Perspectives

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Emerging Markets: Maintaining perspective

- EM should continue to benefit from a number of positive fundamental and technical forces that are not expected to abate anytime soon.
- We continue to see a meaningful bifurcation between the investment-grade-rated and high-yield-rated segments, which is the natural evolution of any growing bond market.
- For now, it makes sense to focus on USD-denominated EM sovereign and corporate debt for their more defensive qualities — and playing EM local markets tactically.

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Emerging Markets – Maintaining Perspective

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Portfolio Manager, 2006–

Citigroup Investment Banking
Senior Credit Officer and Market Risk Manager, 2002–2006

Fiduciary Trust International
Investment Strategist, 1999–2000

Global Emerging Markets Advisors, L.P.
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*In this Q&A, **Western Asset Portfolio Manager Robert Abad** discusses the latest dynamics and trends within emerging markets (EM). Although EM continue to demonstrate resiliency, Mr. Abad believes that given the amount of global uncertainty today, it is important that investors evaluate opportunities alongside a manager equipped to guide them through the risks and rewards of this evolving asset class.*

Q: Given the uncertain global environment, is there the risk of a flight-to-quality away from EM debt?

A: We don't foresee anything on the immediate horizon that would result in a full-scale retreat. During past EM crises, we would typically see a flight-to-quality of funds away from both EM debt and equity at the first sign of trouble, as investors sought the liquidity and relative safety of other traditional, "risk-free" asset classes. What we've been observing during recent periods of market duress is a flight-to-quality *within* EM—an intra-EM dynamic—where funds move out of higher beta sectors such as EM equity and EM currencies and move instead into lower beta sectors such as high-grade USD-denominated EM sovereign and corporate credit. This isn't surprising to us.

Prior to the S&P downgrade of the US last year, we argued that EM, as an asset class, had "graduated" on the global capital structure of risk—that the investment-grade tier of EM offered investors another viable fixed-income alternative with the defensive qualities of similarly rated, fundamentally sound developed market (DM) assets. This intra-EM dynamic supports our argument, as well as our long-held thesis that EM experienced a "structural break" following the 2008 crisis; investors recognize that the stronger fundamental position of EM no longer justifies a wholesale liquidation of EM exposure during crises, nor an outsized spread premium relative to DM. If anything, this "upside-down" story—one of worsening DM fiscal balances and public debt-to-GDP[1] levels versus EM—combined with strong, longer-term oriented flows into the EM asset class, should help forestall the kind of capital flight and severe spread volatility we observed in EM more than a decade ago.

Q: Is the rally in EM debt sustainable given its strong performance year-to-date?

A: EM should continue to benefit from a number of positive fundamental and technical forces that are not expected to abate anytime soon. At the top of this list is the resilience of EM growth, which has continued to surprise many observers, given that global growth forecasts continue to be revised lower. But as we've argued before, balance-sheet strength and policy flexibility matter more for EM in this global macro environment than does their ability to sustain the high growth rates to which investors have been accustomed. It's the reason why EM have been able to weather the body blows coming from the US and Europe, and why EM debt has continued to outperform EM equities.

From a technical perspective, outperformance among EM since 2008 has attracted a diverse mix of new investment flows into the asset class. We continue to see a broadening and deepening of the EM investor base, with greater participation by longer-term oriented investors, such as US, European and Asian pension plans, insurance companies, sovereign wealth funds, and more activity from a more volatile base of Asian private bank clients, all of whom continue to search for yield and diversification in a world of decreasing supply of USD spread product.[2] The presence and participation of these new investors, coupled with the reinvestment activity of existing investors who are benchmarked to EM debt indices, should continue to provide strong technical support for USD-denominated EM sovereign and corporate debt.

Q: Is the recent euphoria over EM justified?

A: It's certainly justified given the strong fundamental improvements we continue to observe, among them, recent sovereign ratings upgrades in Turkey, the Philippines, Indonesia, and South Korea against a backdrop of more downgrades

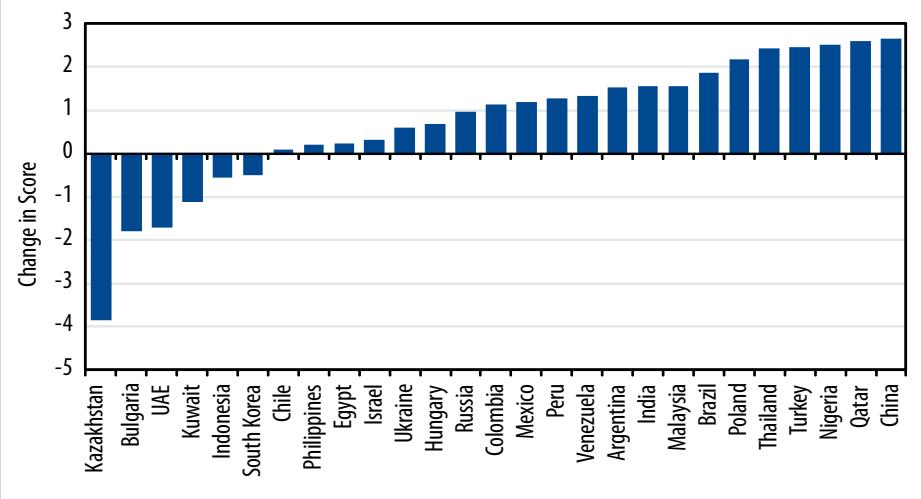
[1] Gross Domestic Product ("GDP") is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

[2] "Net issuance of USD spread product peaked in 2006 at US$1.6 trillion and since has declined sharply, reaching US$462 billion in 2009 and expected to be US$264 billion in 2012." JP Morgan, "EM Rerates as an Asset Class", August 10, 2012

in the developed world. However, no one should be deluded into thinking that EM "decoupling" is real, that EM face no internal risks, or that EM are immune to external shocks such as a European banking crisis.

Strong global liquidity conditions, which can promote excessive domestic credit growth and artificially boost commodity prices, have played a critical role in the positive trajectory of EM over the past decade. However, financial history has shown that such conditions, when artificially sustained for an extended period of time, can produce negative outcomes. The eventual contraction of liquidity and its impact on domestic markets can fuel capital flight and balance of payments instability, especially in countries with weak political regimes, managed exchange rate regimes, volatile sources of export revenue, and/or fragile financial systems. With monetary policy in the G-3[3] remaining highly accommodative for the foreseeable future, the pace and quality of growth in EM—for example, the amount and type of issuance throughout the EM corporate credit space and the level of asset quality and leverage in EM banking systems—bears close monitoring to identify potential balance-sheet vulnerabilities percolating under the surface.

Exhibit 1
EM Balance-Sheet Strength Has Generally Remained Resilient Since 2008 Crisis



Source: Haver Analytics, IMF, World Bank, Western Asset

Bars represent the change in Total Sovereign Vulnerability Score between 2011 and 2008. The actual country score is based on a scale of 0 (low stress) to 10 (high stress) which reflects economic/financial risk based on select domestic/external indicators.

Q: Is EM debt still attractive versus EM equities?

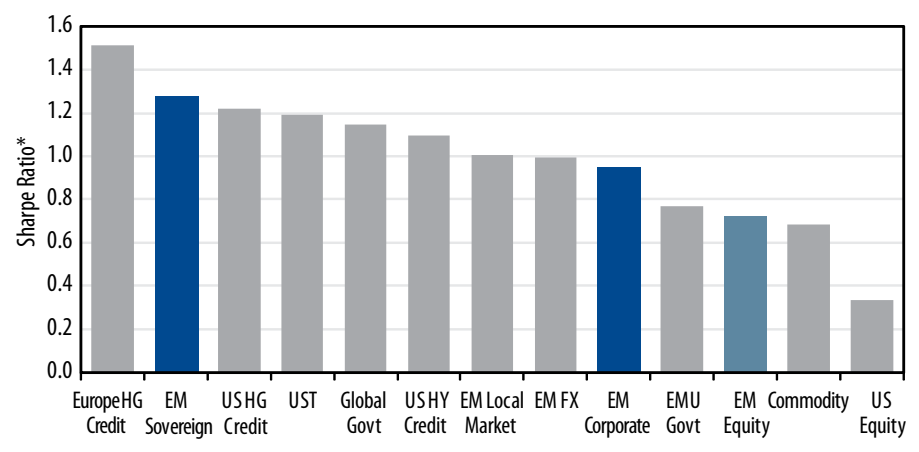
A: We believe so. Since the 2008 crisis, EM equity continues to outpace EM debt *in terms of volatility*. This year has been no different, with sharp bouts of market volatility stemming from US-, Europe- and China-related growth fears, helping to extend EM equities' track record of poor risk-adjusted returns relative to EM debt. As a result, we're seeing more traditional holders of EM equity considering a partial or outright reallocation to EM sovereign and/or corporate credit. This shift in investor mindset reflects a growing recognition that balance-sheet strength and policy flexibility in EM will likely be more supportive of EM debt valuations than EM equities, which remain more vulnerable to technical-driven rallies and further downward revisions to global growth. With intra-EM flows highlighting investors' stronger preference for EM debt over EM equities, it's difficult to see anything fundamental, barring a sudden and credible resolution of today's major headline risks, that would change that dynamic anytime soon.

Q. Have you observed any new trends developing in the EM debt space?

A: We continue to see a meaningful bifurcation between the investment-grade-rated and high-yield-rated segments, which is the natural evolution of any growing bond market. Indeed, while investor demand remains strong for diversified and sector specific EM debt products (such as local markets or corporate credit), we've also seen growing interest for cus-

[3] G-3 refers to the US, Europe and Japan.

Exhibit 2
EM USD Debt Continues to Outpace EM Equities on a Risk-Adjusted Basis



Source: JP Morgan, August 2012. ***Past performance is no guarantee of future results.*** *This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Please note that an investor cannot directly invest in an index.*

**Sharpe Ratios: Average annual returns since Jan 2003/Annualized standard deviation of monthly returns since Jan 2003. Standard deviation measures the volatility of an investment's return over a particular time period; the greater the number, the greater the volatility.*

tomized and unconstrained (benchmark unaware) mandates that focus either on the higher liquidity and relative safety of investment-grade-rated sovereign and corporate debt, or the higher income and total return potential offered by high-yield-rated EM assets. The latter trend has been a particularly interesting space to watch with the proliferation of new EM high-yield (EM HY) benchmarks and the launch of new (passively managed) Exchange Trade Funds (ETFs)[4] in this sector. EM HY is an area that's expected to grow further in the years ahead and one for which Western Asset is well positioned.

Q. How should investors be positioned in EM as we move into year-end?

A: Investors should brace for more headline-driven volatility throughout 4Q12. We have China "hard-landing" fears to consider, a leadership transition there in October, which could produce some policy surprises, the prospect of more political brinkmanship in the US following the presidential elections in November, which might result in another US ratings downgrade, the possibility of the European Central Bank once again having to defuse peripheral European tail risk, and the risk that more Middle East related turmoil will precipitate another sharp move in oil prices. Historically, the impact of one of these headlines has resulted in a higher degree of cross asset class correlation[5] and sawtooth-shaped trading patterns.

If you consider the source of market volatility in EM over the past two years, most of it came from US dollar/euro volatility rather than an EM sovereign credit event or sharp, unexpected moves in EM local rates or US long-term interest rates. However, should global macro conditions stabilize or quantitative easing/growth-induced inflationary fears materialize, it would certainly heighten concerns over duration risk.

Weighing all of these fundamental factors along with the technical dynamics discussed earlier, it makes sense to focus on USD-denominated EM sovereign and corporate debt for their more defensive qualities—investors have more options to calibrate their liquidity, credit quality and duration preferences—and playing EM local markets only tactically. Investing in EM local markets certainly remains an attractive fundamental story over the long term, but in the near term, given the prevailing high and positive correlation of EM currencies to global markets and the possibility of another round of macro-prudential measures (as EM policymakers attempt to mitigate the negative effects of open-ended quantitative easing by DM central banks), the risk/reward balance currently favors EM USD-denominated debt.

[4] An ETF is an unmanaged compilation of multiple individual securities and typically represents a particular securities index or sector of the securities market. Investors should carefully consider an ETF's investment objectives, risks, charges and expenses before investing in an ETF.

[5] Correlation is a statistical measure of the relationship between two sets of data. When asset prices move together, they are described as positively correlated; when they move opposite to each other, the correlation is described as negative. If price movements have no relationship to each other, they are described as uncorrelated.

Q. Why should investors look to Western Asset for EM?

A: Western Asset has been involved in EM mandates since 1993 and dedicated EM strategies since 1996. As the EM universe has grown over the past 20 years, so has the depth of our collective experiences and our respect for what it takes to opportunistically navigate markets through smooth and turbulent times.

Western Asset's EM effort is essentially an EM "boutique" supported by a global fixed-income powerhouse. Combined with our team culture and globally integrated investment approach, this arrangement has really contributed to our success in EM. With thirty dedicated EM professionals located in four offices on four continents, there's a high degree of communication and collaboration and a passion for the countries and sectors they cover. In a new world order where the lines between the developed and emerging world continue to blur, having a top-down and bottom-up approach to global investing is essential; this is why the EM team has benefited greatly from the input it receives from seasoned professionals across various sector teams and from forums such as our Global Investment Strategy Committee and Global Credit Committee.

Our EM product line-up, which continues to evolve with the asset class, offers investors the ability to invest across the spectrum of EM debt. In a nervous market where risk sentiment can swing sharply from week to week, and there's little consensus over what direction markets are headed toward over the medium term, we have the ability to rotate across all three sectors of the EM asset class—EM USD sovereigns, EM USD corporate credit, and EM local markets—seeking the opportunity to capture the best risk-adjusted returns possible. Alternatively, an investor can choose to focus on a specific sector, such as our EM corporate credit product, for which we have the longest track record in our peer group.

Given the events we're seeing today, there's no doubt that a paradigm shift is well underway in the global economy. These shifts, unfortunately, are never smooth and the trajectory of progress is rarely linear. The staying power of EM will depend in large part on how the developed world addresses its structural problems and whether EM can avoid policy mistakes that could potentially reverse years of hard-earned progress.

With this view of risk and reward, we believe a global story is best managed by a global firm in terms of scale and scope, and by a process such as Western Asset's.

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