

## Box 2

### THE SPILLOVER OF THE SEARCH FOR YIELD TO NON-TRADITIONAL EMERGING MARKET ASSETS

As investors came to believe that the upside potential of traditional emerging market debt – broadly defined as foreign currency-denominated debt issued by EME sovereigns with an established credit record – became more limited after substantial spread compression, they began to shift their attention to securities that promised higher returns within the EME universe. These included external debt issued by less established EME issuers, EME local currency bonds and EME equities. This Box describes recent trends in the structure and breadth of EME markets and assesses their implications for market stability.

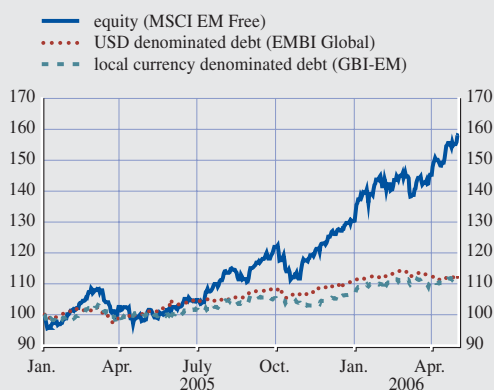
Many of newer EME issuers with low credit standing have successfully placed bonds in international capital markets amid the tight spread environment in recent years. Some of these non-traditional issuers have migrated into mainstream portfolios owing to their inclusion in benchmark bond indices (including Pakistan, Serbia and Vietnam, following their inclusion into the EMBIG benchmark index during 2004/2005). In spite of this, the average credit quality of the typical EME market portfolio has considerably improved because of the small weight of these issuers in total asset allocations and because of rating upgrades of some countries with high market capitalisation (e.g. Brazil, Russia and Turkey) in benchmark indices (see Chart 1.26). Some non-traditional issuers (such as Nigeria) have improved their fundamentals due to high commodity prices and their bond spreads tend to be correlated with traditional EME debt, which is also sensitive to this factor. However, other issuers (such as Serbia) would appear to have contributed to the diversification of investors' portfolios, as is also the case with distressed or illiquid EME securities.

Local currency debt issued by EMEs has also made rapid inroads into mainstream portfolios, as demonstrated by the availability of benchmark indices for such securities since mid-2005. The share of local currency-denominated bonds in total marketable EME sovereign debt has steadily increased at the expense of foreign currency debt since the late 1990s, in particular in Latin America and emerging Europe.<sup>1</sup> This has reflected structural changes in EME securities markets, including deliberate policies to develop domestic debt securities markets. A growing local base of institutional investors has also contributed, often fostered by pension reform and also helped at times by local currency issuances by regional intergovernmental institutions. In addition, foreign investors increased the weight of local currency EME debt in their portfolios, as swift disinflation and the perception that some currencies were undervalued following periods of financial turmoil raised their return expectations, with the downside risks in this context mitigated by improved macroeconomic stability and better economic governance in EMEs. The increased availability of structured or 'access' products (such as credit-linked notes) decisively contributed to the broadening of the foreign investor base, as did the availability of local currency bonds issued in international markets (by both sovereigns and corporates, above all in Latin American economies such as Mexico, Brazil and Colombia). The tightening of valuations of established EMEs' local debt led to growing foreign interest in African local debt markets (e.g. Ghana, Namibia, Tanzania and Zambia), which provides a further indication of the spillover effects of the search for yield within EME asset class segments.

<sup>1</sup> Foreign currency sovereign debt has traditionally been low in Asian EMEs.

**Chart B2.1 The performance of EME equity markets in comparison to EME debt**

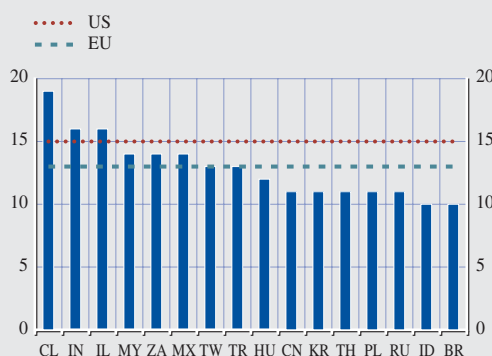
(index Jan. 2005 = 100)



Source: Bloomberg.

**Chart B2.2 EME equity market valuations in international comparison**

(February 2006, price-earnings ratios, %, 12 month trailing)



Source: Deutsche Bank.

Note: CL = Chile, IN = India, IL = Israel, MY = Malaysia, ZA = South Africa, MX = Mexico, TW = Taiwan, TR = Turkey, HU = Hungary, CN = China, KR = South Korea, TH = Thailand, PL = Poland, RU = Russia, ID = Indonesia, BR = Brazil.

In addition, EME equities appear to be the latest beneficiary of the global search for yield within the broad EME asset class. Net portfolio equity flows to EMEs reached an all-time high of USD 61.5 billion in 2005, according to the Institute of International Finance, with indications that these inflows accelerated in the early part of 2006. This led to a substantial price rally in EME equity markets after mid-2005 (see Chart B2.1). As a result there was a significant narrowing of the valuation gap between EME companies and those of mature economies with some valuations even rising above those of mature economies (see Chart B2.2).

Overall, the spillover of the search for yield into non-traditional EME assets appears to have reflected not only ample global liquidity, but also a new-found appetite in the market for apparently undervalued assets on account of structural changes underpinning the broad EME asset class. The increased appetite of public and private pension funds for EME securities (primarily fixed income) has been just one example of this. To some extent, these investments should contribute to the diversification of risk in investors' portfolios.

Notwithstanding the benefits of the deepening and broadening of the EME asset class, three principal risks for financial stability can be identified. First, high exposure to certain (and perhaps more risky) market segments by single market participants cannot be ruled out, particularly as the combination of ample liquidity and low volatility on a global scale has placed fund managers under increasing pressure to outperform both their peers and the applicable benchmarks. In the current environment, market participants in the broad EME asset class tend to see periods of volatility as an opportunity to engage in opportunistic purchases. The largely temporary correction in EME financial markets following the outlook change for Iceland's sovereign debt rating in end-February 2006 may be seen as an illustration of this.

Second, certain sub-segments may suffer from overstretched valuations. For example, most EME equity markets still seem to be trading at a discount compared to mature markets, but price-earnings ratios indicate that some EME equity valuations have started to look tight on account

of the specific risks associated with these assets. Such performance is often justified on the basis of significantly improved balance sheets and the steady earnings growth prospects of EME firms (due to exposure to the commodities cycle, or higher growth potential relative to mature economies, for example). However, in spite of improvements in this context, EME firms tend to lag behind mature economy firms in terms of international accounting and disclosure standards and corporate governance levels. A parallel case may be drawn concerning certain similarly rated fixed income sovereign credits for EMEs which nonetheless exhibit significant differences in terms of the perceived quality of the institutions underpinning economic governance.

Third, while the overall share of less traditional EME assets in the portfolio of most investors has remained small, specific risks may have to be reassessed under more adverse market conditions, regardless of whether developments underpinning these asset segments are deemed to be structural or cyclical in nature. These include currency risk (which appears to be hedged only selectively), the convertibility risk of local markets, and liquidity risk. Following the considerable yield compression and currency appreciation of recent years, returns on local EME debt may be subject to differentiated corrections, in particular in economies where disinflation has not progressed as fast as anticipated, or in those with high current account deficits. The concentration of foreign investors toward the long-end of yield curves in local markets is an additional concern in some cases, particularly in the event of significant financial turmoil involving widespread portfolio rebalancing among market participants. In addition, the correlation between EME equity and external debt markets has in some cases been considerable, perhaps due to the fact that the earnings prospects of EME companies are affected by factors that also impact market assessments of sovereign default risk. This implies that portfolio diversification, which is a key motive behind foreign interest in EME assets, might be hampered. In addition, the market structure for some of these assets may also be of concern, in particular that of EME equity markets which appear to be dominated by hedge funds and short-term-oriented cross-over investors. This suggests that increased purchases by investors with a longer-term view (such as asset management firms) may not suffice to offset the forced selling of assets by leveraged investors in the event of a large and negative shock to these market segments.

In the medium-term, the structural changes to the broad EME asset class which have underpinned the extension of “search for yield” to non-traditional EME assets should contribute to more stable and diversified financing and investment patterns for both borrowing economies and international investors. However in the short-term, concerns about overstretched valuations in certain market segments have not been dispelled.