

MARKET UPDATE

Who's Afraid of Emerging Market Debt?

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The Blurring of Markets

On July 20, 2010, the Wall Street Journal published a cover story on energy use in China. For the first time since the early 1900's, the U.S. is no longer the world's largest consumer of energy. In 2009, China used about four percent more total energy than the U.S., after using only about half as much as recently as 10 years ago.¹ The explosive growth of China and other emerging markets such as India, Brazil, Russia and South Korea, combined with the economic and fiscal problems currently being experienced by some of the developed economies, has begun to blur the differences between emerging markets and developed markets, especially in regards to their economic futures. In the past, it has been a basic tenet of international investing that emerging markets were more risky and more volatile than developed markets, in both equity and fixed income. While this may still be true, there may now be less of a difference than even a few years ago. Investors may need to rethink that assumption going forward, especially in terms of emerging market sovereign debt.

Sovereign Debt and Credit Quality

Sovereign debt is debt issued by the government of a particular country. The sovereign debt of the United States—generally referred to as U.S. Treasurys—has long been considered the safest sovereign debt in the world and traditionally has been used as the risk-free equivalent when pricing various other investments. Historically, the debt of large, developed economies such as the U.S., Germany, and the United Kingdom has been considered very low risk, while the debt of emerging economies has been considered much riskier. In the past, this risk characterization was generally accurate, with some variety on a country by country basis. Currency crises, government and political instability, ineffective central banks, military spending and various other variables have caused several emerging market governments to default on their sovereign debt. Recent emerging market defaults include Russia (1998), Argentina (2001), Turkey (1978), Mexico (1982) and Indonesia (1999). However, the assumption that all emerging market debt is riskier than developed market debt is probably no longer accurate. As the Greek debt crisis of the past few months underscores, some emerging market debt is arguably safer than the debt of many so-called developed market countries.

Assessing Sovereign Debt Credit Quality

A number of variables go into analyzing the credit quality of a particular country's sovereign debt, including both quantitative and qualitative factors. Quantitative factors are things like the

¹ "China Tops US in Energy", [The Wall Street Journal](#), Vol CCLVI No. 16, July 10, 2010.

size of the country's economy (GDP), the expected growth rate of its GDP, total debt as a percentage of GDP and the current fiscal deficit as a percentage of GDP. Qualitative factors include things like the perceived effectiveness of the country's central bank and stability of the political system. One quick way of observing the market's opinion of the relative risk of specific sovereign debt is to examine the pricing of Credit Default Swaps for the debt of that particular country. A Credit Default Swap (CDS) is a derivative contract that basically allows an investor to insure against the default of a bond. The buyer of the CDS pays a premium over the life of the swap to the seller of the swap. If the bond that is being insured defaults, then the seller of the swap pays the buyer a payoff. If the bond does not default, the swap expires and the seller keeps the premium as a profit. When the market perceives the risk of default is increasing, the cost of Credit Default Swaps also increases.

Which Would You Buy?

Imagine the sovereign debt of two countries, we'll call them Country A and Country B. Here are a few variables regarding each country to consider²:

	Country A	Country B
Expected 2010 GDP Growth	3.2%	6.5%
Expected 2011 GDP Growth	1.7%	4.5%
Total Governmental Debt as % of GDP	197.6%	60.6%
2010 Fiscal Deficit as a % of GDP	-7.5%	-4.3%

The economic variables provided in the table seem to favor Country B. Over the next two years, its economy is expected to grow two to three times faster than Country A's, total government debt is 60 percent of GDP compared to nearly 200 percent for Country A and the expected 2010 fiscal deficit as a percentage of GDP is about 40 percent lower for Country B than Country A. If you had to buy the sovereign debt of one of these countries, which would you invest in? In this example, Country A is Japan and Country B is Brazil. At first glance, which country do you think investors consider more risky, at least historically?

But, the decision may not be as simple as it appears. It is important to note that this particular exercise does not take the difference in inflation rates between the two countries into consideration, which can be a challenge for investors in emerging market debt. Over the past five years, Japan's inflation rate has remained significantly lower than Brazil's. This underscores

² Economic data from Goldman Sachs, IMF, Credit Suisse, European Commission & OECD as of June 2010.

the importance of conducting due diligence on prospective investments. As part of the due diligence process, in the example above, investors should look at the risk premium on the Brazilian bonds to determine whether Brazil's deficit advantage is more significant than Japan's inflation advantage.

The Economic World is Changing

Many individual investors prudently choose mutual funds as their primary vehicle for investing in international fixed income. Most individuals do not have the time or ability to perform credit analysis and make macroeconomic assumptions regarding the sovereign debt of individual countries. Using a mutual fund or other professionally managed investment vehicle makes sense for investors who want exposure to international bonds but do not want to choose which countries to invest in or do not have a large enough asset base to get broad diversification across numerous countries or regions. However, most third-party evaluators of mutual funds categorize international bond funds as developed market or emerging market funds. The general assumption is that developed market sovereign debt will be less risky than emerging market debt. While this can be true, in the future, it might not be such a clear cut distinction. There are some recent emerging market fixed income plays that are becoming increasingly available to investors. Some international bond funds now allow for more selectivity and diversification within the developed and emerging market classes. However these targeted bond funds, carry an increased level of liquidity risk. The risk-reward trade-off should be considered thoroughly as part of the due diligence process for funds in this sub-class.

Below is a table that outlines some key economic statistics between the four primary developed markets and the four largest and most important emerging markets:

Country (2010 Estimates)	USA	Euro- area	Japan	UK	Brazil	Russia	India	China
Government Debt- % of GDP	93.90%	79.30%	197.60%	80.30%	60.60%	8.80%	59.60%	19.10%
Fiscal Debt - % of GDP	-10.70%	-6.60%	-7.50%	-11.50%	-4.30%	-6.30%	-6.80%	-3.30%
GDP Growth	3.20%	1.20%	3.00%	1.30%	6.20%	5.50%	8.00%	10.00%

Data Source: Information in the table is sourced from Goldman Sachs Asset Management and IMF, Credit Suisse, European Commission and OECD.

In almost every category, the fiscal and economic situations of the four BRIC (Brazil, Russia, India, and China) emerging markets look better than the four developed market economies.

Conclusion

Over the past several decades, it has been easy for investors to assume that, in general, the sovereign debt of developed market countries was safer than that of emerging market sovereign debt. However, the fundamentals of the world economy are changing. A combination of the growth of the emerging markets, especially the BRIC countries, along with prudent management of their fiscal situations combined with structural problems in many developed market economies has blurred the distinction between the two categories. While there are inherent risks in any type of investment, and issues such as currency fluctuations, political turmoil and economic fluctuations will continue to be risk factors for emerging market debt, some of the old assumptions may need to be changed. In the future, it may not be so easy to assume the risk of all emerging market sovereign debt is greater than that of developed market debt. While much developed market debt will most likely remain a relatively low risk investment, it is important to delve more deeply into the specifics of each issue to make the most informed investment decision.

Our Strategic Asset Allocation guidance is global across all asset groups, including fixed income. Global allocations include both emerging and developed markets. Our current guidance is for a two percent allocation to emerging market debt across all investment objectives. As an investment objective becomes more growth and less income-oriented, the overall fixed income allocation drops; however the two percent allocation remains constant, thereby increasing the proportion of emerging market debt in the overall fixed-income allocation. We feel it is important to include emerging debt as a part of a strategic asset allocation to capture the diversification and economic opportunity that this global segment offers investors. A diverse asset allocation spread across four asset classes, including developed and emerging market equities and fixed income, is the optimal approach to diversify for risk, and position a portfolio for growth

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