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Emerging Markets as Drivers of Global Growth and Wealth Creation

As economic and financial power in the globe shifts, emerging markets are becoming increasingly important as a core allocation in fixed income portfolios.

In the first of a series of Q&A articles highlighting the major investment implications of PIMCO's recent Secular Forum, portfolio manager Ramin Toloui discusses the unique role PIMCO sees emerging markets playing in driving global growth and wealth creation in the years ahead.

Q. Before discussing trends favoring emerging markets, let's address one potential snag. Will trouble in the developed world constrain growth in export-driven emerging markets?

A. In an absolute sense, yes. The difficulties in industrialized countries are a negative for global growth, including growth in emerging markets. In relative terms, however, emerging markets are poised to grow faster than their industrial

counterparts due to their nascent stage of development and much lower debt burdens.

A key to emerging markets realizing a larger global role will be an evolution of their growth model from an emphasis on export-oriented growth to more domestic demand-driven growth. Lower levels of indebtedness compared with industrial countries should help them facilitate that transition, giving them room to finance expanding domestic demand and investment.

Q. So you are not predicting a "golden age" for emerging economies, but you do believe they will perform relatively better than developed economies?

A. Golden age is not the right term to use, since emerging markets will face a drag from the problems affecting industrial countries. But emerging markets will be much more important in global economic dynamics and play more of a leadership role than has been the case in the past.

Q. In PIMCO's long-term (secular) view are emerging markets less risky than in the past? And, if so, will returns be less volatile?

A. Let me address that by first noting: Traditional patterns of indebtedness are being turned on their heads. Public debt in industrialized countries is over 90% of GDP, and it is projected to increase dramatically to almost 110% of GDP in the next five years, according to the International Monetary Fund. By contrast, in emerging markets, public debt is substantially lower at 38% of GDP and is projected to decrease to 34% over the same period of time.

That context – where levels of debt are lower in emerging markets and rates of economic growth are higher – is prompting investors to reassess traditional notions of quality in global fixed income. This is likely to result in larger allocations by global investors to emerging markets as a core fixed income destination. This will not be a seamless process; it will be subject to fits and starts related to cyclical risks. Over the long term, however, that portfolio reallocation is going to be an important factor supporting attractive return opportunities in emerging markets.

Q. Let's discuss China, which is arguably a dominant player among emerging economies. What are the arguments for and against China becoming a leader of the global economy?

A. China's role has expanded dramatically in recent years, and we expect it will continue to do so, supported by China's strong national balance sheet. This certainly does not mean that China will replace the U.S. – it is still a much smaller economy and is at a different stage of economic development. But the massive fiscal stimulus China implemented in response to the financial crisis illustrates just how potent China's global impact can be: Our estimate is that in the first half of 2009, China contributed over 1.50 percentage points to global GDP growth, about a third of which came from the spillover effect of China's stimulus on other countries.

There are several risks to watch, most importantly the extent to which the credit expansion that has helped maintain growth during the crisis has sown the seeds of asset bubbles and problems in the banking sector. Bringing all the positives and negatives together, however, the most likely baseline scenario is continued strong growth.

Q. Certainly, not all emerging economies are great growth stories. Could you discuss the disparities in the emerging world?

A. That's a very important point. "Emerging markets" is shorthand to refer to large systemically important countries like China,

Brazil, India, Mexico, Korea and Indonesia. Never before have the systemically important emerging market countries had such a strong set of fundamentals and low levels of debt.

There is essential differentiation within the emerging market world between such countries that have stronger balance sheets versus countries with weaker balance sheets and higher levels of debt. For example, countries in Eastern Europe have built up high levels of debt in recent years, much of it denominated in foreign currencies. For the same reason that high debt levels will constrain economic growth in industrialized countries, those emerging markets with high debt levels will also find it more difficult to grow quickly.

Q. So what are the best opportunities for investors eyeing emerging markets?

A. Bonds denominated in the local currencies of emerging market countries are a particularly attractive opportunity. That's because in an environment where emerging markets have stronger growth dynamics and are more prominent

destinations for capital, emerging market currencies are likely to appreciate relative to industrial currencies. Many investors have their only exposure to emerging market currencies via emerging market equities, meaning they have all of these equity risks tied in with their emerging market currency exposure. A more appealing strategy – one that potentially offers a way of substantially reducing portfolio volatility while maintaining the potential for attractive returns – is to take advantage of the high yields offered in local-currency emerging market bonds to gain exposure to the currency potential without the equity risk.

Dollar-denominated bonds of emerging markets are also an opportunity to diversify credit exposure away from U.S. and other industrial country corporates. Many corporations in emerging markets are global market leaders and offer attractive yields and risk-return profiles relative to their industrial counterparts.

Thank you, Ramin.

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