

CONJECTURE

This week's panel consider emerging market debt and how it has moved from a niche area into the mainstream

Emerging market debt appears on mainstream investors' radar

By Lawrence Gosling

Emerging market debt is one of those sectors that in the last two years has become increasingly popular and has gone from being a niche area, in investment terms, to becoming more mainstream.

This week's panel comprised Michael Story, product specialist at Western Asset Management; Colm McDonagh, head of emerging market debt at Insight Investment; and Kate Hollis, global head of fixed income and alternatives fund research, at Standard & Poor's Group

How do you define the emerging market debt sector and what does it cover?

Michael Story (MS): It has become an interesting question during the last few years. It is increasingly a grey area, and now there is even

talk of sub-emerging markets, which in our opinion may be taking it a bit too far.

But I think maybe the first point of definition is we feel it is wise to move away from the ratings themselves. There is a lot of crossover across the regions and countries, and certainly the ratings are good proxy, but the old way of having that cut-off between above and below investment grade no longer qualifies in our opinion. There are a lot of countries that are below and above now.

There are a lot of countries that are bumping up against the investment grade ceiling and may have crashed through. And if you look at the EMBI+ index, J.P. Morgan's external sovereign index, close to 60% of that index is now investment grade. At its inception in 1992, I think it was closer to

2% or 3%. So it is very much a transformed index if you go simply by the ratings.

Kate Hollis (KH): I cannot comment on S&P's credit ratings side, because I am not in that division. But from

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Michael Story, Western Asset Management

the point of view of emerging market debt managers, I entirely agree with what Michael has been saying.

We have noticed over the past couple of years fund

managers are taking a pragmatic attitude to this. For example, everybody seems to take the line that a country is emerging if it is in an emerging market index, or it used to be in an emerging market index, or it has never been in an index but it looks like it might possibly be soon.

Many of the indices have a formal GDP per capita requirement, and when I was last in the US discussing emerging market debt, I asked a lot of people about this. They all universally assured me Greece, for example, is unlikely to be an emerging market any time soon because its GDP per capita is too high, but that this might change at some point in the future.

Colm McDonagh (CM): We are talking about a universe that continually fluctuates.



Michael Story, Western Asset Management

And it is very true now that on average, emerging market indices are investment grade, which is a big change from a number of years ago.

I would make the argument though that the rating agencies themselves, and it is something we take a view on, are typically always late to really evaluate something.

So the fact most emerging markets are investment grade is to do with economic reforms that took place a number of years ago. We can clearly see what is happening in Europe at the moment, that with an awful lot of the downgrades that are taking place, they tend to really affirm what has taken place, rather than what is happening in the future.

In our view, whether a

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Colm McDonagh, Insight Investment



Kate Hollis, S&P

country is investment grade or not is not a criteria for us. It is very difficult to define and, as Kate said, how does it become part of an index? Is it geographically in an emerging market region, or has it been, or not?

Abu Dhabi and Qatar, for example, are considered to be part of the emerging market universe, despite the fact they are probably currently some of the best credit countries in the world. By the same token, Greece, for example, is by any measure an emerging market and it would be one of the worst emerging market countries in our universe.

What would you argue is the most compelling story for buying emerging market debt?

MS: It kind of plays on how

to define emerging markets in the first place. If you were to compare Greece or even Italy or Spain to Brazil, which is the more creditworthy country? Is it the peripheral of Europe, where per capita GDP levels are three times that of Brazil? Or is it Brazil because the peripheral has three times the debt burden Brazil has? It is a very difficult question to answer.

And so it has thrown open the debate on how to select these countries and how much to hold and what is sovereign risk.

One of the most compelling rationales for holding emerging market debt is the sources of risk, and there certainly is remaining risk in emerging markets. There are very different drivers

of risk emerging now in the G7, which is simply the level of debt. You do not have the same debt burden in emerging markets. So while you certainly have risks that remain, they are being driven by very different and, I would argue, uncorrelated factors.

Can you feasibly compare the G7 and the emerging markets, from a risk perspective? Or do you have to look at them in isolation and then, in portfolio terms, weigh up how much exposure you want to each region, according to the client?

CM: I think you can compare, but a straight quantitative comparison between, say, debt/GDP levels, that has been thrown into sharp relief over the last year or two, has not had an awful lot of merit. There are various other differences that will determine the prospects for a country, and that can be either politically or more importantly, infrastructural. Typically, one of the definitions of an emerging market was a country that might be in very good shape, but it is developing its political, its financial and its capital market institutions.

So as countries develop

those capital markets, then they become less emerging and more developed. And Even at the moment when there is a crisis in the G7, the institutions there are far more evolved than in many of the countries we look at, with some exceptions of course.

So when you are making a comparison about the risk you are taking, it is not just a debt/GDP number or a fiscal unsustainability. You have to take other factors into account. In the same way, you cannot compare Brazil with Russia because they are in different stages of evolution.

Kate, from the managers you are talking to, how is this G7 versus emerging debate being thought about?

KH: Managers I talk to are normally not part of that debate at all, because most of their inflows are coming from sovereign wealth funds, who have got all the G7 bonds they want and are buying emerging market debt for diversification.

One of the things I might possibly take issue with is to say emerging market debt does not have the same duration characteristics as G7 debt, and I think that is part

true.

But I think it very much depends country to country. Either because countries like China correlated very closely with the US Treasuries in 2008, or because countries like the Philippines are doing big restructurings and extending out the maturity of all of their external debt.

That is not to say they do not have credit characteristics as well, but if the price of the long bond really gets hurt, it is likely to be the long end of the Philippines market, or the Brazil market may be affected, depending on where spreads are at the time.

THE NEXT DEBATE

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