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## What to expect for 2005

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- **We try to look into 2005 with the benefit of the experience of the past year.**
- **But first a quick note on the remainder of 2004: We remain constructive and expect the current supportive credit environment to continue and to contribute to still tighter spreads.**
- **2004 has been a difficult year for the market; still EM has returned approximately 9% year to date and there have been several positives this year:**
  - **Fundamentals have continued to improve across growth, fiscal, and external indicators. This will make near-term default risk very low for the vast majority of credits.**
  - **The market has demonstrated the ability to perform well even as the Fed hikes.**
  - **The carry, which, as spreads tighten, represents a larger portion of expected returns, has been earned.**
- **However, there were also some negatives that are important to keep in mind:**
  - **Sub-investment grade Sovereigns have underperformed US High Yield Corporates.**
  - **EM has been substantially more volatile than US Corporates. In our view this is perhaps the biggest negative of 2004.**
- **We suspect that the relatively high volatility of EM spreads in 2004 will have a couple of negative repercussions: (i) weakening the case for further crossover investment in the non-investment grade-rated sector, and (ii) making current spread differentials between EM and Corporates look less compelling.**
- **If we then add the risk of higher US rates – which raises the question of whether EM would be able to perform well in spread terms when long-dated US yields rise – and the fact that spreads are historically quite low, we believe it makes sense to get ready for a reduction in risk.**
- **We believe crossover investors should sit on the sidelines and wait for better opportunities to buy EM.**
- **We recommend dedicated investors with long beta positions to use the year-end strength to rein in some risk and make sure their portfolios are sufficiently diversified. We are doing just that with our dedicated model portfolio.**
- **In the case of our model portfolio we believe it is wise to reduce the beta of our positions and to diversify some of the highly concentrated positions, such as our large Brazil overweight.**
- **In terms of interest rate risk, we continue to recommend lower exposure than the benchmark.**

We expect a strong finish to 2004

Before starting to look into 2005, we would like to point out that our outlook for the last month of the year has not changed. We remain constructive and believe that spreads will continue to tighten as per the trend that has been in place for several months. All credit markets continue to enjoy a supportive environment, and this climate, coupled with the reduced liquidity of year-end, should support the technicals.

2004: A difficult year, but EM has delivered good returns

Most investors probably expected 2004 to be a difficult year. And indeed it was, but not for the reasons we had foreseen. US interest rates, expected by most to be rising sharply, are ending the year only a few basis points wider than the January 04 levels, but there was a sharp sell-off in April and May that was quickly reversed during the summer. Sentiment has shifted often. Ultimately, however, EM has performed a lot better than most would have expected, returning approximately 9%.

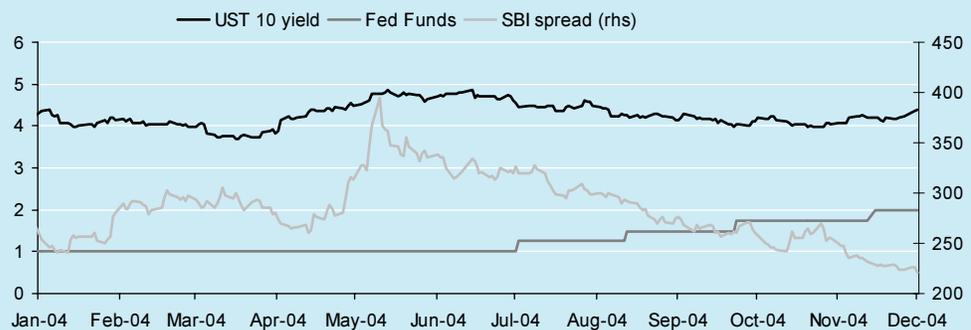
EM has showed many improvements in 2004

Looking back at 2004, there are many positives for EM:

- Fundamentals have continued to improve. Fiscal discipline is now the norm in many countries. Growth has accelerated or remained high in most countries, and external liquidity indicators have also improved in general. As a result, in this environment it is highly unlikely that EM-endogenous factors will be the source of high volatility, and the risk of default in the near-term is very low in the vast majority of credits. In addition, the recent experience tells us that political risk is probably not as high a source of instability as in the past. We have witnessed several changes in government that have resulted in no major policy changes.
- Fed hikes, identified as a major source of risk for EM performance, have not prevented EM from delivering good returns, with spreads being stable or tighter.
- EM has delivered its carry to investors, resulting in approximately 9% return. Not bad at all for a difficult year, and also a good omen as, at this levels of spreads, collecting the carry is probably one of the best 2005 scenarios for the market.

Chart 1 Sovereigns have performed well despite higher fed funds

SBI is CSFB Sovereign Bond Index



Source: Credit Suisse First Boston

But there were also some negatives that could affect crossover investors' appetite

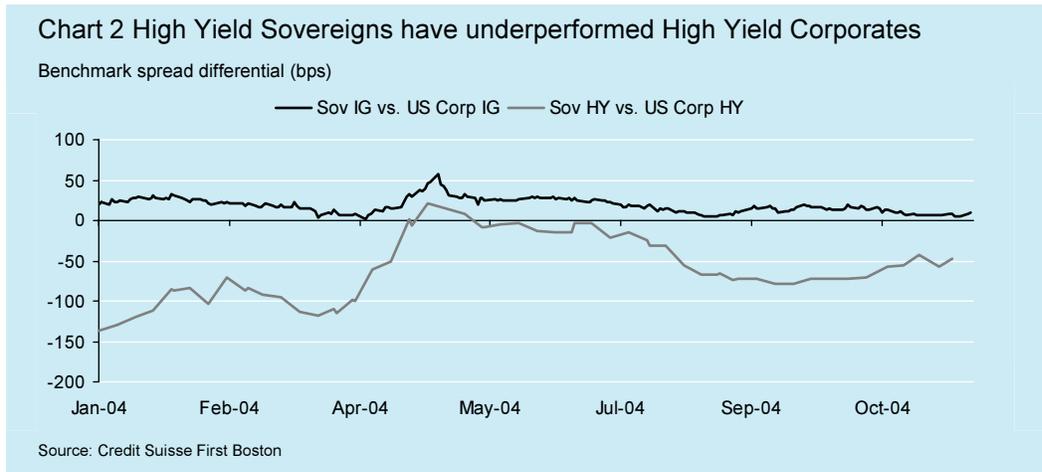
But we can also point to a couple of negatives in the performance of EM in 2004. And in our view these are quite important as they could potentially change (for the worse) the way crossover buyers (the source of so much EM demand over the past three years) look at EM.

crossover investors' appetite

The main negative of EM performance is that if an investor had opted for US High Yield debt instead of below investment grade EM, he would have obtained better returns and would have been exposed to substantially lower volatility. While the fact that EM has been more volatile is in line with the recent experience, for the first time in a few years the higher volatility has not been rewarded with higher returns. And this could potentially be a problem for an asset class where non-dedicated crossover investors represent a very large portion of the investor community.

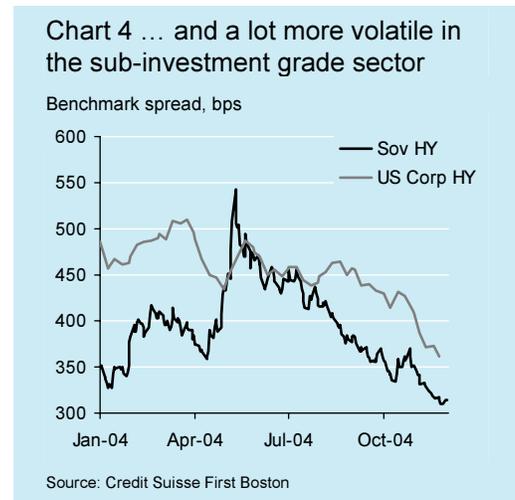
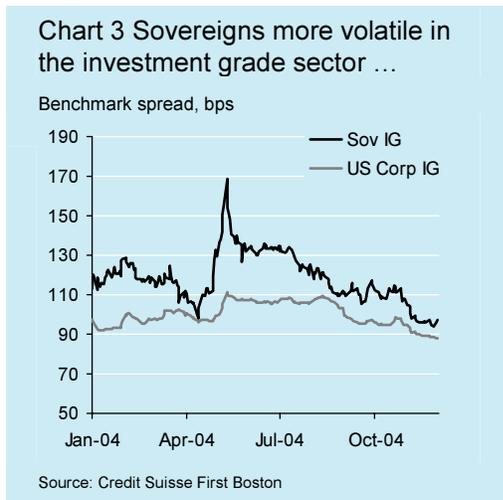
High Yield Sovereigns underperform corporates

As Chart 2 below shows, while the investment grade sector of EM has tightened (modestly) vs. corporates, High Yield Sovereigns underperformed corporates by 80 bps.



Sovereign spreads have been substantially more volatile

In addition, Sovereign spreads have been more volatile than Corporates. While the April-May sell-off was clearly the period in which relative volatilities fell part, a tendency towards higher EM volatility can also be observed after the April-May sell-off (Chart 3 and 4).



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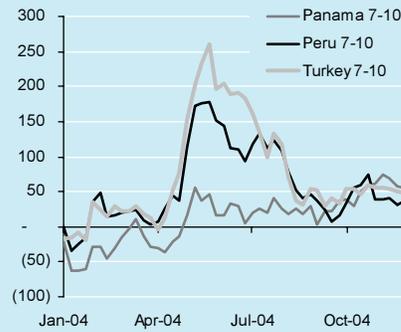
And although Sovereigns still yield more than Corporates, their higher volatility explains much of the pick-up

When we compare Sovereigns and Corporates we have often pointed out how some credits – for example EM BBs – still yield quite a bit more than Corporates (Chart 5 and 6). However when accounting for the higher volatility, the relative value vs. Corporates looks a lot less exciting. In general the picture is one of considerably higher volatility, but not proportionally as high a spread pick-up (Chart 7).

When we look at a country-by-country distribution (Chart 8), Ecuador, Brazil, and Ukraine appear to be the outliers even within EM, while Venezuela, Uruguay, Lebanon, and the Philippines are those closer to displaying spread levels and volatilities more in line with the Corporate market.

**Chart 5 Some countries still offer a pick-up vs. Corporates**

7-10 year Sovereign index vs. BB rated corporates (benchmark spread, bps)



Source: Credit Suisse First Boston

**Chart 6 Some countries still offer a pick-up vs. Corporates**

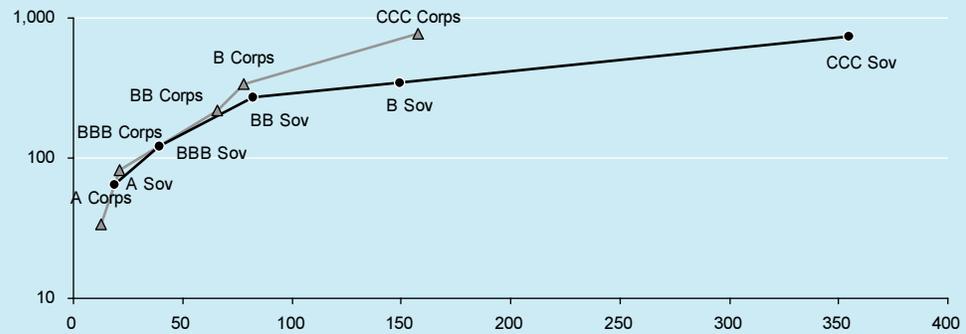
7-10 year Sovereign index vs. BB rated corporates (benchmark spread, bps)



Source: Credit Suisse First Boston

**Chart 7 But, after adjusting for the higher volatility, EM does not look so attractive**

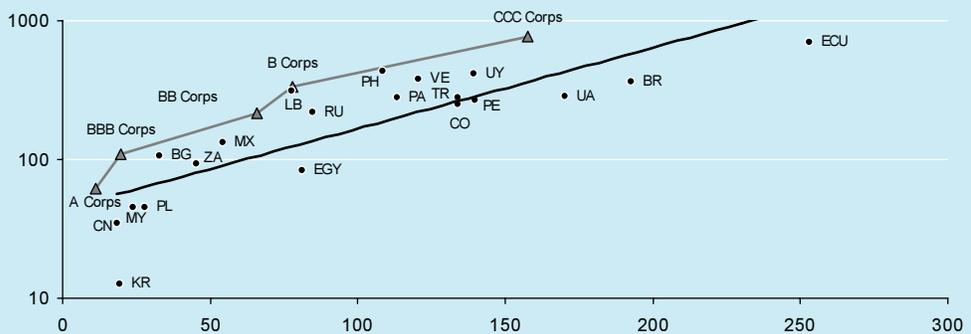
Benchmark spread (Y axis, log scale, bps) vs. year-to-date annualized weekly spread volatility (X axis, bps)



Source: Credit Suisse First Boston

**Chart 8 But, after adjusting for the higher volatility, EM does not look so attractive**

Benchmark spread (Y axis, log scale, bps) vs. year-to-date annualized weekly spread volatility (X axis, bps)



Source: Credit Suisse First Boston

If you don't have to be invested, it is difficult to find a compelling reason to buy now

**We believe crossover investors should sit on the sidelines and wait for better opportunities to buy EM.** We cannot see many good reasons for non EM-dedicated investors to buy the market at present. Spreads are historically quite tight; where some pick-up is available it comes at the cost of substantially higher volatility. If then we add the risk that continued Fed tightening would bring higher long-term rates, we see this as an environment in which investors will prefer to limit off-index positions. However, volatility and strong fundamentals could produce interesting opportunities to get involved in EM again next year. Should the market punish EM spreads excessively (as was the case in May, in our view), we believe that would be an opportunity to cross over into EM again. Even more so if, as it was the case in May, short-dated assets cheapen up substantially. Frankly however, while we do expect volatility and opportunities, we believe the market learned a valuable lesson last May and will be less keen to short EM after substantial spread widening, while longer-term investors will probably look to add.

Dedicated investors should reduce risk somewhat and make sure high-beta positions are well diversified

**The strategy is more difficult for dedicated EM investors. In case of portfolios very long beta and/or heavily concentrated in the higher yielding names, we believe a reduction in the beta and a more diversified exposure are warranted.** Indeed, as explained in the next section, this is what we are doing with our model portfolio. After all, if we are right and the crossover buyer takes a break, and given the risk of higher rates as well as the fact that we are transitioning from a period of historically strong seasonals (Nov-Dec) to one of weaker seasonals (Jan-Feb, when normally the primary market is very active – for a more complete picture of market technicals, please see the Appendix on page 17), and given the already impressive spread tightening witnessed, we think it makes sense to scale down beta in the year-end strength.

Continue to limit interest rate exposure

Finally, although Treasury yields have been rising lately, we continue to advocate a lower interest rate exposure than the benchmark. While it is quite possible that the Fed will have to pause (as implied by the market) because continued tightening without an increase in inflation would otherwise send real fed funds too high and hinder economic activity, we nonetheless see room for a temporary “inflation scare” that would realign the Treasury curve with a scenario of continued steady hikes by the Fed.

Whether inflation continues to rise or not is one of the key questions for 2005. Our central scenario is that inflation will remain quite low and the Fed will have to pause. The above-mentioned inflation scare would then be only temporary. However, if we are wrong and job recovery leads to higher inflation, fixed income markets (and particularly EM) would be severely challenged not only by higher Treasury yields, but also by the possibility of reverse flows from fixed income into equities. This would obviously be quite different from 2004, when, although rates were rising, fixed income remained the unchallenged recipient of savings flows.

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