WHERE WE SEE THE GREATEST OPPORTUNITIES IN EMERGING MARKET FIXED INCOME: PART I

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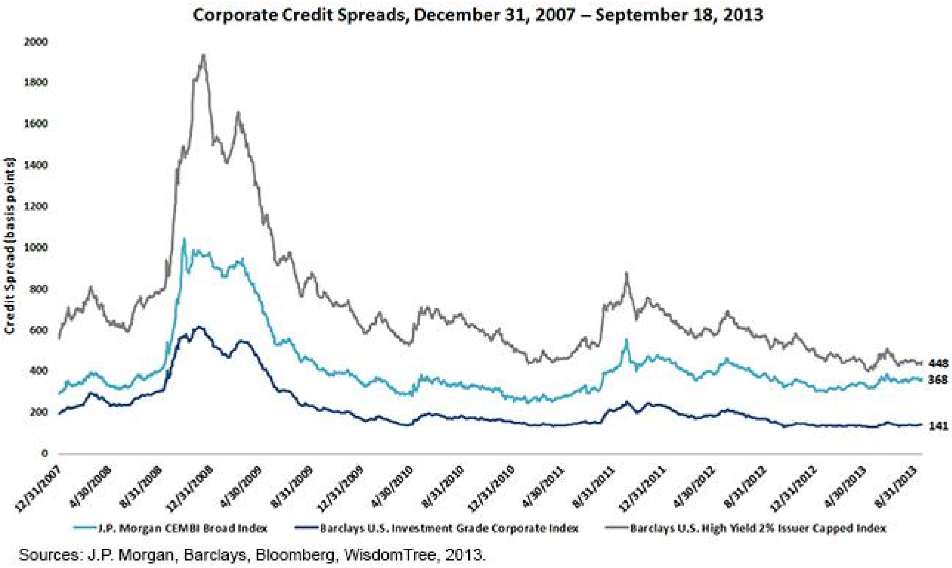
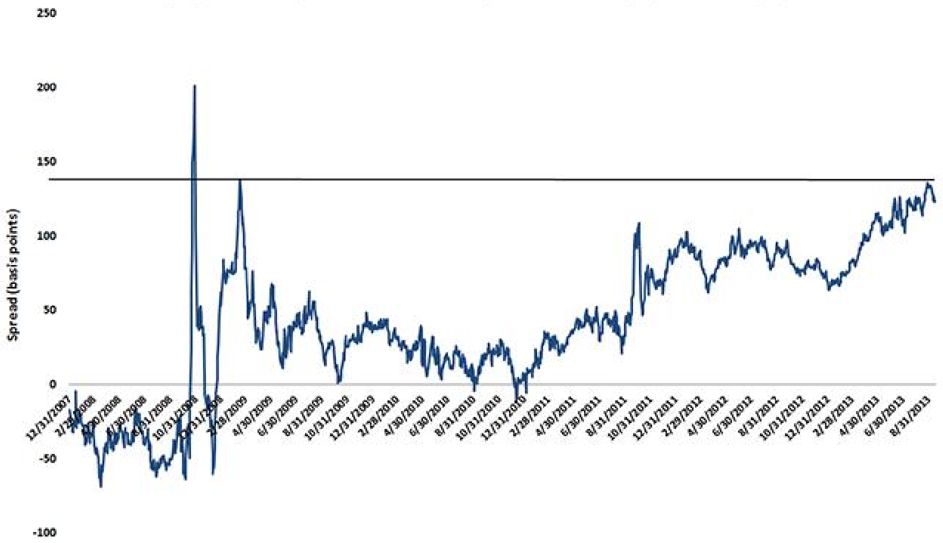
09/24/2013

After the Federal Reserve surprised markets by not reducing the pace of their asset purchases, yields on fixed income securities corrected sharply. With the prospect that Chairman Bernanke may now refrain from reducing stimulus before his term expires, sentiment within fixed income markets appears to be improving. In light of these recent events, where does it make sense for investors to add incremental risk to their bond portfolios? In our opinion, investors should consider increasing their exposure to emerging market (EM) fixed income: • **Long-term fundamentals broadly intact:** While a few EM countries seek to reduce external vulnerabilities, the economic fundamentals of many EM countries remain intact from our perspective. • **Sell-off has been overdone:** The extent of the sell-off in recent months has created attractive entry points for both EM currencies and fixed income relative to other sectors. • **China appears resilient:** The combination of stronger growth and improving sentiment contrasts with the headwinds faced earlier this year. Within emerging market fixed income, it is important for investors to determine what risks are worth taking. EM corporate credit and EM local sovereign debt will have very different potential drivers of return going forward. In part one of this two part series, we examine EM corporate credit as an alternative to other U.S. dollar-denominated fixed income. Specifically, • U.S. corporate bonds are trading at levels near their 12-month average; emerging market corporate bonds have sold off along with other emerging market assets • EM corporate bonds appear attractive compared to U.S. corporate debt • EM corporate credit touched the closest relative levels to U.S. high yield in its history on September 5, 2013 **EM Corporate Credit** Similar to U.S. corporate bonds, EM corporate bonds are primarily denominated in U.S. dollars and trade at a spread relative to U.S. Treasury bonds. As a consequence, investors are exposed to changes in U.S. interest rates when investing in EM corporate bonds. In an uncertain interest rate environment, the potential value from investing in emerging market corporate credit is achieved through exposure to securities that provide a sizable yield cushion that can potentially dampen principal losses should rates rise.



For definitions of terms and indexes in the chart, please visit our Glossary. As shown in the chart above, credit spreads have generally trended lower over the last five years. With a recovering global economy and healthy corporate profits, companies posed less of a risk to lenders. After a momentary spike in September 2011 (caused by concerns in Europe), credit spreads continued to tighten through mid-2013. For much of this period, EM corporate spreads moved largely in concert with those of U.S. companies. However, due to a combination of moderating Chinese growth and better than expected U.S. data, yields in emerging market corporate bonds began to diverge. Even though spreads in U.S. credit continue to trade at or below their 12-month average, spreads in emerging markets have widened to 368 basis points, currently near their closest relative spread to U.S. high yield in history. Although emerging markets present an additional wrinkle for investors', the narrowing of the spread between EM corporates (an asset class that is currently rated 69% investment grade[1]) to an all high-yield portfolio should have EM popping up on more investors' radars. In perhaps an even more interesting development, the so-called "EM premium" is currently trading at levels not seen since the bottoming of the global financial crisis in early 2009.

Emerging Market Corporate Credit – U.S. Corporate Credit: 12/31/2007 thru 9/18/2013



Sources: J.P. Morgan, Barclays, Bloomberg, WisdomTree, 2013.

In the chart above, we compare a similarly rated composite of U.S. corporate bonds to the J.P. Morgan Corporate Emerging Markets Bond Index Broad. In the last week, the relative credit spread between emerging markets and the U.S. was trading at all-time wide levels. In our view this implies that either EM corporate bonds are undervalued or that U.S. credit is overvalued, at least when using credit ratings as a proxy for risk. **Overcoming the EM Stigma** Even though they understand the quantitative advantages of EM credit investing (higher yields for comparable credit quality businesses), the thought of lending to companies headquartered in a foreign country seems to cause some investors concern. However, just like equity investing, by limiting your investable universe to developed markets, you severely restrict your investment opportunity set (and the potential for declining correlations and excess returns). With EM lagging across virtually all asset classes this year, it might be trendy to decry the end of EM investing. But many of the companies represented in the EM corporate investable universe are multi-billion dollar, multinational corporations with significant track records and credit histories. The combination of solid fundamentals and above market interest rates due to their country of domicile could make for an attractive investment if investors can put their biases behind them. While investor interest has been increasing in recent years, EM corporate credit comprises only 4% of the Barclays Global Aggregate Corporate Index.[2] At current levels, EM corporate debt appears to be attractively priced compared to U.S. credit. Should investors believe in the long-term opportunity of emerging markets, EM credit may provide an attractive way to generate income in their portfolios while at the same time reducing volatility relative to traditional equity investments in these markets. [1]Source: J.P. Morgan, August 31, 2013. [2]Barclays, August 31, 2013

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DEFINITIONS

Corporate Bonds : a debt security issued by a corporation.

Corporate Credit : compensation associated with the risk of lending to a corporation.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Widen : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

Basis point : 1/100th of 1 percent.

JP Morgan Corporate Emerging Markets Bond Index Broad (CEMBI Broad) : The JPMorgan Corporate Emerging Markets Bond Index Broad (CEMBI Broad) is a market capitalization weighted index consisting of US dollar-denominated Emerging Market corporate bonds. The index serves as a global corporate benchmark representing Asia, Latin America, Europe and Middle East / Africa. US dollar-denominated corporate issues from index-eligible countries are narrowed further by only including issues with more than $300m current face outstanding and at least five years to maturity (at the time of inclusion into the index).

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's, Moody's or Fitch.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.