Update on the EM Corporate Bond Market

Robert L. Rauch, Portfolio Manager rrauch@gramercy.com +1-203-552-1905
Ted Nguyen, Research Analyst tnguyen@gramercy.com +1-203-552-1942

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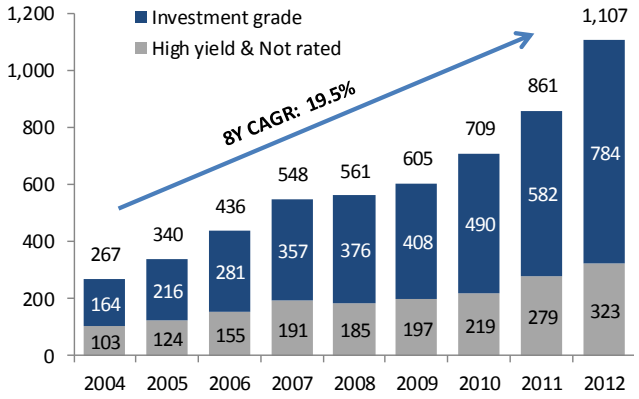
Overview

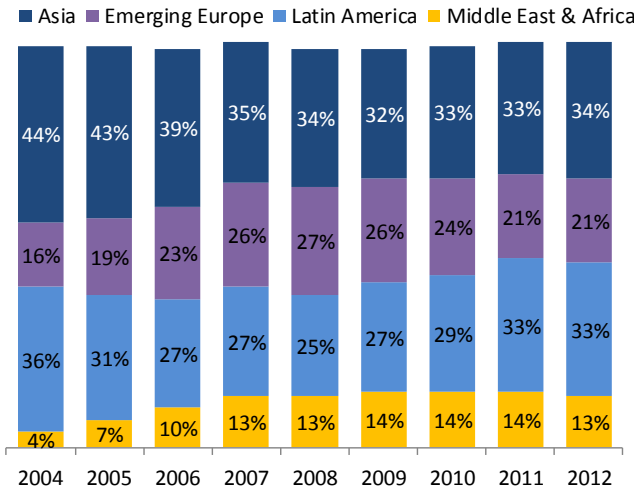
USD emerging market corporate bonds have been one of the fastest growing asset classes in global fixed income over the past few years. According to JPMorgan data, there are approximately US$1.1 trillion of hard currency EM bonds outstanding globally, which makes the EM corporate bond market now nearly comparable in size to the US$1.2 trillion US high yield market. The outstanding hard currency debt stock has grown as a direct result of the rigorous pace of corporate issuers accessing the debt capital markets. In fact, hard currency EM corporate bond issuances have grown at a compounded annual rate of 19.5% from 2004 to 2012. With high yield issuances growing at an annualized rate of 15.4% and investment grade issuances at 21.6% over the period, we believe the market will continue to be receptive to issuers of all credit qualities.

Exhibit 1: EM Corporate Bonds (US$ billions)



Source: JPMorgan, as of 2012YE.

Exhibit 2: EM Corporate Bond Stock by Region



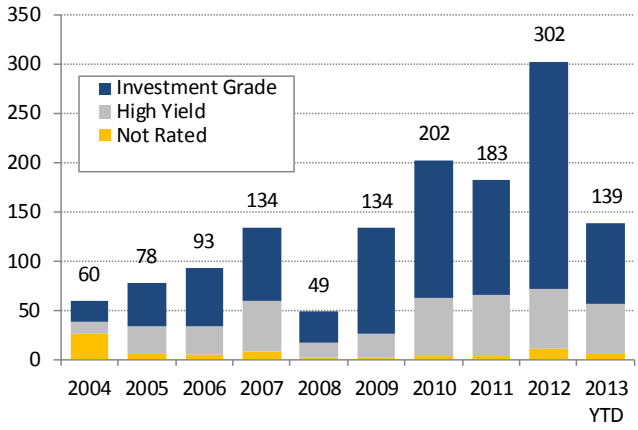
Source: JPMorgan, as of 2012YE.

This growth has been fuelled by a number of developments. From a supply standpoint, the stability of EM sovereigns and the development of deep USD sovereign bond curves have laid the groundwork for corporates to issue. Rapidly growing and increasingly international companies domiciled in emerging markets have outgrown their bank lines and look to diversify funding using the bond market. From a demand standpoint, traditional EM fixed income investors who face declining hard currency sovereign supply have been moving into the corporate sector, where EM bond yields continue to be favorable to their US counterparts. Corporate credit risk is now distinct from sovereign risk, particularly in high grade countries.

Despite these improvements, the asset class has room to develop further. Liquidity is a global problem in corporate bonds but continues to affect EM corporates more than DM corporates. Transparency, either in corporate balance sheets or pricing, is not at developed market levels yet. Corporate governance and investor protection in bankruptcy are not as strong as in developed markets. We expect many of these to be resolved with time.

Issuance of hard-currency EM corporate bonds has rebounded quite strongly off the lows of 2008, exceeding US$180 billion in each of the last three years and reaching a record US$302 billion in 2012. Investment grade issuance has been significantly more robust than high yield, as investment grade issuers have accounted for approximately 69.2% of all corporate issuance since 2010 (see Exhibit 3). Over the same period, high yield corporate bond issuances in EM totaled only 27.9% of all issuance.

Exhibit 3: EM Corporate Bond Issuances (US$ billions)

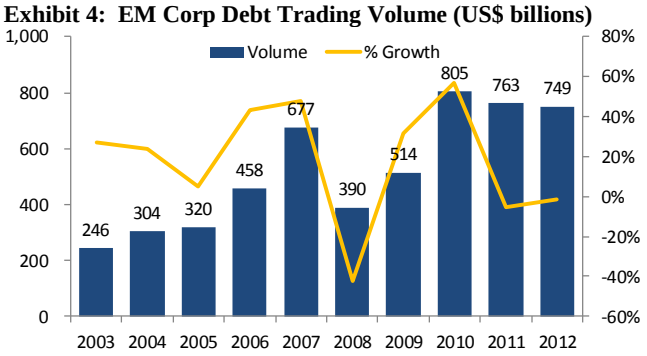


Source: Bank of America Merrill Lynch, as of April 2013.

Trading liquidity in EM corporate bonds picked up significantly in 2010, rebounding well from weak volume in 2008 and 2009. However, after peaking at US$805 billion in 2010, annual trading volume has declined incrementally, falling 5.3% in 2011 and 1.7% in 2012. Despite the recent decline in volume, EM debt trading volume has grown at a compounded annual rate of 14.5% since 2002. We expect trading liquidity to remain robust as the pace of new issuances increases the overall opportunity set and

continued inflows into EM fixed income provide a healthy capital stock for investors.

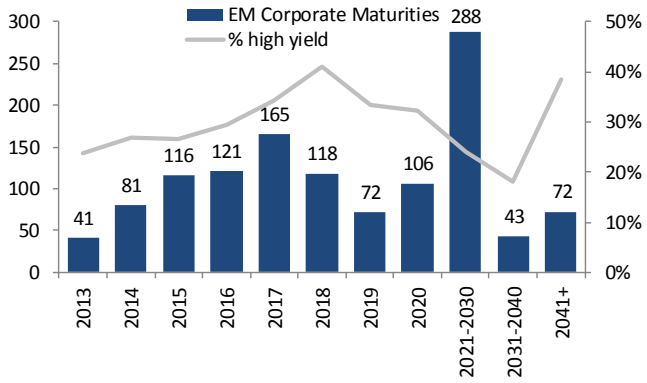
Exhibit 4: EM Corp Debt Trading Volume (US$ billions)



Source: Emerging Markets Traders Association, as of 2012YE.

Early on, EM corporate were issued with five year tenors. However, as seen in Exhibit 5, this has changed in recent years as maturities have been pushed out further.

Exhibit 5: EM Corporate Debt Maturities (US$ billions)



Source: JPMorgan, as of March 2013.

Index Information

There are numerous indices that have been developed to track EM corporate bonds. Although many Wall Street firms have developed such indices in the last several years, the JP Morgan CEMBI remains the benchmark. The CEMBI offers a robust variety of various issuers from all emerging markets across all major industries. Exhibit 6 below highlights the key characteristics of EM fixed income indices.

Exhibit 6: Major EM Fixed Income Indices

	Index Description	Min Bond Size	Sov. Req.	Maturity
EM Corp Indices				
Barclays USD EM Corp	USD global EM corps	500mn	Baa1/BBB+ or lower	Min 1y
JPM CEMBI	USD EM corps	500mn	World Bank/ OECD definition	Min 5y at entry, 3y once in
EM Fixed Income Indices				
Barclays EM USD	USD EM corps, quasis, and sovereigns	500mn	Baa1/BBB+ or lower	Min 1y
JPM EMBI Global	USD EM corps, quasis, and sovereigns	500mn	World Bank/ OECD definition	Min 5y at entry, 3y once in
JPM EMBI+	USD EM corps, quasis, and sovereigns	500mn	World Bank/ OECD definition	Min 2.5y at entry, 1y once in
Global/Other Indices				
Barclays Global Agg	Global corporates, quasis, and sovereigns	Varies, 300mn for USD	None	Min 1y
Barclays US Credit Corp	USD corporates	250mn	None	Min 1y

Source: Barclays.

There are four primary versions of the JPMorgan CEMBI index: CEMBI and CEMBI Diversified (Narrow), and the CEMBI Broad and CEMBI Broad Diversified. The CEMBI Diversified is a global, liquid corporate emerging markets benchmark. It is a market capitalization-weighted index and includes EM corporate bonds that have an initial minimum of five years maturity and a minimum of $500 million face amount outstanding. Once added, an instrument may remain in the index until 36 months before maturity. Created in Dec 2007, data is backdated to December 2001.

The CEMBI Broad Diversified was launched as a more comprehensive index, including smaller issues to cover a wider array of corporate bonds and those with something besides a fixed coupon and bullet maturity. In contrast to the CEMBI, the minimum amount outstanding required is $300 million for the CEMBI Broad. Once added, an instrument may remain in the index until 12 months before maturity. Created in Jan 2008, it includes data backdated to December 2001. The characteristics of the various CEMBI indices are outlined in Exhibit 7. The geographic and industry components of the CEMBI Diversified are illustrated in Exhibits 8 and 9. **It is important to note that investment grade issuers comprise 68% of the index today.**

Exhibit 7: Current Characteristics of CEMBI Indices

Index	Total Face (US$ mm)	Duration (years)	Yield (%)	Spread (bps)	# of Issuers	# of Issues	IG
CEMBI	300,897.0	6.33	4.84	338.1	246	350	68.0%
CEMBI Div	180,413.6	6.28	4.59	315.5	246	350	68.0%
CEMBI Broad	600,934.3	5.71	4.81	335.4	404	854	65.0%
CEMBI Broad Div	252,468.7	5.51	4.56	317.0	404	854	65.0%
CEMBI Div HY	54,737.8	5.58	6.38	509.6	93	112	0.0%

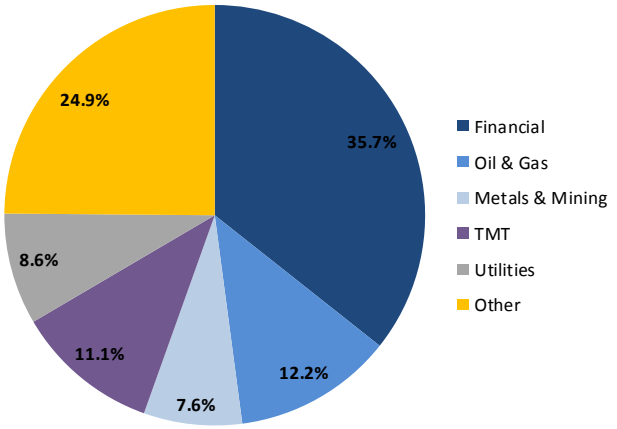
Source: JPMorgan, as of April 2013.

Exhibit 8: Current Geographic Breakdown of the CEMBI Broad Diversified at April 2013

Country	% of Index
Russia	6.1%
Hong Kong	6.1%
China	6.1%
Mexico	6.1%
Brazil	6.1%
South Korea	6.0%
India	5.8%
United Arab Emirates	5.2%
Qatar	4.9%
Singapore	4.8%
Turkey	4.5%
Chile	4.4%
Colombia	3.9%
Thailand	3.8%
Peru	3.8%
Israel	3.0%
South Africa	2.8%
Malaysia	2.7%
Indonesia	2.5%
Philippines	2.4%
Other	9.3%

Source: JPMorgan, as of April 2013.

Exhibit 9: Current Industry Breakdown of the CEMBI Broad Diversified at April 2013



Source: JPMorgan, as of April 2013.

Local Currency Corporate Bonds

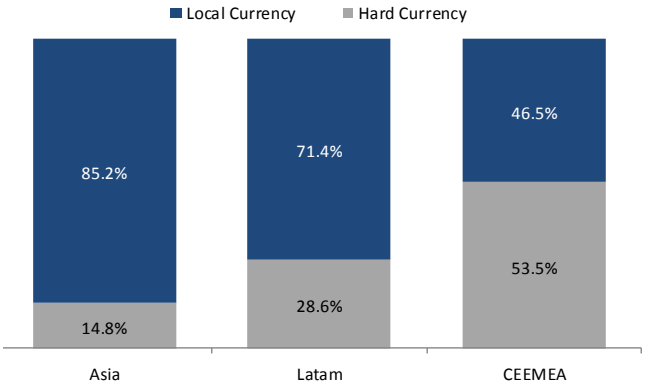
The financing market in EM has evolved significantly over the last 15 years as the last Brady bonds were retired. Corporate financing preferences differ by region: Asia has the most developed local currency markets, while LatAm and EEMEA local currency markets are underdeveloped such that the focus tends to be more on USD and other hard currency debt. Moreover, over the past several years, many EM corporations have shifted their funding away from syndicated loans and into bonds. In 2007, bond financing as a percentage of total EM financing was 29%; today, it represents 50%. The move from loans to bonds has been led by LatAm companies (issuing in dollars) and even more so by Asian companies (issuing in local currencies). In contrast, CEEMEA companies have generally kept a stable funding mix between loans and bonds during this period.

Exhibit 10: EM Debt Stock by Type and Region (US$ billions)

US$ in Billions	Asia	Latam	CEEMEA	Total
Sovereign				
Hard Currency	115	313	415	843
Local Currency	4,563	1,457	1,807	7,828
Subtotal	**4,678**	**1,770**	**2,222**	**8,671**
Corporate				
Hard Currency	416	392	353	1,161
Local Currency	2,399	978	307	3,684
Subtotal	**2,815**	**1,371**	**660**	**4,846**
Total				
Hard Currency	531	705	768	2,005
Local Currency	6,962	2,436	2,114	11,512
TOTAL	**7,493**	**3,141**	**2,882**	**13,516**

Source: ING, as of 2012YE.

Exhibit 11: EM Corporate Bonds by Currency Type



Source: ING, as of 2012YE.

Over the last several years, the Asian local currency market has grown significantly and now dwarves the external currency corporate bond market. With nearly insatiable local demand due to regional liquidity, from private bank clients to institutional investors, the market has exploded. Nonetheless, the markets have been largely distorted due to this demand, with extremely low yields, poor governance structures, and fairly limited secondary market liquidity. Due to these reasons, we do not believe that this is an area ready for global investor interest in a major way yet, although it may certainly develop in the next five years as the market matures and interest broadens. We would want to see a much broader mix of issuers beyond China and Brazil before suggesting that this could become a core part of a global EM corporate portfolio (see Exhibits 12 and 13).

Exhibit 12: Local Currency EM Corporate Bonds Outstanding (US$ millions)

Local Currency Issues	Amount	% of Total
China	1,427,983.0	38.8%
Brazil	642,778.0	17.4%
Korea	403,969.0	11.0%
Mexico	193,937.3	5.3%
India	171,035.3	4.6%
Malaysia	135,133.9	3.7%
Colombia	115,369.3	3.1%
Russia	110,013.2	3.0%
Taiwan	91,727.7	2.5%
Thailand	68,799.0	1.9%
Israel	56,259.8	1.5%
Singapore	44,373.7	1.2%
South Africa	37,068.2	1.0%
Kazakhstan	25,090.6	0.7%
Indonesia	19,982.6	0.5%
Czech Republic	18,883.7	0.5%
Hong Kong	16,769.4	0.5%
Turkey	14,716.3	0.4%
Philippines	13,839.4	0.4%
Costa Rica	8,983.5	0.2%
Poland	8,980.5	0.2%
All others	58,398.8	1.6%
TOTAL	**3,684,092.3**	**100.0%**

Source: ING, as of 2012YE.

Exhibit 13: Local Currency EM Corporate Bond Issuances Since 2012 (US$ millions)

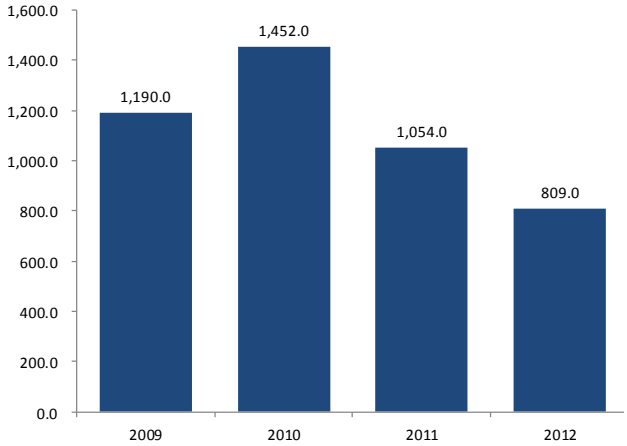
#	Country	Amount
1.	Russia	$68,179
2.	Brazil	$59,431
3.	China	$56,250
4.	Hong Kong	$36,629
5.	Mexico	$28,672
6.	Korea	$28,335
7.	Singapore	$21,746
8.	India	$17,499
9.	Turkey	$16,370
10.	Chile	$12,530
11.	Abu Dhabi	$11,794
12.	Peru	$11,313
13.	Dubai	$10,089
14.	Indonesia	$9,283
15.	Qatar	$7,771
16.	Colombia	$7,647
17.	Kazakhstan	$7,335
18.	Thailand	$6,900
19.	Malaysia	$6,640
20.	Israel	$5,481
21.	Poland	$5,198
22.	South Africa	$4,985
23.	Philippines	$4,775
24.	Czech Republic	$4,541
25.	Saudi Arabia	$4,500
26.	Other	$4,278

Source: Barclays, as of April 2013.

EM Credit Default Swap Market

Total EM CDS trading volumes have dropped over the last two years (see Exhibit 14 below), with the majority of volumes coming from sovereign CDS activity. The decline in volumes is largely related to increased regulation in the market.

Exhibit 14: Total EM CDS Trading Volumes (US$ millions)



Source: Emerging Markets Traders Association, as of 2012YE.

The EM Corporate CDS market is still somewhat undeveloped. Most of the activity takes place with the broad market CDX index owned by Markit Group around which there is trading activity. The CDX EM Diversified has 40 underlying credits with a five year maturity and includes both sovereign and corporate issuers. On a single name basis, trading is limited to the largest issuers in the market. The Emerging Markets Traders Association monitors trading volumes for a basket of nine issuers (America Movil (Mexico) Cemex (Cementos Mexicanos), CVRD (Companhia Vale do Rio Doce) (Brazil), DBS Bank (Singapore), Gazprom (Russia), PDVSA (Petroleos de Venezuela), Pemex (Petroleos de Mexico), Petrobras (Petroleo Brasileiro), Telmex (Telefonos de Mexico), several of which are quasi-sovereign (BTA Bank of Kazakhstan was dropped when it defaulted).

JP Morgan tracks a broader list of more frequently traded single name CDS, but it is still quite limited (see Exhibit 15).

Exhibit 15: Actively Traded Single-Name EM Corporate CDS

EM Corporate CDS Issuers			
Brazil		***Malaysia***	
BANBRA	Banco de Brasil	PETMK	Petrolian Nasional BHD
BRADES	Banco Bradesco	***Mexico***	
BRASKM	Braskem	AMXLMM	American Movil
CVRD	Vale	CEMEX	Cemex
FIBRIA	Fibria	BIMBOA	Grupo Bimbo
GERDAU	Gerdau	PEMEX	Pemex
JBS	JBS	TELVIS	Grupo Televisa
OGX	OGX Petroleo e Gas	TFONY	Telefonos de Mexico SAB
PETBRA	Petroleo Brasileiro	URBIMM	Urbi Desarrollos Urbanos
Chile		***Peru***	
CDEL	Codelco	SCCO	Southern Copper
Colombia		***Russia***	
BANCOL	Bancolombia	GAZPRU	Gazprom OAO Via Gaz Capital
PRECN	Pacific Rubiales	SIBNET	Gazprom Neft
Dubai		VTB	TVB Bank
DPWDU	DP World	***Tunisia***	
Hong Kong		TNBMK	Tenaga Nasional Bhd
HUWHY	HK Hutch	***Ukraine***	
Jamaica		NAFTO	Naftogaz
DLLTD	JM Digicel	***Venezuela***	
		PDVSA	Petroleos de Venezuela

Source: JPMorgan.

Quasi-Sovereign Issuers

An important issuer class that cannot be ignored in EM corporate bonds are the quasi-sovereign issuers. The Barclays indices system defines quasi-sovereigns as either "government-owned, no guarantee", or "government sponsored". "Owned, no guarantee" indicates a greater than 50% ownership (including indirect ownership through other owned entities), with no explicit guarantee. "Government sponsored" entities carry out government policies and benefit from closeness to central governments, i.e., Fannie/Freddie pre-2008. JP Morgan, in its Global-EMBI index, defines a quasi-sovereign more narrowly as an entity that is 100% guaranteed or 100% owned by the national government, and resides in the index eligible country. In our view, the true defining factor of a quasi-sovereign is the degree of implicit support from the sovereign. This often coincides with a large equity stake, but ownership is not necessary for an implied backstop to exist. Similarly, equity ownership does not automatically imply a sovereign backstop. These are some of the biggest corporations in many EM countries and many offer an interesting pickup to pure sovereign instruments. Nonetheless, there are potential pitfalls to relying on non-explicit sovereign support, thus making credit analysis a bit tricky. We highlight some of the major quasi-sovereign issuers in Exhibit 16.

Exhibit 16: Selected Quasi-Sovereign Issuers in EM (US$ millions)

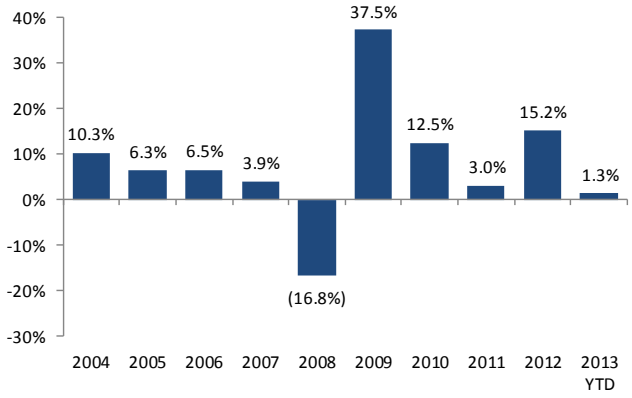
	Issuer	Sector	Country	Outstanding (US$ Millions)
Latam	PDVSA	Oil/Gas	Venezuela	28,718.4
	Petrobras	Oil/Gas	Brazil	24,248.0
	PEMEX	Oil/Gas	Mexico	26,806.4
	Banco do Brasil	Banks	Brazil	12,869.1
	Centrais Eletricas Brasileiras	Electricity	Brazil	3,050.0
	TOTAL			**95,692.0**
EE/CIS	Gazprom	Oil/Gas	Russia	14,583.3
	VTB	Banks	Russia	13,954.3
	Sberbank	Banks	Russia	10,992.2
	KazMundayGas	Oil/Gas	Kazakhstan	10,790.0
	Russian Agricultural Bank	Banks	Russia	5,446.4
	Vnesheconombank	Banks	Russia	6,450.0
	AK Transneft	Oil/Gas	Russia	2,950.0
	TOTAL			**65,166.2**
GCC	Abu Dhabi National Energy	Energy	Abu Dhabi	9,183.7
	Qatari Diar Finance	Real Estate	Qatar	3,500.0
	Ras Laffan LNG	Oil/Gas	Qatar	3,816.3
	International Petroleum Inv	Oil/Gas	Abu Dhabi	7,000.0
	Qatar Telecom	Telecom	Qatar	6,900.0
	Mubadala	Infrastructure	Abu Dhabi	3,250.0
	DP World	Logistics	Dubai	3,258.0
	Saudi Basic Industries Corp	Chemicals/Steel	Saudi Arabia	1,000.0
	TOTAL			**37,908.0**
Asia	Export-Import Bank of Korea	Banks	Korea	15,844.1
	Korea Hydro & Nuclear Power	Electricity	Korea	2,950.0
	CNOOC	Oil/Gas	China	8,428.1
	Korea National Oil Corp	Oil/Gas	Korea	5,440.0
	Temasek	Financial	Singapore	5,450.0
	Korea Development Bank	Banks	Korea	10,274.7
	TOTAL			**48,386.9**

Source: Bloomberg, as of April 2013.

Historical Returns

As of data available March 2013, since 2002, the CEMBI Broad has delivered a compounded annual return of 8.71% and a Sharpe ratio of 0.72. This compares favorably with US high yield at 8.13% (0.52), US treasuries at 5.93% (0.51), and the S&P at 8.58% (0.32). Year to date through end of March, the CEMBI Broad has returned 0.54%, which lags US HY (3.01%) and the S&P (10.61%). Returns since 2004 are highlighted in Exhibit 17.

Exhibit 17: CEMBI Broad Returns from 2004 to 2013 YTD



Source: JPMorgan, as of April 2013.

Exhibit 18: Comparative Returns from 2004 to 2013 YTD

	CEMBI Broad	JPM HY	US Treasury	EM Free	S&P 500	JPMCCI
TR 2004	10.26%	11.55%	3.75%	25.95%	10.88%	23.13%
TR 2005	6.35%	3.07%	2.94%	34.54%	4.91%	39.80%
TR 2006	6.51%	11.45%	3.09%	32.59%	15.79%	5.79%
TR 2007	3.93%	2.88%	9.20%	39.78%	5.49%	23.33%
TR 2008	-16.81%	-26.83%	14.26%	-53.18%	-37.00%	-35.03%
TR 2009	37.49%	58.90%	-3.77%	79.02%	26.46%	20.46%
TR 2010	12.46%	15.05%	6.09%	19.20%	15.06%	13.82%
TR 2011	2.96%	5.73%	9.94%	-18.17%	2.11%	-4.52%
TR 2012	15.22%	16.20%	2.17%	18.63%	16.00%	1.38%
YTD 2013	**0.54%**	**3.01%**	**-0.24%**	**-1.79%**	**10.61%**	**-0.75%**
Cum. Return	**155.81%**	**350.41%**	**203.05%**	**204.60%**	**387.51%**	**358.79%**
Ann. Return	**8.71%**	**8.13%**	**5.93%**	**5.96%**	**8.58%**	**8.24%**
Ann. Volatility	**8.95%**	**8.56%**	**4.74%**	**24.15%**	**15.39%**	**16.59%**
Sharpe Ratio	**0.72**	**0.52**	**0.51**	**0.1**	**0.32**	**0.28**

Source: JPMorgan, as of March 2013.

Exhibit 19: EM Correlations to Other Assets

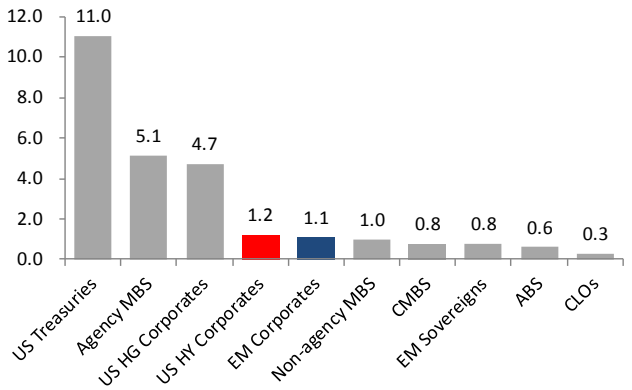
	EMBIG	CEMBI Broad	JPM HY	U.S. Treasury	EM Free	S&P 500	JPMCCI
EMBIG	1.00						
CEMBI Broad	0.87	1.00					
JPM HY	0.55	0.78	1.00				
U.S. Treasury	0.14	0.22	-0.14	1.00			
EM Free	0.68	0.63	0.66	-0.23	1.00		
S&P 500	0.53	0.50	0.63	-0.19	0.74	1.00	
JPMCCI	0.26	0.46	0.39	-0.10	0.48	0.36	1.00

Source: JPMorgan, as of March 2013.

EM versus US HY

As indicated in Exhibit 20 below, the size of the hard currency EM corporate bond universe is now close to the size of the US high yield bond market.

Exhibit 20: Comparative Asset Class Size (US$ trillions)

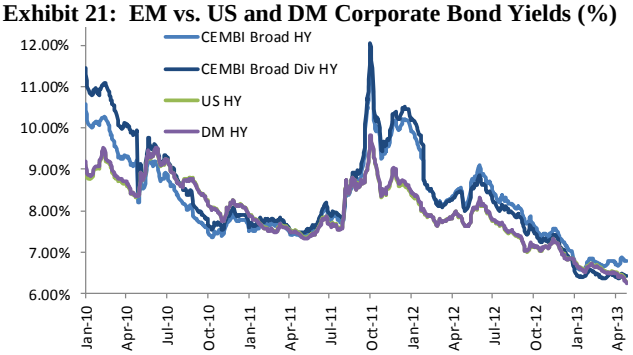


Source: JPMorgan, as of April 2013.

EM high yield corporate issues have traditionally traded at a meaningful premium to their US and developed market counterparts. According to index data from JPMorgan, currently emerging market high yield bonds are trading 50 basis points and 52 basis points wider to their US and developed market high yield peers, respectively (see Exhibit 21). Since the beginning of 2012, on average, emerging market corporate bonds have traded 50 basis points and 35 basis points wide to their US and developed market high yield peers, respectively.

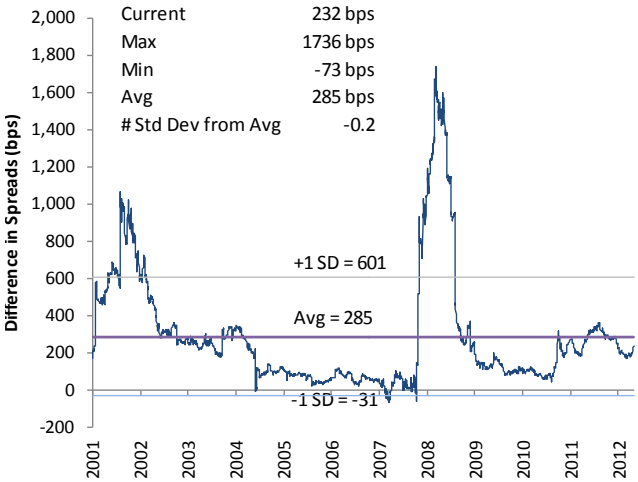
Since 2001, we calculate that the average spread of EM HY to US HY bonds has been 169 bps. We also break down this comparison in spreads between EM and US high yield bonds by rating category, which may be a more useful comparison because of the different complexion of the two universes (see Exhibits 22 and 23). We note that EM HY has only a 1.5% weight in CCCs, while such names represent 17.2% of the US HY, which obviously skews the comparison in aggregate. Per rating category, the average spread difference since 2001 is 172 bps for BBs and 285 bps for single-Bs.

Exhibit 21: EM vs. US and DM Corporate Bond Yields (%)



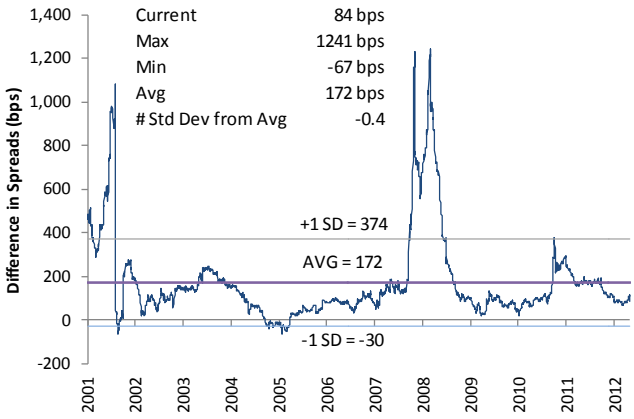
Source: JPMorgan, as of April 2013.

Exhibit 22: EM HY vs. US HY (B Rated Only)



Source: JPMorgan, as of March 2013.

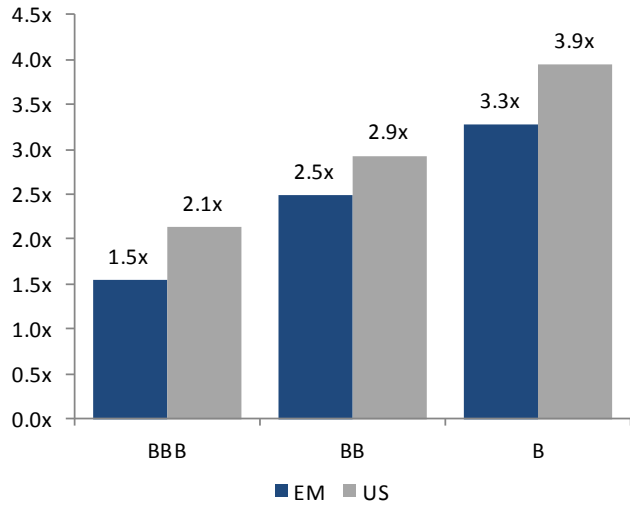
Exhibit 23: EM HY vs. US HY (BB Rated Only)



Source: JPMorgan, as of March 2013.

Despite this yield and spread premium, EM corporates of a similar rating tend to have slightly better credit metrics than their US counterparts (see Exhibit 24). We ascribe that to the more qualitative risks of investing in EM corporate bonds, which require a greater awareness of management/shareholdings and local jurisdiction issues. We also note that many corporates are capped in rating by the "sovereign ceiling" on the rating. In addition, while liquidity has improved, it is still a key risk factor that influences spreads, as liquidity tends to disappear quickly during downturns (even more than in US HY markets).

Exhibit 24: Median Net Leverage for EM and US Corporates



Source: Bank of America Merrill Lynch, as of April 2013.

As seen in the exhibits above, EM corporates offer significantly more yield with materially improved credit fundamentals vis-à-vis US or developed market corporates. We would expect the qualitative issues described above to be resolved over time as emerging economies continue to develop a more robust legal framework with respect to creditor rights.

In an April 2013 report, Bank of America Merrill Lynch (BAML) sought to quantify this so-called "EM premium" by analyzing the risks of the asset class relative to the US and developed markets. This included understanding comparative fundamental risks, as well as technical risks such as liquidity and volatility. As indicated in the exhibits above, EM corporates have historically enjoyed better credit metrics in relation to their US counterparts. The BAML report also indicated that EM corporate default rates have been lower than in the US since the mid-2000s. However, while leverage and default risk are relatively lower in EM, investors are also significantly more concerned with fraud in EM than in the US and other developed markets. Another interesting finding is the relative recovery rates for creditors in EM, which BAML argues is not any worse than those in developed markets. However, it is important to note that while the average recoveries of senior unsecured bondholders is comparable to the developed markets, the range of recoveries is much wider in EM.

The other risks the report highlights are the risk that EM corporates not being able to access the primary markets in times of market distress, the risk of insufficient trading liquidity, and the role of volatility on the EM premium. While EM corporates generally issue less in times of market turbulence, the ability for EM corporates to tap the local debt markets provides an

alternative financing window. Market access risk for EM corporates may be more apparent in times of EM-centric market uncertainty as opposed to the developed market distress cycle of 2008-2009. In terms of liquidity, the report notes that EM investment grade volumes are actually greater than those in the US, once adjusted proportionately. The report concludes that, while EM corporates are considered a higher-beta asset than US corporates, in most cases, EM credit often behaves in line with US credit as long as markets are stable and risk appetite is high. However, the moment some event triggers a reversal, EM's true beta emerges from hibernation, and pushes all of these metrics (including the beta itself) to levels on the opposite end of the risk spectrum.

BAML attempted to quantify this uneven behavior by assigning factor values reflecting these conditions (see Exhibit 25). They estimated that, all things considered, EM IG spreads should be trading at 1.20-1.30x multiple against the US, while EM HY would be fairly valued at 1.15-1.25x range. Today, these numbers are 1.50x and 1.25x, respectively, which suggest to them a preference for EM over US IG in relative value terms.

Exhibit 25: EM vs US Credit Spread Relative Value Analysis

	IG	HY
Fundamental metrics (50% weight)		
Leverage	0.9x	0.8x
Defaults	-	1.2x
Recoveries	-	1.3x
Rating migrations	1.0x	1.0x
Market access (20% weight)	2.0x	1.2x
Liquidity metrics (15% weight)		
Trading volumes	1.0x	1.2x
Bid-ask spreads	1.4x	1.5x
Mark-to-market volatility (15% weight)	1.0x	1.4x
Weighted average valuation score	**1.21x**	**1.19x**

Source: Bank of America Merrill Lynch, as of April 2013.

Expected Developments in the EM Corporate Bond Asset Class

With our managers having been actively involved with EM corporate bonds since the inception of the asset class in 1992, we at Gramercy offer the following observations.

- With the emergence of EM countries on the global financial scene, EM corporate bonds will continue to be an increasing part of the investment landscape. Similar to the US markets, we expect the ratio of investment grade as a percent of the total EM corporate universe to stabilize around 75% (where it is close to now in the indices), although it may go higher given the large amount of quasi-sovereign issuers in EM.

- EM corporate bonds can offer superior returns to similarly rated developed market bonds, but credit metrics don't tell the whole story. Because of the qualitative issues in EM – governance issues, lack of full transparency, controlling shareholder conflicts of interest, etc. – security selection will continue to be important. It is going to take some time for premiums to diminish which enhances income potential.

- Over the next five years, it is likely that US$/EUR denominated bonds will remain the primary investable form of corporate bond instrument for global investors. However, we expect to see local currency corporate bond issuance expand beyond the current parochial issuance sphere of China and become a viable alternative investment instrument within the decade for global investors. Nonetheless, the current market dynamic still restricts its viability as a liquid and diversified portfolio component for the time being.

- We expect that EM corporate bonds will remain a somewhat high-beta asset class compared with similarly rated US bonds. Investors will need to remain comfortable with this volatility and adjust portfolio construction accordingly to incorporate an element of market timing for tights and wides.

- We would expect excess beta for EM over US corporate bonds of 20-60 bps for IG bonds and 100-250 bps for high yield issues over the next five years. Given the inefficiencies that we expect will persist in EM, we anticipate that alpha-generating opportunities for managers prepared to exploit them will remain in the IG, high-yield, and distressed areas of the asset class.

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