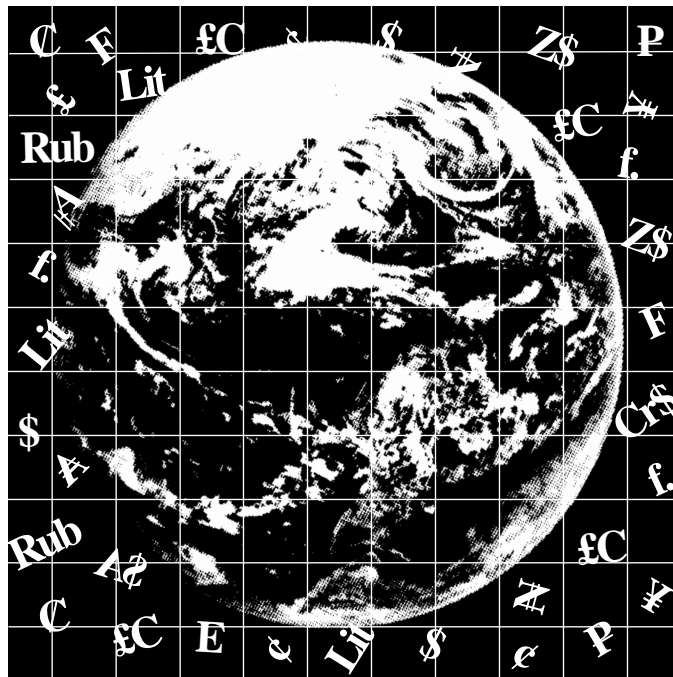

Emerging Market Financing

Quarterly Report on Developments and Prospects



Third Quarter 2000

By a Staff Team led by Bankim Chadha



INTERNATIONAL MONETARY FUND

The quarterly *Emerging Market Financing* report is an integral element of the IMF's surveillance over developments in international capital markets. It has been published beginning with the report for the second quarter of 2000. The report draws, in part, on a series of regular informal discussions with a broad set of private financial market participants.

The report is prepared in the IMF's Research Department. The project is directed by Bankim Chadha, Chief, Global Markets Unit. Co-authors of the report are Gabrielle Lipworth and Christopher Morris, Senior Economists; Anna Ilyina, Subir Lall, and Jens Nystedt, all Economists; Martin Edmonds, Senior Financial Systems Officer; Anne Jansen, Senior Research Officer; and Christian Carrillo and Peter Tran, Research Assistants. Sheila Kinsella provided expert drafting assistance.

The report has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors (following their discussion of the *Emerging Market Financing* report on November 3, 2000). The analysis and views are those of the contributing staff and should not be attributed to Executive Directors, their national authorities, or the IMF.

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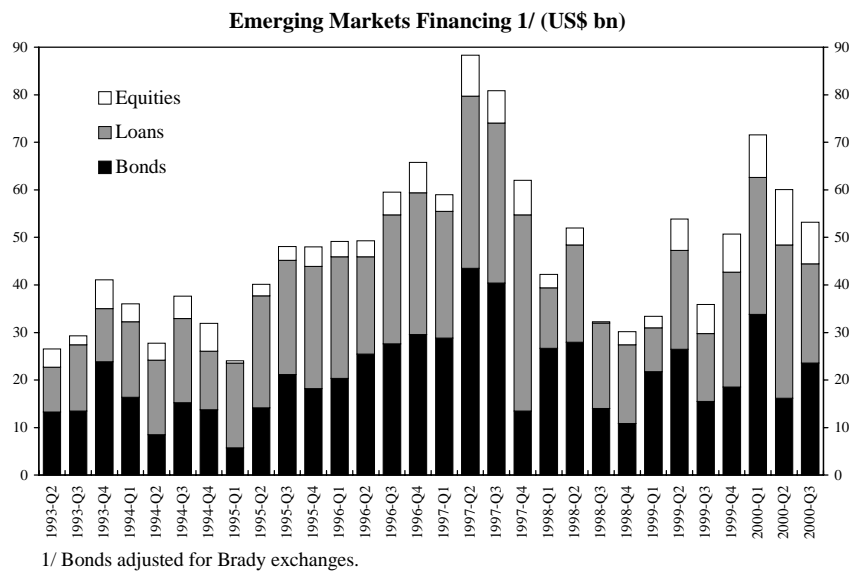
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I. OVERVIEW

As global markets began factoring in a slowing in the US economy, oil prices rose, and the euro fell to new lows during the third quarter, the performance of emerging market assets diverged sharply:

- Supported by a variety of fundamental, structural, and technical factors, the emerging debt markets proved resilient (5.2%), ranking the best performing fixed-income asset class.
- Emerging equity markets (-13%) on the other hand almost unanimously registered losses, with those in Asia (-23%) falling substantially more than their counterparts in the emerging and mature markets.

While total emerging markets fundraising on international capital markets continued to moderate in the third quarter from the pace of the first two quarters, partly reflecting the seasonal August slowdown, it held up relatively well as increased bond issuance, especially from the private sector, offset declines in equity placements and syndicated lending. With the best third quarter in three years, gross fundraising year-to-date already exceeds the annual amounts raised in 1998 or 1999.



External factors continued to play a dominant role in determining the performance of emerging market assets. The perceived slowing of the US economy, ratified by disappointing corporate earnings reports, prompted a reallocation of funds from equity to bond markets. The poor performance of mature equity markets, especially the Nasdaq, directly impacted emerging equity markets, while increased uncertainty prompted global equity fund managers to rebalance portfolios in favor of cash and away from emerging markets. Asian equity markets fared worst because, in addition to being vulnerable to a slowdown in the US economy, they have the highest share of Technology, Media and Telecommunications (TMT) in the world, and they were almost unanimously vulnerable to high oil prices.

We discuss a variety of structural changes underway with regards to sector and industry benchmarks that have important implications for emerging markets: declining supply in the US Treasuries market that may have masked some of the improvement in credit spreads; adjustments to the major equity benchmark indices for the free floats of individual company

stocks (i.e., that can be traded easily), which are expected to reduce the share of emerging markets, but should lower their volatility over the longer term; and the increased management of bond funds against global indices that have a higher share for emerging markets, which is already significantly impacting the level and stability of allocations to emerging markets.

Beginning in September and intensifying in October, conditions for emerging market borrowers deteriorated. With spreads widening across the board, there was a sharp fall off in new fundraising on bond markets. Our outlook for emerging markets financing is guarded. As a quarter ago, we expect overall financing flows to moderate further in the last quarter. We expect conditions on bond and equity markets to remain choppy, with issuers continuing to exploit windows of opportunity, while we expect the syndicated loan market to remain supportive. Our list of sources of risks includes: higher-than-expected US inflation sparking a sell-off in global bond markets; sustained high oil prices increasing expectations of a sharper slowdown in corporate earnings and global growth; substantial further corrections and volatility in “old-” or “new-economy” US equities led by a continued rerating of the telecom sector; a sharp correction of the US dollar; finally, we highlight the threat posed by investor reallocations to competing asset classes as emerging markets are, for the first time since the Asian crisis, once again trading at levels close to the US high yield sector.

	1998	1999	1999				2000			July.	Aug.	Sep.	Oct. 2/	YTD 2/
			1st qtr.	2nd qtr.	3rd qtr.	4th qtr.	1st qtr.	2nd qtr.	3rd qtr.					
(In billions of US dollars)														
ISSUANCE	156.7	173.8	33.4	53.9	35.9	50.7	71.6	60.1	53.2	21.2	15.2	16.7	10.7	195.5
Bonds	79.5	82.4	21.8	26.5	15.5	18.6	33.8	16.1	23.6	10.6	4.6	8.3	1.0	74.5
Equities	9.4	23.2	2.4	6.7	6.1	8.0	8.9	11.7	8.7	3.5	3.0	2.2	4.7	34.0
Loans	67.7	68.3	9.2	20.8	14.2	24.1	28.8	32.3	20.9	7.1	7.6	6.2	5.1	87.0
ISSUANCE BY REGION	156.7	173.8	33.4	53.9	35.9	50.7	71.6	60.1	53.2	21.2	15.2	16.7	10.7	195.5
Asia	41.1	65.9	12.5	18.0	18.9	16.6	30.6	29.5	21.4	6.2	5.4	9.7	7.5	89.1
Western Hemisphere	65.9	61.4	13.2	21.8	9.4	16.9	23.7	13.9	18.2	7.3	7.0	3.8	0.9	56.7
Europe, Middle East, Africa	49.7	46.6	7.7	14.1	7.5	17.2	17.2	16.6	13.6	7.7	2.7	3.2	2.2	49.7
SECONDARY MARKETS														
Bonds:														
EMBI+ (spread in bps) *	1,037	703	1,046	939	965	703	674	712	677	680	643	677	793	793
Merrill Lynch High Yield (spread in bps)	536	435	490	447	465	435	543	582	628	590	602	628	715	715
U.S. 10 yr. Treasury Yield (yield in %)	4.7	6.3	5.2	5.9	5.9	6.3	6.0	6.0	5.8	6.1	5.8	5.8	5.7	5.7
Equity:														
(in percent)														
DOW	16.1	25.2	6.6	12.1	-5.8	11.2	-5.0	-4.3	1.9	-1.6	6.2	-5.0	-3.0	-10.2
NASDAQ	39.6	85.6	12.3	9.1	2.2	48.2	12.4	-13.3	-7.4	-5.0	11.7	-12.7	-12.1	-20.6
IFC Investable Composite	-21.9	67.1	10.9	23.8	-3.2	25.7	1.5	-10.4	-13.0	-4.8	0.4	-8.9	-8.3	-27.4
Asia	0.7	72.6	6.5	43.2	-8.0	23.1	4.1	-11.7	-22.6	-8.3	-1.7	-14.1	-6.7	-33.6
Latin America	-35.5	61.8	13.4	15.4	-7.9	34.2	5.9	-7.9	-4.6	-1.8	3.3	-5.9	-10.8	-17.0
Europe/Middle East	-20.8	68.4	12.1	13.2	7.8	23.1	-5.7	-10.7	-6.9	-2.4	0.7	-4.6	-8.1	-27.4

Sources: Bloomberg; Capital Data Ltd; International Finance Corporation, and Emerging Markets Data Base.

* On April 14, the EMBI+ was adjusted for the London Club agreement for Russia. This resulted in a one-off (131) bps decline in average measured spreads.

1/ Issuance data are as of October 24, 2000 close-of-business London and Secondary markets data are as of October 25, 2000 cob New York

2/ Year-to-date data as of October 25, 2000.

II. RECENT DEVELOPMENTS

A. The External Environment

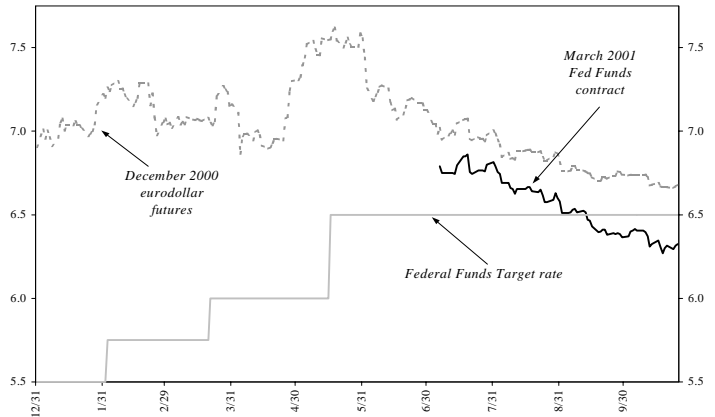
Developments in international financial markets **continued** to provide a **volatile backdrop** for the performance of emerging markets in the third quarter. Even as **some sources of uncertainty and volatility receded, others increased.**

Interest rate fears in the US, which had begun to recede in June, **continued to ease** during July and August (see chart). By mid-September, expectations of a slowing US economy had led to **expectations of interest rate cuts** by early 2001, with the yield on Federal Funds futures maturing in December onwards falling below the Federal Funds target overnight rate.

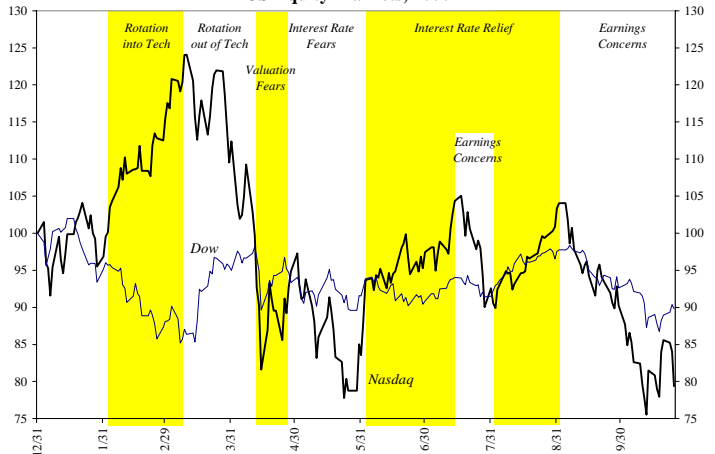
While the **benign interest rate environment supported** US equity markets until the end of August, TMT stocks suffered a temporary sell-off in mid-July following poor corporate earnings news (see chart). **Perceptions the US economy was slowing** were then ratified in September by a string of **sharply disappointing earnings estimates**, setting the stage for a broad-based sell-off. By mid-September, the **slide of the euro**, which hit a new low during the quarter, also began affecting the outlook for US multinationals with

significant presences in Europe. Finally, **higher oil prices** added to expectations of a slowing economy and lower corporate profitability. **High valuation sectors, especially TMT, proved most vulnerable.** The vulnerability of the TMT sector was magnified by a **global rerating of the telecom sector.** In a **broad based sell-off** across sectors, the Dow fell 8%

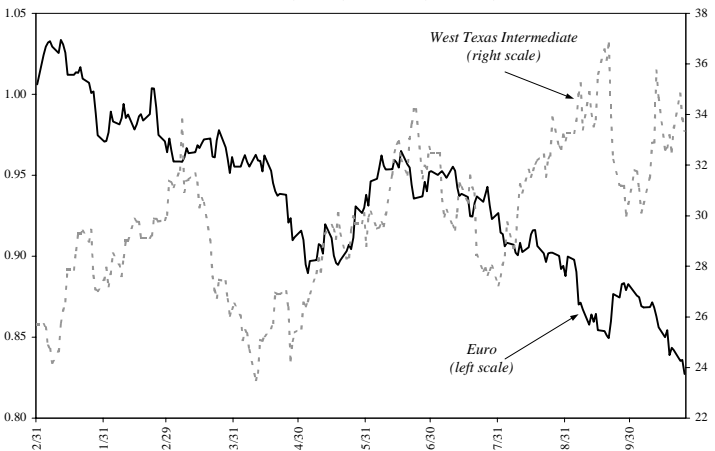
US Interest Rates and Expectations (%), 2000



US Equity Markets, 2000



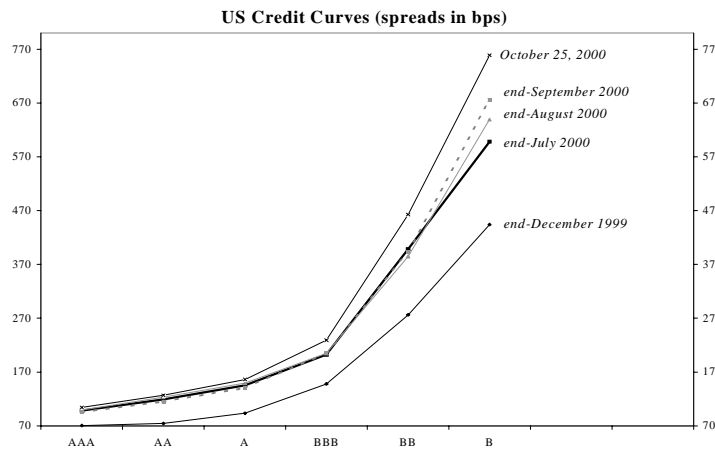
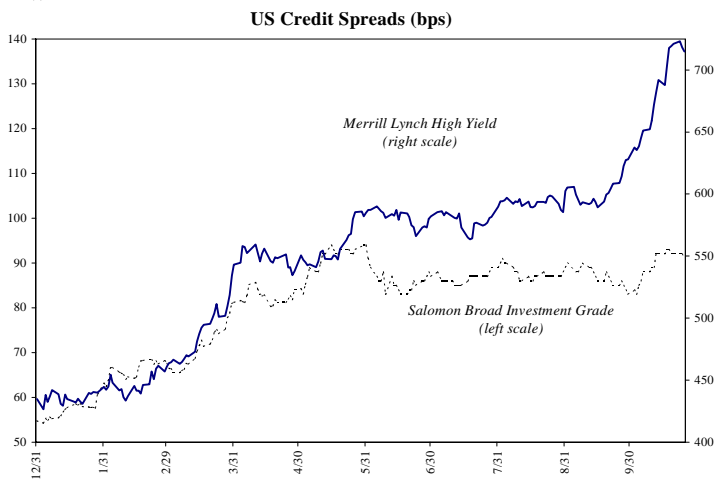
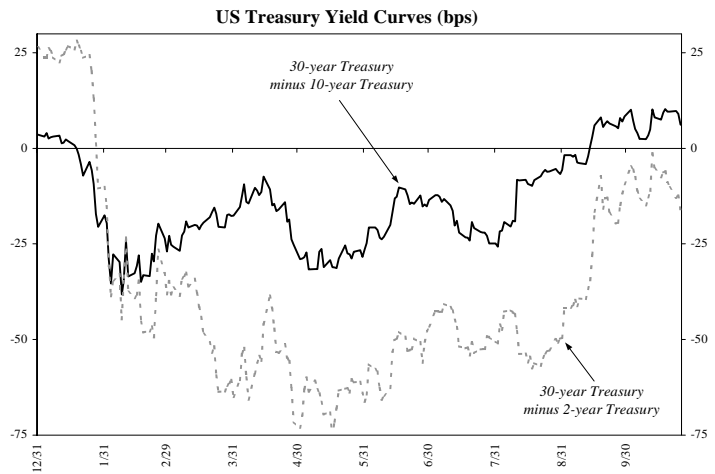
The Euro (\$/unit) and Oil (\$/barrel)



and the Nasdaq 23% from September through October 25.

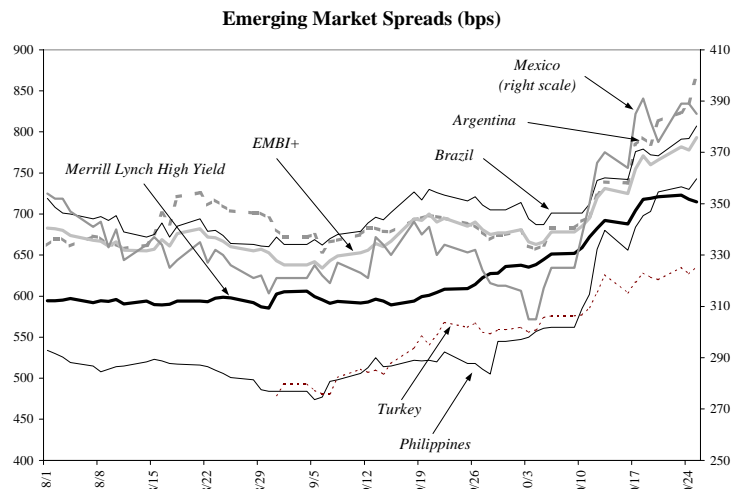
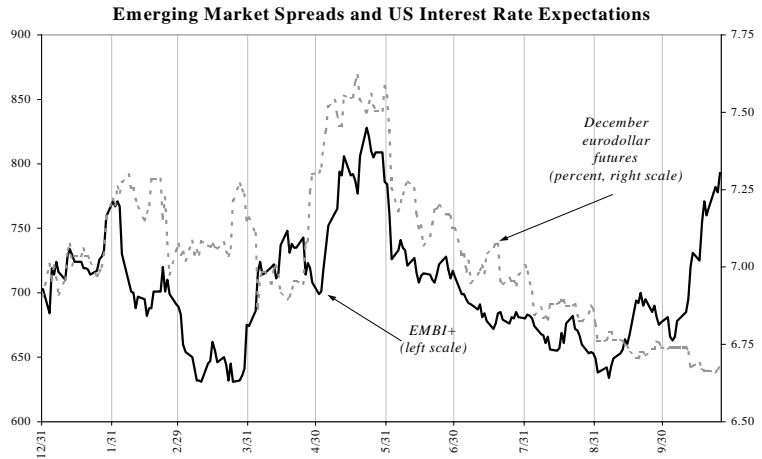
In US bond markets, a variety of factors prompted a **flattening and disinversion of some portions of the yield curve** by mid-September (see chart). The view that the growth slowdown would be accompanied by lower short term (policy) interest rates prompted reallocations toward the short end of the yield curve. The slowdown was expected to reduce future budget surpluses resulting in smaller reductions in the stock of outstanding long bonds. The two leading presidential candidates elaborated spending and tax cut measures that were also seen as reducing the likely size of anticipated debt stock reductions. Higher oil prices raised expectations of longer-run inflation. The sharpness of the move also reflected unwinding of trades positioned to take advantage of a continued “richening” of the long end of the curve in a market where liquidity has been markedly reduced.

In credit markets, the US **high yield sector continued to suffer** (see chart). High yield fund managers continued to experience **redemptions**, with reduced demand and a **heavy prospective issuance calendar** in September led by the telecom sector pushing spreads wider in anticipation. In the event, a re-rating of the telecom sector inhibited issuance and prompted a sell-off of the sector, while for the broader market, perceived **default risk** rose with actual default rates and expectations of a slowing economy. In contrast, the **high grade sector remained relatively resilient**, consistent with early signs of a “**flight to quality**” that can be expected to accompany an economic slowdown, as investors reallocate up the credit spectrum, away from the vulnerable to the stronger credits.



B. Emerging Bond Markets

Spreads narrowed relatively steadily during July and August, **supported by subsiding interest rate concerns** in the US (see chart), with the spread on the EMBI+ tightening 78 bps from 712 at end-June to a low of 634 bps by the first week of September. They **then widened** quickly, hitting 700 bps by the third week, giving up almost all of the previous two months gains. While this widening coincided **with the deterioration and increased volatility in global markets, factors specific to emerging markets** also played a role. The announcement of a **merger** between JP Morgan and Chase, both major players in the emerging debt markets, was seen as reducing market liquidity. The political situation in **Peru** also pressured spreads wider. There was some reallocation towards the **US high yield** sector as yields there picked up. Finally, though **oil prices** could be expected to be positive for emerging market debt (see below), the peak in spreads coincided with that in oil prices, reflecting the view that if oil prices remained at high levels, in the resulting global slowdown, there would be less risk capital devoted to emerging markets. As oil prices subsided and the situation in Peru improved, spreads narrowed again, **tightening by a relatively modest 35 bps over the quarter**. Spreads then **widened sharply across the board in October** (see chart) along with the deterioration in the mature credit markets and increased volatility in the mature equity markets, closing on October 25 at 793 bps, **not far below the May high** for the year associated with concerns about US interest rates.



Emerging market debt delivered impressive total returns of 5.2% during the third quarter, proving the **best performing asset class** among the major fixed income asset classes (see table), and far

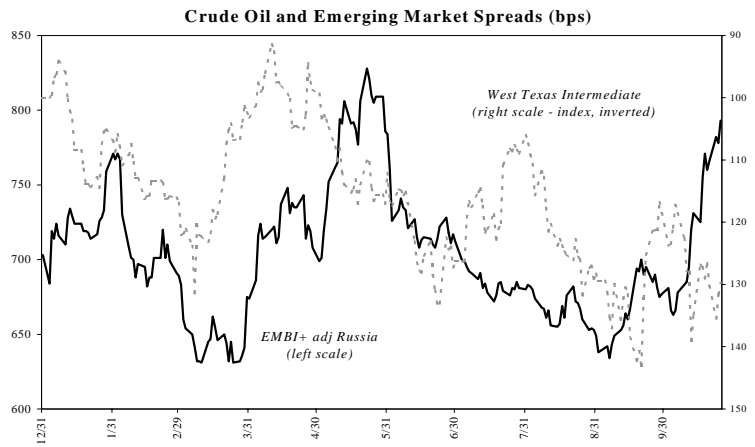
Relative Performance of Emerging Market Debt				
(Total return in %)				
	Q1	Q2	Q3	Q1-Q3
EMBI+	7.6	0.4	5.2	13.7
EMBI+ ex-Russia	4.2	-0.3	5.3	9.4
US Govt. Bonds (JP Morgan GBI)	4.0	1.5	2.6	8.3
US Investment Grade (Salomon's BIG)	2.2	1.7	3.0	7.1
US High Yield (MLHY)	-1.8	0.6	1.3	0.1

exceeding returns on the mature and especially emerging equity markets.

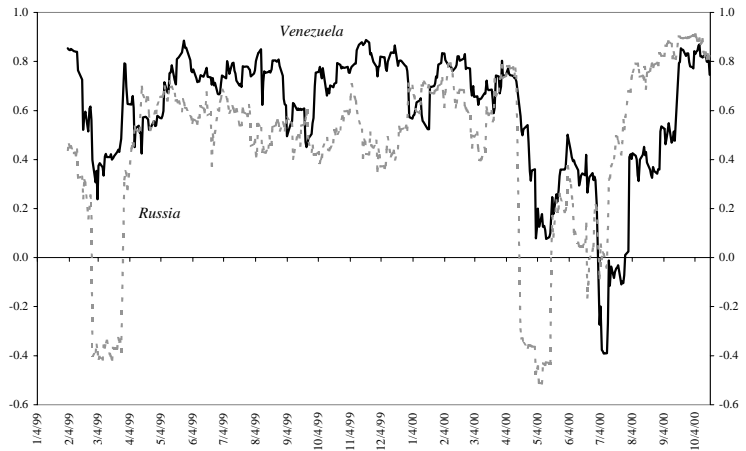
The impact of **oil prices** on emerging markets has been a key consideration this year. With around **60% of the EMBI+ comprised of net oil exporting countries** (Argentina (23.4%), Mexico (15.7%), Russia (12.5%), Venezuela (5.5%), Colombia (1.4%), Ecuador (1.2%), and Nigeria (0.8%)), **high oil prices should be a net positive for emerging debt markets**. While the broad market suggests a relationship between emerging market spreads and lagged oil prices through the first half of this year (see chart), the relationship breaks down in the third quarter. At an individual country level, **high correlations for Russia and Venezuela** are evident, briefly interrupted by US interest rate uncertainty in April-May (see chart). It is also notable that **year-to-date** (through October 25), the **spreads of only two emerging markets had tightened**, and these were **both oil exporters**: Ecuador (-2021) and Russia (-1283). Both **Ecuador and Russia also benefited from successful restructurings** of external debt completed during the quarter which were associated with significant capital gains and spread tightening (see Box 1), however, making it **difficult to disentangle the effects of higher oil prices**.

Despite the seasonal low in August, new bond **issuance rose** in the third quarter to \$23.6 bn (adjusted for Brady and other exchanges).

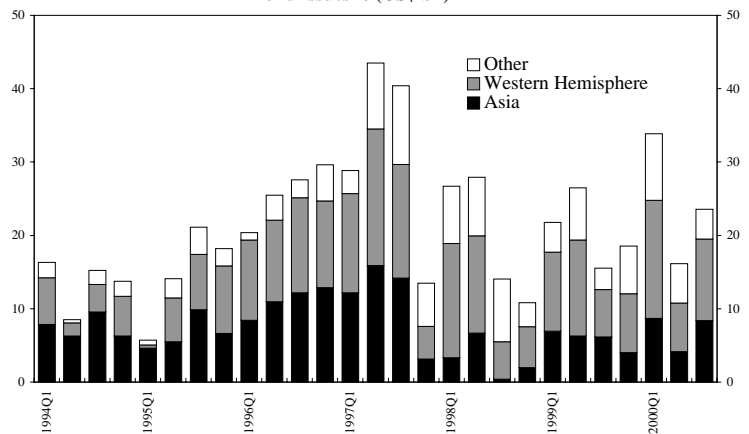
The fact that the largest emerging market borrowers had nearly completed their financing programs during the second quarter permitted a **widening of access** in the third quarter. **Smaller sovereigns**, such as Costa Rica, Jamaica and Romania, successfully tapped the market, and **corporate issuance rebounded** (see chart below).



Correlation of Russian and Venezuelan EMBI+ Sub-indices with Oil Prices (21-day, spread signs reversed)



Bond Issues 1/ (US\$ bn)



1/ Bonds adjusted for Brady exchanges.

Box 1: Recent Experience with Sovereign Bond Restructurings

The third quarter saw the successful completion of exchanges of defaulted debt for new eurobonds by Russia and Ecuador (other recent cases were Ukraine and Pakistan).

- In **Russia**, the resolution of default involved the exchange of \$32 bn in Prins, Ians, and past-due interest, for \$21 bn in new eurobonds, and resulted in an upgrade in the obligor status of the bonds from Vnesheconombank, a state entity, to that of the Russian Federation.
- In the case of **Ecuador**, the resolution involved both collateralized and uncollateralized Brady bonds as well as regular eurobonds, totaling \$6.4 bn, which were exchanged for \$3.75 bn in new eurobonds and \$1 bn in cash.

Bond **valuations depend upon expected recovery rates**, that is the amount investors can expect to receive in the event of default. The experience to date with emerging market *sovereign* bond restructurings has, however, been limited. In the absence of an empirical basis, market participants have typically ascribed relatively low ad hoc recovery values of around 18-20%. The successful resolution of the two cases raises questions about what implications they have for valuations of the asset class. We draw attention to the following:

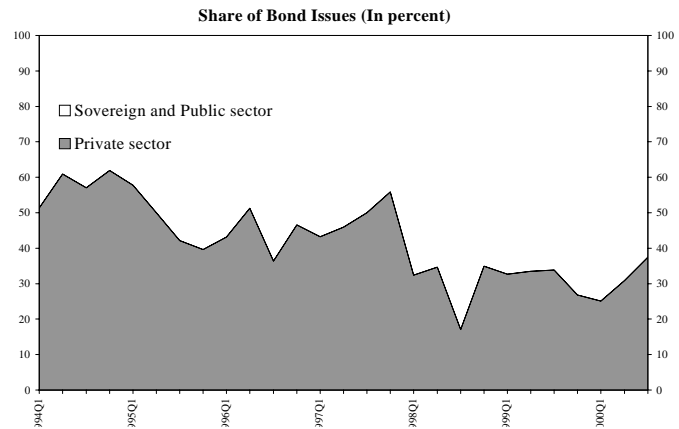
Market Reactions to Recent Bond Exchanges

	Date of Default	Exchange Announced	Exchange Completed	Listing Price	Price 1-day after default	Price 1-week before ancmnt	Price 1-week after ancmnt	Price at completion	Face value write-off	Completion / listing price	(in percent)	
											Post-ancmnt / pre-ancmnt price	Completion / pre ancmnt price
Pakistan												
<i>6% USD 2002 eurobond</i>	no Default	11/15/99	12/6/99	100.0	...	58.3	60.4	63.6	0	-36	4	9
Ukraine												
<i>16% DEM 2001 eurobond</i>	1/20/00	2/4/00	4/7/00	100.0	50.0	55.5	67.0	81.5	0	-19	21	47
Russia												
<i>Prins</i>	12/2/98	2/11/00	8/17/00	57.8	6.5	18.5	24.4	32.0	-38	-45	32	73
<i>Ians</i>	6/2/99	2/11/00	8/17/00	67.2	10.0	21.1	25.0	32.8	-33	-51	19	55
Ecuador												
<i>Brady Par Bond</i>	11/28/99	7/27/00	8/11/00	27.4	35.8	35.5	39.5	39.5	-60	44	11	11
<i>Brady Discount Bond</i>	8/28/99	7/27/00	8/11/00	47.0	34.4	37.0	46.7	46.7	-42	-1	26	26
<i>Brady PDI Bond</i>	2/28/00	7/27/00	8/11/00	27.0	23.5	25.3	30.5	30.5	-22	13	21	21

Note: Bonds presented are not all of those restructured. Prices are ask and includes accrued interest, when bond is in default. For Pakistan accrued interest is estimated. Default is the date of the first missed coupon payment, except in the case of Ukraine, where the default reflects the missed amortization on its Oct-2000 eurobond.

- Ecuador (52%) and Russia (47%) have been the **best market performers year-to-date**.
- The resolutions were **surprisingly smooth and fast**, taking about 2 years in the case of Russia, and about 1 year for Ecuador. This stands in stark contrast to the loan restructuring experiences of the 1980s (the lost decade) and compares well with the US high-yield sector (average 2.1 years).
- Salient features of **market price reaction** over the cycle of default and resolution were: **very low prices upon default**, suggesting the market was very **pessimistic as to recovery values**; **positive reactions to announcements of exchange offers**, with prices rising by an average of 20% on impact in the cases of Ecuador and Russia, suggesting the sweeteners offered were larger than expected; **prices at the time of completion** were typically **much higher** than at the time of the announcement of the exchange offers, rising on average 37% for Ecuador and Russia. This reflected declines in completion risk as the exchanges looked increasingly likely to succeed, and improving fundamentals (higher oil prices in the case of Russia).

The **Argentine sovereign** raised \$2.5 bn, returning to the dollar market with a \$1.25 bn 30-year eurobond. The remainder of the sovereign's issuance was in the euro- and yen-markets, where **retail demand** for emerging market credits remained strong. The Mexican sovereign, taking advantage of the smoother-than-expected election, raised \$2 bn, with a notable \$1.5 bn issue that attracted significant interest from US high-grade investors. **Latin America** continued to dominate issuance, accounting for about half (47%) of all issuance. **Asian activity rebounded** with a \$3 bn convertible bond issued by Hutchison Whampoa from Hong Kong. The third quarter saw the **largest swaps of Brady bonds** (\$5.6 bn) for eurobonds (\$5.5 bn) since the third quarter of 1997, with Brazil swapping \$5.2 bn in Brady bonds for a \$5.16 bn 40-year eurobond in a single transaction. Brady-eurobond exchanges have now retired \$32.6 bn of Bradys, or about a fifth (22%) of the outstanding stock at end-1996. The **deteriorating conditions in October then caused new issuance to fall off sharply**, with only \$1 bn raised through October 25. This **compares with a low** of \$2.6 bn raised in **April** at the **height of concerns about US interest rates**.



The **investor base** was subject to **conflicting forces** during the quarter. On the **negative** side, portions of the **dollar-based crossover** investor base and **hedge funds** sold off in September as concerns about high oil prices and moderating global growth argued for a round of profit taking. For similar reasons, **dedicated investors** moved into more defensive positions, increasing their cash holdings. For reasons mentioned earlier, the deteriorations in the US **high-yield** sector (redemptions, increased default risk) kept fund managers from the sector on the sidelines of the emerging debt market. In Europe, demand from **euro-based institutional investors remained limited**, with **retail investors accounting for most** of the demand, and the share of euro issuance fell off (see table).

On the **positive** side, **yen issuance** (see table and Box 2) continued to surprise on the upside, providing an additional venue for emerging

Currency of Issuance
(Shares in %)

	97Q1	97Q2	97Q3	97Q4	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3
U.S. dollars	69	77	77	71	62	76	86	83	62	67	59	53	62	51	64
Euro	0	0	1	0	8	9	7	0	26	28	36	37	33	28	19
Deutsche mark	16	5	2	16	15	8	6	14	2	0	2	0	0	0	0
Yen	8	6	3	3	0	0	0	1	2	1	1	8	3	17	14

market sovereigns to take pressure off the dollar segment. **High amortization and coupon** payments during the quarter provided “technical” support for new emerging market issues, providing cash to dedicated investors which needed to be reinvested in order for them to maintain exposures. Finally, there was a notable **structural shift** in the management of **US high-grade funds**, which increased allocations to emerging debt markets, with an increasing number benchmarking their performance against the Lehman Universal index (about 4.0% in emerging markets) away from the Lehman Aggregate (about 0.7% in emerging markets). We view this as a key shift and discuss it in detail below (see Staff Appraisal).

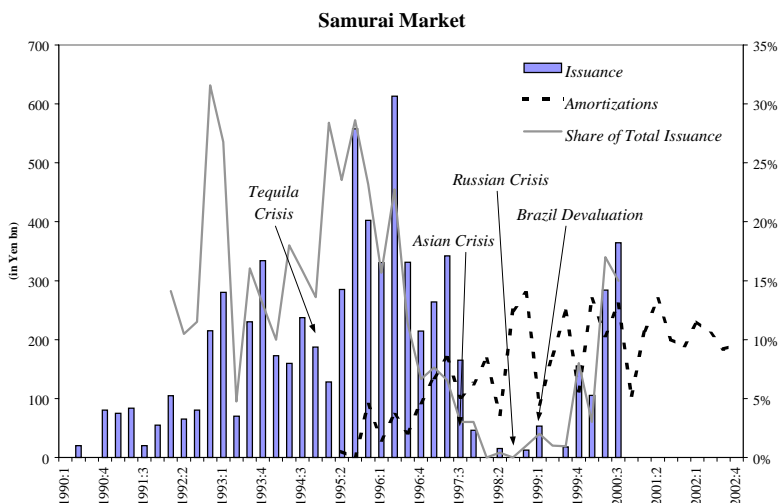
Box 2. The Revival of Emerging Market Yen-Issuance

Prior to the Asian crisis, the yen market (Samurai and Euroyen) played an important role for emerging market issuers (mostly sovereigns), taking up around 15% of total issuance. Emerging market issuance in the sector has been recovering rapidly recently, supported by the maturing of Japanese **postal savings**, subdued Japanese **corporate issuance giving little competition**, and **rollovers of maturing bonds**.

Emerging market issuers returning to the market have so far generally been the **lower rated borrowers**, proving attractive primarily to **retail rather than institutional investors**, with the latter focusing on the large volume of high-grade corporates from the mature markets, who have also made placements in the yen market.

This year's **rapid growth in issuance may be starting to cool**. Some issuers considering the Samurai market, including Thailand and the Philippines, recently changed their plans. In some cases, **higher coupon rates** on alternative investments as Japanese interest rates rise further are believed to have reduced the attractiveness of emerging market bonds to retail investors.

Concerns following the default by China's Hainan International Trust and Investment Corporation have also cooled demand.

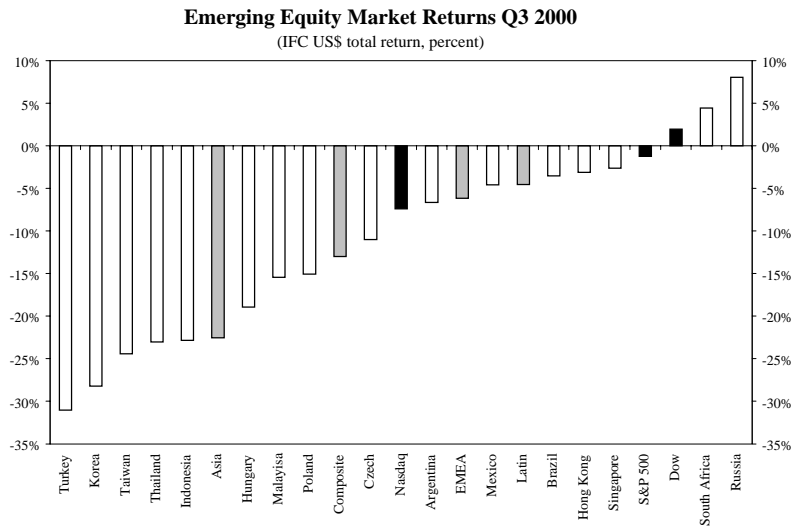


Top 10 Emerging Market Issuers 1999-2000:Q3

Rank	Issuer	Number of Transactions	Issue (in US\$ mn)	Issue (in Yen bn)
1	Argentina	4	1,473	159.5
2	Mexico	3	1,235	130
3	Turkey	2	836	90
4	Croatia	2	611	65
5	Brazil	1	560	60
6	KEPCO	2	571	60
7	Petronas	1	452	51
8	Tunisia	1	463	50
9	KDB	1	476	50
10	Pohang	2	461	50

C. Emerging Equity Markets

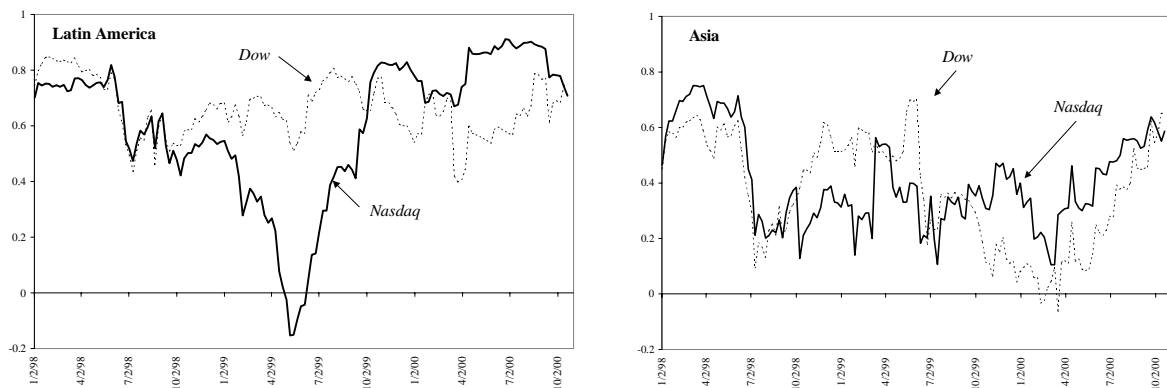
During the third quarter, **emerging equity markets continued to underperform the mature equity markets**. Total returns on the IFCI composite were **-13.0%** in dollar terms, compared with **1.9%** on the Dow and **-7.4%** on the Nasdaq. Emerging markets enjoyed a brief rally in August along with US markets but continued their downward slide in concert with the mature markets in September. Asian markets (-22.6%) again led declines, followed by Emerging Europe, Middle East and Africa (EMEA) (-6.2%), and Latin America (-4.6%). The **declining trends continued in October**.



The continued **role of the external environment** in determining the performance of emerging equity markets was evident as:

- Short-term **correlations** between the returns on emerging and mature equity markets generally **remained at the already high levels** of the second quarter for **Latin America**, while they **rose for Asian markets** (see chart).

Rolling correlations of weekly returns between regional IFCI and US indices, 1998-2000

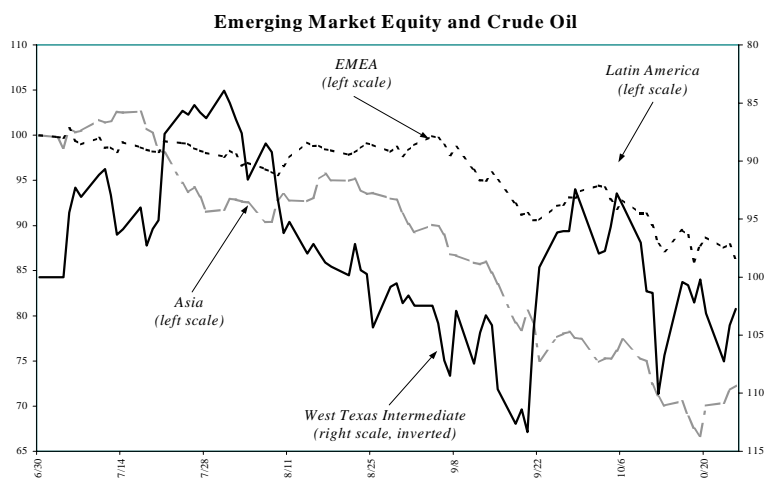


- The pattern of regional emerging market performance reflected the **sectoral underperformance of the TMT sector in the mature markets**, where the Nasdaq led declines. Asian emerging markets, which have a higher TMT component (52%) suffered

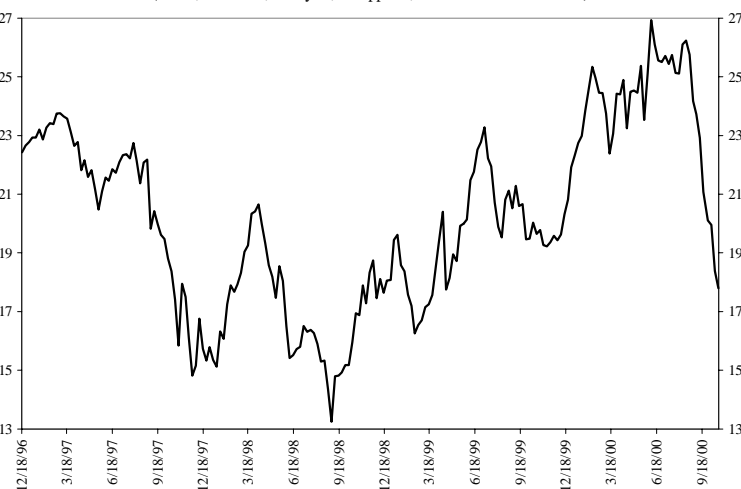
more than Latin markets (38% TMT share) and EMEA (18% TMT share). TMT-heavy Asian markets Korea and Taiwan Province of China were hit particularly hard.

- The pattern of **regional emerging market performance** also **conformed with** what would be expected from a **rise in oil prices**. Given Asia's relatively heavy dependence on oil imports, and the region's heavy reliance on exports to other oil importing economies, Asian markets again suffered more from the rise in oil prices. On the other hand, Russia (+8%), one of the only two emerging markets delivering positive performances during the quarter, benefited from the oil price rise.

As in the mature markets, **earnings estimates were revised downward** in the third quarter for Asia (earnings per share in 2000 were lowered 7.7%) and Latin America (2.6%), while they were revised modestly up for EMEA. The sharp declines in Asian markets this year has lowered **valuations**, as measured by price-earnings ratios, to well below the average value during the last four years, which includes the **crisis period** (see chart), and around that prevailing in October 1997, suggesting the market is pricing in a rather pessimistic earnings outlook.

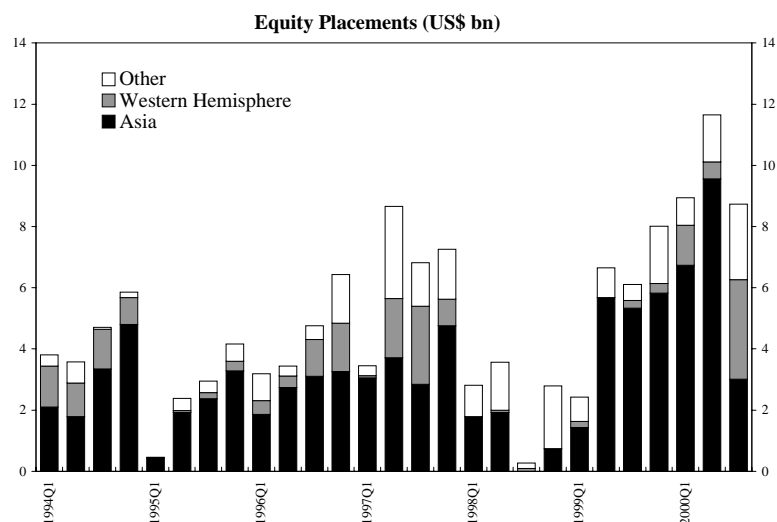


Asia: IFCI market-cap weighted P/E Ratios
(Korea, Indonesia, Malaysia, Philippines, Thailand and Taiwan PoC)



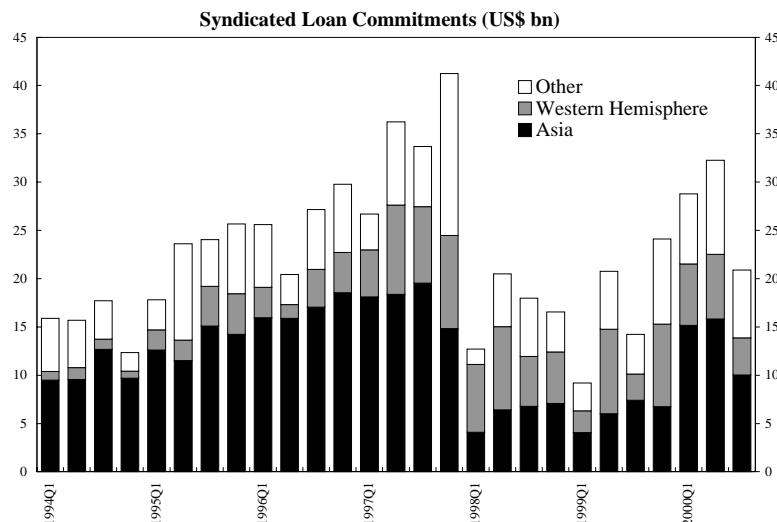
Country specific factors also played a role. Among the worst performers, in **Turkey** (-31%), investors turned cautious on the state of the banking system during the disinflation program, as well as the failed privatization of Turk Telecom. In **Korea** (-28%), concerns about corporate restructuring were highlighted by Ford's withdrawal from talks with Daewoo, and in **Taiwan Province of China** (-24%), financial sector concerns revived. Both Asian countries also suffered from the falling semiconductor chip market. In **Thailand** (-23%), banking stocks led declines on continued concerns about the pace of banks' restructuring of NPLs and election uncertainty.

Reflecting worsening sentiment on global equity markets, and the seasonal low in August, international equity **placements fell** from \$13.3 bn in the second quarter to \$8.7 bn in the third quarter. There was a sharp **drop-off in the share of TMT issuance**, from 91% in the second quarter to 54% in the third. The share of the **energy sector rose** (31%), while **financial services were absent** altogether. Reflecting the sectoral trend and regional performance, there was a sharp decline in issuance by Asian entities (from \$9.6 bn to \$3 bn). Issuance was dominated by three large deals: Petrobras (\$2.6 bn), Brazil's largest oil and gas company; United MicroElectronics (\$1.3 bn) from Taiwan Province of China; and Turkcell (\$1.5 bn), Turkey's mobile phone company.



D. Syndicated Lending

Heightened awareness of the **concentration of credit exposures to the telecom sector** played a role in shaping the syndicated lending of the major international banks to the emerging markets in the third quarter. While the **overall volume of syndicated lending remained strong** at \$20.8 bn, it was notably lower than in the second quarter, which had benefited from the \$9 bn loan to fund Pacific Century CyberWork's takeover of telecom, Cable & Wireless HK.



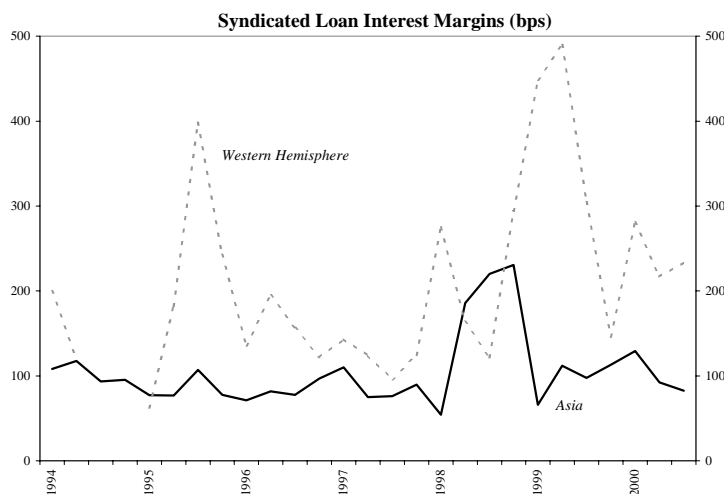
Asian countries continued to receive around half of all loans, with Malaysia and Korea receiving the biggest shares. In Malaysia, sovereign borrowing was dominant, with the government refinancing its \$1.35 bn 5-year sovereign loan at 52 bps over Libor, down from its original December 1998 issue price of 290 bps. In Korea, public sector financial institutions accounted for the bulk of borrowing.

Conditions for emerging market borrowers continued to be **favorable**, reflecting:

- The international banking system's **flush liquidity**, as evidenced by the substantial over subscriptions for jumbo syndicated loans in the mature markets. Furthermore, banks' internal risk limits on lending to emerging markets remain underutilized.
- Banks' heightened awareness of their credit exposures to the telecom sector had two effects. First, it prompted them to focus on the better credits in the sector from the mature markets, **reducing the desire to finance smaller and emerging market telecoms**. Second, it encouraged banks to **actively seek non-telecom exposures** in an attempt to reduce the concentration of their exposures to the telecom sector.
- The continued **push by Japanese banks** into the Asian syndications market, following their efforts to recapture dominance of their home market from foreign banks. In some instances, Japanese banks reportedly bid for deals of strong Asian corporates at pricing that undercut the established arranger. As a result, Japanese banks are leading the league tables in the Asian region for the first time since the crisis, and have been four of the top five arrangers of syndicated loans for the first eight months of the year.
- **Rising oil prices** led to perceptions of a continued improvement in credit quality of oil exporters. **Middle Eastern** financial institutions continued to tap the syndicated loan markets, while oil and gas related projects in India, Malaysia and the Philippines also received financing.

The third quarter witnessed **supply-driven** imbalances being manifested in **competitive pressures** and **pricing** in certain segments:

- Last quarter, we noted that **competitive pressures** had eroded loan spreads, with several deals clearly being priced aggressively for "relationship" reasons, that is in the hope of generating ancillary business. This trend continued in the third quarter, spurred by banks seeking lending opportunities in non-telecom sectors. In particular, two sovereigns and a number of emerging market corporates were enticed by arranging banks into the syndicated loan market with the offer of lower pricing in the hope of generating higher-yielding ancillary business.



- On loan pricing, there are an increasing number of **cases of pricing returning to pre-crisis levels**, partly reflecting “relationship pressures.” Last quarter we noted the decline in spreads to Turkish banks to pre-crisis levels. More recently, in Hong Kong SAR, Hutchison Whampoa broke through 1997 levels with its all-in spread of 56.5 bps over Hibor on a HK\$5 bn facility.
- However, while banks may participate in tightly priced loans for relationship purposes, a **number of recent refinancings have failed to attract much interest** due to the perception that pricing had been pushed down too far, with arrangers having to keep a substantial portion of the deal on their books.

III. STAFF APPRAISAL

There were several particularly notable developments in the performance of emerging market assets and financing on international capital markets in the third quarter. First, there was a **sharp divide between the performance of emerging debt (up 5.2%) and equity markets (down 13%)**. Second, attention was drawn during the quarter to a number of **structural changes** relating to benchmark indices in both the bond and equity markets that have far reaching implications for emerging markets. We discuss these in turn below, before turning to the outlook and risks.

A. Bifurcation Between Emerging Bond and Equity Markets in Q3, 2000

We note that in **measuring the performance** of emerging debt and equity markets:

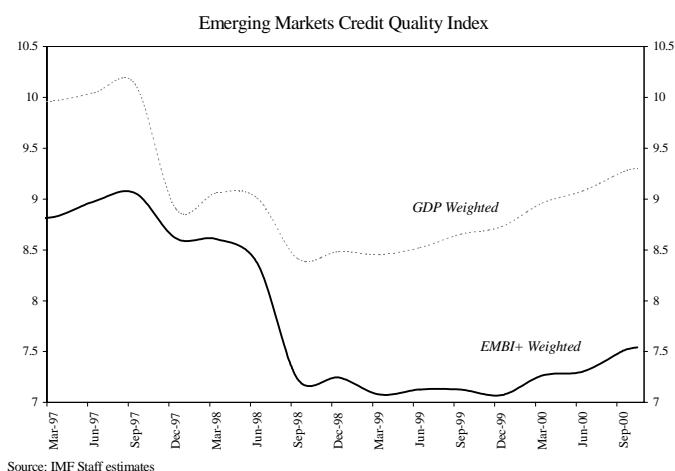
- There are important **regional differences** in coverage between the major benchmark indices for emerging bond and equity markets. The EMBI+, the most widely used benchmark for the performance of emerging debt markets heavily weights Latin America (74%), less so emerging Europe (21.5%), and gives very little weight to Asia (4.5%), reflecting the respective amounts of external bond debt outstanding. Emerging equity markets on the other hand, measured for example by the IFCI indices, give much greater weight to Asia (49.5%), with the rest divided between emerging Europe (27.1%) and Latin America (23.4%), reflecting the relative sizes of regional market capitalizations.
- Comparing regional bond and equity markets **also reveals notable differences** (see table), with a **hefty 26 percentage points differential in Asia**.

Bond and Equity Market Performances Compared, Q3 2000				
(Total Returns in %)				
		Bonds	Equity	Diff
US (JP Morgan GBI and S&P500(Nasdaq))	2.6	-1.2	(-7.4)	3.8 (10.0)
Emerging Markets (EMBI+ and IFCI)	5.2		-13.0	18.2
Latin America (regional EMBI+ and IFCI)	5.7		-4.6	10.3
Emerging Europe (regional EMBI Global and IFCI)	3.4		-6.9	10.3
Asia (regional EMBI Global and IFCI)	3.3		-22.6	25.9

- The debt and equity markets encompass **different entities**, and returns for taking on different risks. The emerging debt markets, as represented by the EMBI+ yield return to investors for taking on **sovereign credit risk**, as compared to equity markets where returns should be linked to developments in **corporate profitability**.

What explains the divergence between emerging debt and equity markets? Why was it greater for Asia? In our view:

- A reallocation of global fund managers' portfolios from equity to bond markets is consistent with markets increasingly **factoring in an economic slowdown** in the US, with the accompanying decline in corporate earnings **discouraging equity investment**, and the prospect of lower interest rates **encouraging bond investments**. Returns in the US conformed with this reallocation, with bond markets outperforming equity markets (see table above).
- The **reallocation** of global portfolios away from equity to bond markets meant a **retrenchment from emerging equity markets**, but was **supportive of emerging debt markets**.
- Returns on emerging market debt can conceptually be broken down into: (i) yields and capital gains on underlying **US Treasuries**; (ii) the **yield pick up** from emerging market spreads; and (iii) capital gains from price appreciation reflecting improved perceptions of **credit quality**. While an actual practical decomposition of returns into these three components is complicated, the total returns from underlying US Treasuries can be proxied by the return on JP Morgan's government bond index, which was 2.6% during the quarter. Similarly, the yield pick up from emerging market debt can be proxied by average (quarterly) spreads, or 1.6%. As suggested by the modest improvement in spreads during the quarter, this decomposition confirms that the capital gains from price appreciation due to perceived improvements in emerging markets credit quality were the remaining modest 1%. The **bulk of performance, therefore, came from developments in US Treasury markets and the high yield** on emerging markets. In view of the poor performance of other fixed-income asset classes, especially US high yield, this breakdown suggests a **resilience rather than any sharp improvement** in perceived emerging markets credit quality.
- Reported emerging market **sovereign credit quality improved**, albeit gradually during the third quarter (see chart). Perhaps more importantly, our reading of ratings outlooks indicates a number of countries on the cusp of being upgraded, suggesting expected



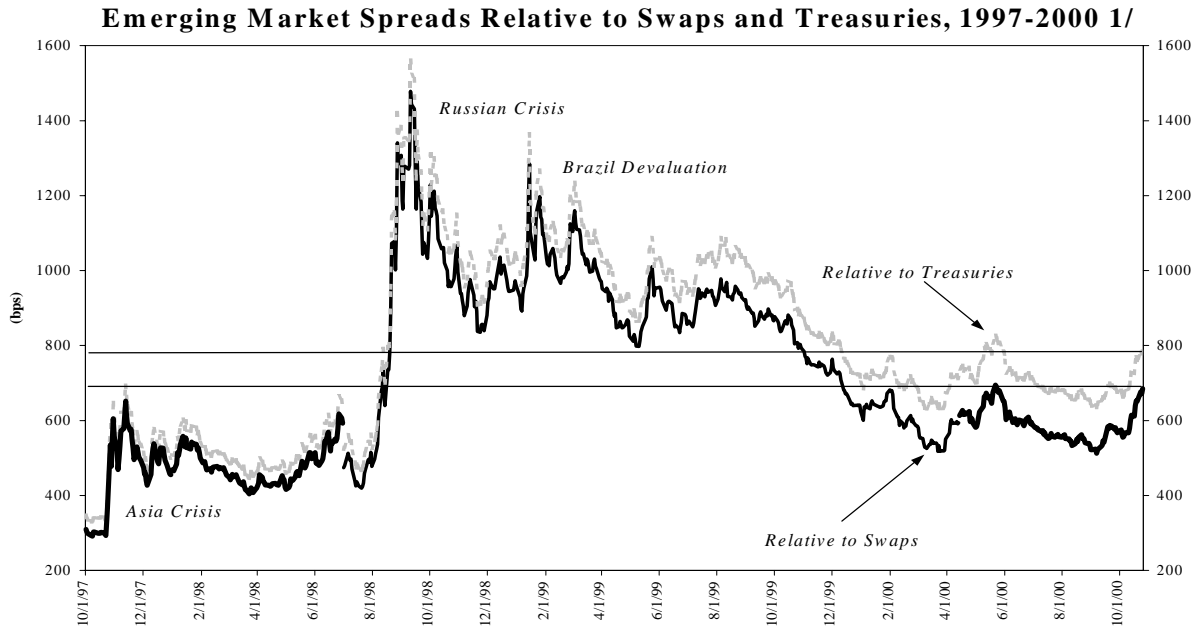
credit quality is likely higher than indicated.

- The performance of **Asian** emerging debt markets was supported by the **tight supply of sovereign debt** from the region.
- We noted above the sharp **downward revision in earnings** forecasts for Asia. We also noted that **direct sectoral links** meant an impact on emerging equity markets of a decline in the Nasdaq would be expected to be felt proportionately more in Asia because of its higher share of TMT. Similarly, we noted that higher **oil prices** are expected to have a larger impact on Asia, without eroding sovereign credit quality which has been bolstered by large accumulations of reserves.
- Over and above the global reallocation from equity to bond markets, the uncertainty created by the **rerating of the TMT sector** and the impacts of higher oil prices **raised the value at risk** of equity portfolios. As fund managers attempted to maintain preferred Sharpe ratios of performance—returns adjusted for volatility—for overall portfolios, this encouraged a retrenchment from **high-volatility assets**, which included emerging market assets, especially those with high TMT components, and those in countries more vulnerable to oil price increases, again impacting Asia most.
- Continued **low domestic interest rates** in much of Asia also made the cost of hedging exchange rate exposures in the wake of higher oil prices and volatility in equity markets attractive, placing downward pressure on currencies, and lowering dollar returns.

B. Ongoing Structural Changes in Emerging Markets Financing: Benchmark Issues

Are US Treasuries Masking Improvements in Emerging Market Credit Spreads?

Emerging market credit spreads, as measured by the spread of the EMBI+ relative to comparable US Treasuries, for example, are perhaps the most widely and closely watched summary indicator of the state of emerging debt markets. The reduced liquidity and increased volatility of US Treasuries in light of uncertain and declining supply, which resulted in a hitherto unimaginable short squeeze earlier this year, however, called into **question the universally adopted paradigm in fixed-income credit markets of spread relative to US Treasuries** for pricing and relative value comparisons. While the process of seeking out a new benchmark for fixed-income markets remains in its initial stages and will take time, with most observers expecting the swaps (Libor) market and some the Agencies curve as eventually taking on this role, the structural “richening” of the longer end of the Treasuries yield curve has made **comparisons of current emerging market spreads with historical levels less meaningful and potentially misleading**. In contrasting emerging market spreads as measured relative to the swaps curve with those relative to the Treasuries curve (see chart below), it is evident that:



1/ In order to analyze a long enough time period several versions of the EMBI were used (EMBI for 10/1/97-12/30/97, EMBI+ for 12/31/97-6/30/98, EMBI+ (Adjusted for Russia) for 7/1/98-4/13/00 and EMBI+ for 04/14/00-10/25/00).

- For much of the period, the behavior of emerging market spreads appears in fact to have been **very similar measured relative to either benchmark**. This reflects the fact that prices on emerging market debt collapsed with the onset of the Russian crisis. Relative to either benchmark the **movement in spreads was large**, and the difference in using the two benchmarks, therefore, small.
- The difference in spreads measured relative to the two benchmarks **increased in 1999-2000 and has become more apparent**, reflecting both the richening of Treasuries earlier this year, and the fact that a differential of this magnitude is more evident (and relevant) at lower spread levels. Nevertheless, by **either measure they are above Asian crisis peaks and remain well above (300-400 bps) pre-Asian crisis boom lows**.

The Impact of Free Float Adjustments to Benchmark Equity Indices

In February, Morgan Stanley Capital International (MSCI) announced it was considering changes in its index construction methodology to a free-float basis. Under this approach, constituent companies' weights in the indices would reflect the free floats of their shares, i.e., those that could be traded easily. The move would entail adjustments for cross-shareholdings, block holdings, government ownership, and foreign ownership restrictions. The move follows similar changes by MSCI's competitors, FTSE International and DJ STOXX. In July, MSCI indicated it will announce a final decision by year-end, but began adding new entrants into its index at float-adjusted market capitalization weights, and markets view **MSCI's shift to a free float-based index as inevitable**.

MSCI produces the most widely followed international equity indices by fund managers. As much as \$2-4 trn is estimated as being benchmarked against its All Country World Index

(ACWI), and \$600 bn against the family of its Emerging Markets Free (EMF) indices. In the aftermath of the decline of most of the large macro hedge funds, international equity investment flows have come to be dominated by real money (nonleveraged) fund managers. MSCI's move can, if the weights in the new indices differ from existing ones, be expected to **generate large and significant capital flows** as fund managers rebalance portfolios:

- **Emerging market equities typically have a lower free float** than those in mature markets, reflecting partial government ownership of former state enterprises, foreign ownership restrictions in many emerging markets, and cross shareholdings due to concentration of corporate ownership within family-owned conglomerates in others. Adjusting the benchmark indices for their lower free floats, therefore, implies a decline in the share of emerging markets in world indices. Market estimates suggest a **sharp reduction of the share of emerging markets in world indices**: from 5.5% to around 4% in the ACWI free. These estimates suggest **potential outflows from emerging equity markets of between \$30-60 bn**.
- There would also be a **redistribution within the emerging markets**. While market estimates of the likely impact on individual countries varies, it is generally expected that both **Latin America and Asia will gain relatively at the expense of Emerging Europe**.

Are **free-float based indices “better”** than market-capitalization weighted indices?

- Free-float adjusted indices **avoid some of the mispricing problems** seen when, for example, **companies with a large market capitalization** are introduced into an index on that basis but **offer a relatively small proportion of their shares in an IPO**, forcing index based fund managers to chase up the prices of the available shares.
- The same argument suggests that the move to free-float based indices **would reduce the volatility of emerging equity markets**. The larger stocks in such an index would, by construction, be the ones that are more tradable and liquid, and thereby less volatile in response to investor flows than one with, say, an index in which the large stocks were those with large market capitalizations but with small free floats.
- Competition between emerging markets for international investment flows could **encourage privatization** of state enterprises to increase free floats, and moves towards greater **capital account liberalization** and increased access by foreign investors.

Increasing Importance of Global Benchmark Bond Indices for Emerging Debt Markets

There has been a notable increase in the US recently in fiduciaries awarding **mandates to fund managers benchmarked to the Lehman Universal away from the Lehman Aggregate**. The switch has been driven partly by recent performance and potential diversification benefits, and partly because hiring (putting money with) dedicated fund managers requires allocations across asset classes (high grade, high yield, and emerging

market) classes be made (and regularly reviewed) by the fiduciary. Given the volatility of credit markets recently, many fiduciaries no longer want the responsibility of determining the allocations, and such a move shifts the decision from the fiduciary to an active fund manager. For such fund managers this change expands the universe of bonds they can invest in, in two directions. First, unlike the Aggregate, the Universal is *not* restricted to bonds registered only in the United States, thereby including dollar denominated globals and eurobonds. Second, the Universal is much less restrictive in terms of credit quality. The Aggregate index covers US registered investment grade bonds, including government, corporate, and various mortgage bonds. The Universal index subsumes the Aggregate, and includes in addition, non-investment grade dollar denominated bonds such as high-yield corporate bonds and privately placed bonds, as well as bonds issued by emerging markets. Importantly, it includes Brady bonds as well as domestically issued dollar-denominated debt. Such a switch has **important implications for the level and stability of allocations to emerging markets:**

- The shift will generate **significant inflows** into emerging market debt as the share of emerging markets in the Universal (4%) is substantially bigger than in the Aggregate (0.7%), and some of these inflows were witnessed in the third quarter.
- The shift will **increase the stability of allocations to emerging market debt**. We discussed in some detail last quarter the predominance of “crossover” investors in emerging market debt who have invested opportunistically in emerging markets which were (mostly) not in their benchmark indices. The inclusion of emerging markets in global bond indices will make the investment allocation decision to emerging markets of such fund managers more a function of their market capitalization in world markets, and during periods of uncertainty or volatility in international fund managers will tend to encourage fund managers to take an index-weight, i.e. neutral, position in these markets, rather than liquidate their positions. We in fact **consider the weight of emerging markets in global indices, times funds managed against such indices, as “dedicated” allocations** to emerging markets.

C. Outlook

Following the sharp deterioration of the external environment (global earnings slowdown, higher oil prices, depreciating euro, rerating of the telecom sector) in September, our **baseline outlook** for financing to emerging markets is **guarded**. Absent further shocks, we see emerging markets **subject to conflicting forces**, and expect overall **financing flows to moderate further** in the last quarter, with issuers on bond and equity markets forced to exploit windows of opportunity.

On **emerging bond markets:**

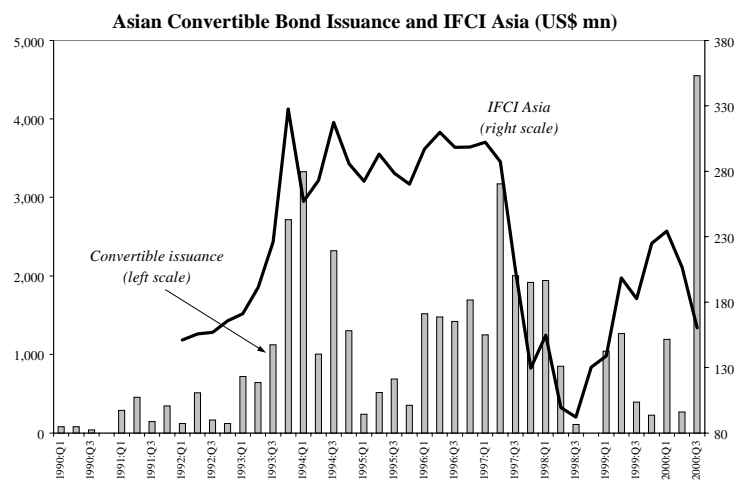
- On the one hand, both the **technicals and fundamentals are good**. There is **no immediate overhang of new issuance**, which stands in sharp contrast to the US high yield, and especially telecom issues, markets. The notable structural change in the

investor base discussed above, with **increasing allocations from US high-grade investors**, will prove supportive. **Mexico's awaited upgrade** to investment grade from S&P, and purchases by high grade fund managers of Mexican bonds from fund managers of dedicated emerging market portfolios will free up the latter's resources for investments in other lower-rated emerging markets. There are a number of other **pending ratings upgrades**. Finally, **net oil exporters comprise 60% of the EMBI+**, and stand to gain from high oil prices.

- On the other hand, the **convergence of yields on emerging market debt with those in the US high yield sector**, and poor prospects for the latter, will constrain the performance of emerging markets (see next section). The environment of **heightened uncertainty** in global markets has pushed dedicated investors to adopt **defensive positions** closer to their benchmarks and to increase holdings of cash. Thus, their appetite for new issues which represent off-index bets such as the smaller sovereigns who exploited the window of opportunity afforded in June-August is likely to be limited. Similarly, it is hard to see much appetite for corporate issuance, which has buoyed recent financing levels, until the prevailing negative view on the TMT sector subsides, though corporates from the oil sector will have good access. We expect fundraising on the bond markets to be dominated by opportunistic prefinancing for next year by the major sovereign borrowers who have already met this year's targets.

The **outlook for emerging equity markets** remains **closely tied to those in the mature markets**.

With substantial proportions of emerging equity markets comprised of **TMT** stocks, they remain vulnerable to gyrations of the Nasdaq. This is **despite their markedly improved valuations** both on a historical basis and relative to the mature markets. The recent **sell-off in the TMT sector**, which has been an important driver of emerging markets fundraising on international equity markets, will **inhibit issuance** going forward. The path of world **oil prices** **remains key** for expectations of



corporate profitability and, therefore, issuance, though issuances from the **energy sector may provide some respite**. With the steep declines in emerging equity markets, especially in Asia, there has been a recent **resurgence in convertible bond issuance** (see chart). Convertible bonds allow borrowers to lower offered coupons in exchange for out-of-the-money call options on the companies' stock. If a segment of the investor base believes the company's stock is "undervalued" and general market volatility is high, then the stock

options are valuable, and we would expect such issues to increase if current conditions continue to prevail.

We expect the **syndicated loan market to remain supportive** of emerging markets, but for **volumes to moderate**. With a heightened awareness of their credit exposures to the telecom sector over the summer, international banks can be expected to focus on the bigger and better telecom credits (in the mature markets) at the **expense of the smaller telecom players in the emerging markets**. On the other hand, they are likely to actively pursue exposures outside the telecom sector in an effort to reduce the concentration of their exposures to the sector, and we see **non-telecom sectors, including emerging market sovereigns, as important beneficiaries**. As the window for international corporate bond issuance closes, we fully expect the syndicated loan market to perform its “lender-of-next-to-last-resort” function as it has done in the past. **Outside the telecom sector**, we expect **continued downward pressure on loan margins**, as international banks’ liquidity remains abundant, and Japanese and other banks compete actively for business, especially in Asia.

D. Risks

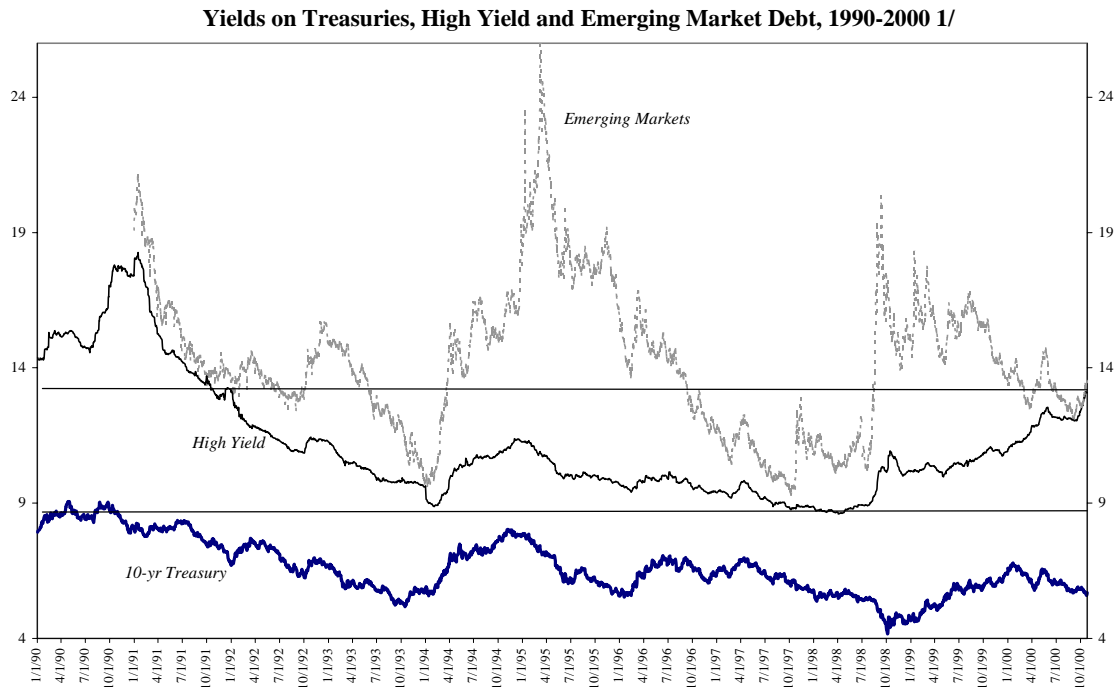
The shift in investor sentiment from concerns about US interest rate hikes in the second quarter to factoring in an economic slowdown in the **third quarter provided a supportive environment globally for fixed income investments**. This, as we have argued, was a major reason for the strong performance of emerging debt markets, and led to a substantial divergence in performance from emerging equity markets. Though expectations of the growth slowdown in the US were fuelled in part by the prospective impact of high oil prices, the latter did not appear to have had a major impact on expectations of inflation in the US or for that matter in other mature markets. A key risk, therefore, remains the possibility of **higher-than-expected inflation** sparking a sell-off in global bond markets, with attendant implications for the emerging debt markets. Sustained **high oil prices** also hold the risk of increasing expectations of a faster slowdown in corporate earnings and global growth, with attendant implications for the mature and emerging equity markets. Despite the recent corrections, in view of the global **rerating of the telecom sector**, which does not as yet appear to have run its course, we maintain on our list of sources of event risk, substantial **further corrections and continued volatility in “old-” or “new-economy” US equities**, that could disrupt emerging markets financing on international capital markets. We also continue to maintain on our list, the possibility of a sharp **correction of the US dollar**. Finally, there is the threat posed, for the first time since the Asian crisis, by the **convergence between yields on emerging debt markets and those in the US high yield sector**, which we discuss in some detail below.

The Emerging Market-High Yield Nexus

Yields on **emerging market debt continued to inch closer to those in the US high yield sector** during the third quarter. Measured by the yield differential between the EMBI+ and the Merrill Lynch High Yield index, from a peak of close to 1200 bps following the Russian crisis in September 1998, and around 800 bps in October 1999, this differential fell from 113

bps at the end of the second quarter of this year to 2 bps by early September (see charts below).

The historical behavior of relative yields in the two sectors can be summarized as follows:



1/ In order to analyze a long enough time period several versions of the EMBI were used (EMBI for 1/1/90-12/30/97, EMBI+ for 12/31/97-6/30/98, EMBI+ (Adjusted for Russia) for 7/1/98-4/13/00 and EMBI+ for 04/14/00-10/25/00).

- Average **emerging market yields have generally been wider** than those in the high yield sector.
- Episodes of convergence in the past have generally been brief, and **followed by sharp and persistent widenings of emerging market debt**, both on an absolute basis and relative to the high yield sector. These widening phases lasted for **extended periods**.

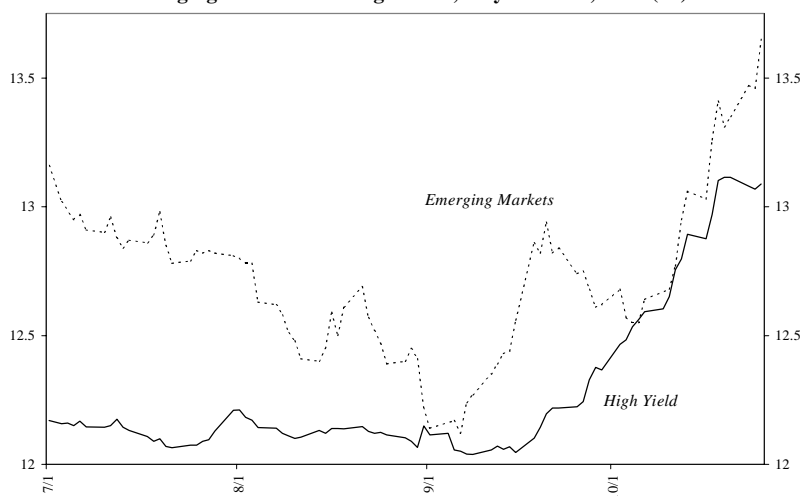
The previous episode of convergence in October 1997 is widely viewed as representing the pinnacle of over-exuberant investor behavior which elevated flows to emerging market debt, compressing spreads (over Treasuries) to unsustainable historic lows in the run up to the Asian crisis. With the **compression of the differential having been a leading indicator of big cycles of widening** in emerging market debt spreads, the **recent compression of the differential naturally raises a number of questions**:

- The US high yield market is **important for the emerging debt market** because fund managers in the high yield sector are an important **source of “crossover” investor flows**

into emerging market debt, and the two markets represent important **competing asset classes** for global and high grade fund managers.

- The behavior of relative yields suggests a **dynamic where crossover investor inflows** from the high yield sector into (higher yielding) emerging market debt **continued until spreads were bid down to those in the high-yield sector**. Perceived **changes in the riskiness of emerging markets, triggered** by the monetary policy tightening cycle in the US during 1994, and the Asian crisis in October 1997, then prompted **investors to do a “double take.”** With judgements on **relative value between the two asset classes being a highly subjective exercise** (see Box 3), the **retrenchment from emerging markets then became both widespread and massive**.
- A **key difference between the present period** of compression and the last two episodes of October 1997 and December 1993 is that it has **occurred at a higher level of average absolute yields** on both emerging market debt and the high yield sector. Those episodes of compression occurred in environments of generally falling and low yields, with the convergence of emerging market yields to those in the high yield sector occurring at, or near, low points of yields in the high yield sector. The most recent compression has in contrast occurred when yields in the high yield sector have been rising. This conforms with our view that the **narrowing of the differential recently has resulted primarily from differential movements in fundamentals in the two sectors**—with fundamentals improving in emerging markets and deteriorating in the high yield sector—**rather than any broad based hunt for yield** from the high yield sector into emerging markets.

Emerging Markets and High Yield, July-October, 2000 (%)



- The general market consensus is that deteriorating fundamentals will continue to pressure spreads in the high yield sector wider, while improvements in emerging market fundamentals will tend to push their spreads narrower. With no compelling case for spreads in one sector to be dominated by the other (see Box 3) it should **not be surprising to see emerging market yields fall below** those in the US high yield sector.
- In our view, however, which is borne out by the recent behavior of yields in the two sectors (see chart), since the two represent **competing asset classes for a large variety**

of investors, absent large negative shocks in either market, **yields on emerging market debt will remain constrained from moving too far below** those in the US high yield sector, and this will **inhibit issuance**.

Box 3. Are Emerging Market Spreads Bound by those on US High Yield?

Relative value, especially when comparing US corporates that comprise the high yield sector with emerging market sovereigns which comprise the emerging debt market, is a **highly subjective exercise**. A variety of “fundamental” factors argue alternatively in favor of lower spreads on one asset class over the other:

- **Credit quality of issuers as measured by ratings is different**, with emerging markets in the EMBI+ having, on average, a higher credit rating. While the high yield sector is, by definition, limited to non-investment grade issuers, emerging market indices include investment grade sovereigns. This argues in favor of **lower** spreads on emerging market debt.
- **Rating changes**—especially downgrades—**have tended to be more frequent for corporates** than for sovereigns, with this higher ratings volatility arguing in favor of **lower** spreads on emerging market debt.
- Besides credit quality as measured by formal ratings, however, **directly estimating default risk for sovereigns** by simulating a country’s balance sheet as is done for a corporate is **much more difficult**. Besides, few countries publish such balance sheets. Debt-issuing corporates are in general subject to stricter disclosure requirements requiring them to publish balance sheets, arguing in favor of **higher** spreads on emerging market debt.
- The **high yield sector has a larger number of issuers**, arguing for greater diversification benefits and, therefore, **higher** spreads on emerging market debt.
- The “**rules of the game**” for **international lending** and investment, **especially as they apply to sovereign borrowers**, have always been, and remain, **quite different and much less clear** than those that apply within domestic boundaries to corporates. The associated uncertainty with the resolution of sovereign debt argues in favor of **higher** spreads on emerging market debt.
- The **experience with default and recovery rates on sovereign bonds remains limited** compared to that on US corporate bonds. Market participants have generally ascribed lower expected recovery rates from sovereign bonds than US corporate bonds, typically 18-20%, while recovery values on corporate bonds have averaged around 45%, arguing in favor of **higher** spreads on emerging market debt. Some observers have argued that expected recovery values in light of recent experience with restructuring Russia’s and Ecuador’s external debt (see Box 1 above) should be raised.
- **Emerging market debt is more “liquid”** than US high yield debt, being traded more actively. A premium paid for this liquidity would argue for **lower** spreads on emerging market debt. However, this higher liquidity has also meant higher inflows and outflows as investors have traded emerging market debt as a proxy for wider credit market exposure, and, on net, **higher volatility**, arguing for **higher** spreads on emerging debt markets.

These factors yield **no clear winner**, implying there is **no fundamental reason why spreads on emerging market debt should be bound by those in the US high yield sector**. The relative importance of these factors is, moreover, likely to change over time, suggesting that **relative yields could and should switch around over time**.