

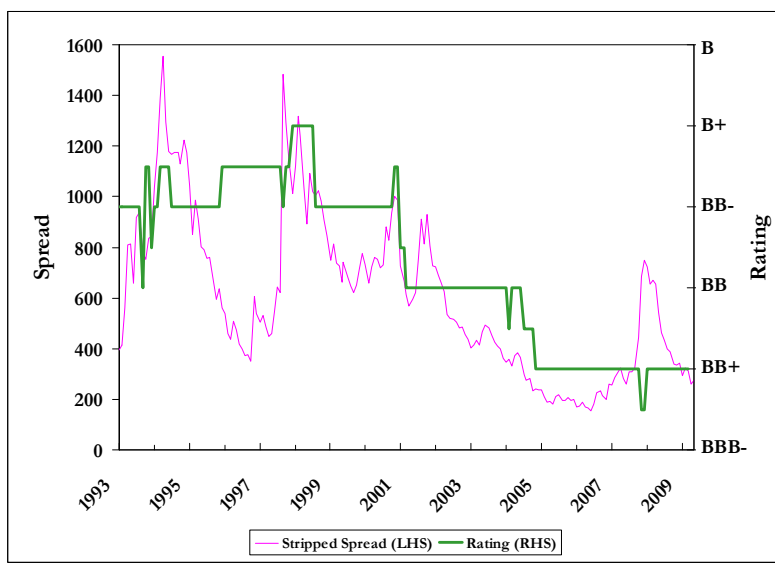
History of USD vs Local Emerging Markets Debt

The start of the traditional USD Emerging Markets Debt (EMD) sector as it is known today originated with the introduction of the Brady Plan following the lost decade of the 1980s. Emerging economies had gone through a sharp boom and then bust phase during the 1970s and 1980s. The boom in lending during the 1970s was driven by the sharp increase in oil prices and the accumulation of petrodollars by many Middle Eastern oil exporting nations. As petrodollars accumulated at money center banks, primarily in the US, a period of rapid lending occurred heading into the 80s. This lending ultimately proved unsustainable and much of the emerging world went through a period of default on these bank loans and resulted in what many call the lost decade of the 1980s for emerging economies.

In an effort to take these non-performing loans off bank balance sheets, Secretary of the Treasury, Nicholas Brady, instituted a plan to restructure the defaulted emerging country bank loans into a tradable bond market. Starting in 1989, he helped restructure these loans into what were termed “Brady Bonds” by creating new debt that was backed by US treasury strips to guarantee the principal repayment to bond holders. In some cases, coupon payments also had rolling interest guarantees normally for the next two payments. The restructuring of these debts created a strong demand from investors as they were now tradable securities with much more limited risk of default, given the coupon and principal protection from the United States.

This led to a vibrant market from the early 1990s all the way to today, allowing EM governments renewed access to capital markets and to issue and eventually replace the Brady bond market with normal fixed coupon global bonds. Another driver of this market was the strong tailwinds from the commodity price boom, which began in 1998, peaked in 2008, but remains a strong support to EM economies. This period, however, was not marked by calm as there were a number of crisis which caused periods of high volatility in EMD. The Mexican Tequila crisis in 1994, the Asian flu in 1997, the Russian debt crisis in 1998 and more recently, the Argentina default in 2001. Bond returns were very strong during this period despite these episodes and bond investors were rewarded for holding this debt.

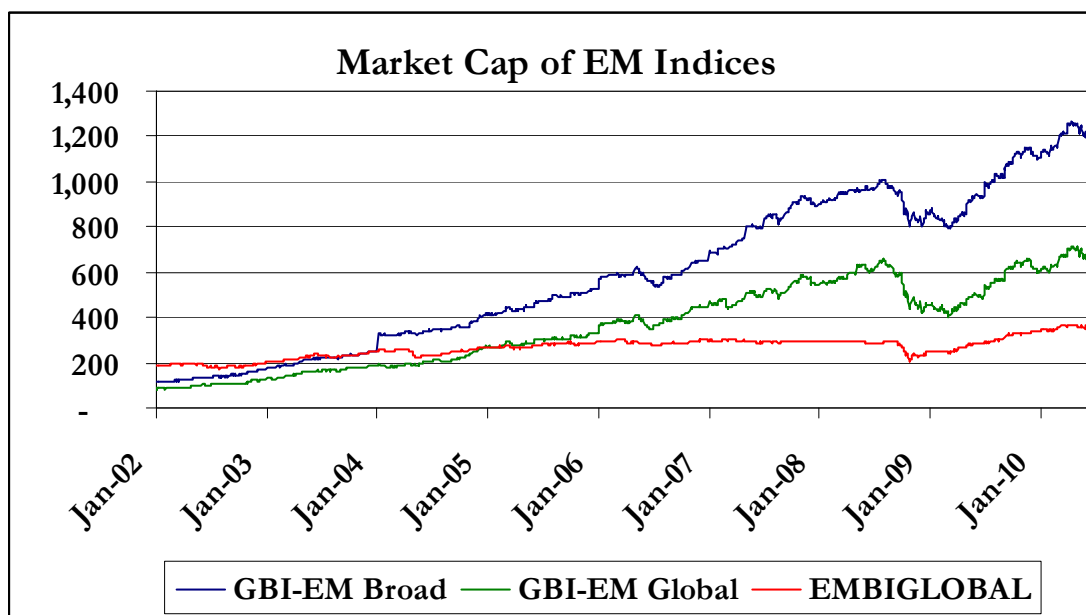
Today, the USD debt market, as measured by the EMBI Global, has an outstanding market cap of \$366 billion with a yield of 6.63%. The other interesting statistic is that the market has gone from about 10% investment grade in 1997 to now 58.4% investment grade, a tremendous improvement in credit quality.



The Rise of the Local Debt Market

While local debt of EM economies has been around for decades, the increased foreign appetite only began very recently. The turning point for local markets debt began in the middle part of the 2000s as governments focused on liability management, issuing less debt and thereby reducing their debt to GDP ratios, buying back their USD debt and issuing more in local currency. This is the transition that one would anticipate for maturing markets as issuing in ones own currency reduces the burden on governments by not exposing them to the movements in the foreign exchange market.

Traditionally, foreign countries of lesser quality always had to issue in USD. Investors were reluctant enough to lend them money, much less in a local currency that might devalue due to local inflation or misplace policies. As countries started generating higher GDP, floating their currencies and creating independent central banks, investors started increasing their appetite in local bonds. Concurrently, local banks and businesses started purchasing more bonds and local pension funds started asking for longer maturities to match up their liabilities. This transition in issuance led the local debt markets to increase almost 8X in size during the past decade and now surpasses the size of the USD EMD market. The graph below shows the growth rate of Local Markets and how they have now surpassed USD markets.



As stated previously, the USD EMD market has a market capitalization of \$366 billion, whereas the local EMD market, as measured by the GBI-EM Global, has a market cap of \$647 billion. This isn't the broadest measure of the market. Including both China and India (which the most popular index doesn't include due to capital controls), the GBI-EM Broad is \$1,196 billion in total market cap. The yield on the GBI-EM Global at 7.12 is also 49 bps higher than the EMBI Global, although the composition is very different. Comparing external USD debt yields with local yields offers a more direct comparison.

As you can see, a growing local market is actually another sign of a developing market. As these countries continue to move towards investment grade, they will continue to rely less on USD issuance and more on their own local, stable investor base. By investing now, you are at the forefront of this movement.

