CURRENT VALUATIONS SUGGEST GREATER RESILIENCY ACROSS EMERGING MARKET (EM) DEBT

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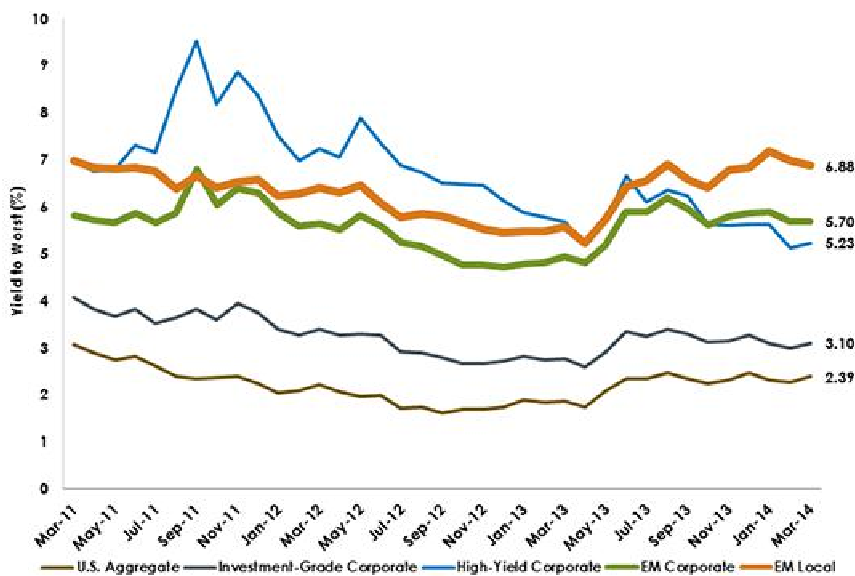
• Compared to this time last year, valuations are markedly different for EM debt than for other opportunistic fixed income sectors.[1] • Significant yield premiums compared to alternatives suggest greater investor opportunities for and resiliency within EM debt. • Risks remain, but existing positions provide, in our view, adequate compensation and could offer compelling re-entry points for investors. 2013 was a painful year for EM debt investors. In retrospect, valuations got progressively tighter, bottoming at all-time lows in the spring.[2] The "Taper Tantrum" of May and renewed fears of a Chinese hard landing resulted in a "reactive de-risking" among portfolio managers around the world. As a result, emerging market assets sold off in dramatic, successive waves. In response, EM officials scrambled to tighten policy and employ foreign exchange reserves to stem currency weakness. One year later, the backdrop for valuations and vulnerabilities suggests greater potential resiliency for EM debt in our view. In this the first of a two-part series, we look at relative valuations among a variety of growth-sensitive fixed income sectors. As a result of our analysis, we believe that the current amount of cushion in EM debt compared to other alternatives warrants the consideration of asset allocators to continue increasing their holdings of emerging market fixed income. **Year-to-Date** EM yields have retraced since hitting fresh highs at the end of January but remain at elevated levels compared to last year.[3] With the decrease in Treasury yields in the U.S., high-yield and investment-grade corporate bonds[4] have actually rallied in price since last fall, with rates for speculative corporates dropping 160 basis points (bps) since last September to 5.09%.[5] Last April, high-yield corporates offered comparable yields to EM local sovereign debt and more yield than EM corporate debt denominated in U.S. dollars. Fast-forward to this April: EM local debt and EM corporate debt offer 160 bps and 64 bps more in yield than U.S. high-yield corporates. Yield pickup over U.S. investment-grade corporate bonds is almost 380 bps for EM local debt and 270 bps for EM corporate bonds, respectively. As shown in the table below, we believe that EM debt is now attractively priced compared to other U.S. fixed income sectors. **EM Corporate & Local Debt Yield vs. U.S. Alternatives**

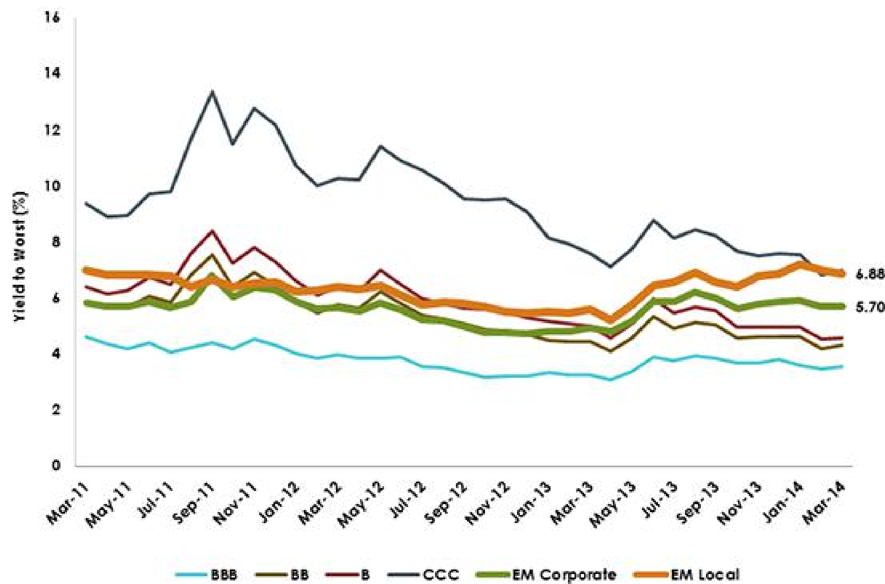


Yield to worst series from 3/31/11 through 4/30/14. Sources: Barclays, J.P. Morgan, Bloomberg. U.S. Aggregate, Investment-Grade Corporate, High-Yield Corporate, EM Corporate and EM Local represented by the Barclays U.S. Aggregate Bond Index, U.S. Corporate Index, U.S. High Yield 2% Issuer Capped Index and the JPMorgan CEMBI Broad and GBI-EM Global Diversified. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of terms and indexes in the chart, please visit our Glossary. U.S. high-yield corporate and EM local debt might not be natural substitutes and involve different risk factors, such as local investor preferences and the assumption of non-U.S. currency risk in local debt. But in a yield-starved environment, picking up nearly 160 bps with an investment-grade portfolio remains compelling in our view.[6] Over the longer term, we believe that these valuations will encourage many investors to take an opportunistic look at the costs, benefits and merits of these exposures. **A Comparison of Corporate Debt** Emerging market corporate debt may be seen as a more straightforward comparison for some. Both U.S. high-yield and EM corporate bonds are denominated in U.S. dollars. As such, both markets trade at a spread relative to U.S. Treasuries in order to compensate investors for taking on credit risk. EM corporate bonds are slightly longer in duration than high-yield bonds in aggregate, but are overwhelmingly (70%) composed of investment-grade issuers versus a, by definition, 100% speculative-grade portfolio.[7] Given that these companies are headquartered in emerging markets, investors are compensated by an additional 64 bps in yield over high-yield corporate bonds, even though they represent higher-credit-quality businesses. Additionally, EM corporates feature only about 5% of overlap with the U.S. investment-grade and high-yield corporate universe.[8] Given the potential for geopolitical risk, a discussion of emerging market corporate debt would not be complete without acknowledging the impact the current crisis has had on Russian corporate borrowing costs. Russian allocations within EM corporates may understandably give pause to some investors. However, after a de-escalation in tensions in recent days, markets appear to be trading more favorably. Coupled with the fact that nearly all of these businesses pose strategic long-term importance to the global economy, we continue to view the current difficulties as a long-term buying opportunity for active managers. **Stratifying Opportunities across Credit Ratings** In seeking to further refine our assessment of potential opportunities in emerging market fixed income, we sought to graph opportunities in U.S. corporate bonds yields according solely to their credit ratings.[9] While this analysis gives a high degree of discretion to credit rating agencies, we believe this analysis meaningfully highlights the dramatic transformation we have seen in markets over the past year. In April 2013, U.S. CCC-rated corporate bonds yielded 190 bps more than EM local debt. At the end of April 2014, EM local sovereign debt offered an additional 9 bps in yield compared to CCC-rated corporate borrowers, a shift of nearly 200 bps. Prior to 2014, local debt had never offered, even during the depths of the financial crisis, more yield than CCC-rated corporates in the

history of the J.P. Morgan GBI-EM Global Diversified Index.[10] Conducting this same analysis for EM corporates, this EM asset class now yields over 110 bps more than B-rated credits in the U.S. In April 2013, the premium was only 20 bps, and at the start of 2013, B-rated high-yield debt actually provided higher absolute yields. Again, the key takeaway from the chart below is that across virtually every measure of relative value, EM debt currently provides a compelling pickup in income potential compared to lower-rated U.S. corporate debt. Additionally, while yields have continued to fall since August 2013 in the U.S., yields of emerging market fixed income have continued to climb over the last six months, potentially creating attractive relative value opportunities.

EM Locals Trading Like CCC-Rated Corporates, EM Corporates Wider Than B-Rated Corporates



Sources: Barclays, J.P. Morgan, Bloomberg. Series from 3/31/11 through 4/30/14. BBB, BB, B, CCC, EM Corporate and EM Local represented by the Barclays Baa Corporate Index, Ba U.S. High Yield Index, B U.S. High Yield Index, Caa U.S. High Yield Index and the JPMorgan CEMBI Broad and GBI-EM Global Diversified.
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Conclusion

While emerging market investing entails a potentially different risk profile compared to U.S. corporate debt, we believe that when investors are looking globally for income in their portfolios, all asset classes should be on the table. In the current market environment, we believe that emerging market fixed income is priced attractively compared to other risky fixed income sectors. Compared to last year, valuations suggest a greater resiliency to weather a potential rise in global interest rates. In our view, fundamentals suggest a potential margin for error as well.

[1]Emerging market local debt is proxied by the J.P. Morgan GBI-EM Global Diversified. EM corporate debt is proxied by the JPMorgan CEMBI Broad. All data as of 4/30/14 unless otherwise noted [2]Source: JP Morgan [3]Sources: JP Morgan, Bloomberg [4]As represented by Barclays High Yield [5]Source: JP Morgan [6]Source: JP Morgan. As of 4/30/14, the J.P. Morgan GBI-EM Global Diversified Index was 93% investment grade [7]Source: JP Morgan [8]Sources: Barclays, WisdomTree [9]Analysis was completed by using the Barclays indices for each credit rating [10]Source: JP Morgan. Real-time history of the index begins in December 2006

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise.

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DEFINITIONS

Premium : When the price of an ETF is higher than its NAV.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Foreign exchange reserves : The total balance of foreign currency deposits and bonds held by a central bank or monetary authority.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

High Yield : Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securitie.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Basis point : 1/100th of 1 percent.

Sovereign : A national government.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor’s, Moody’s or Fitch.

CCC-rated : Standard & Poor’s credit rating that implies the issuer is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

B-rated : Standard & Poor’s credit rating that implies the issuer is more vulnerable to nonpayment than obligations rated ‘BB’, but the obligor currently has the capacity to meet its financial commitment. Adverse business, financial, or economic conditions will likely impair the obligor’s capacity or willingness to meet its financial commitment on the obligation.

Margins : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.