The Evolution and Future of Emerging Markets Fixed Income

As the emerging markets (EM) fixed income asset class evolves, investors want to know which trends are lasting and which are fleeting. To that end, looking at the major inflection points over the history of the asset class can provide a useful perspective. One very relevant theme that emerges is: Innovation in the EM asset class has often followed periods of global financial market volatility.

I. Development of emerging markets fixed income

Beginning of an EM external debt market

During the 1970s, most Latin American countries borrowed heavily from U.S. and European commercial banks to finance balance of payments and fiscal deficits. The banks were flush with deposits from the capital surpluses of oil-exporting nations and were faced with sluggish economies in much of the developed world due to two major energy shocks during the decade. Fueled by these loans, EM economies grew at a relatively robust pace. EM exchange rates were mostly fixed at the time and generally became overvalued as inflation in EM countries exceeded that of their trading partners.

In the early 1980s, an unprecedented sharp rise in U.S. policy rates made it difficult for EM countries to service their floating rate debt while a sharp global recession caused a collapse in oil and other commodity prices. A series of Latin American defaults and devaluations followed. In 1989, U.S. Treasury Secretary Nicholas Brady crafted a new way for developing countries to convert their rescheduled foreign bank loans into long-term bonds collateralized by zero coupon U.S. Treasuries. The Brady program involved a substantial amount of debt forgiveness, which helped EM countries regain their ability to service their
debts. The issuance of these so-called “Brady bonds” presented global investors with the first liquid, investable EM debt instruments. Until then, investors’ primary option for gaining exposure to these countries had been through equities.

**Overview of the 1990s EM crises**

While the Brady program allowed EM countries to emerge from default, they remained financially vulnerable. They continued to have relatively high, though reduced, levels of debt, much of which was denominated in foreign currency. Local domestic issues rarely had maturities longer than one year, with three to six months being the norm. This was partly due to a lack of investor confidence in EM countries’ ability to service longer-term debt; at the time, most EM countries had relatively short histories of credible central bank inflation-fighting policies, which made investing in longer tenor local bonds seem risky.

Many EM countries ran large trade and current account deficits during this period. At the time, many people believed this was justifiable from a macroeconomic and developmental perspective, taking the view that countries at lower levels of per capita income should be borrowing to invest in their economies. The prevailing macroeconomic wisdom also held that fixed exchange rates provided an anchor for stability in EM countries where fiscal and monetary policies had a short history in the wake of the 1980s debt crises.

Unfortunately, the combination of deficits and fixed exchange rates made EM countries highly dependent on foreign capital flows to finance the deficits. When endogenous or exogenous shocks eventually hit, capital flows into EM countries threatened to rapidly reverse. As the countries used their foreign exchange (FX) reserves to support fixed exchange rate regimes, outflows of capital generally meant reductions in FX reserves, setting in motion a vicious cycle in which capital outflows would cause local interest rates to rise, FX reserves to fall, economic growth to slow, and currencies to weaken – a combination that produced growing debt burdens that then would further erode confidence and generate additional capital outflows.

**Impact of the Mexican Tequila crisis**

In late 1994, the Mexican “Tequila Crisis” represented the first time that a major EM country faced a significant currency and solvency crisis after the introduction of Brady bonds. At the time, Mexico had been using the apparent certainty of a fixed exchange rate regime to attract foreign capital to finance significant fiscal and current account deficits. The country’s currency regime came under pressure when the U.S. Federal Reserve decided to hike its policy rate early in 1994 by 300 basis points (bps). That action coincided with unrest in Mexico’s Chiapas province and the April assassination of leading presidential candidate Luis Colosio, creating a perfect storm for Mexico. Foreign capital exited the country and foreign exchange reserves plummeted.

As the crisis intensified, newly elected President Zedillo was forced to let the peso float freely in December 1994. The peso promptly lost value, depreciating from 3.4 to the dollar in early December 1994 to a low of 7.8 in March 1995. In response, investors in Mexico’s foreign and domestic debt markets accelerated sales of Mexican sovereign debt. Of particular concern was the huge amount of debt with principal indexed to the prevailing dollar/peso exchange rate. The country managed to narrowly escape default on its local and external debt when the U.S. intervened and led an international rescue package. Mexico’s economy recovered within 18 months but the repercussions of Mexico’s devaluation and near default soon spread to other emerging countries.

The next wave of EM currency crises began in July 1997, when the Thai baht collapsed, led by many of the same drivers that caused Mexico to massively devalue its currency. Faced with dwindling foreign exchange reserves, the Thai government was forced to float the currency, and it promptly declined to record lows against the U.S. dollar. Once the baht was devalued, the fixed currencies of nearby countries came under pressure. Moreover, what had started as an Asian currency crisis became an Asian corporate debt crisis with regional companies eventually forced to restructure their dollar-denominated debt. Like Mexico, several Asian governments narrowly avoided
default due to a series of bailouts from multi-lateral organizations such as the International Monetary Fund (IMF) and World Bank.

Russia’s devaluation and default came next. Facing the same currency pressures that plagued Mexico and Asian countries, in August 1999, Russia defaulted on both its local bonds and on the external debt of the former Soviet Union (which had been previously assumed by the Russian Federation). This represented the first local debt default by a major emerging country in recent memory. Highlighting once again the perils of maintaining a fixed exchange rate regime, the eventual floating of the ruble added significant stress to long-simmering pressures on the Brazilian real and Argentine peso, both of which were fixed. Soon after, Brazil and Argentina were forced to devalue their currencies by letting the real and peso float in 1999 and 2001, respectively. Argentina also defaulted on its local and external debt, the largest sovereign default in history at that point (although Greece’s recent default dwarfed that of Argentina). The overlap in the drivers of all these crises is striking; in each country, the combination of an overvalued fixed exchange rate, low levels of foreign exchange reserves and large fiscal and current account deficits proved toxic.

**Post-crisis reforms and growth of investor demand**

As Figure 1 illustrates, EM external debt spreads (representing the difference in yields versus benchmark bonds such as U.S. Treasuries), as measured by the J.P. Morgan Emerging Markets Bond Index (EMBI)\(^2\), oscillated wildly during the turbulent period from 1994 to 2002. Any one of the EM crises could have spelled the end of the market for EM new bond issues. The fact that this did not happen is testament to a fundamental truth about EM sovereign investing: Unlike companies, countries that default do not disappear. Even countries like Argentina, Ukraine, Ecuador and Greece, which have been habitual defaulters, continue to find investor interest in their bond issues, especially in the periods immediately following debt restructurings. This is generally because after countries undergo some measure of debt forgiveness and implement reforms to address the vulnerabilities at the root of their default, they again become viable candidates for investment. The real issue that concerns most investors following a default is whether a country has restructured its debt and instituted the reforms that are necessary for the country to sustainably service its lower debt levels. It is the quality and sustainability of the reforms undertaken in conjunction with debt relief that distinguish countries that exit the cycle of defaults successfully from those that do not.

![FIGURE 1: SPREADS OF EM DOLLAR SOVEREIGN DEBT](source: J.P. Morgan As of 30 January 2014)

The reforms that followed the Latin American and Asian financial crises played an important role in restoring investors’ confidence in EM. The reforms became known as the Washington Consensus and were spread across the globe through the conditions required in most IMF bailout packages. The reforms often included a combination of structural and institutional changes that aimed to rein in government spending, privatize state-owned enterprises and force through balance-of-payment adjustments. As confidence and credibility returned to EM, issuance of EM sovereign and corporate dollar debt grew once again, with bonds outstanding rising from $593 billion in 2000 to almost $2.0 trillion in 2013 (see Figure 2).
As EM issuance rose and interest in dedicated EM funds grew, investors sought a benchmark by which to measure the performance of managers focused on EM debt portfolios. In February 1995, barely two months after the Tequila Crisis began, J.P. Morgan had introduced the Emerging Market Bond Index (EMBI), which originally consisted of a handful of EM external sovereign bonds, mostly Brady bonds. The EMBI evolved into the EMBI + and the EMBI Global a few years later, when EM countries began to issue bonds in the international capital markets. The launch of a widely-followed index is often a key development in the evolution of an asset class; along with the creation of an index comes the development of tracking error against that index. Tracking error creates an incentive for investment managers who manage assets against a particular index to continue owning the bonds that the index contains, which in turn establishes more consistent U.S. dollar flows to the asset class, including during periods of stress. Today, almost 50% of EM external sovereign bonds are managed to the EMBI family of indices.

**Transformation of EM fundamentals**

Looking back at the macroeconomic conditions of EM countries during the crises of the 1990s, it is remarkable how much these countries have been able to transform over such a short period of time. Current account deficits crossed over into surpluses in the early 2000s, creating a situation where many large EM countries are net creditors to the world. This transposition in roles between the emerging and developed markets (illustrated in Figure 3) has empowered EM countries, making them considerably less vulnerable to external financing shocks than they have been in the past.

At the same time, EM countries began building up large war chests of foreign currency reserves (Figure 4), imparting policy flexibility and insurance against global economic and market stress. These additional layers of financial protection significantly changed the risk profile of EM countries, fortifying them against systemic market risks and enabling their continued growth trajectories over the early 2000s.
The strength of EM fundamentals today becomes even more pronounced when comparing the state of many EM countries’ balance sheets to those of developed countries. As shown in Figure 5, following the 2008 crisis when global balance sheets increased dramatically in efforts to restore liquidity in the markets, EM countries were able to deleverage at a much faster pace than developed economies.

These illustrations serve to highlight the remarkable rebound of EM countries following their rocky introduction to global financial markets. With cleaner sovereign balance sheets, rapid growth rates, and increasingly open economies, EM countries once again became a “hot spot” for investor capital in the early 2000s. At the same time, in the wake of the Latin American, Russian and Asian currency crises, the larger EM countries focused on paying down external debt. As countries like Mexico, Brazil and Chile began to issue longer term bonds in their domestic markets, the universe of investable EM financial products broadened.

Expansion of the EM asset classes: local and corporate markets

As EM country external and internal imbalances moderated and government balance sheets strengthened, investors became more interested in owning EM local debt, which generally yielded more than external debt and had higher credit ratings. Given EM countries’ negative experience with U.S.-dollar-denominated debt in the 1980s, many EM countries also began to favor local over external issuance. Yield-hungry global investors responded positively to the stronger balance sheets of emerging countries and began to invest more widely in EM local debt.
Emergence of domestic pension funds increases demand for local debt

The growth of a domestic pension fund industry within EM also had a profound impact on the development of the asset class, as it provided a natural domestic investor base for long-term local currency debt. In the early 2000s, fully-funded defined contribution pension systems began to take the place of the dominant pay-as-you-go social security systems in Latin America and Eastern Europe. Pension reform across EM strengthened the domestic investor base and drove rapid growth in the volume of institutionally-managed assets. Chilean pension assets, for example, grew to almost 60% of GDP in 2003 from negligible levels in the early 1980s. Since pension funds focus on long-term investment horizons, their strategic asset allocations are often biased toward buy-and-hold strategies, and this helped flows to both grow and stabilize in the EM local debt market. The added depth and liquidity in the local government bond markets in turn helped establish local currency-denominated yield curves.

As interest in local debt expanded, J.P. Morgan introduced the GBI-EM family of indices for EM local bonds in 2005. With this development, investors that wanted to invest in funds dedicated to EM local bonds now had a benchmark by which to gauge the performance of their managers. Figure 7 shows the rapid growth in EM local debt managed to the J.P. Morgan family of local EM indices.

The 2008 crisis and its impact on EM

The 2008 global financial crisis was the first big test for EM in the era of floating currencies. EM countries came into the crisis with mostly floating currencies, strong foreign exchange reserves, sharply reduced levels of external debt, more competitive economies and relatively benign fiscal imbalances. With these robust fundamentals, several EM currencies rallied going into the Lehman bankruptcy in September 2008, as seen in Figure 8. At the time, many investors believed that EM would escape the global financial crisis.

They were wrong. The massive illiquidity of the immediate post-Lehman period meant that investors were forced to liquidate what they could rather than what they wanted to sell. EM bonds and currencies, as they were relatively more liquid than other credit asset classes, were sold indiscriminately. Figure 9 shows the dramatic fall and sharp rebound in the value of the indices for EM external and local debt.
The turbulence in EM markets proved to be relatively short-lived, and EM assets rebounded sharply in 2009. In a stunning development during the post-Lehman period that PIMCO called “The New Normal,” local government bonds of key EM countries, such as Mexico, Brazil and South Africa among others, began to fall in value during periods of economic weakness and rise during periods of higher inflation or growth. This is a characteristic that PIMCO calls “hard duration” and had previously been associated only with developed country bonds. Until this point, higher interest rates in EM countries were thought to be compensation for currency weakness and credit-related issues. However, with sharply improved balance sheets combined with credible monetary and fiscal policies, local bonds in countries with hard duration began responding to changing economic conditions in the same way as developed market bonds. This helped inspire investor confidence in the asset class and reinforced the importance of country differentiation in EM fixed income investing.

EM bonds today

With fundamentals improving over many years, EM fixed income has risen from being a low single-B asset class in the early 1990s to one that is now generally investment grade (see Figure 10). That development has expanded the investor universe for EM fixed income further to include many institutional investors that are restricted from purchasing or holding bonds below investment grade bonds. Rising EM credit ratings have reflected the opposite trend seen in developed markets during and after the financial crisis, when ratings were mostly declining, in some cases to below investment grade.

Today, local EM bonds are the highest rated within the EM fixed income space; the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified has ratings of Baa2/BBB+/BBB+ from the three major rating agencies compared to external debt ratings of Baa3/BBB-/BBB- (EMBI Global) and corporate debt ratings of Baa2/BBB/BBB (Corporate Emerging Markets Bond Index – CEMBI – Diversified.)

The rapid growth in EM debt investing has led to different types of instruments in the local markets. The EM local sovereign universe now includes a wide array of securities, including fixed-rate, floating-rate and inflation-linked bonds, interest-rate swaps, options and currency forwards. These options allow an investor to choose which risks they are willing to assume and isolate those accordingly.

In addition, corporate bond issuance in emerging markets, which was slow to develop, has taken off in recent years: First issued in the early 1990s, new corporate bonds exceeded new dollar sovereign bonds for the first time in 2005.
Following the 2008 global financial crisis, with U.S. interest rates depressed due to successive quantitative easing campaigns, a global search for yield intensified, and because EM sovereigns were increasingly turning to their local markets for issuance, EM corporates began to fill the demand for EM debt denominated in dollars. Corporations flocked to the dollar space (rather than local markets) where they found investment capital for longer tenures and at lower yields than in the local markets. Renewed appetite for commodities, especially energy, led to large corporate capital expenditure programs from commodity producing companies, and these expenditures were increasingly financed with long-term bonds.

Dollar EM corporate bonds hit a milestone in November 2007 when J.P. Morgan introduced the CEMBI family of EM dollar corporate bond indices. Fast forward to the present and corporate dollar issuance has outpaced sovereign dollar issuance in recent years (see Figure 2), and assets managed to the CEMBI family of indices have grown from $7 billion in January 2010 to $63 billion in December 2013.

The rise of EM Asia

Based on both market capitalization and number of issues, one area to watch for growth in the coming years will be U.S.-dollar-denominated Asian sovereign and corporate credit. Asia already has the highest level of domestic tradable debt among the EM regions and over the last five years, external debt from Asian corporates, sovereigns and quasi-sovereigns has more than doubled (see Figure 11).

The main drivers of the growth in Asian external issuance are (1) a lack of U.S.-dollar denominated sovereign supply as countries develop and prefer to issue in their own currencies; (2) continued strong demand for spread product as net issuance globally remains at low levels relative to pre-crisis levels; and (3) post-crisis deleveraging within the banking sector, which has forced companies to look outside their banks for financing. In particular, the emergence of high yield corporate issuers in Asia over the last few years has been remarkable. 2013 set a record in new Asian high yield issuance with 94 new issues totaling over $38.8 billion.

II. The outlook for EM debt as an asset class

Investors remain underweight EM debt

Global government bond investors remain underweight to EM sovereign debt, with only an estimated 6% allocation, despite EM economies representing almost half of the global economy and 80% of the world’s population.
The share of EM debt in investor portfolios is also smaller than the 12% that EM represents of total global government debt. Given the enormous increase in developed economies’ government debt in the post-Lehman era, it is no surprise that the size of developed market government debt is disproportionately greater than that of EM debt. However, the size of the combined indices for EM sovereign and corporate debt (in dollar terms) is three times that of the combined indices for global commercial loans and almost twice that of high yield bonds (Figure 13). While the mortgage and investment grade credit markets still dwarf the investable EM market, PIMCO believes that EM as an investable asset class will continue to expand and eventually catch up to other global asset classes, and the continued efforts of institutional investors to reduce their global underweights to EM will be a key driver of this trend.

At PIMCO, we have seen a strong commitment by long-term investors such as sovereign wealth funds, pension funds, central banks and insurance companies to reduce their portfolio underweightings by increasing strategic investments to EM fixed income, especially local bonds. EM debt inflows totaled US$6.2 billion in 2013, with net inflows of $9.2 billion going into local strategies and net outflows of $2.9 billion coming from external strategies. While retail investors were the main source of outflows from EM debt over the second half of 2013 (see Figure 14), strategic institutional flows into the asset class surpassed outflows from retail investors. This indicates that strategic investors remain committed to reducing their underweight to EM debt. We think this is a long-term trend that will likely continue over five years or more, despite any outflows or volatility in the asset class in response to market events.
Over the long term, we also believe that investors will be able to invest in the EM equivalent of various existing developed-market asset classes and EM local bonds from larger sovereigns will increasingly be viewed as another alternative to developed market government bonds. Currently, most global government bond indices are based on market capitalization, and the massive increase in developed country debt following the global financial crisis served to secure developed markets’ higher weighting in most global indices. Despite the improvement in EM fundamentals and the higher amount of issuance, EM’s weighting in the Barclays Global Aggregate index has only risen from 2% in 2003 to 6% in 2013 (see Figure 15).

**FIGURE 15: EM AS %MV OF BARCLAYS GLOBAL AGG BREAKDOWN**

![Figure 15: EM as % MV of Barclays Global AGG Breakdown](image)

Source: Barclays
As of 31 December 2013

While traditional government bond indices tend to favor economies that are heavy borrowers (due to their market capitalization-weighted approach), other index approaches may not. For example, PIMCO has created a global government bond index, Global Advantage Index (GLADI) Government, which is GDP-weighted. Over the past five years, EM has had a regional weight target of 36% in the GLADI Government index. If more global government debt investors switch to GDP-weighted indices, as we expect, investor allocations to EM debt will increase to a level that better reflects EM’s portion of global GDP.

**The EM debt universe will continue to expand**

Although we believe the EM dollar sovereign space will continue to be important, it will likely have a more bifurcated structure with five to six countries comprising 50% or more of the market capitalization of the asset class and frontier and other small countries representing the remainder. In addition, as Figure 16 shows, we believe the local debt market, particularly local corporate debt, will represent the fastest growing part of the asset class looking forward.

**FIGURE 16: SIZE OF EM DEBT MARKET OVER TIME**

![Figure 16: Size of EM Debt Market Over Time](image)

Source: BofA Merrill Lynch Global Research, BIS, Bloomberg
As of 31 December 2013

The dominance of local issuance in the future will likely be especially pronounced for sovereign debt markets, particularly in the larger EM countries. As strategic allocations to EM local...
fixed income rise, local markets should become more liquid and capital flows more stable. The inclusion of EM local market bonds in more global bond indices is also likely to provide a more stable form of long-term local currency financing for EM governments, and the growth of EM domestic pension funds should help deepen local capital markets.

**Impact of growing domestic pension funds**

As EM countries continue to move up the credit spectrum, reflecting the development of a middle class, local citizens’ demand for long-term financial planning and pension funds will increase and should fuel expansion in the universe of EM local market securities. Today, most domestic EM pension funds hold their local fixed income positions in fixed rate sovereign debt; we believe they will increasingly need to insulate their portfolios from long-term inflation risk by investing in inflation-linked bonds and diversify their portfolios away from their home countries, a trend we are already seeing in Chile and other EM countries. The growth in domestic pension assets should lead corporates to increase issuance in local markets, especially at longer tenures.

**Local corporate markets underdeveloped**

With historically low foreign demand, however, local corporate debt markets are underdeveloped, which has led many domestic pension portfolios to be over-allocated to government assets at the expense of private securities. Despite having a market capitalization of $5.9 trillion, local EM corporate bonds do not yet have a widely followed benchmark, reflecting the low demand from foreign investors. Several constraints are currently discouraging to foreign investors. Almost 75% of local EM corporate bonds are issued by Asian companies, many of which reside in countries where foreign investors cannot access the local markets. China, for example, is one of the biggest sources of corporate debt issuance, representing 46% of EM corporate debt outstanding in 2013 (see Figure 17), but due to Qualified Foreign Institutional Investor (QFII) restrictions, most foreigners cannot access its market.

Additionally, EM local corporate bonds have been characterized as relatively short maturity bonds with significant withholding tax issues that have made them unattractive to foreign investors. Liquidity in the local corporate markets is generally limited in part because the dominant players are long-term investors such as insurance companies, banks and pension funds, which prefer to buy and hold securities until maturity, in many ways substituting them for bank loans.

However, as domestic pension funds grow and seek active management of their fixed income portfolios, and as foreign investors continue to gain interest in a more diversified opportunity set within local markets, we believe local corporate debt markets will deepen. Eventually, as the investor base diversifies, this will lead to greater liquidity in the market.

Furthermore, it is likely that a local EM corporate index will eventually develop. As was the case with external and local sovereign debt markets, once investors begin managing assets against an index, the market is likely to gain more depth. In our view, this development is three to five years away at the earliest.

In 2013, EM dollar corporates dominated the new issue market, with issuance more than four times that of dollar sovereigns. We expect the corporate market to increasingly dominate the dollar space at the expense of sovereigns.
Key trends in emerging markets

As our historical overview of EM highlights, the drivers of EM debt returns are continually evolving. In the years to come, we believe three current trends will impact the evolution of the EM debt space: the growth slowdown in China, the emergence of frontier markets and the increased differentiation between EM countries.

China growth moderates

Through the debt crises of the 1980s and 1990s, the U.S. was one of the primary drivers of EM financial conditions. Changes in the U.S. economic and financial environment often had outsized impacts on EM countries. Over the last few years, this dynamic has changed, with China replacing the U.S. as the biggest export destination for many EM countries. This has led to concern among EM watchers that EM countries will be faced with significant economic headwinds from a China that is not growing as fast as it had in prior decades.

Slower growth in China of course also means slower growth for the rest of Asia and indeed, the rest of the EM. The composition of China’s growth will also have large and varying effects on different countries. Commodity exporters like Brazil and Indonesia will be challenged by what is likely to be slower growth in Chinese demand for the raw material inputs to physical investment. At the same time, exporters in both northeast and southeast Asia involved in the production chains for electronics and other consumer goods may be positioned to benefit from a more robust emergence of the Chinese consumer.

Frontier markets emerge

Growing sovereign issuance from frontier markets, especially in the dollar space, is another significant trend in EM. Frontier markets generally are countries whose bond, currency or equity markets have lower market capitalization and often less liquidity than those in “traditional” EM countries. This universe may be rewarding to long-term investors but often involves transacting in markets that are less liquid and subject to higher economic and political uncertainty than traditional EM. The entry of frontier-type countries into the dollar EM sovereign indices has accelerated in recent years. Each month seemingly brings a first-time bond issue from a small EM country; in the one year period from December 2012 to 2013 alone, Morocco, Paraguay, Honduras, Tanzania, Slovakia, Trinidad and Tobago, Armenia and Mozambique joined the EMBIG (source: J.P. Morgan Data Query). Figure 20 illustrates the growth in the number of countries in the EMBIG, especially in the last three years.
Perhaps surprisingly, many of these smaller countries have actually outperformed larger countries in the EM external debt space. During the volatile period from 24 May to 31 August 2013, the top-performing 20% of countries in the EMBIG – most of them frontier issuers – in the EMBIG had an equally weighted return of -1.60% compared to -8.63% for the index as a whole (source: PIMCO and J.P. Morgan). Does this mean that the smaller EM countries have substantially stronger debt repayment capacities or greater willingness to pay their foreign debt than larger ones? In fact, several of these smaller countries are first-time issuers in the international markets with weak balance sheets, substantial imbalances and, in some cases, no history of paying commercial debt obligations at par.

Instead, we believe the outperformance of the external debt of many smaller EM countries masks a significant vulnerability: weak secondary market liquidity. Investors sell what is liquid rather than what they want to sell during market downturns. This is a pattern we have seen in various asset classes in the post-Lehman period, and EM external debt is no exception. At some point, spreads for smaller EM countries will likely reflect both their low relative liquidity and weaker relative creditworthiness.

**Country differentiation increasingly matters**

Many investors have questioned whether periodic large outflows from EM ultimately impact their growth potential. We believe these conditions will produce greater country differentiation within EM, with more fundamentally sound countries most likely to weather the volatility without long-lasting damage to the countries’ finances. Lower-quality EM will typically need time to regain control of financial conditions, and might even need assistance from third-party balance sheets.

While the trends toward greater EM local sovereign and dollar corporate markets issuance present many opportunities, success will depend on a greater level of scrutiny and risk assessment. The time when “a rising tide could lift all boats” in EM is over and greater return dispersion between EM countries has already started to surface.
Going forward, we believe that valuations in EM will increasingly become tied to fundamentals, even when risk sentiment is high. Country differentiation will therefore be crucial to investing successfully in EM.

A top-down macroeconomic outlook and fundamental country assessments are essential to focusing on countries that offer the most attractive risk-adjusted return potential, as well as to gauging the external susceptibilities arising from the increasing interdependencies of today’s global economic structure. Constant on-the-ground analysis and a strong risk management framework ensure consistency between views and portfolio positioning, while taking advantage of relative value opportunities.

Thank you to Christopher Getter for his input to this paper.

Appendix – All as of 31 December 2013

APPENDIX A: ANNUAL RETURNS FROM EM EXTERNAL DEBT

Source: Bloomberg
As represented by JPM EMBI index

APPENDIX B: ANNUAL RETURNS FROM EM LOCAL DEBT

Source: Bloomberg
As represented by JPM GBI-EM index

APPENDIX C: ANNUAL RETURNS FROM EM CORPORATE DEBT

Source: Bloomberg
As represented by JPM CEMBI Index

APPENDIX D: ANNUAL RETURNS FROM EM CURRENCIES

Source: Bloomberg
As represented by JPM ELMI+ Index

APPENDIX E: ANNUAL YIELDS FROM EM EXTERNAL DEBT

Source: Bloomberg
As represented by JPM EMBI Index
APPENDIX F: ANNUAL YIELDS FROM EM LOCAL DEBT

![Graph showing annual yields from EM local debt](image)

Source: Bloomberg
As represented by JPM GBI-EM Index

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APPENDIX G: ANNUAL YIELDS FROM EM CORPORATE DEBT

![Graph showing annual yields from EM corporate debt](image)

Source: Bloomberg
As represented by JPM CEMBI Index

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APPENDIX H: ANNUAL YIELDS FROM EM CURRENCIES

![Graph showing annual yields from EM currencies](image)

Source: Bloomberg
As represented by JPM ELMI Index
Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. Derivatives may involve certain costs and risks, such as liquidity, interest rate, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested.

The JP Morgan Corporate Emerging Markets Bond Index (JPM CEMBI) is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities. The JP Morgan Emerging Markets Bond Index Global is an unmanaged index which tracks the total return of U.S.-dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady Bonds, Loans, Eurobonds, and local market instruments. The JP Morgan Emerging Markets Bond Index Plus is a total return index that tracks the traded market for U.S. dollar-denominated Brady and other similar sovereign restructured bonds traded in the emerging markets. The JP Morgan Government Bond Index-Emerging Markets (GBI-EM) indices are comprehensive emerging markets debt benchmarks that track local currency bonds issued by Emerging Market governments. The index was launched in June 2005 and is the first comprehensive global local Emerging Markets Index. The PIMCO Global Advantage Bond Index (GLADI) is a diversified global index that covers a wide spectrum of global fixed income opportunities and sectors, from developed to emerging markets, nominal to real assets, and cash to derivative instruments. Unlike traditional indices, which are frequently comprised of bonds weighted according to their market capitalization, GLADI uses GDP-weighting which puts emphasis on faster-growing areas of the world and thus makes the index forward-looking in nature. PIMCO’s GLADI methodology is intellectual property covered by U.S. Patent No. 8,306,892. GLOBAL ADVANTAGE and GLADI are trademarks of Pacific Investment Management Company LLC.

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