

# An Introduction to the **Emerging Market Debt Asset Class**

Emerging-market debt has become a recognized asset class in its own right, with a maturity mirroring that of its constituent countries. While recent performance and asset flows in emerging-market bond funds may appear atypically strong, we believe these economies' outperformance is supported by sound underlying fundamentals.

The recent global recession upended much of the established wisdom in capital markets—starting with the belief that in times of extreme stress, the developed world is necessarily more resilient than the emerging world. The reality is that, despite its name, the “global financial crisis” had its origins in the developed world—and was most keenly felt there.

Indeed, the relative resilience of developing countries in the wake of the crisis points to a new maturity. Current account surpluses, increasing currency reserves, improving political stability, favorable demographics and flexible exchange rates are all positive indicators of the ascending power of emerging markets. These fundamental changes hold important implications for investors who wish to align their portfolios with this dynamic new reality.

Rather than being an outlier, we see recent large flows into the emerging market debt asset class as representing a recalibration from a historical underweight. We estimate that at current levels of inflows, it will take global investors more than five years to become market weight in emerging market debt.

Despite these very positive trends, it must be stressed that emerging markets are not homogenous. We will likely see differentiated returns across countries and regions. So while we are bullish overall on the asset class, country selection and credit work is essential to construct a diversified emerging market debt portfolio.

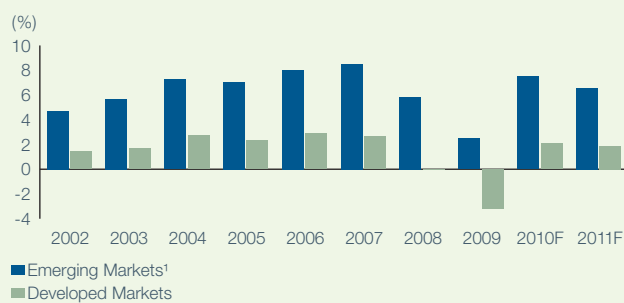
## Better Macroeconomic Fundamentals

### Leading Global Growth

The global crisis has put into sharper focus a shift in the balance of power within the world economy.

While many developed economies are grappling with public and consumer debt burdens, developing countries have been driving the recovery phase, showing more resilience and returning to growth more swiftly than their developed counterparts.

**Exhibit 1**  
Real GDP Growth Rate



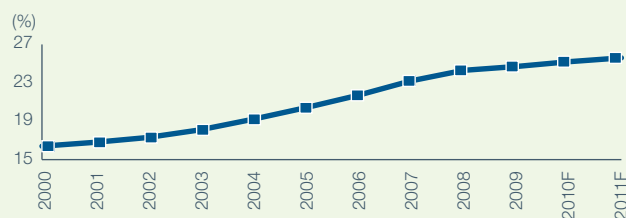
As of November 2010

1 Includes 20 EM countries

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: Moody's, Lazard

**Exhibit 2**  
Contribution of Emerging Markets<sup>1</sup> to Global GDP Growth



As of November 2010

1 Includes 19 EM countries

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: World Bank, Bloomberg

As Exhibit 1 shows, the divergence in recent growth patterns and prospects could not be starker.

Exhibit 2 shows that there has been a clear shift in the growth drivers of the world—from OECD member countries to emerging markets.

### Less Debt

Although emerging markets are typically known for high rates of growth, what is perhaps surprising is their low levels of debt. As Exhibits 3 and 4 illustrate, emerging-market fiscal deficits are at less than half the level of developed markets, while their debt-to-GDP ratios also exhibit long-term stability.

**Exhibit 3**  
Strong Fiscal Indicators in Emerging Markets  
(Nominal Deficit as a Percentage of GDP)

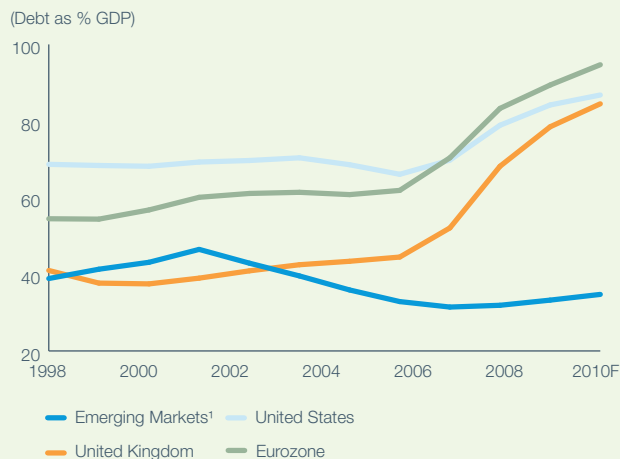
	2007	2008	2009	2010F
Developed Market Economies	-1.1	-3.4	-8.1	-8.5
United States	-1.1	-3.1	-8.8	-11.1
United Kingdom	-2.6	-6.2	-13.2	-12.8
Japan	-2.5	-2.7	-8.7	-8.0
Euro Area	-0.6	-1.9	-5.9	-7.2
Emerging Market Economies	0.6	-0.6	-3.8	-2.8
Latin America	-0.2	-0.8	-3.0	-2.4
Brazil	-2.2	-2.0	-4.1	-2.0
Mexico	0.0	-2.0	-2.1	-1.4
Eastern Europe	1.0	-0.1	-6.2	-4.8
Hungary	-4.9	-3.8	-3.9	-4.4
Poland	-1.9	-3.6	-5.6	-2.8
Russia	5.4	4.1	-6.3	-4.0
Emerging Asia	0.9	-1.3	-3.8	-2.8
China	0.6	-0.4	-3.3	-2.9
Korea	3.8	1.3	-2.7	-4.1

As of June 2010

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: J.P. Morgan

#### Exhibit 4 Lower Debt/GDP Ratios in Emerging Markets



As of December 2010

<sup>1</sup> Includes 20 EM countries

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: Moody's, Lazard

## Global Integration

This strong position has afforded many developing countries the luxury of free-floating currencies, which, owing to strong inflows of capital, has strengthened their value. Floating currencies have not only contributed to more stable economic policy, they have also enabled developing countries to be further integrated into international capital markets. The capital markets of emerging economies have grown strongly and are diversified more broadly than in the past.

#### Exhibit 5 Total Global Bond Market Capitalization

US Aggregate and High Yield	\$13.4 trillion
Global (ex-U.S.) Aggregate	\$19.5 trillion
Emerging Market Local Bonds	\$6.5 trillion
Emerging Market Hard Currency Bonds	\$1.5 trillion

As of December 2010

Source: J.P. Morgan, Bank of America Merrill Lynch

## The Emerging-Market Debt Environment

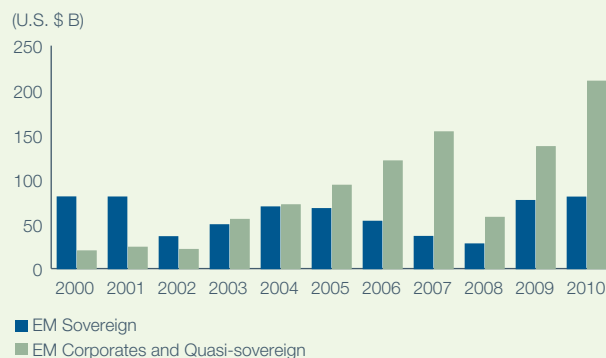
The asset class' economic progress is mirrored by improvements in its fixed-income markets as well. As an asset class, emerging-market debt has benefited from a series of structural improvements. The abandonment of fixed exchange rates and the adoption of inflation targeting—combined with reduced external debt burdens, lower fiscal deficits, and increased foreign exchange reserves—have dramatically improved the credit quality of emerging-market sovereigns and decisively altered the asset class.

Emerging-market debt is now deep and broad, and offers many opportunities, in our view. It accounts for approximately 20% of global bond market capitalization, of which—after excluding markets like China and India, where foreign investment is restricted—10% is investable (see Exhibit 5).

In the past, emerging-market sovereign issuers dominated external debt issuance, while emerging-market corporates tended to borrow from banks. However, corporate issuance has increased significantly since 2005—and, according to J.P. Morgan research, emerging-market debt issuance will exceed U.S. \$256 billion in 2010, with corporate issuance accounting for more than twice the level of sovereign debt issuance. Exhibit 6 illustrates how almost all of the growth in emerging markets debt issuance is coming from corporates and quasi sovereigns.

#### Exhibit 6 Hard Currency Issuance – Sovereign and Corporate

EM sovereign and corporate borrowing needs are far advanced with U.S. \$186 billion issued so far this year versus U.S. \$256 billion forecast



As of December 2010

Source: J.P. Morgan, Bank of America Merrill Lynch

#### Exhibit 7 Hard and Local Currency Index Market Values



As of December 2010

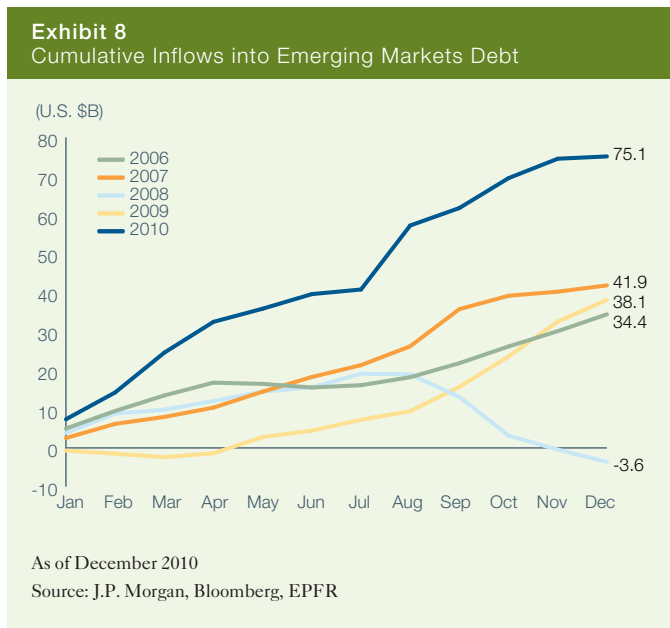
Source: J.P. Morgan, Bank of America Merrill Lynch

### Local-currency Issued Debt

A decade ago, when emerging market sovereigns and corporates needed to raise capital, they would predominantly issue bonds denominated in U.S. dollars due to concerns over inflation, underdeveloped local markets and the instability of local currencies. Today's improved macroeconomic environment has led to better sovereign creditworthiness, lower levels of inflation, and more-stable local currencies, resulting in an increase in local currency issuance over the last 10 years. Many local markets now offer yield curves that extend 30 years along with inflation-linked instruments.

Exhibit 7 shows how stark the trend towards local-currency issuance has been. The sharply rising green line represents the market value of the J.P. Morgan GBI-EM Broad Index, which tracks locally issued debt, while the more stable blue line represents the traditional hard currency benchmark, the J.P. Morgan EMBI Global Index.

Increasingly flexible exchange rates have contributed to the development of more-liquid, deeper, and longer-maturing debt markets, fuelling increased investor participation in emerging debt markets.

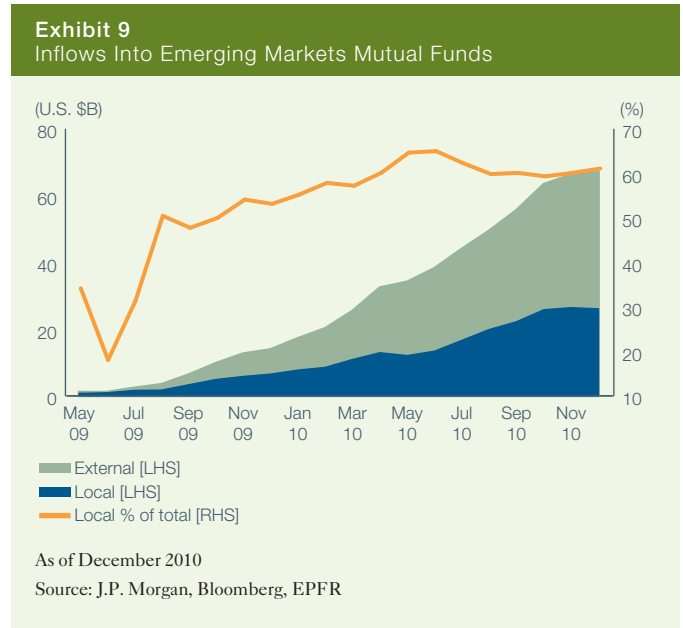


As Exhibit 8 shows, this year's inflows have already exceeded last year's total, while Exhibit 9 illustrates how the composition of flows is shifting more towards local currency and blended mandates.

It is also significant that the inflows have been coming from a more diverse and increasingly institutional investor set. While in the past, investments in emerging markets debt were seen as tactical plays, the money flowing into the asset class today is coming from pension funds, Asian investors, sovereign wealth funds and central banks. This shift in the investor base—towards longer-term asset allocators—is leading to a less volatile environment for the asset class.

### An "Asset Bubble"... Or an Underweight Correction?

The dramatic increase in emerging-market debt inflows has recently led the financial press to raise concerns about an asset bubble. We do not share these concerns. The classic definition of a bubble is a situation where valuations or prices have outstripped underlying fundamentals. In our view, these strong flows are merely a correction from a long-term underweight strategic exposure to the asset class.



For example, pension funds typically have a close-to-zero allocation to emerging-market debt, and, as can be seen in Exhibit 10, assets in emerging-market bond mutual funds account for only 1.5% of the total assets invested in U.S. fixed-income mutual funds. Furthermore, as mentioned earlier, current structural trends

favor emerging-market assets, and we expect the shift of investor capital into emerging-market debt to continue at a brisk pace.

## Why Emerging Markets Debt Now?

### Strong Risk-adjusted Returns

Emerging-market debt has outperformed other asset classes on both an absolute and risk-adjusted basis over an extended period of time (see Exhibit 11). It is understandable, therefore, that some investors may be concerned about buying at the top of the market. We believe, however, that this asset class's performance has not run ahead of the underlying fundamentals, and that it has been supported by stronger economic data—largely due to fiscal and monetary reforms—and favorable secular and demographic trends.

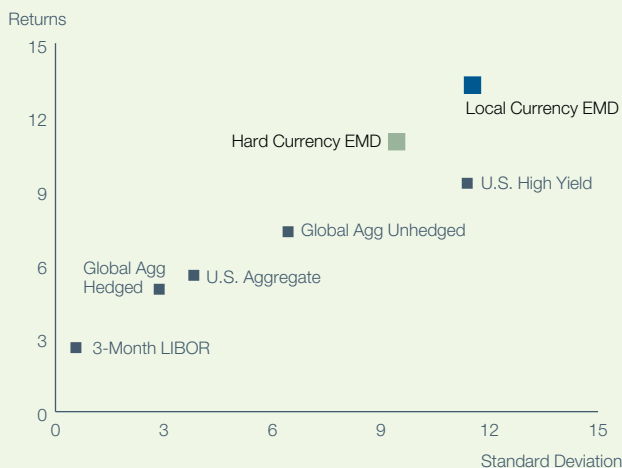
### Strong Economic Fundamentals Driving Spread Compression

On average, emerging countries have half the level of fiscal deficits and twice the growth rate of developed markets. This has led to improved emerging-market sovereign and corporate credit ratings and lower levels of volatility.

Exhibit 12 clearly demonstrates the link between improving fundamentals and credit ratings that have been reflected in lower sovereign spreads.

More importantly, we expect sovereign cashflow and balance sheet strength to continue over the short-term. We believe that sovereign debt spreads continue to offer investors attractive risk-adjusted value. Sovereign debt spreads are well above pre-crisis levels. As of 30 November 2010, spreads were +307 basis points

**Exhibit 11**  
Risk/Return Chart for 9 Years Ended December 31, 2010



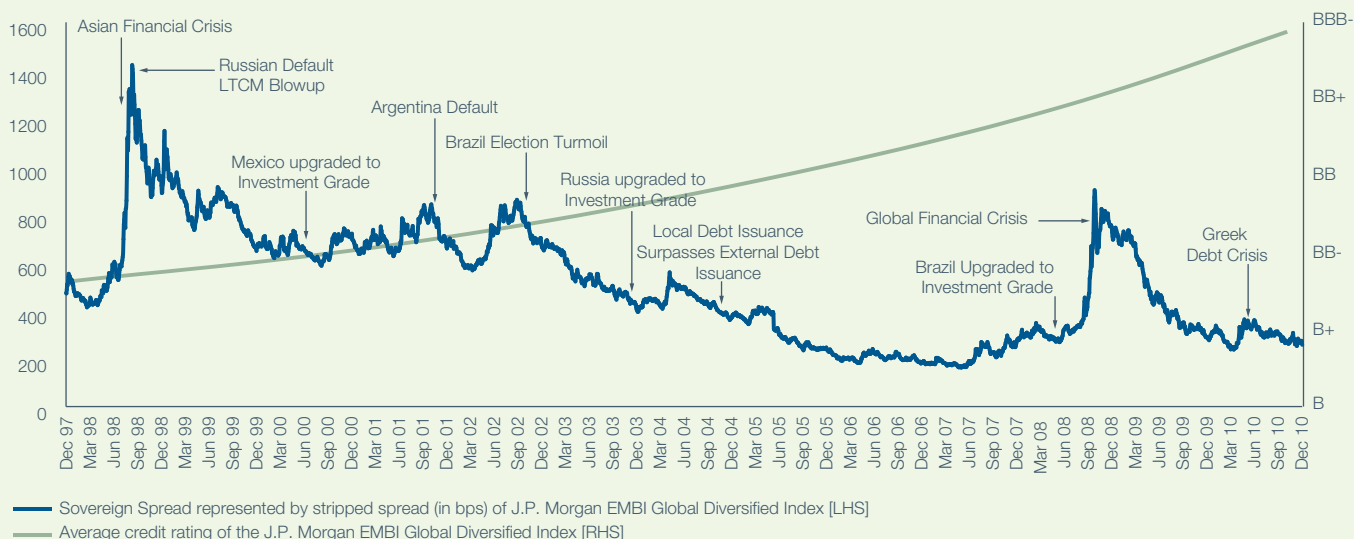
Hard Currency EMD = JPM EMBI Global Diversified; Local Currency EMD = JPM GBI-EM; US Aggregate = BC US Aggregate; US High Yield = BC US High Yield; Global Agg Hedged = BC Global Agg USD Hedged; Global Agg Unhedged = BC Global Agg Unhedged; 3-Month LIBOR = ML 3-Month USD LIBOR

All data as of December 2010; Time period represents the longest shared history of all the asset classes (the Local Currency EMD benchmark, the JPM GBI-EM Global Diversified Index, launched in January 2002).

Past performance is not a reliable indicator of future results.

Source: Lazard, Bloomberg

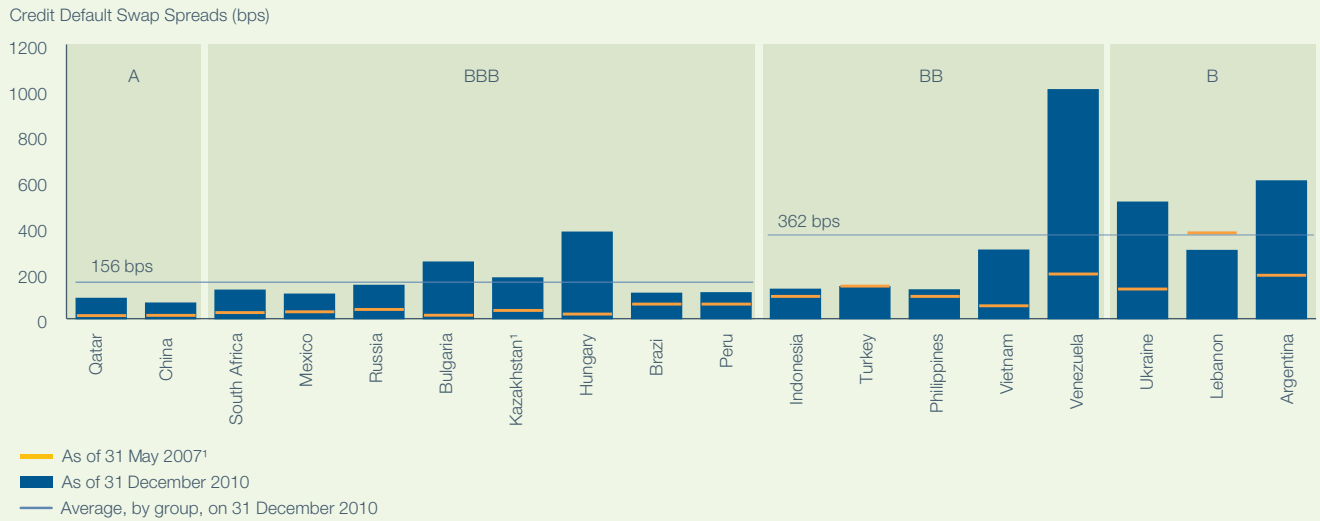
**Exhibit 12**  
History of Emerging Market Sovereign Spreads



As of December 2010

Source: J.P. Morgan, Lazard

### Exhibit 13 Sovereign Spreads Are Still Above pre-Crisis Levels



As of December 2010

<sup>1</sup> Did not have bonds on 31 May 2007; used tightest spread level since issued

Source: Bloomberg, Standard and Poor's

### Exhibit 14 EM Real Yields Still Compelling on a Historic Basis



As of November 2010

Source: J.P. Morgan

over U.S. Treasuries, approximately 145 basis points off historic lows, and in some cases far higher.

**A Broad Opportunity Set**

Emerging-market debt makes up approximately 10% of the investable global bond market. It offers investors broad geographical diversification and access to bonds issued by countries at different stages of economic and interest rate cycles, providing the potential for attractive returns.

The varying ranges of spreads (see Exhibit 13) within each credit rating sector offer opportunity for a diversified investor to capital-

ize on country selection. We believe this is where the real value is for an investor who is able to differentiate on intrinsic value.

**Compelling Yields**

Despite their contrast in fortunes, in 2010 emerging markets yields have largely tracked those of developed markets (see Exhibit 14). The combination of compelling real yields in local emerging markets (versus that of developed markets), and nominal emerging-market currency appreciation, points to increased interest in local emerging markets as a product and its potential to outperform.

**Exchange Rates Generally Within Fair Territory**

Exhibit 15 shows real exchange rates levels versus their 10-year averages. Currencies of countries listed on the negative side of the chart are trading at a premium to 10-year averages. While there has been overall appreciation, we believe that the significant improvement in external fundamentals—a key driver of currency valuation—in these countries are not fully priced in, and that many currencies will continue to appreciate versus their developed market peers. As such, we continue to support allocations to local currency at this time, though opportunities are on a selective basis.

**Emerging Market Domestic Interest Rates Are Favorable**

Looking at domestic interest rates, we believe that the re-rating of macro fundamentals has been more priced in for hard currency yield curves as compared to local currency yield curves. The y-axis in Exhibit 16 shows the 5-year local rate differential versus the U.S. dollar, while the x-axis shows average inflation differentials versus the United States. Therefore, countries above the diagonal line have positive real rates versus inflationary pressure. As the chart shows, there are numerous opportunities for real rates to converge in the emerging world, another benefit for local currency investors.

**Positioning and Outlook**

In view of this broad backdrop, what are the implications for investors for the near future?

**Asset Allocation**

We believe that near-term price movements in emerging-market debt and currencies will be more dependent on economic conditions in the developed world than on those in developing countries. We have relatively high conviction that core growth rates in emerging markets will sustain at elevated levels regardless of various permutations in the developed world.

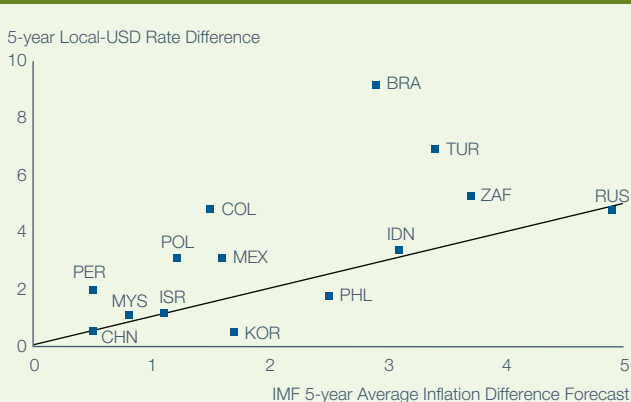
The ideal condition for emerging-market fixed-income valuations would be a continued slow recovery in the developed world. In such an environment, we would expect emerging-market debt spreads to fall moderately. In our view, local currency bonds can sustain their high running carry, as low developed-market growth should limit the amount of inflation that is exported to the emerging markets.

**Exhibit 15**  
Real Effective Exchange Rates  
(Current versus 10-year Average)



As of December 2010  
Source: J.P. Morgan

**Exhibit 16**  
EM Domestic Interest Rates Are Favorable



Source: Barclays Capital EM Strategy ("Local versus external under a 'new norm,'" 25 October 2010)

With interest rate increases already priced into many local curves over the next 12 months, we believe there is room for investors to realize the high carry of local rates in spite of positive growth fundamentals. In this slow-recovery scenario, local currencies will likely continue their appreciating trend versus the U.S. dollar due to prolonged monetary easing in the United States and Japan, high growth rate differentials with the developed world, and rising commodity prices due to supply/demand imbalances.

Analyzing various local currency markets on a bottom-up basis, there are select opportunities for further appreciation of emerging-market currencies, in our view, thus generating potentially positive total local market returns in emerging markets.

### Risks

In our view, the largest long-term risks for emerging-market debt are: rising inflation; abrupt fiscal or monetary measures by the Chinese authorities intended to temper rapacious growth and inflationary pressures; rapidly rising or falling growth rates in the developed world; potential complacency of EM policy makers; and ad hoc capital controls. Continued inflows into emerging markets and potential complacency by fiscal authorities could lead to lower primary surpluses and inefficient spending. It is important for emerging-market sovereigns to maintain fiscal discipline, especially in the wake of higher revenues from rising commodity prices. Rising long-term inflation expectations have historically been the Achilles' heel of many emerging-market sovereigns, as inflation becomes very difficult to control with imperfect monetary tools.

Regarding the fiscal/monetary policy risks in China, thus far, the authorities have deftly managed to engineer a gradual slowdown of their economy with little collateral damage to other markets. Any more aggressive measures could trigger a bout of risk aversion throughout global markets.

Also, as mentioned above, within the developed world, a quick move into a double-dip recession or much more rapid growth would be negative for emerging-market assets. In particular, a severe double-dip recession would likely cause a flight to safety, and money flowing out of emerging-market assets, thus putting pressure on prices.

### Summary

Overall, we remain bullish on emerging market debt. The gradual growth scenario in the developed world is quite constructive for emerging market valuations, as it is strong enough to maintain high fundamental economic difference between the two markets, yet not large enough to cause inflationary concerns.

While we are cognizant of the strong recent returns across emerging-market debt assets, we believe that both external and local debt remain undervalued in the current environment.

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## Important Information

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Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss.

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