

The changing dynamics of emerging markets



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The emerging market investment scenario is changing profoundly

One thing that is clear is that the structure of the world economy is changing in important ways, with effects that are difficult to predict.

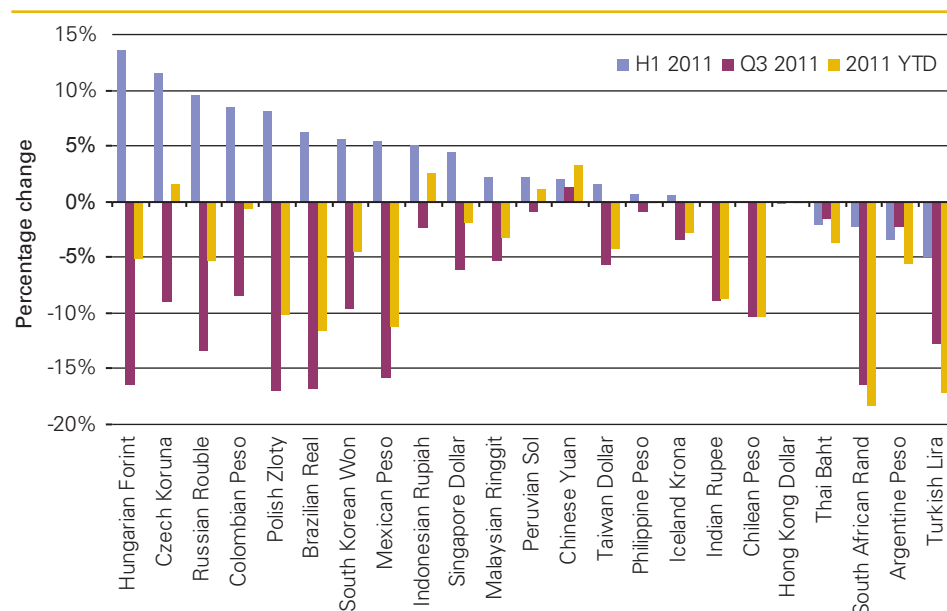
The past may no longer be a good guide to the future and relying too much on conventional wisdom - either old or new - may be dangerous.¹

Global asset sell-offs in Q3 2011 saw emerging market suffer

The first half of 2011 saw good performance in emerging markets (EMs), building on the extremely strong returns of recent years, with investors beginning to recognise and reprice the positive EM fundamental story. However, in September 2011 emerging markets came under pressure with both debt and equities experiencing sharp reversals. However, these setbacks have largely reflected external developments and we believe the underlying growth story of emerging markets remains intact and that long-term investors in emerging market debt will be well-rewarded.

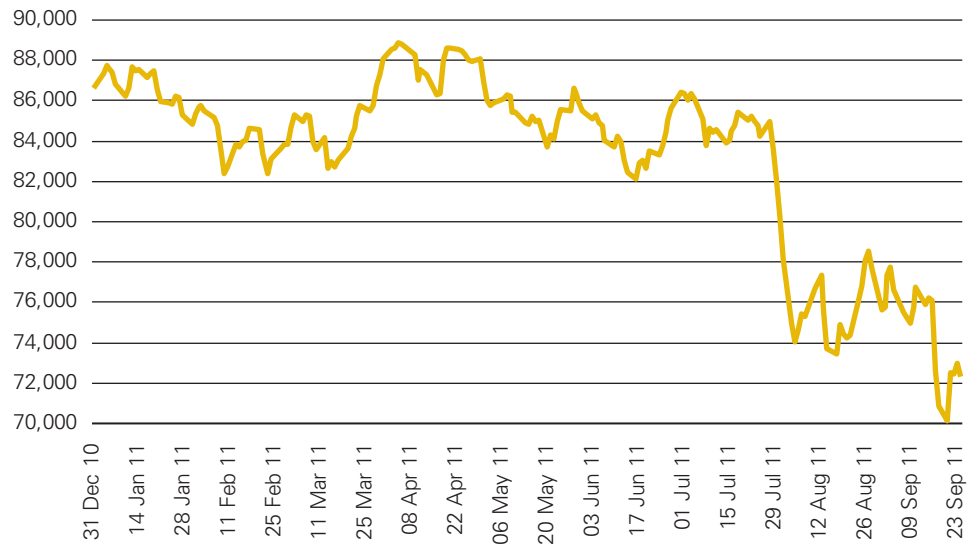
Rising economic concerns led investors to liquidate global assets on a mass scale. This put particular pressure on emerging market local currency markets as investors bought back US dollars as a safe haven. Stock markets plummeted as institutional investors sought defensive positions. Spreads widened, reflecting an increase in demand for credit protection for investment in emerging markets. Fear was driven by the crisis in Europe and concerns over the US recovery, and globalisation means that EMs are not decoupled from Western economies. Indeed, in a time of economic anxiety largely restricted to advanced economies, investors (still largely from Western countries) reverted to the EM=risk position and once again abandoned "risky" EM assets.

Many EM currency appreciations against the US dollar during 2011 have turned around



Note: Currency spot returns during the first half of 2011, Q3 and YTD 2011.
Source: Datastream.

The emerging market equity index has plummeted since August 2011

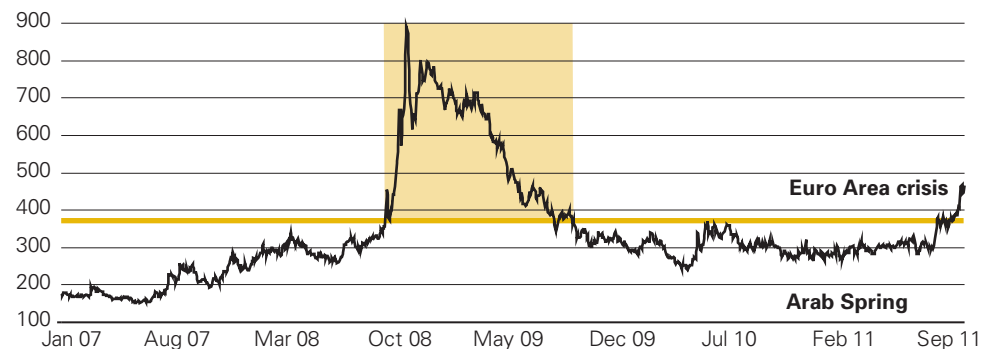


Note: Emerging markets equity index, total returns, 2011 YTD.
Source: Datastream.

Yet it is possible to make a strong case for arguing that the perception of emerging markets as inherently more risky than their developed counterparts is wrong. It certainly ignores the dramatic improvements that have taken place over the past decade in terms of policy management and the economic fundamentals in these countries. Certainly the risks associated with investing in emerging markets have diminished considerably both in absolute terms and relative to the more advanced economies over the past ten years.

The graph below, illustrating JPM EMBI spread (bps) shows the attractive opportunity available to investors in emerging markets. Since September, spreads are at seven year highs (excluding the 2008/09 dysfunctional period), with relatively low risk levels.

EM bond index spreads have widened in Q3 2011



Note: JPM EMBI spread (bps).
Source: Threadneedle as at 30.09.2011.

Risk-on / risk-off is back, heightening volatility in emerging markets

The markets have undoubtedly undergone a serious correction, but why did this happen and what does it really mean for the dynamics of emerging markets – a story that hitherto has been unreservedly positive for some time?

The sharp sell-offs that occurred recently are undoubtedly a return of the risk-on/risk-off trading that occurred during the recent financial crisis. This tendency for all risky assets to move lockstep reflects a number of key (and interrelated) factors that feature in current markets:

- A link between market volatility, stress and the indiscriminate sell-off of assets.
- An increase in the number and importance of negative macroeconomic factors which can significantly impact on all risky asset classes.
- A tendency for greater correlation between risky assets during periods of volatility (which can have a spiral effect).
- Globalised markets and technology have altered the significance of crowd behaviour.

These types of factors come together in a period of risk aversion to produce a number of outcomes that heighten volatility. Such volatility may be felt more in emerging markets due to the structural features of some emerging markets, including lower levels of liquidity and higher spreads. In thin markets, smaller changes in supply or demand can have a more pronounced impact on price, so comparatively fewer trades can increase volatility.

In a risk-off environment, when investors are losing money in a lot of markets, a point is reached where investors start taking off trades when they still have risk-on. Emerging market local currency bonds were very crowded trades. So whenever there are highly volatile risky environments, one can look to where there are crowded trades and expect those to come off, but those are precisely the opportunities investors want to buy into after the correction.

The resilience of emerging markets is not undermined by recent market activity

The events of September 2011 were therefore essentially a market correction. The paradigm shift that the next section of this paper addresses remains fundamental. It is a secular change that has arisen through a long cycle of accumulating debt in the developed world, as power shifted to emerging markets. It does not mean that these latter countries are insulated from volatility (as we have seen), but instead that the fundamentals remain in place for them to be able to exhibit great resilience. There is no reason at all why emerging markets will not reassert themselves.

The shifting patterns of the global economy have a profound effect on asset allocation. With traditional borders breaking down, a new framework for analysing relative value is needed - one that encompasses a more holistic approach, with the ability to compare, for instance, the relative positions of Greece, the UK, China and Brazil. The changing dynamics of the global economy and their impact on investment thinking and asset allocation are the focus of the rest of this paper.

The dynamics of emerging markets are part of a diverging global environment

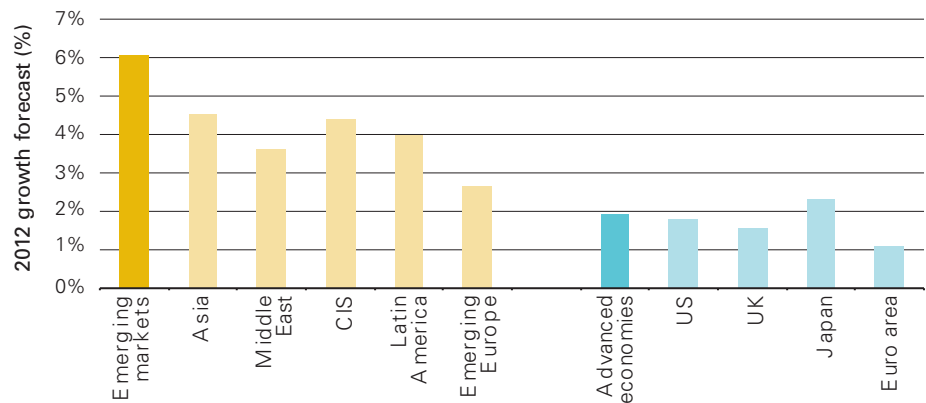
Emerging economies are leading global growth

The recent risk averse sell-offs in emerging markets belie the fundamentals. The economic performance of key emerging market countries is already giving rise to a tremendous change in global power, with the development of emerging markets driving world economic growth. In 2011, as advanced economies remain largely in the doldrums, emerging markets are leading the way out of global recession, with a forecast average growth rate of 6.1% in 2012, compared with just 1.9% in the advanced economies.

With the growth prospects of the world divided, a greater emphasis on debt sustainability needs to be incorporated into assessing investment opportunities in developed and emerging markets.

Within emerging markets the nature of growth is also changing. EMs are becoming less reliant on exports to developed markets, as many economies harness growth through strong domestic consumption and intra-emerging markets trade, both of which have increased significantly over the past ten years.

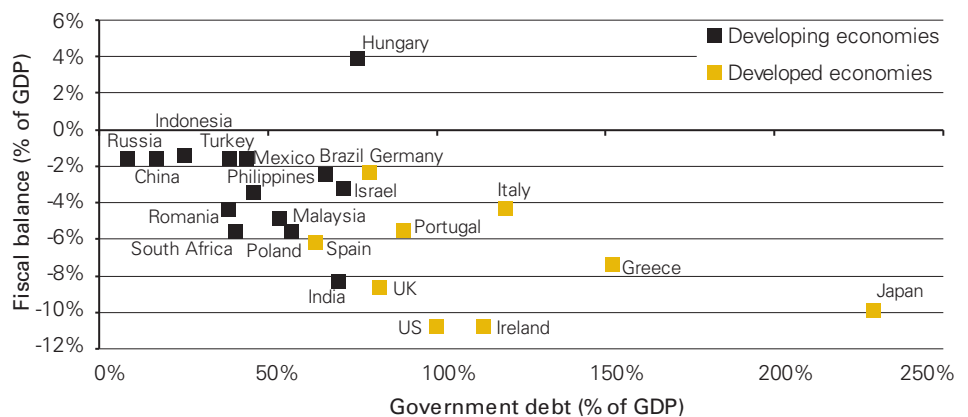
Emerging market growth is set to exceed that of advanced economies in 2012



Source: IMF, September 2011.

The global debt scenario is part of the two-speed world

Emerging markets demonstrate strong balance sheets



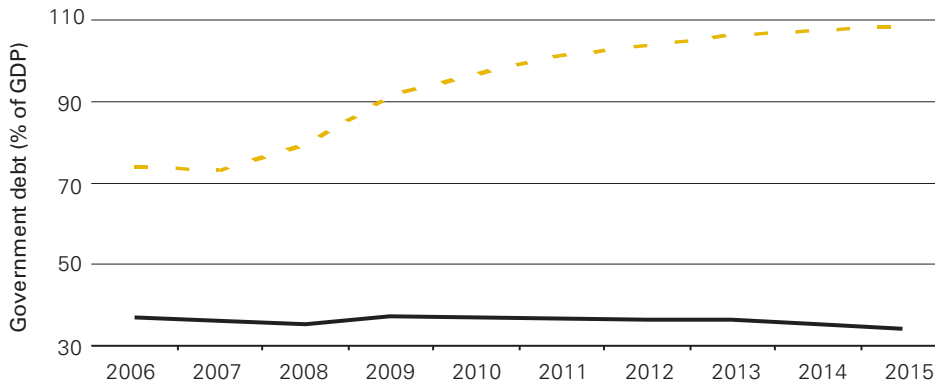
Note: For an analysis of advanced economy debt, please see Threadneedle's paper, Global debt: All at sea, published September 2011.

Source: Threadneedle, IMF, April 2011 and Haver Analytics, 30.04.2011.

The trajectories for emerging and advanced markets will continue to diverge

The debt challenges currently facing developed economies are largely absent from the EM world. Following many years of sound fiscal policies, government debt levels remain at very manageable levels. Government debt/GDP is on average close to 35% for the 30+ countries which constitute the EM debt universe.

Emerging market debt is low and sustainable

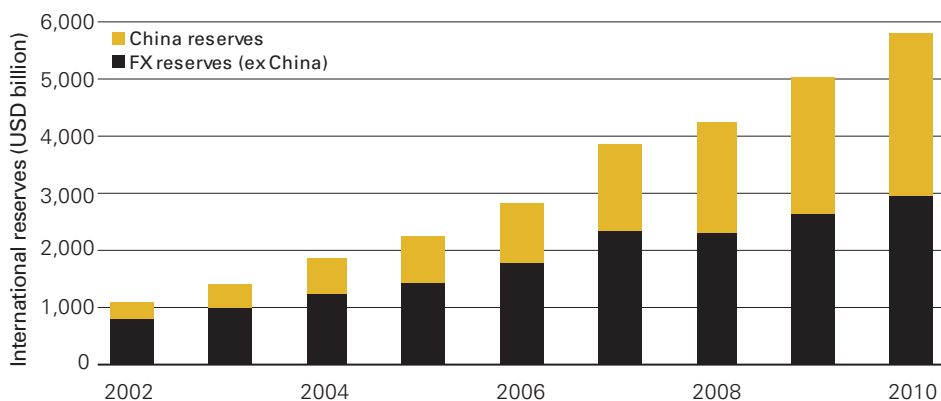


Source: Threadneedle, Haver Analytics, May 2011.

The better debt position of the growth economies largely reflects the comparative ease with which these economies have been able to weather the global crisis. They entered the crisis in a sounder position than many developed countries, with emerging markets having experienced sustained favourable economic performance and institutional changes that contributed to deficit and debt reduction from the early 2000s (when advanced economies had steadily rising debt ratios).

Most emerging markets have strengthened their balance sheets, making them less susceptible to a fragile debt sustainability dynamic. This has partly been achieved through refinancing existing debt at lower rates for longer maturities and, in some cases, in their own domestic currency. At the same time, EM central banks have built record-high reserve cushions, leaving those countries better able to defend against any crises which may threaten their economies. While China's level of foreign reserves is well known, this is a scenario which is mirrored across much of the EM universe. The result is that emerging markets are well positioned to take advantage of the changing economic landscape of a post-crisis world.

EM central banks have built record-high foreign reserves



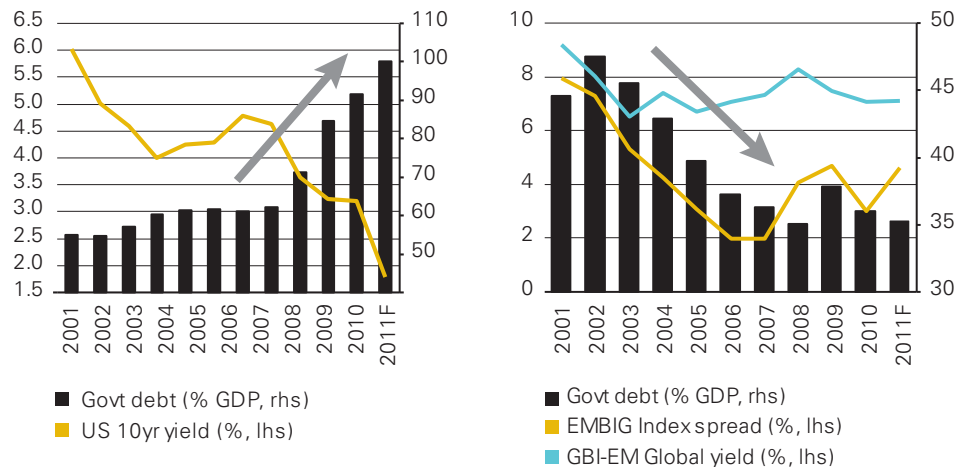
Source: Threadneedle, Haver, May 2011.

Inefficient valuations have created opportunities in emerging markets

Most of the macro risks that we see are exogenous to emerging markets; in particular, fiscal risks in the US and sovereign debt sustainability in Europe - concerns over which have intensified in mid-2011. In the US, debt-to-GDP is forecast to be around 100% this year, having risen from 60% five years ago. Despite this, treasury yields have been trending lower. Recent growth indicators from the US have been poor, with markets beginning to question the durability of the nascent economic recovery. In addition, the end of quantitative easing has removed an important buyer of US government bonds. These many drivers are making the future path of treasury yields extremely uncertain.

The fiscal improvements of EM countries, maintained over a period of ten years, would not seem to be reflected in either spreads of US dollar debt or yields of locally denominated instruments. This mispricing is part of the wider phenomenon of a breakdown in distinctions between asset classes, where securities valued as being more risky by the market are classified as investment grade, while emerging market corporates may face low costs of credit protection and developed market corporates must pay more for credit protection. Investor guidelines for adapting to the breakdown of fixed income sectors are presented in the final section of this paper.

Current valuations present investment opportunities in emerging markets

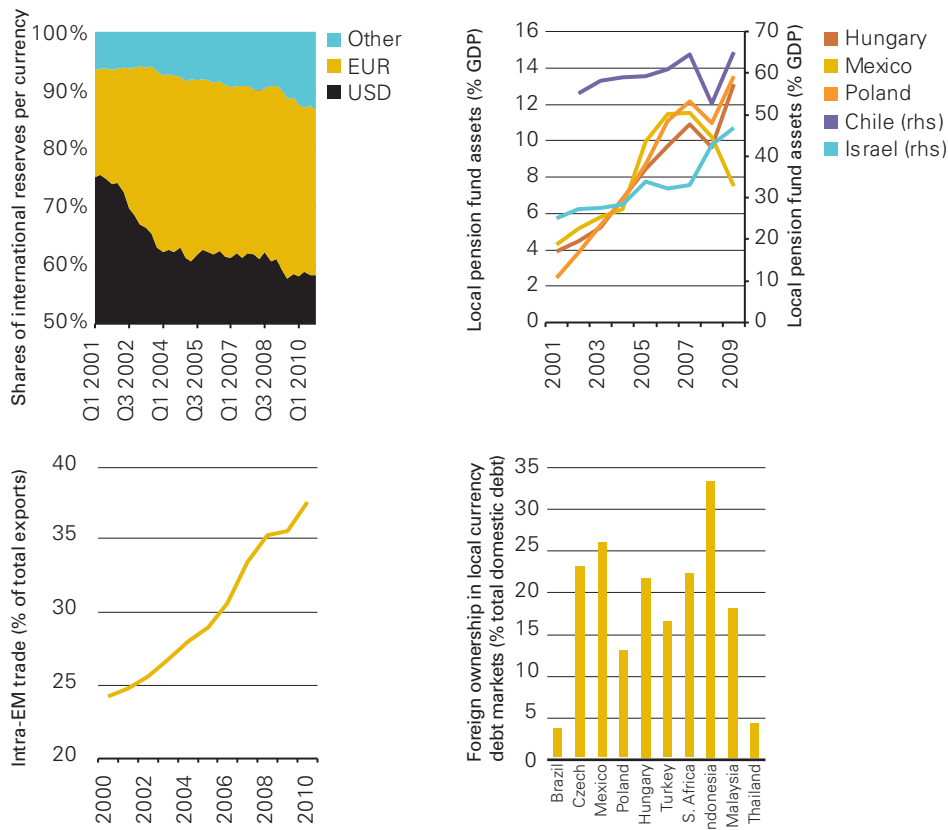


Source: IMF, JPMorgan, Threadneedle, October 2011.

While Western investors are beginning to rethink the EM=risk equation, emerging markets are going it alone

Emerging markets are not waiting for western investors or credit agencies to catch up. They have the resources to be going it alone and emerging markets have been diversifying away from US dollars into other quality currencies. They have also developed their local investor base and now have significant local institutional investment in their own markets.

Emerging financial markets are forging ahead with their own development



Source: Threadneedle, Bloomberg, Haver, May 2011.

Local market investing will continue to grow in significance in emerging countries

We expect local market investing to become an increasingly important facet of the EM fixed income opportunity set in years to come. Pension funds have been a feature of the local investor base in countries such as Chile and Mexico for a number of years and many other EMs have begun to follow this path - Poland and Hungary, for example. The development of domestic pension and insurance industries creates demand from local investors for a locally denominated benchmark asset, while foreign investors have also recognised the merits of investing in local market debt. We expect to see a predominance of sovereign issuance in local currencies in the future, particularly as EM countries have less need to borrow in US dollars to fund a balance of payments disequilibrium.

Investor guidelines for adapting to a world where asset class boundaries are crumbling

We have seen evidence of the shifts in the world economy that have profoundly altered the global investment landscape. The changes represent a real globalisation of fixed income markets with a rupture of traditional asset classes, which challenge conventional investor thinking.

The distinctions between fixed income sectors are breaking down

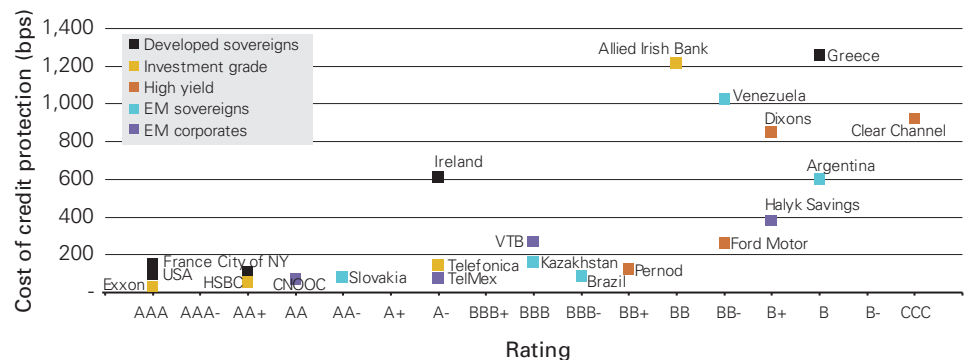
The characteristics that once defined fixed income asset classes have become less relevant and less pronounced. This has significant implications for asset allocation decisions. The ascendancy of emerging markets as documented in this paper, along with the deterioration of some developed market economies, are not short-lived curiosities. Many developed nations, following years of growing fiscal imprudence and higher leverage, are bankrupt. The healing process will be long and arduous, and will have a lasting impact on markets.

Asset classes have been torn down – fixed income increasingly requires a holistic approach; you need to be able to compare Greece, the UK, China and Brazil.

Jim Cielinski, Head of Fixed Income, Threadneedle.

The blurring distinctions between fixed income sectors are readily seen in the chart below. It shows the market-perceived credit risk of a range of issuers plotted against those issuers' credit ratings. For most of the past three decades, the different asset class categories would have appeared as reasonably tight clusters in this chart. The degree of overlap across asset classes is now unprecedented. Simply knowing which category an asset resides in offers very little insight into its price. Equally interesting is the extent of dispersion within the various asset classes, which also remains at historically high levels. Is it fair to call both Greece and France developed markets, when the underlying risk and observed prices have almost nothing in common?

The blurring distinctions between fixed income sectors



Source: Bloomberg (as at 17.05.2011).

Throw out the definitions and focus instead on risk and return

Investors should give careful thought to how they respond to these changes. If the shifts are indeed permanent, as we believe, the current framework employed to assess these risks is archaic and inadequate. There is a better way.

With artificial asset class definitions doing a poor job of capturing market behaviour, the focus must shift. Investors should look to capture the most attractive risk/return opportunities in the market, irrespective of asset class. Tearing down the asset class barriers is the best way to exploit the dislocations that emerge from traditional, definition-driven investing. Emerging markets should play a pivotal role in any diversified portfolio.

Conclusion: Fixed income markets have become fully globalised and the outlook is good for emerging markets

As borders in the fixed income markets disappear, asset class allocation may never be the same again. Yet, many plan sponsors and managers remain mired in an allocation process that is rapidly becoming obsolete. Too much time and effort is spent on exercises that may offer diminishing value in future years. Even worse, the analysis may be overly reliant on historical measures of risk and return, which bear little resemblance to how the global economy is evolving. The shifts we are witnessing today are the culmination of five decades of globalisation. As with all transformations, there will be dislocations that persist. But in general, fixed income markets have become fully globalised and the outlook is good for emerging markets.

We have outlined many indicators of strengthened emerging markets and growing investment opportunities compared with greater challenges in fragile, slower-paced developed economies. The most powerful investment decisions in the coming period will be ones that successfully bring together the seismic changes in globalisation with investment thinking processes that confront the prevailing risk reality and embrace non-traditional asset allocation factors. Exciting opportunities await those that can take advantage of these historical shifts, which Threadneedle will continue to evaluate. Watch out for our regular 'Threadneedle Thinks' market commentaries throughout the year.

More Threadneedle thinks to follow

Threadneedle will continue to evaluate the impact on markets of the changing global economic order. Watch out for updates as well as our regular 'Threadneedle Thinks' market commentaries over the next 12 months.

References

¹ M. Ayhan Kose and Eswar Prasad. The Financial Crisis and Emerging Markets. Brookings Institution. 24 September 2008.



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