

Viewpoints

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Rising Domestic Consumption in Emerging Markets Looks Good for Global Investors



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PIMCO expects the five largest emerging markets (EM) – Brazil, Russia, India, Mexico and China – will grow their economies at an average rate of about 6% this year. That's more than six times the average rate for the US, Japan and eurozone nations. And there is potential for more – much more – because EMs account for most of the world's population but currently less than half of all economic output.

Indeed, what's happening in the world's most developed nations likely will further fuel interest in developing nations that are now undergoing a developmental breakout phase: The US remains one of the most dynamic countries and the owner/exporter of the world's reserve currency, but its public finances have been hit hard and are not expected to recover soon. Europe is in the midst of a deflationary drag that threatens the very makeup of the eurozone. And Japan faces increasing demographic and debt headwinds.

So what is the missing ingredient to fully activate the potential of EMs? Answer: domestic consumption. Leaders of emerging nations now realise their economies are vulnerable if they remain largely dependent on export demand. They learned this lesson from the difficulties (recessions, bloated fiscal balance sheets) of their best "customers" – the developed nations. This is why we expect emerging nations to facilitate domestic demand over the next three to five years, and we hope to see transitional benefits even sooner as more EMs pick up their trade with China, the country that in our opinion will contribute the most to global growth in the near term.

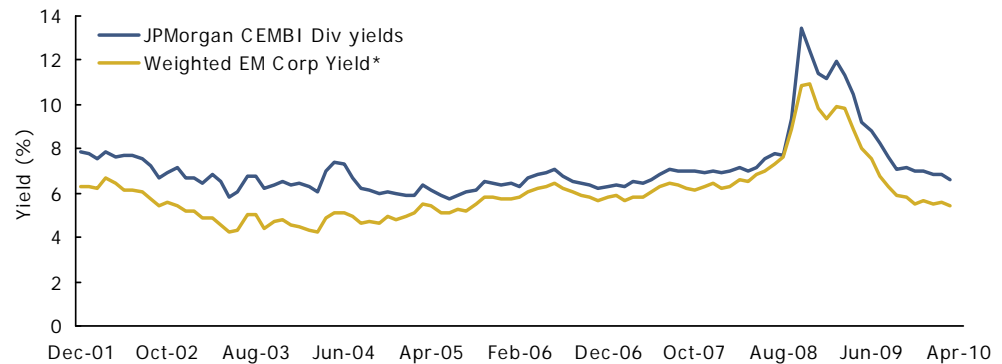
Of course, there's likely to be market volatility tied to headlines along the way – indeed, EMs have historically been more volatile than developed markets – but the big picture is that the EM macro story is strong and getting stronger.

The very good news for investors is that the markets – and the ratings agencies – haven't caught up to this improving fundamental story: as shown in the graph below, EM corporate bonds, for example, are paying yields averaging more than 6%, about 100 basis points more than comparably rated developed market corporates, according PIMCO calculations using JP Morgan and Bloomberg data.

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EM Corporate Yields



SOURCE: JPMorgan, Bloomberg

* Weighted EM Corp yield= BofA/ ML US High Yield Master II Index yield * (JP Morgan CEMBI Div High Yield MV%) + BarCap US Aggregate credit Index yield* (JP Morgan CEMBI Div Inv grade MV%)

Conditions Ripe

Part of the reason why we are seeing this opportunity is because emerging nations over the past 15 years have fundamentally improved their conditions for growth: They now have workable floating currencies, sustainable fiscal dynamics, tempered inflation, larger pools of domestic savings and substantial reserves. While not all these conditions are present in all nations – China’s currency could use some flexibility against the dollar – some mix is generally present in the strongest nations, which also enjoy robust reserves.

In contrast, several developed countries are lumbering under large sovereign debt burdens, while businesses and consumers have lost their animal spirits. This greater indebtedness has started to create additional concerns about a “vicious cycle” that may weigh on industrial economies’ growth for years to come.

For an emerging country with a disproportionate share of national output concentrated in exports, problems in the developed world ought to spark change at home. In order to maintain robust growth, such an emerging nation would need to focus on internal demand. Should this happen, over time, the gap between developed and emerging markets will close.

We see tremendous potential for that demand growth. Consider that private consumption accounts for roughly 50% of GDP in Brazil, Russia, India, China and Mexico. Industrialized economies, meanwhile, have been averaging around 70% of their GDP from private consumption. Further, the combined population of China and India alone accounts for roughly 40% of the total world population, while their combined consumption equals about \$2.4 trillion. By comparison, in the US annual consumption totals around \$10 trillion, with a population of about 4.5% of the world.

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Getting There: The Journey

Emerging nations must take several steps to mobilize domestic consumption. The first: Facilitate the transition from rural to urban. The majority of the emerging population is rural. Moving the rural population to cities, or developing rural areas, will require land reforms that are politically driven and may be difficult to enact. A key goal and result of urbanisation is to boost household income, which hopefully translates into more spending and higher tax revenues, particularly in those EMs that have young and rapidly growing populations.

Second, emerging economies should expand their service sector, including wholesale and retail distribution, domestics, transportation, logistics, healthcare and education. Ultimately, this would allow several emerging market countries – and mainly the ones that are heavy exporters, such as China – to become less dependent on labour-intensive manufacturing and more on labour-intensive services.

Next: Break the paradox of thrift. In order to reduce savings in emerging economies, governments need to demonstrate a social safety net – i.e., social security, medical coverage and perhaps corporate pension plans – so that consumers feel safe to spend. Some emerging countries have worked toward these goals, while others remain far behind, but there is growing acceptance of the desirability of reorienting economic growth toward domestic consumption.

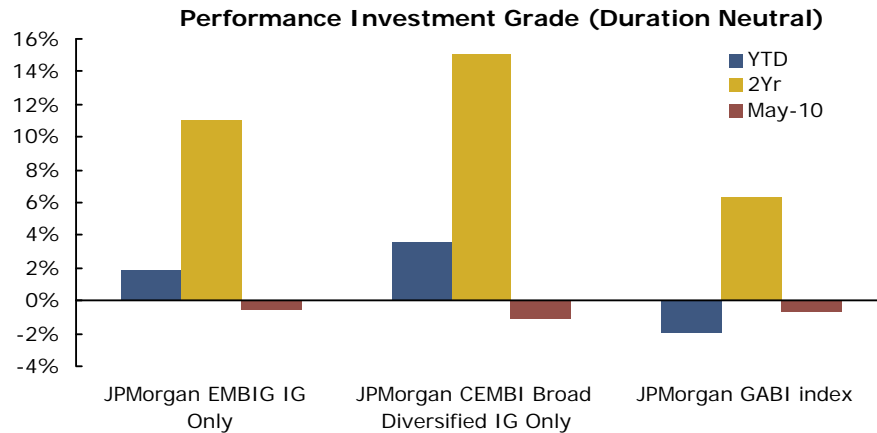
Opportunities for Investors

Global investors already appear to be getting the message about EMs. From the start of 2010 alone, nearly \$24.5 billion have flowed into EM markets bonds and equity, according to Barclays Capital and EPFR Global, a global fund flow and asset allocation data firm.

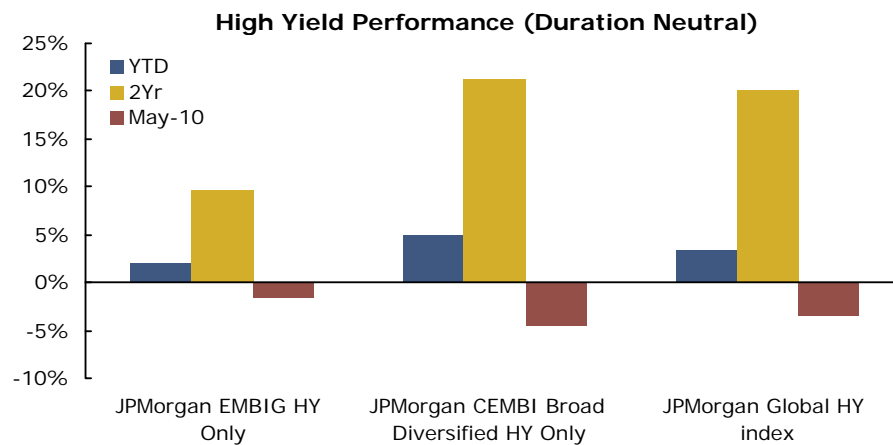
Turning to specific opportunities brings us to a review of EM corporates, a deep market totaling an estimated \$620 billion in bonds in 2009; additionally, there were nearly \$400 billion in local corporate bonds issued that year, according to JPMorgan and Bond Radar.

Looking ahead, investors may wish to consider infrastructure bonds, including corporate debt related to entities in five sectors: energy, telecom, water/sewage, transportation and housing. Nations serious about stimulating consumption will need to spend liberally on infrastructure. Also, we have seen increasing opportunities in bonds issued by state-owned entities, which are quasi-sovereigns. Finally, with infrastructure bonds investors should be able to focus on areas of national importance, suggesting public support in times of stress.

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SOURCE: JPMorgan as of 05/31/10



SOURCE: JPMorgan as of 05/31/10

We also believe that, over time, the local currency corporate bond market will be an important vehicle for investors and most likely will eventually be larger than the current dollar-denominated bond market for emerging markets.

Put it all together, and the future looks set to include an expanding opportunity set for EMs – and for savvy bond investors.

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Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Infrastructure entities are involved in the construction, operation, ownership or maintenance of physical structures, networks and other infrastructure assets that provide public services; infrastructure entities, projects and assets may be sensitive to adverse economic, regulatory, political or other developments and may be subject to a variety of events that adversely affect their business or operations. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not.

The JPMorgan Emerging Markets Bond Index Global (EMBIG) is an unmanaged index which tracks the total return of U.S.-dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady Bonds, loans, Eurobonds, and local market instruments. JPMorgan Corporate Emerging Markets Bond Index (CEMBI) Diversified is a uniquely-weighted version of the CEMBI index. It limits weights of those index countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding. The CEMBI Diversified results in well-distributed, more balanced weightings for countries included in the index. The countries covered in the CEMBI Diversified are identical to those in the CEMBI, which is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities. JPM Global Aggregate Bond Index (GABI) consists of the JPM GABI US, a U.S. dollar denominated, investment-grade index spanning asset classes from developed to emerging markets, and the JPM GABI extends the U.S. index to also include multi-currency, investment-grade instruments. Launched in November 2008, the JPM GABI represents nine distinct asset classes: Developed Market Treasuries, Emerging Market Local Treasuries, Emerging Markets External Debt, Emerging Markets Credit, US Credit, Euro Credit, US Agencies, US MBS, Pfandbriefe. The JPMorgan U.S. Dollar Global High Yield Bond Index is a dollar-denominated index consisting of non-investment-grade corporate

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bonds, which are issued by both U.S. and non-U.S. companies. It is not possible to invest directly in an unmanaged index.

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