Emerging Markets 3, Developed Markets 0

Ajay Jani ajani@gramercy.com +1-203-552-1958
Jeff Grills jgrills@gramercy.com +1-203-552-1955

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Since the end of 2007, we have witnessed market turmoil including one major market cataclysm (Lehman 2008), one severe market hiccup (Europe Spring/Summer 2010) and we are now in the midst of another market sell-off that may be morphing into something more ominous. During this period, emerging markets asset prices have begun to demonstrate a quality previously unknown to the class: *Resiliency*.

In this note, we provide data-based evidence of this resiliency, and some explanation for the notable change in emerging markets asset price behavior during crisis periods. The asset prices we evaluated include:

Asset Prices and Related Indices		
	Emerging Markets	**Developed Markets**
Equity (USD terms)	MSCI EM	MSCI EAFE
Sovereign Debt	JPM EMBIG	Barclays Global Aggregate Govt. Bonds
IG Corporate Debt	CEMBI IG	Barclays U.S. Corporate Credit
HY Corporate Debt	CEMBI HY	Barclays U.S. High Yield
Foreign Exchange	EUR/BRL	EUR/BRL

Note: We were unable to find emerging markets "EM" and developed markets "DM" currency proxies. Instead, we use the EUR/BRL cross-rate as the currency reference to directly compare DM vs. EM.

When examining the recent period of market turmoil, it's interesting to note that EM have exhibited notable differences compared to past performance. In the tables below, we examine three different periods of pronounced market volatility. The three episodes highlight the time periods surrounding the 2008 liquidity crisis, the 2010 European debt crisis and the 2011 European debt crisis part II. It's interesting to note that EM assets (equity, debt and FX) typically performed better during these recent periods of stress. Much of that can be explained by the fact that EM economies are in a much better position fundamentally and are providing a better investment environment for EM related assets. Clearly, these more recent periods were caused by both U.S. and European specific drivers, however, the old mantra was that when the U.S. (or developed nations) sneezed, emerging markets caught a cold. This time, EM wasn't immune, but the long term holders of EM assets who didn't panic through the volatility were generally rewarded. 2008 had some characteristics of past episodes in that the selloff in emerging equity was more pronounced in the early stages, however, the total return over the time period was an outperformance of close to 10%.

Episode 1: Global Credit Crisis and its Aftermath (2008-2009)			
	Emerging Markets	**Developed Markets**	**Winner**
Equity (USD terms)	-20.6%	-29.9%	**Emerging**
Sovereign Debt	+14.2%	+13.3%	**Emerging**
IG Corporate Debt	+16.7%	+8.9%	**Emerging**
HY Corporate Debt	+18.5%	+16.8%	**Emerging**
Foreign Exchange	See note	-3.7%	**Emerging**

Episode 2: European Debt Crisis (May – Aug. 2010)			
	Emerging Markets	**Developed Markets**	**Winner**
Equity (USD terms)	-4.9%	-8.1%	**Emerging**
Sovereign Debt	+7.0%	+5.9%	**Emerging**
IG Corporate Debt	+5.6%	+3.5%	**Emerging**
HY Corporate Debt	+3.2%	+1.1%	**Emerging**
Foreign Exchange	See note	-3.7%	**Emerging**

Episode 3: European Debt Crisis (Aug. 2011)			
	Emerging Markets	**Developed Markets**	**Winner**
Equity (USD terms)	-9.2%	-9.3%	**Emerging**
Sovereign Debt	+0.5%	+1.9%	Developed
IG Corporate Debt	+0.1%	-0.7%	**Emerging**
HY Corporate Debt	-3.8%	-4.0%	**Emerging**
Foreign Exchange	See note	+2.4%	Developed

For comparison, we also provide similar data for the 2001-2002 bear market:

Episode 4: Global Bear Market (2001-2002)			
	Emerging Markets	**Developed Markets**	**Winner**
Equity (USD terms)	-12.5%	-36.2%	**Emerging**
Sovereign Debt	+14.7%	+17.4%	Developed
IG Corporate Debt	N/A	+19.8%	N/A
HY Corporate Debt	N/A	+3.8%	N/A
Foreign Exchange	See note	+109.7%	Developed

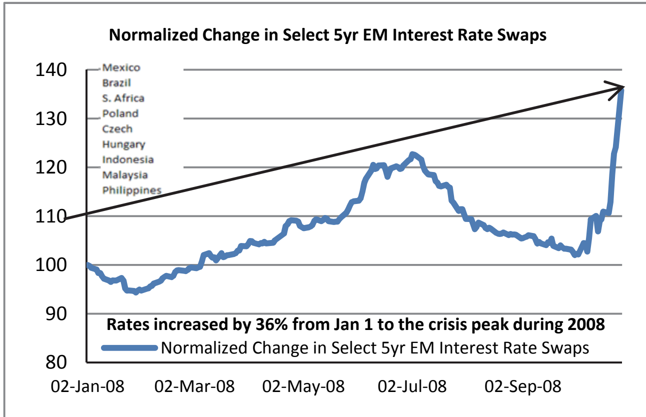
* EM corporate indices had not yet been formed and thus the data is incomplete for 2001-2002.

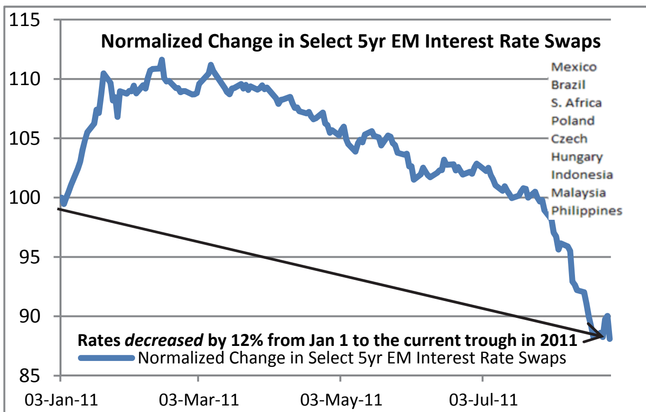
Overall the figures demonstrate that emerging markets assets have begun to display resilience in the face of global stress**.** This is in marked contrast to asset price behavior during 1990 to 2001 when most global crises had their roots in EM, and emerging assets suffered the brunt of investor selling during a panic**.**

Emerging Markets and Volatility – What is Different This Time?

One of the main highlights from August was the performance of EM local currency bonds. EM local market bonds actually rallied during the month with yields dropping from 6.76% to 6.39%. EM local yields have decreased by 12% so far in 2011 and by 20% since mid-February. Compared to 2008, when rates rose on average by 36%, this is a notable reversal of behavior for local markets.

Historically, EM local rates have behaved more in line with 2008, when an increase in market volatility led EM local rates to spike dramatically as liquidity dried up and investors rushed for the exit.





Yields have never rallied during periods of dramatic volatility like August. We think this can be attributed to three developments: 1) EM central banks are now mostly independent and have been managing monetary policy in line with their countries economic cycles; 2) Local bond investors are much more comfortable holding domestic assets due to improved fundamentals; and 3) EM local bond funds continue to see strong inflows, supporting the asset class as managers invest new cash in support of the market.

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20 Dayton Avenue • Greenwich, CT 06830 • Tel: 203.552.1900 • Fax: 203.552.1901 • www.gramercy.com