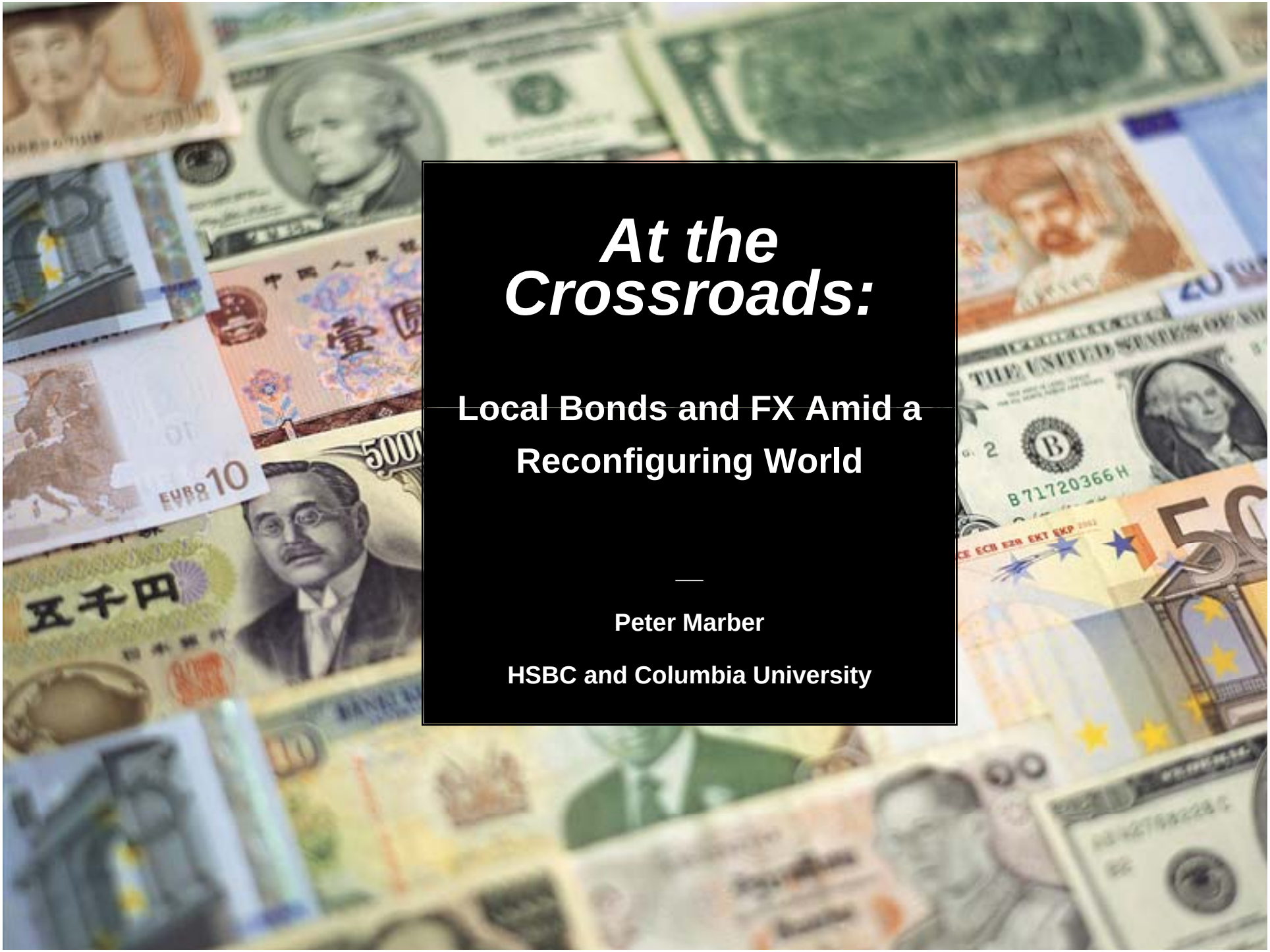


At the Crossroads:

Local Bonds and FX Amid a Reconfiguring World

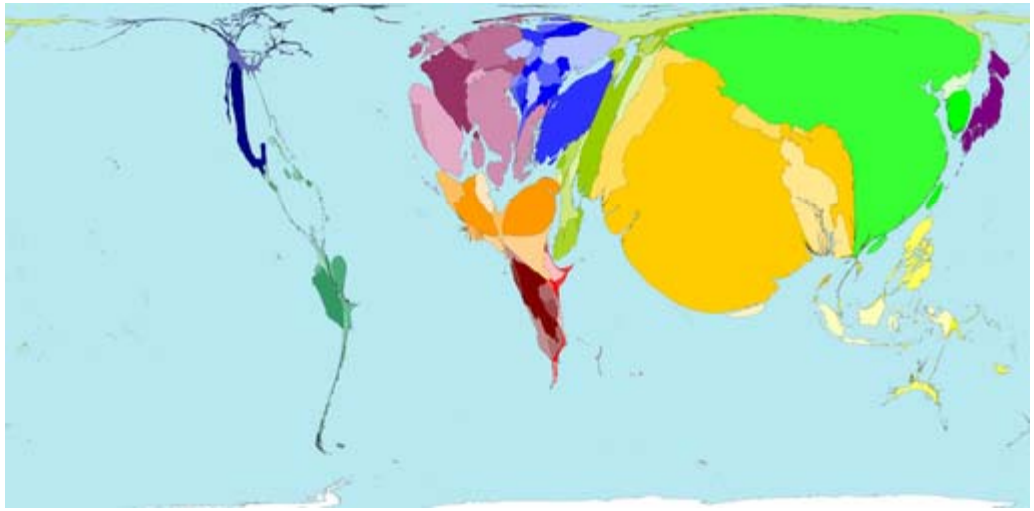
Peter Marber

HSBC and Columbia University

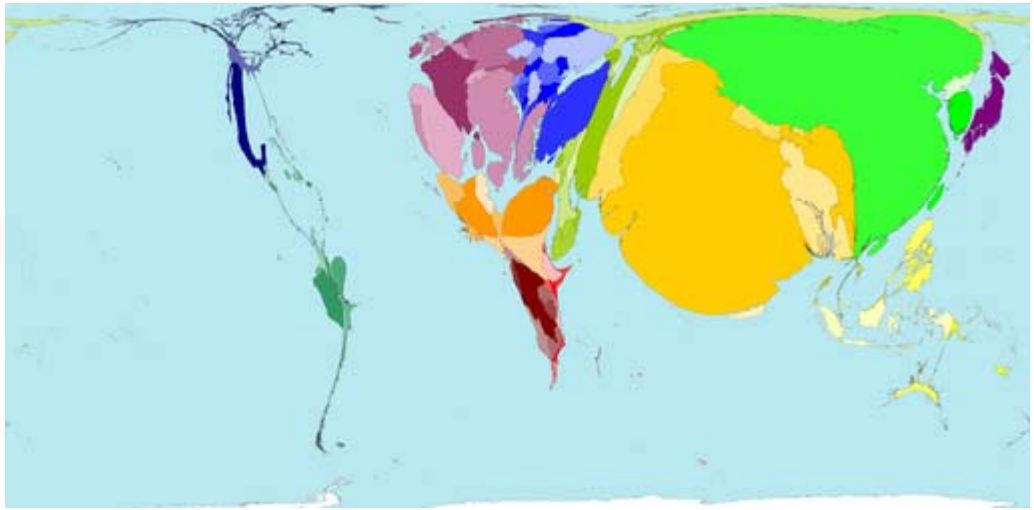
“The Elephant in the Room” – Globalization

- **More interconnected than ever before**
  - **Instantaneous mobile capital**
  - **Unprecedented, complex linkages**
- **Rise of new economic and financial powers**
  - **Their actions affect the global system**

World Output in Year 1 CE



World Output in Year 1 CE

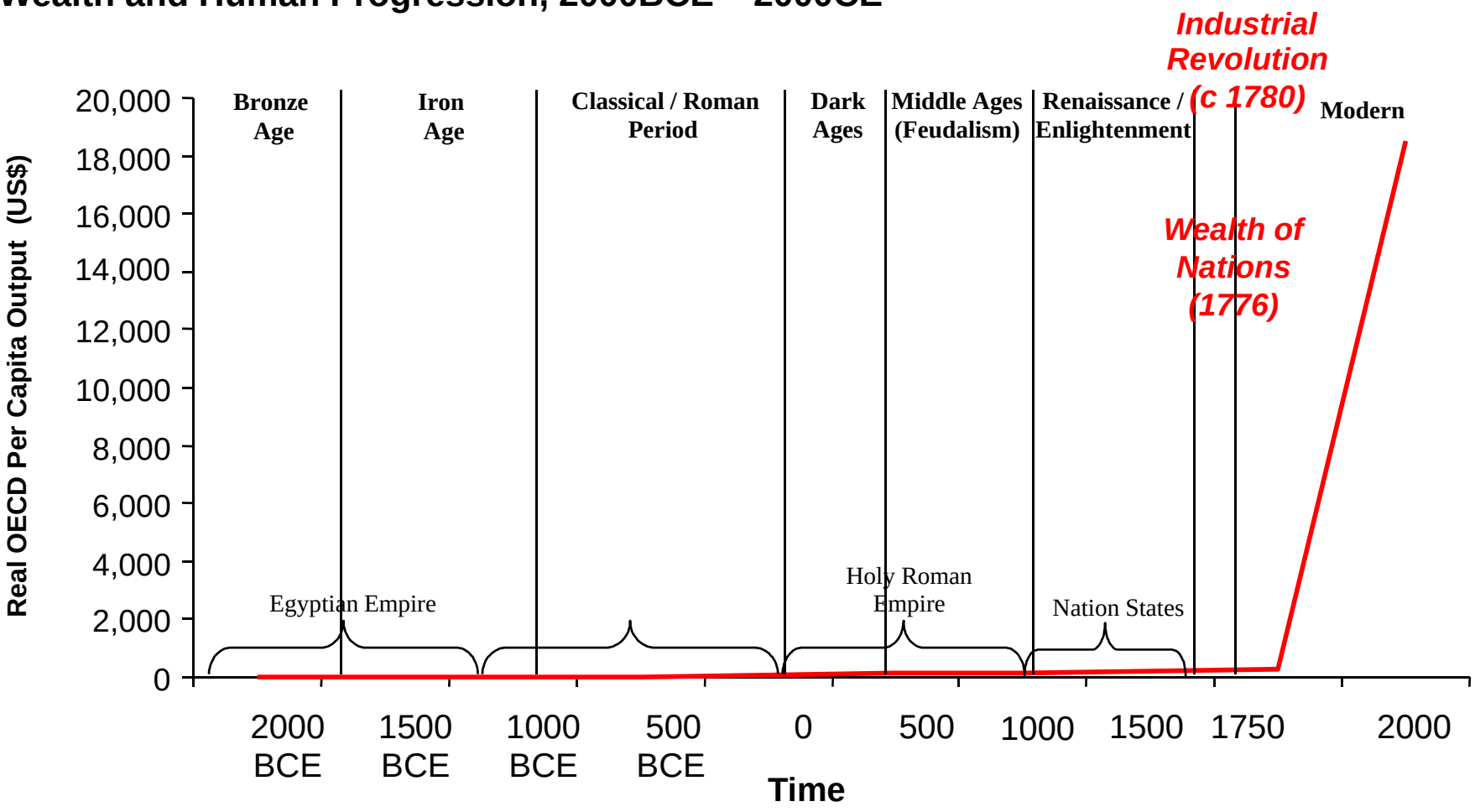


Source: Worldmapper. © Copyright SASI Group (University of Sheffield) and Mark Newman (University of Michigan).

- **Country wealth and output is linked to human productivity and population growth**
  - **Historically, countries with more people were the largest economies**
  - **Little difference in human output until the Industrial Revolution in early 19th century**
  - **This has been for the human species for millennia up until the last 200 years**

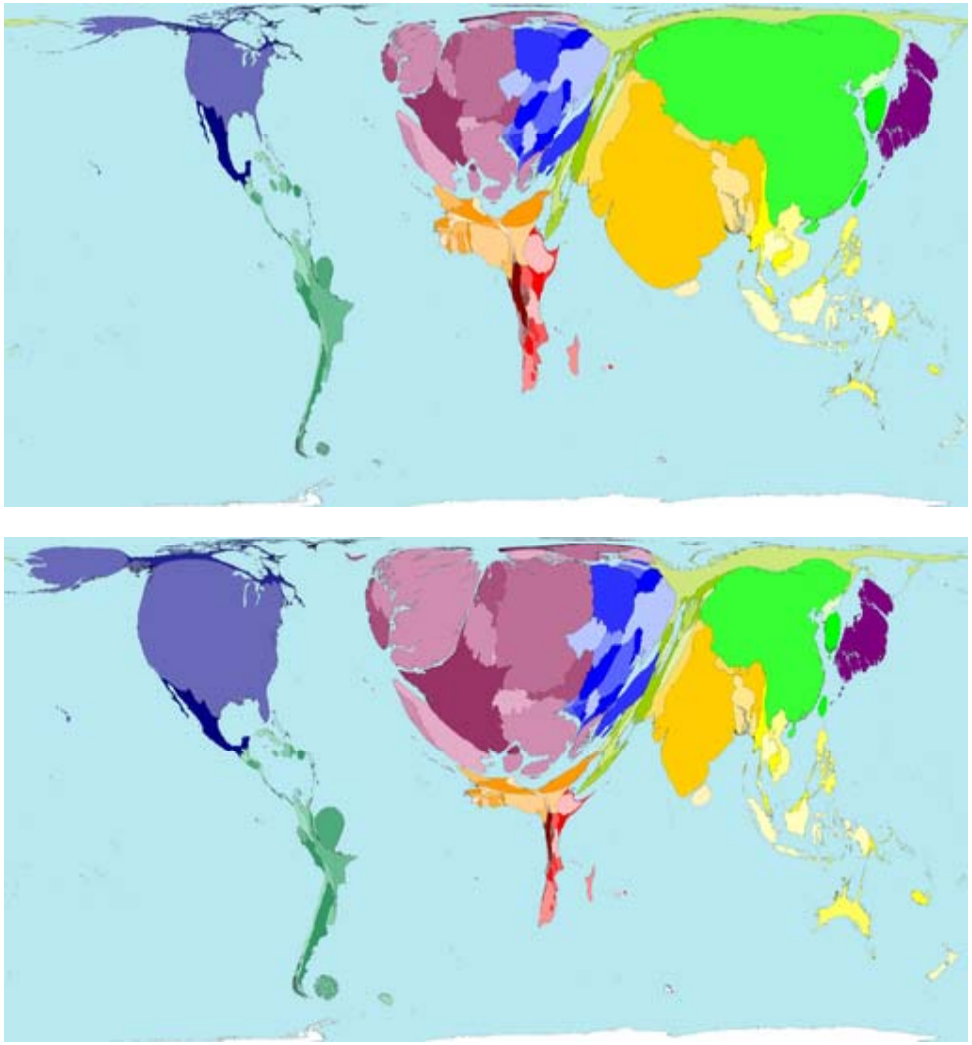
Increased Human Output is a Recent Phenomenon

Wealth and Human Progression, 2000BCE – 2000CE



Source: Money Changes Everything: How Global Prosperity is Reshaping Our Needs, Values, and Lifestyles, Peter Marber, 2003.

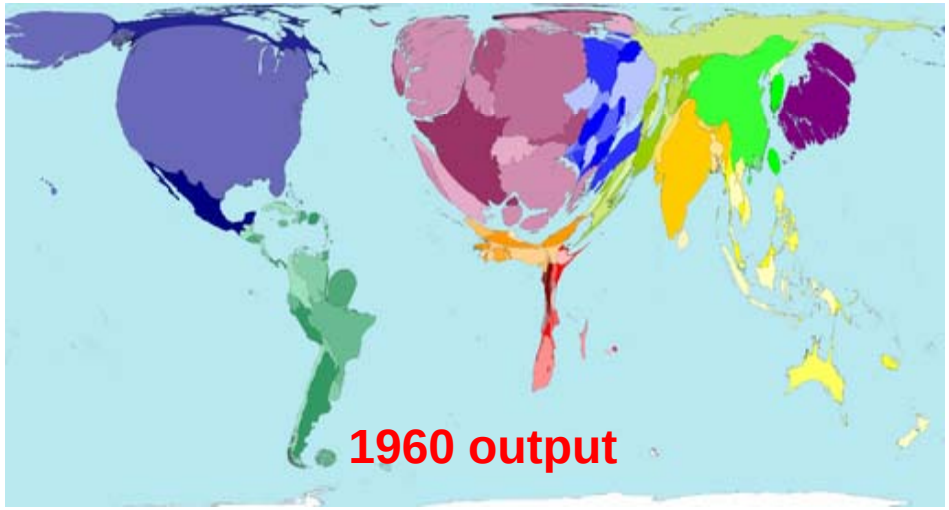
By 1900, Global Population and Productivity Started to Change Dramatically

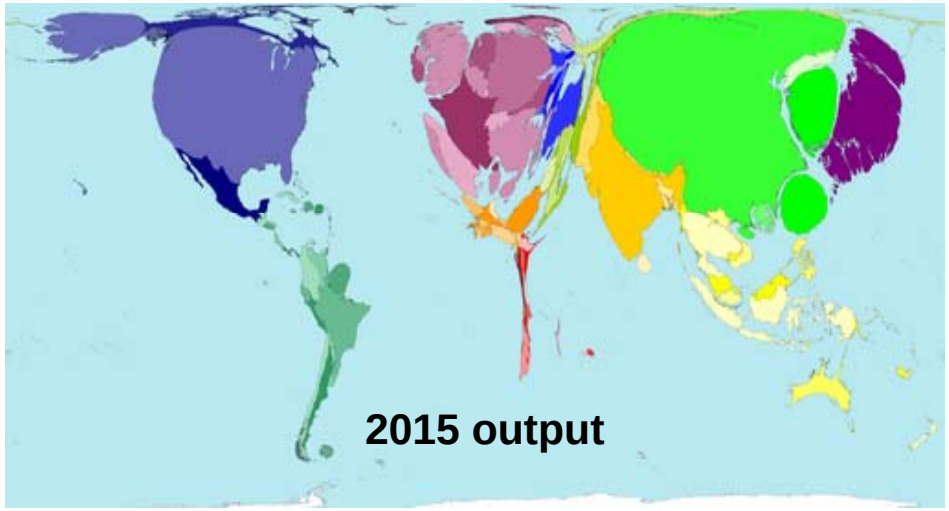


- **Seminal changes in less than one century**
  - **Industrial Revolution in the West, almost non-existent in Asia and Africa**
  - **Europe and the U.S. output per capita dramatically increases; mass education key to increasing output**
  - **The "Western" dominated global economy is born**
    - **But it won't last that long**

Source: Worldmapper. © Copyright SASI Group (University of Sheffield) and Mark Newman (University of Michigan). HSBC Global Asset Management

Technology Proliferation and Free Market Economics has Created a Different Global Economy Since 1960





Source: Worldmapper. © Copyright SASI Group (University of Sheffield) and Mark Newman (University of Michigan).

- **1960: 150 Years After the Industrial Revolution**
  - **European and American populations grow and become more productive**
  - **China and India stagnate in terms of individual output**
  - **US becomes the largest single country economy**
- **2015: world shifts towards pre-Industrial Revolution period**
  - **China and India rising again**
  - **Some new countries rising**
  - **Older wealthy economies slowing**

World economic leaders

1820-2050F

1820		1870		1950		2005		2050F	
China	**33%**	China	**17.20%**	US	**27.30%**	US	**20.30%**	China	**28.10%**
India	**16%**	India	**12.20%**	USSR	**9.60%**	China	**14.60%**	US	**21.90%**
France	**5.50%**	UK	**9.10%**	UK	**6.70%**	Japan	**6.60%**	India	**17.20%**
Russia	**5.40%**	US	**8.90%**	Germany	**6.50%**	India	**5.90%**	Japan	**4.80%**
UK	**5.20%**	Russia	**7.60%**	China	**5.00%**	Germany	**4.10%**	Brazil	**4.40%**

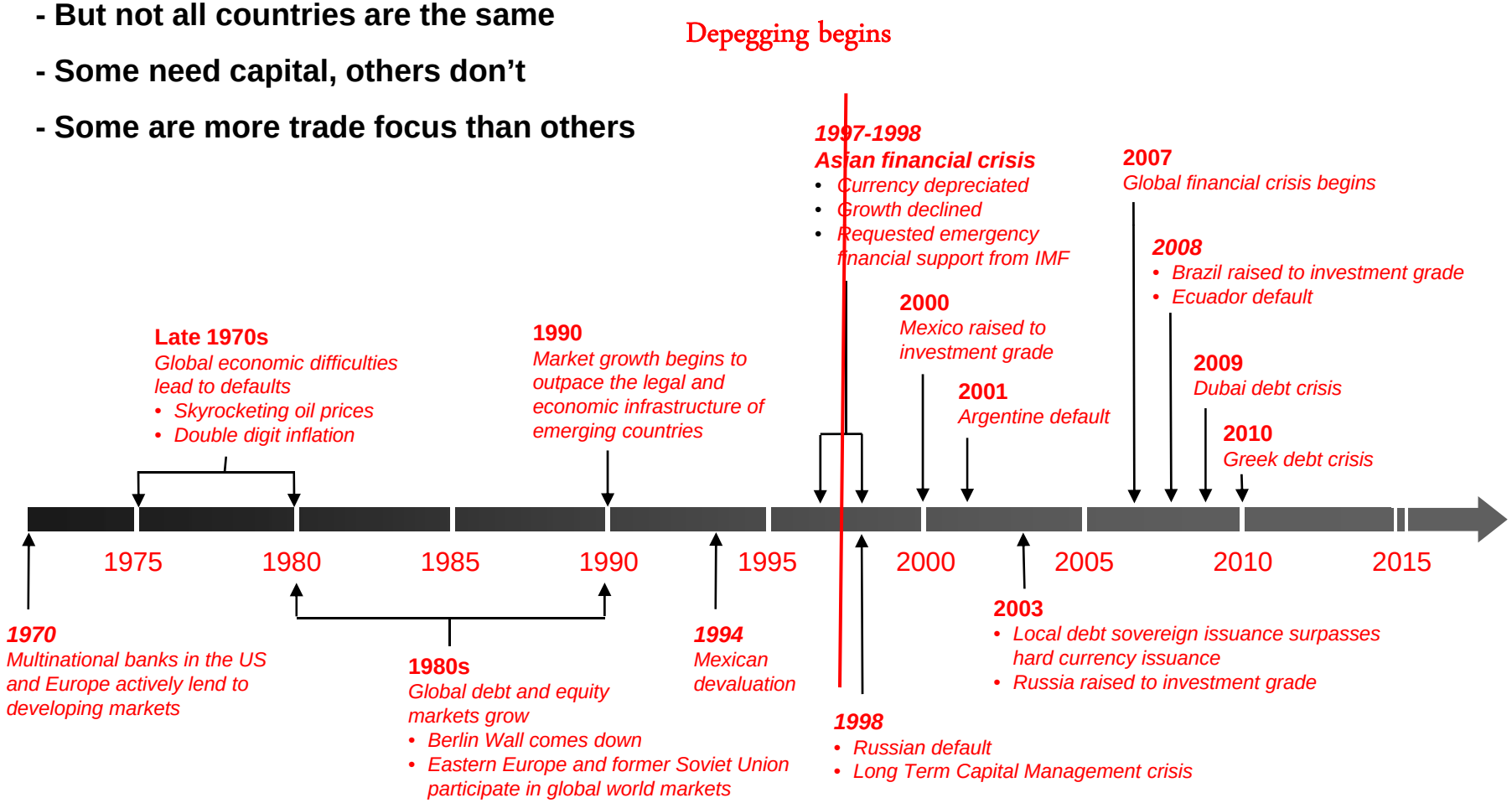
Represents percentage of world GDP.

Sources: OECD, World Bank, Goldman Sachs (2005).

Maturation of Emerging Markets in Recent Decades

*** As governments have undergone reform, emerging markets economic policies have greatly improved and continue to**

- **But not all countries are the same**
- **Some need capital, others don't**
- **Some are more trade focus than others**



World Financial Momentum is Shifting

EM hard currency reserves, US$billions, 1996-2010

Country	Late 1996	2010
China	89	2,399
Hong Kong	60	260
India	18	259
Indonesia	15	66
Malaysia	25	93
Philippines	8	44
South Korea	36	264
Thailand	38	134
Taiwan	85	348
Singapore	72	207

Country	Late 1996	2010
Mexico	18	91
Brazil	58	239
Argentina	14	43
Venezuela	8	53*
Poland	17	73
Russia	12	438
Hungary	9	43
Czech	13	40
South Africa	1	32
Egypt	1	32

Source: JP Morgan Chase, World Bank, Bloomberg, 2Q 2010
**Estimate*

Theoretical Currency Valuations: Emerging Markets Undervalued?

Top 10 industrialized economies vs. emerging economies

GDP vs. PPP highlights potentially overvalued and undervalued currencies

	GDP	PPP	GDP% of PPP
US	**14,224.58**	**14.224.58**	100.00%
Japan	**5,069.89**	**4154.59**	122.03%
Germany	**3,306.76**	**2,769.01**	119.42%
UK	**2,206.41**	**2,118.45**	104.15%
Switzerland	**493.03**	**323.033**	152.63%
Sweden	**392.509**	**327.957**	119.68%
Denmark	**317.82**	**192.269**	165.30%
Canada	**1,344.89**	**1,278.46**	105.20%
Australia	**960.302**	**815.828**	117.71%

	GDP	PPP	GDP% of PPP
China	**4,862.72**	**8,956.98**	54.29%
Brazil	**1,499.04**	**2,012.54**	74.48%
South Korea	**837.122**	**1,386.17**	60.39%
India	**1,269.31**	**3,615.22**	35.11%
Mexico	**861.143**	**1,600.66**	53.80%
Russia	**1,322.10**	**2,115.73**	62.49%
Turkey	**620.749**	**872.292**	71.16%
Poland	**738.798**	**687.874**	63.79%
South Africa	**285.822**	**500.051**	57.17%

Source: IMF. Data as of May 2010.

The Economist's *Big Mac Index* and Theoretical Currency Value (July 2010)

The Economist's Big Mac index is based on the theory of purchasing-power parity (PPP), the idea that exchange rates should move to equalize the prices of a basket of goods and services across different countries.

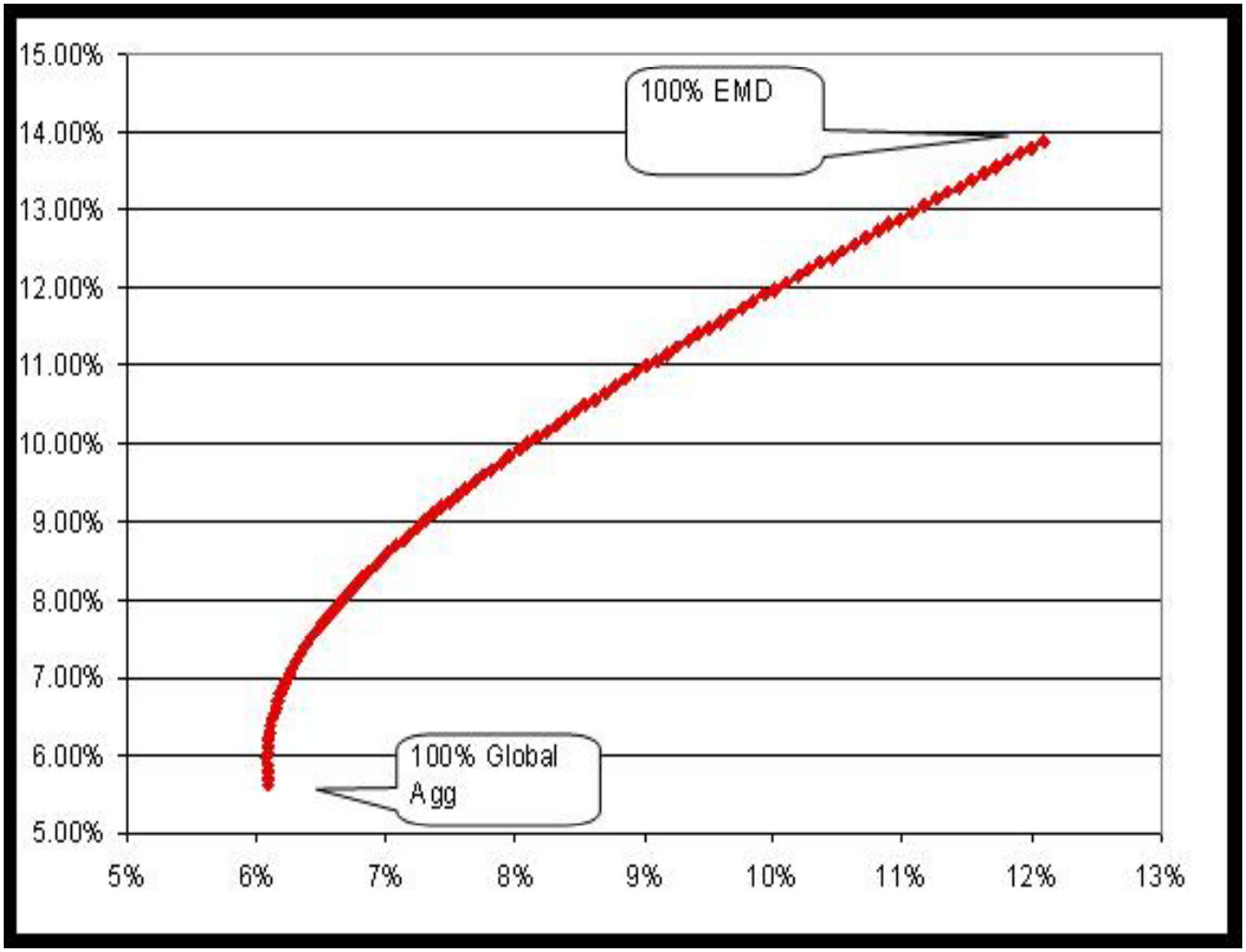
The Economist uses a Big Mac as their simple baskets. For example, the cheapest burgers are in Hong Kong and China, at $1.90-95, compared with an average American price of $3.73. This implies that the yuan is 48% undervalued relative to its Big Mac Dollar-PPP. On the same basis, the Euro is about 25% overvalued, the Yen fair valued.

G7 Investors are Underweight EM Bonds

- **EM Bonds are Roughly 20% of Global Bond market**
  - **Not fully investable**
  - **China and India notable**
- **G7 Investors Have Less than 5% of their Bond Portfolios in Emerging Markets**
  - **Huge migration beginning**

Adding Local Debt to a Traditional Global Bond Portfolio, 1999-2010

Return (p.a.)



Risk (p.a.)

- ***For the same risk, a 7% allocation increased returns by 58 bps***

- ***Add 48%, returns increase by 350 bps while volatility only increases 223 bps.***

Correlation of Emerging Markets Debt to Other Asset Classes (1999-2009)

Index	EMD Hard Currency	EMD Local Currency
EMD Hard Currency	**1.00**	**0.65**
EMD Local Currency	**0.65**	**1.00**
Global Developed Equity	0.65	0.64
European Equity	0.59	0.75
US Equity	0.61	0.56
Global Bond – Unhedged	0.46	0.66
Global Bond – Hedged	0.20	0.15
European Fixed Income	0.22	0.06
US Fixed Income	0.59	0.42

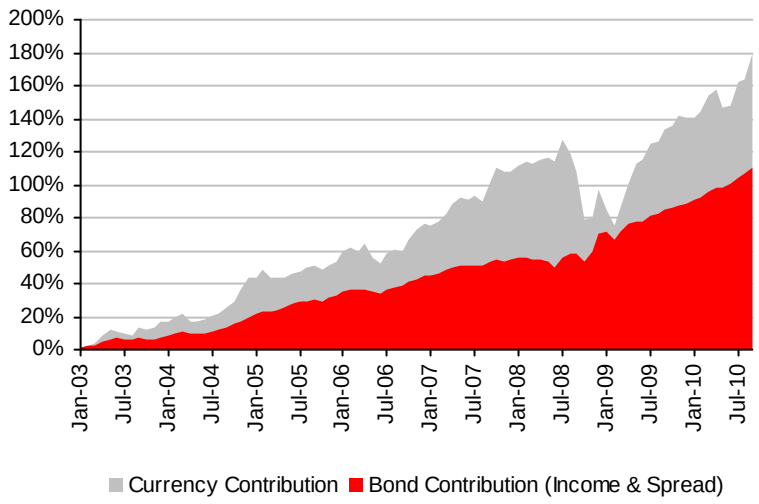
Source: JP Morgan, Barclays Capital, MSCI; Data from 31 July 1999 – 31 July 2009. EMD Hard Currency = JPM EMBIG; EMD Local Currency = JPM ELMI+; Global Developed Equity = MSCI World; European Equity = MSCI Europe; US Equity = MSCI US; Global Bond – Unhedged = JPM GBI Unhedged US$; Global Bond – Hedged = JPM GBI Hedged US$; European Fixed Income = BC Euro Aggregate Hedged US$; US Fixed Income = BC US Aggregate

Emerging Markets Local Debt

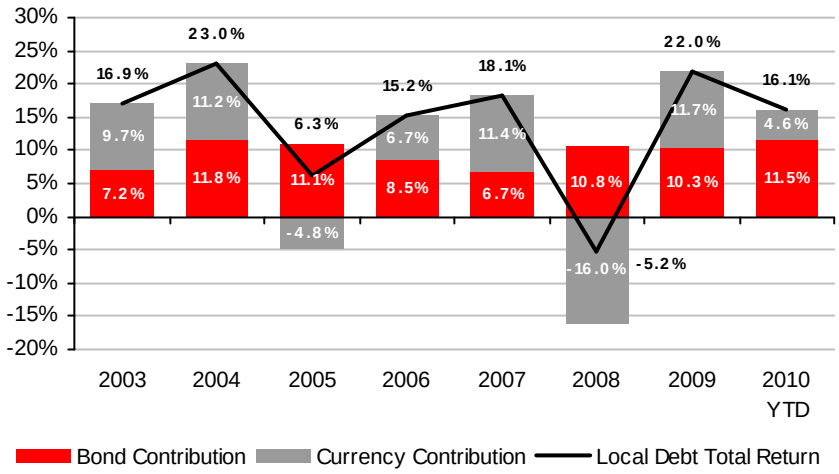
Interest rates and FX are important components

- **Bond (Income/Spread) and FX are both important sources of return for Local Debt**
- **2005 and 2008 represent examples when rates compensated for USD appreciation**

Cumulative Return of the Return Components of Emerging Markets Local Debt



Annual Returns Broken Out by Bond (Income/Spread) and Currency Components



Data as of 30 September 2010. Source: JP Morgan.
Emerging Markets Local Debt is represented by JP Morgan GBI-EM Global Diversified Index. Past performance is not indicative of future performance.

Real Interest Rate Differentials, October 2010

	US	Thailand	Israel	Peru	Korea	Malaysia	Colombia	Poland	Philippines
2011e CPI	*1.30%*	*2.10%*	*2.00%*	*2.40%*	*3.20%*	*2.60%*	*3.60%*	*2.40%*	*4.90%*
O/N	0.25%	1.25%	1.50%	1.50%	2.00%	2.50%	3.00%	3.50%	4.25%
1 YR	**0.24%**	**1.99%**	**2.06%**	**2.59%**	**3.20%**	**2.87%**	**3.75%**	**3.35%**	**4.66%**
3 YR	**0.78%**	**2.77%**	**2.65%**	**1.89%**	**3.92%**	**3.16%**	**5.47%**	**4.97%**	**5.39%**
5 YR	**1.52%**	**3.04%**	**3.09%**	**4.85%**	**4.49%**	**3.35%**	**7.02%**	**5.42%**	**6.10%**
10 YR	**2.82%**	**3.42%**	**3.54%**	**5.64%**	**4.85%**	**3.86%**	**7.24%**	**5.81%**	**7.39%**
1Y - O/N	-0.01%	0.74%	0.56%	1.09%	1.20%	0.37%	0.75%	-0.15%	0.41%
3Y - 1Y	0.54%	0.78%	0.59%	-0.70%	0.72%	0.30%	1.72%	1.61%	0.72%
5Y - 1Y	1.28%	1.05%	1.03%	2.26%	1.29%	0.49%	3.27%	2.06%	1.44%
10Y - 1Y	2.58%	1.43%	1.48%	3.05%	1.65%	0.99%	3.49%	2.46%	2.73%
5Y Real	0.22%	0.94%	1.09%	2.45%	1.29%	0.75%	3.42%	3.02%	1.20%
10Y Real	1.52%	1.32%	1.54%	3.24%	1.65%	1.26%	3.64%	3.41%	2.49%

	Mexico	India	Hungary	S. Africa	Indonesia	Turkey	Egypt	Brazil
2011e CPI	3.80%	5.80%	2.90%	5.50%	6.70%	7.90%	9.70%	4.60%
O/N	4.50%	5.25%	5.25%	6.50%	6.50%	6.50%	8.25%	9.50%
1 YR	**4.76%**	**6.49%**	**5.60%**	**7.07%**	**5.83%**	**7.90%**	**8.51%**	**11.26%**
3 YR	**5.25%**	**7.30%**	**6.83%**	**7.91%**	**7.08%**	**8.56%**	**8.85%**	**12.02%**
5 YR	**5.81%**	**7.69%**	**6.91%**	**7.52%**	**7.42%**	**8.70%**	**9.41%**	**12.06%**
10 YR	**6.54%**	**7.82%**	**7.09%**	**8.34%**	**7.89%**	**n.a.**	**10.85%**	**12.02%**
1Y - O/N	0.26%	1.24%	0.35%	0.57%	-0.67%	1.40%	0.26%	1.76%
3Y - 1Y	0.49%	0.81%	1.23%	0.84%	1.25%	0.66%	0.34%	0.76%
5Y - 1Y	1.05%	1.20%	1.31%	0.45%	1.59%	0.80%	0.90%	0.80%
10Y - 1Y	1.78%	1.33%	1.49%	1.27%	2.06%	n.a.	2.34%	0.76%
5Y Real	2.01%	1.89%	4.01%	2.02%	0.72%	0.80%	-0.29%	7.46%
10Y Real	2.74%	2.02%	4.19%	2.84%	1.19%	n.a.	1.15%	7.42%

- Low absolute and relative returns are creating unprecedented investor flows and pressure on emerging markets

Local Bond Markets are Smaller, Less Developed, and Less Liquid than G7 Bond Markets

- US bond market is approximately 160% of GDP, Europe 140%
  - Emerging markets much less – 33% on average
    - Mexico is 30%, Turkey is 35%; Brazil only 20%, China 28%
- Emerging market corporates even less developed
  - Maybe 1/3 or less in EMs versus 2/3 in mature economies
- Turnover a fraction of mature markets
  - 1500% per annum in US vs. 200-500% in EMs

Time for New Bretton Woods?

- **Structurally, the center of economic and financial activity is shifting quickly**
  - Imbalances have been building since the EM crises of the 1990's
  - Older powers contending with effects from the credit crisis
- **Local bond markets need to be developed in coordination with other economic and monetary policies**
  - Lack of consensus poses huge risks
  - G20 to the rescue?