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Yields in terra incognita

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Earlier this month, US Federal Reserve Board Chairman Ben Bernanke disclosed to the financial markets that the FED would not be taking away the "punchbowl" any time soon, but would likely serve less punch.

Chairman Bernanke indicated to investors that the Federal Reserve would begin moderating its monthly USD 85 bn assets-purchasing program some time during the coming months, with the possibility of unwinding the program altogether during the course of next year. In response, market correction across the credit spectrum was sharp and intense. Notably, the US 10-year Treasury backed up from a 1.6% level during the month of May to 2.3% as of June 19th. Yet, even given this recent volatility surge, benchmark government yields for reserve currency countries still remain at very low levels historically, and they may remain so for some time. Monetary accommodation is meant to safe-guard global recovery, so policy adjustments may be sparing. And, it is still, in the words of one tenured market observer, "an income wilderness" for the world's investors and savers. Market corrections notwithstanding, investors are inclined to fan out, looking at asset segments that broach all risk dimensions in distinctive ways, among them credit, operational, liquidity and transparency. For large institutions with big investment mandates to fulfil, there runs the chance presently that that this search for yield will bring the risks and potential for surprise that accompany any voyage of discovery.

Emerging market apologists, for example, make a very convincing thesis for the emerging markets (EM) fixed income asset class. Specifically, proponents for EM cite the relative resilience shown among some EM segments despite the recent "risk-off" seizure. Both hard currency denominated EM corporates, and local currency issuance out of EM Asia held their value during the general retracing seen in May, although the bloom on EM corporates did fade a bit during the June correction (see chart attachment). Given the yield range available of 4-6% and duration of 5-7 years, EM does however offer a possible "attractive diversification to Developed Market Sovereigns."

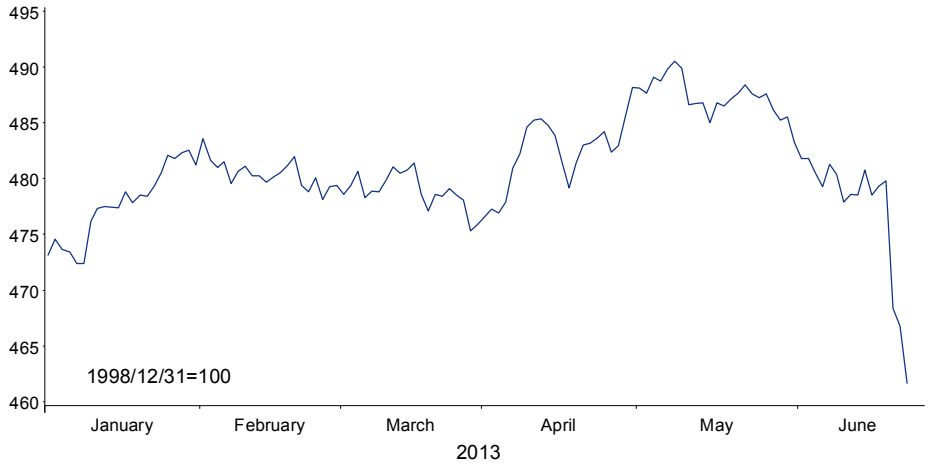
In fact, we agree that diversification and the vetting of investment opportunities in the EM space are both good things, but we think there is more to the story. We would still cite the due-diligence imperative and sound a prudent cautionary note resonating from three developments: 1) in a contrary sense, the current popularity of the asset segment – for investors and issuers alike; 2) the changing "fundamentals" among different EM issuers; and 3) the still developing "infrastructure" of EM investing for large institutional investors.

In its April 2013 World Economic Outlook, the International Monetary Fund (IMF) made the point of citing the risks stemming from what now seem to be the legacy leverage problems among advanced economies, but of also raising the spectre of potentially growing risks in EM, an otherwise stalwart in the wake of the Global Financial Crisis: "Among the risks ahead the most insidious relate to the debt overhang and fiscal deficits in advanced economies and budding financial excesses in emerging markets and developing economies…" In certain respects, such "financial excesses", to the extent they develop, will stem from the alacrity that both emerging market issuers and investors have shown toward shifting from capital raising done through bank lending to tradable debt issuance. Regulatory changes and the re-dressing of global bank balance sheets are two realities behind this trend Earlier this month, the Financial Times reported that emerging market borrowers are "getting three times as much funding from the bond

markets as they are from bank syndicates", making this development "the biggest gap (between debt issuance and bank lending) in over a decade." Indeed, JP Morgan reports that during the past three months to June emerging market companies have issued USD 122.7 bn in tradable bonds vs. the USD 37.5 bn in syndicated loans. Moreover, fixed income investing in the emerging markets has largely entered the mainstream, abetted from the steady growth in this asset class and from the investment grade ratings assigned to several EM sovereign issuers.

Emerging market corporates - a sharp slip in june…

Merrill Lynch global emerging market corporates, B-rated and above, total return USD



Source: EcoWin.

And to repeat, relatively appealing EM corporate returns continue to entice investors, available and historically low borrowing rates duly motivate issuers. Of course, the by-product from this dynamic is greater leverage, and therefore changing "fundamentals" for many EM companies doing the borrowing. As the International Monetary Fund states in an even-handed tone in its Global Financial Stability Review of this past April, "A combination of higher bond financing with relative stagnation in equity issuance (Figure 1.62) has increased debt-equity ratios and thus corporate leverage in emerging markets…" The IMF cites Turkey, the Philippines, China, Brazil, Thailand and Chile as EM countries that have recorded the largest increases in debt-to-equity ratios since 2007, while Korea, Mexico and Indonesia have registered some improvement in this regard. Given current trends in debt issuance, the IMF does see the possibility for some financial strain to develop over time, "…should debt-equity ratios continue to rise at the same pace over the next two years as they have over the past two, the aggregate ratio for the most leveraged quarter of Asian businesses would climb from 185 to 200 percent, while that for the group of leveraged Latin American business would rise from 260 to 300 percent."

So, with dynamic and shifting fundamentals among emerging market borrowers, the need for due-diligence becomes that much more important, the need to be able to trade in and out of a position numbers as a relevant consideration as well. But, the existing market "infra-structure" for this asset segment, i.e. emerging market corporate borrowers, may still be formative: how active is secondary trading and market making for the paper of newly issuing EM companies? How well are they followed? Can investors access transparent and meaningful financial information? In this era of financial globalization, market developments may be keeping apace, but its probably not a given. Investors will surely have to do their homework as they search the world for yield.

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