving demand as well. For example, local instruments provide higher yields than are typically available in the external debt markets. The average yield in local markets currently stands at approximately 7.12%, while external debt markets yield roughly 6.86%. Additionally, we expect yield compression in local markets to add to the return in these markets as local interest rates in EM countries continue to converge toward developed market yields. Local currency denominated bonds may also provide investors with a hedge against a possible decline in the U.S. dollar, which PIMCO expects to continue to be a theme over our secular horizon.

Importantly, local market instruments in EM can provide significant diversification benefits in investors' portfolios. These markets exhibit low correlations with traditional asset classes such as U.S. core fixed income (correlation of 0.41) and U.S. equities (0.44). This low correlation combined with potential risk adjusted returns means adding EM local markets to a portfolio can help push investors up and to the left on the efficient frontier.

Because of these potential benefits, the EM local market asset class is attracting investors looking to access an expanded set of opportunities in an effort to benefit from the ongoing improvement in EM countries as well as investors looking to diversify their portfolios and add strategies that seek to profit from a declining U.S. dollar.

Q: What has been driving performance in EM Local Markets over the last year?

Gomez: An investment in EM local markets will have three elements of return: the starting yield on the portfolio, the impact of a decline or increase in market yields, and the effect of a decline or increase in the value of EM currencies versus the U.S. dollar. Over the last year, all three factors helped to drive strong returns in this sector. About half of the sector's total return came from the yield offered on local market instruments.

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An additional one third of the total return came from appreciation of EM currencies relative to the U.S. dollar as markets continued to worry about the large current account deficit in the U.S. while rewarding EM countries' strong financial results. Compression of local EM yields also was positive for returns as inflation results remained muted, and demand for local instruments was strong.

Q: You mentioned that PIMCO expects a continued decline in the U.S. dollar over the long term. How does an investment in EM local markets fit with other elements of PIMCO's long-term outlook?

Gomez: EM local markets also fit very nicely into PIMCO's views on global growth going forward. Although we do expect growth in the developed world (U.S., Europe and Japan) to moderate to around 2% going forward, we expect to see EM decouple from these economies and continue to grow at a robust 5.5 to 6.5% rate. We believe this decoupling will be able to continue because of EM countries' interaction with China. Most EM countries see China as a customer and not as a competitor, as is the case with many developed countries. As such, as China continues to grow at a robust pace, EM countries will continue to feed into and may benefit from this growth via exports of commodities and other goods to China and its neighbours. This dynamic should help support the economies and currencies of EM countries.

Additionally, due in part to continued strong growth from China and India, PIMCO expects commodities prices to remain strong for the cyclical and secular time horizon. While not all EM countries are commodities exporters, many countries within the asset class benefit from the recent price trends in commodities such as oil, copper, and precious metals. Going forward, stronger commodities prices should continue to be positive for the currencies of countries that export these natural resources.

Q: Thank you, Michael.

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