

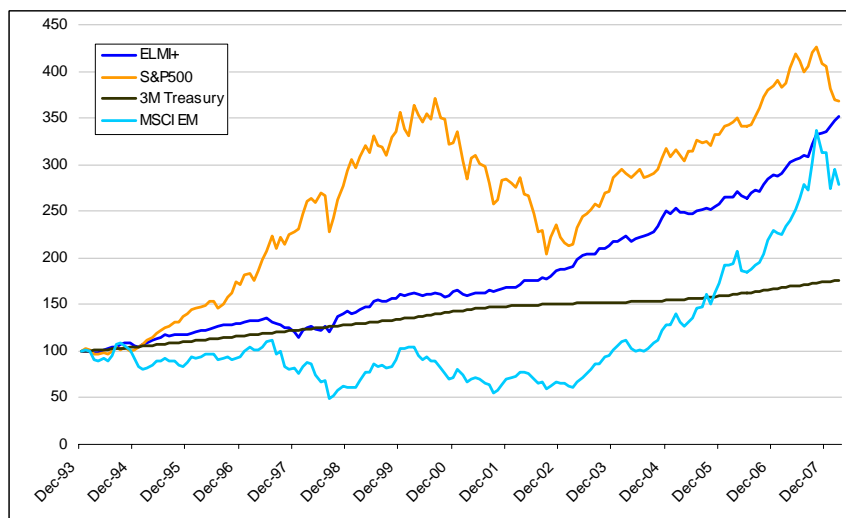
Emerging Market Cash - An Extraordinary Asset Class

April 2008 – Author: Kenneth King, Chairman

JP Morgan produces the Emerging Local Markets Index Plus (ELMI+) which tracks total returns, measured in dollars, for local-currency-denominated money market instruments in 23 emerging markets. They produce series for each market on a monthly basis, beginning in January 1994, and extending through to the end of March 2008.

This has been, to say the least, a volatile period for emerging markets currencies. The first extraordinary characteristic of the index is that it has an annualized return, measured in dollars, over the whole period that is higher than the MSCI Emerging Markets Free Index (equity), higher than the return on US Treasuries, higher than the return on the JP Morgan US high yield bond index and only 34 basis points behind the yield of the S&P 500 total return index.

Total Return Index Levels



Source: JP Morgan, MSCI, Standard & Poor's, Citigroup

The second point to note is even more extraordinary; in the fourteen years of the ELMI+'s existence, it has had a negative total return only once – in 1997 when it fell by 7.36%. This is not the kind of track record that most of us would expect for this asset class.

It is true that the total return on US Treasuries and that the total return on the JP Morgan High Yield Index were negative only twice in the period, but they had yields that were an annualized 281 and 233 basis points lower respectively.

The most obvious questions for investors are:

1. Does the ELMI+ give a fair reflection of risk and returns available in the past?
2. Is this pattern of risk and returns likely to continue in the future?
3. Why is the asset class so little used?

The three questions are answered briefly here and will be explored in further detail in forthcoming Research & Insight documents from Rexiter.

1. Does the ELMI+ give a fair reflection of risk and returns available in the past?

We have reviewed the detail, country by country, of the index returns. We looked especially closely at periods of currency crisis. Typically, large currency losses are made up over the following year by a partial recovery of the currency and, more importantly, by very large increases in interest rates. This increase in rates offset the currency loss.

2. Is this pattern of risk and returns likely to continue in the future?

Emerging markets currencies have low cross-correlations. A large number of them make up the benchmark and large currency weightings are capped at 10%. At any one time, several currencies will be volatile but the benefits of a diversified portfolio are powerful and benchmark volatility will probably continue to be low. The rapid growth of a number of these markets will tend to keep their interest rates high.

Asset Class Correlations							
	EMBIG DIV	GBI-EM Global Div	ELMI+	JPM HY	S&P 500	US Treasury	EM Free
EMBIG DIV	1						
GBI-EM Global Div	0.66	1					
ELMI+	0.50	0.93	1				
JPM HY	0.53	0.48	0.28	1			
S&P 500	0.51	0.43	0.43	0.55	1		
US Treasury	0.17	0.23	-0.06	0.02	-0.15	1	
EM Free	0.65	0.62	0.66	0.55	0.67	-0.23	1

Source: JP Morgan

3. Why is the asset class so little used?

It takes quite a lot to convince people that the answers to the above two questions are correct. Investors have under-allocated to this asset class because it is not fully understood and its potential is therefore often overlooked.

Rexiter will be further exploring this asset class in the coming months. In the meantime however, should you like to discuss the potential of this asset class further, please do not hesitate to contact Rexiter on +44 20 7698 6413 (London) or +1 617 664 6005 (Boston).