BLUE PAPER

Emerging Markets Debt: A New Thinking

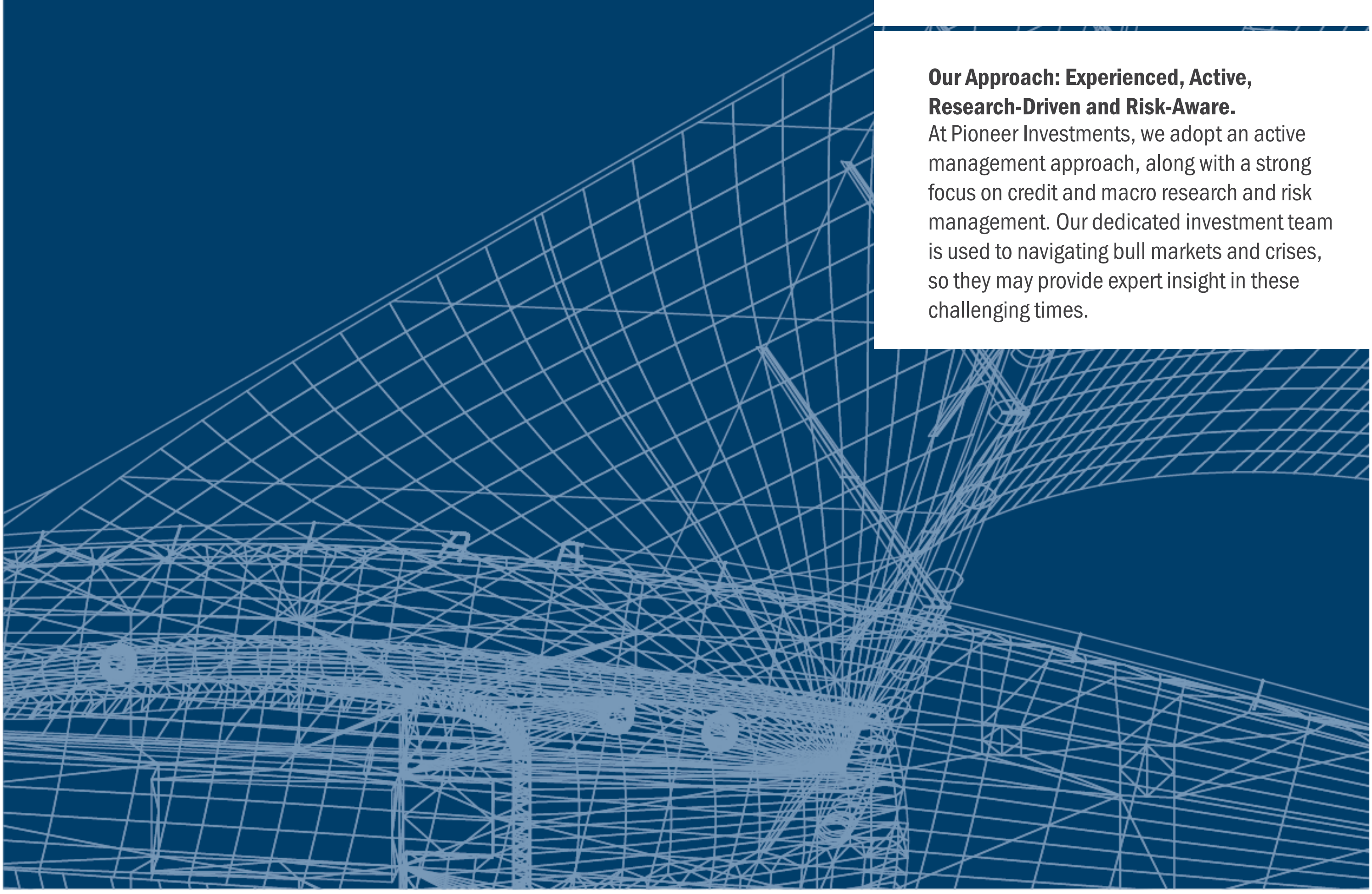
IN BRIEF

July 2014

Emerging Markets Debt: a New Game to Play.
Emerging Economies are dealing with challenging transitions. The era of indiscriminate flows into Emerging Markets Bonds (EMB) is probably over. However, we believe that the asset class will continue to offer selective opportunities for value-based investors.

The EM Puzzle and the Case for Selection.
Identifying the potential winners of the new EM framework, selecting sovereign and corporate issuers that are able to leave behind the legacies of the past and move to a balanced growth path, may add sizable value to those investing in EMB.

Our Approach: Experienced, Active, Research-Driven and Risk-Aware.
At Pioneer Investments, we adopt an active management approach, along with a strong focus on credit and macro research and risk management. Our dedicated investment team is used to navigating bull markets and crises, so they may provide expert insight in these challenging times.



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Key Insights

- In the last twelve months, Emerging Market Bonds (EMB) have experienced periods of high volatility and huge outflows, especially in local currency markets. Tensions have eased to some extent of late, but the uncertainty about future prospects for these economies in transition and the whole asset class remains high.
- In this paper, we try to answer two crucial questions for the EMB investment case: does the recent trend mark the end of the EMB honeymoon? Or, might the recent surge in volatility have a silver lining that leads to a new thinking on EMB and, eventually, brings positive developments for the asset class? We believe that the answer to the first question is yes, as the forces behind huge inflows into EMB from 2008 to around mid-2013 are not as strong as they used to be. Developments such as the end of US Quantitative Easing (QE), China in a deleveraging mode, and the unsustainability of export-led growth models are all challenging the era of indiscriminate flows into EMs.
- Answering the second question, we believe that the current uncertainty has a silver lining that opens the way to a new thinking on EMs with long-term positive effects. Deeper financial markets, improved creditworthiness of issuers and the potential for structural demand are, in our opinion, powerful forces which tend to make EMB more resilient to critical junctures.
- From this perspective, we believe the asset class may continue to offer selective opportunities, benefitting the best-run countries and corporates. To identify these investment opportunities, we focus on the ability of the EM countries to under take structural reforms as the key factor for successfully completing their transitions.
- Investors identifying the potential winners of this new game may gain an advantage. We believe that Pioneer Investments, with its active approach, strong focus on research and rigorous risk management control, offers a solid framework for investing in this compelling asset class. In addition, our dedicated investment team is experienced in navigating bull markets and crises and may offer expert insight for these the challenging times ahead.

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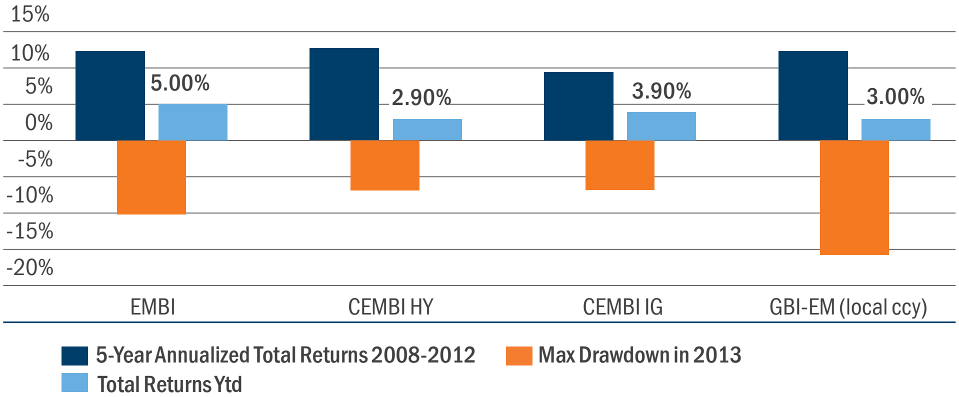
Investors in EMB, used to years of high returns, are now facing an uncomfortable situation, with higher volatility and less visibility for the asset class's prospects.

Emerging Market Bonds: A New Game to Play

In the past five years, Emerging Market Bonds (EMB) attracted huge inflows and the asset class delivered, in all its components, compelling returns.
However, since May 2013, with the start of the Federal Reserve's "tapering" debate and the prospect of higher US interest rates, markets are being tested. The reaction has been quite dramatic with tensions remaining as we progress through 2014.

Emerging Market Bonds Returns: Is the Bull Market Set to Continue?



Source: Bloomberg, Data as of April 30, 2014 EMBI: JPM EMBI Global Diversified; CEMBI IG, CEMBI HY: Corporate Broad Diversified, Investment Grade (IG) and High Yield (HY); GBI-EM: JPMorgan GBI-EM Broad Diversified USD Unhedged. 5-year returns cover the period December 31, 2007- December 31, 2012. Ytd: from 12/31/2013 to 4/30/2014.

Key Points

→ EMB are going through a surge in volatility, which has its roots in the economic transitions that many emerging countries are facing, and their uncertain outcome.

→ As global cyclical factors supporting inflows into EMB are not as strong as they used to be, the focus on domestic issues and unbalanced growth models may prompt EM countries to embark on structural reforms.

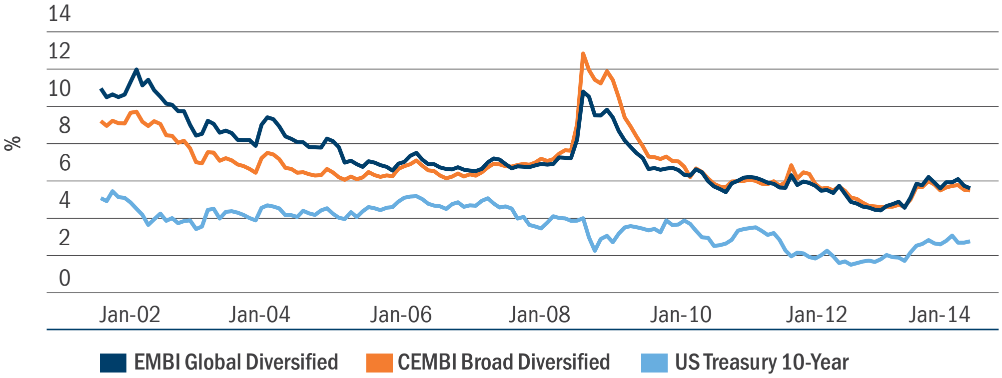
→ Even if volatility may persist in the short term, we believe that the asset class may continue to offer selective opportunities, with virtuous sovereign and corporate issuers supported by more stable inflows.

→ The radical evolution of this asset class in the last decade, in terms of financial deepening, and the improved creditworthiness of sovereign and corporate issuers, has contributed to make EMB more resilient to turbulent times.

Investors, used to years of high returns in emerging markets, are now facing an uncomfortable situation, with higher volatility, lower confidence and reduced visibility for the asset class outlook.

The recent correction has generated a repricing in the market as corporate and sovereign spreads over 10-year Treasury Bond Yield have widened significantly. Persistent low levels of interest rates in Developed Markets and the ongoing search for yield are bringing flows back, supporting the short-term outlook for the asset class. However, with a long-term perspective, we believe that the need to reassess the investment case for EMB is compelling, as the EM world is undergoing profound transformation.

EMB Yields vs. 10-year Treasury Bond Yields



Source: Bloomberg, data as of March 31, 2014.

In this paper, we will try to paint the bigger picture for this asset class, answering two crucial questions: Does the recent volatility mark the end of the EMB honeymoon? Or, might the recent evolution have a silver lining and anticipate a new way of thinking about EMs, eventually leading to new positive developments?

We believe that short- term volatility may give a direction for further positive evolutions for the asset class.

Before answering these questions in the following pages, let us start by saying that volatility will probably continue in the short term as **this asset class is experiencing deep changes.** This is linked to the economic transitions that many emerging countries are undergoing, and their uncertain outcome. However, we are confident for the medium- to long-term, as we believe that **the asset class has already gone through a radical overhaul that is poised to make it more resilient to future shocks. In addition, structural reforms are, today, on the agenda for many EM countries:** the weakening of cyclical factors supporting the huge inflows of the past few years are stimulating EM countries to devise more sustainable growth models.

Is the recent volatility marking the end of the EMB honeymoon? We believe that the answer is yes: the honeymoon is over, as the combination of that attracted huge inflows into EMB between 2008 and mid-2013 is not as strong as it used to be.

Support from cyclical factors is not as strong as it has been in the past bull market phase.

New dynamics are at play both at the global and local levels:

1. **The Fed's tapering of exceptionally loose monetary policy in the US.** This process was a strong headwind when it was announced in May 2013, though it lessened after investors became aware that it would not lead immediately to a tightening cycle. Going forward, we believe that the direction of the US monetary policy will remain relevant for EMB market, though probably not as decisively as it has been in the past. On one side, we believe that the normalization of the US monetary policy will be very gradual (and the new Fed chair Janet Yellen's early moves seem to confirm this view). However, renewed volatility in EMB may be driven by stronger-than- expected US economic figures, which could tilt market expectations back towards more aggressive Fed action.
   On the other side, the rise of EM interest rates (both policy rates and bond yields), triggered by higher US rates, may have material effects on EM domestic economies, switching the attention from global to domestic issues.

2. **China's deleveraging.** The efforts to make China's economy less dependent on bank credit are worthy as they are aimed at correcting the excesses of unproductive investments, but they may be detrimental to the real economy. Moreover, the tightening of financial conditions risks a credit crunch amid more defaults in the opaque areas of the financial system (the bailout of a trust fund in February was just one example of that). At the moment, the slowdown in investments has been significant for state-owned enterprises (SOEs), though less so for private firms, and it may satisfy policymakers and their attempts to downsize the role of SOEs. We believe China's financial system is fraught with risks, because of such features as an oversized "shadow" banking sector and an overheating housing market. These cannot be ignored and may add volatility to markets due to the interconnection of the Chinese economy with both developed and emerging economies.

3. **The slow recovery path in Developed Markets.** The outlook for the developed economies is improving. Specifially, the US economy is expected to grow 2.5-3% in 2014, while the Eurozone appears likely to overcome its recession and Japan is likely to regain economic momentum thanks to the aggressive economic policies implemented by Prime Minister Shinzo Abe (known as *Abenomics*). The renewed strength of developed economies should impact positively on EMs growth through the export component, **even though today's stimulus from developed economies, especially on the consumer side, may not be as strong as before and unable to absorb the excess manufacturing capacity in EMs.** Another factor to watch is the Yen and the future of *Abenomics*. Further monetary infusion would be supportive for inflows into EMs; while EM currencies have become more competitive, a further Yen depreciation (the Japanese currency lost more than 30% against the US Dollar between September 2012 and March 2014) could threaten EM economies and exports.

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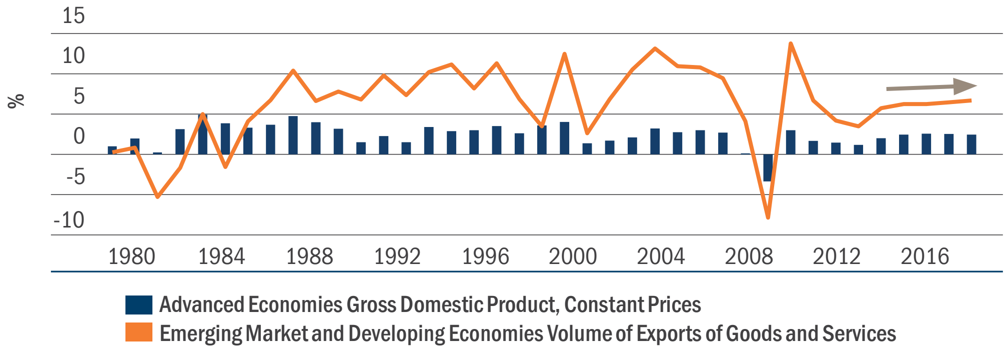
Moderate Growth Outlook for DM Growth and EM Exports



Source: International Monetary Fund, World Economic Outlook Database, April 2014. Data from 2013 to 2018 are IMF's forecasts.

New dynamics are at play, both at the global and local levels, prompting structural changes to EM growth models.

These cyclical factors are prompting structural changes to EM growth models, in order to readdress the flaws of past expansions, which are surfacing as foreign capital flows dwindle.

We believe that strong signals from EM policymakers, in terms of reforms and the correct management of fiscal and monetary policy, may help investors to regain the confidence in the asset class.

Today, there is a broad-based skepticism over the growth models that EMs embraced in the past. Although the group is very diverse, most EMs have suffered a misallocation of resources leading to structural bottlenecks. As we will argue in more detail in the next section, in many EMs, growth-oriented economic policies boosted investment or exports, crowding out domestic consumption and dampening the productivity of value-added domestic sectors. Structural issues take years to be resolved, **but we believe that strong signals from EM policymakers, in terms of reforms and the correct management of fiscal and monetary policy, may help investors to regain confidence in an asset class** that has played a central role in international financial markets and still may offer significant upside potential. Since each country has its own history and its own specifics, a **selective approach should be applied in order to understand progress towards reforms and to identify the successful players in the new EM game.**

This brings us to the second question: *Will this apparent risk aversion have a silver lining and signal a new thinking that will eventually lead to positive developments?* We believe it will.

Powerful forces are behind the resiliency of EMB.

In our view, there are three powerful forces behind the renewed resilience of EMB:

1. The progress made by the asset class in terms of financial deepening – defined as the size of financial markets compared with economic activity and the development of market functions such as intermediation, liquidity, hedging.
2. The re-rating in the last decade for both corporate and sovereign segments.
3. A structural demand for EMB, especially from the institutional side.

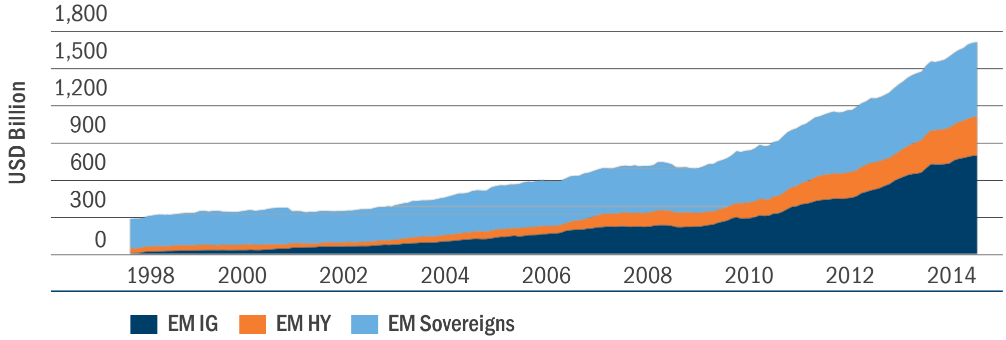
The evolution of the asset class has been significant, in terms of size and composition.

1. The Asset Class's Increasing Depth (Size and Shelf)

The evolution of the asset class has been significant in terms of size and composition. The EM bond universe in hard currency (EUR and USD) has grown at an average annual rate of 12.5% in the last 15 years, going from a niche market valued at $285 billion at the end of 1998, to $1.697 trillion as of January 2014[1]. EM corporate debt was a mere 3.5%[2] of the total of EU and US corporate debt in 1998. Today it stands above 17%, making up an increasingly important segment for bond investors.

[1] Source: Bank of America Merrill Lynch, data as of March 31, 2014.
[2] Source: Bank of America Merrill Lynch, data as of March 31, 2014.

Emerging Markets Bond: A Bigger and Wider Universe



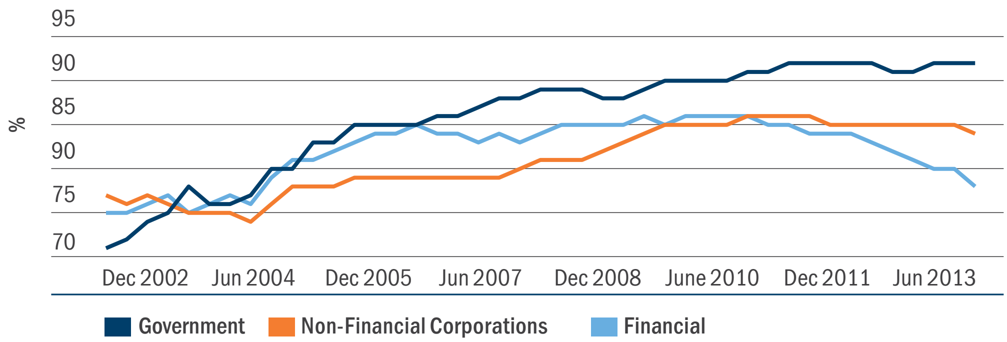
Source: Bank of America Merrill Lynch. Data as of March 31, 2014. Investment Grade stands for securities with credit rating above BBB– according to Standard&Poor's rating agencies. High Yield bonds are securities with credit rating below BBB– according to the same agency. Sovereign bonds are securities issued by national governments.

Major changes have occurred also in local currency-denominated EM sovereign and corporate markets.

Sovereigns and, to a lesser extent, non-financial corporations have gradually shifted issuance from international to domestic markets.

The evolution of local currency bond markets have helped improve the debt structure of borrowers.

Share of EM Debt Issued in Domestic Markets over Total EM Debt



Source: IMF, Financial Stability Report, March 2014

Issuing debt in local currency allows the borrower to reduce the currency mismatch between revenues and debt that has always been a significant source of risk in EM balance sheets. Since the early 2000s, EM sovereigns have taken advantage of this opportunity as they have shown a strong preference for issuing in local currency.

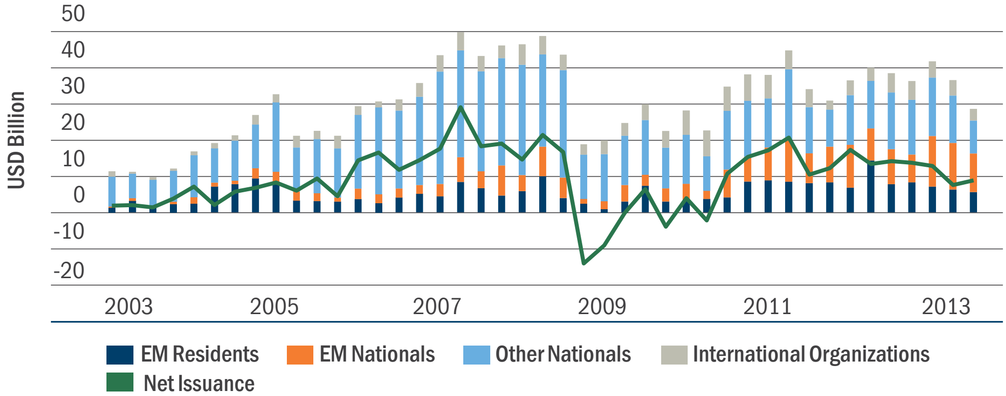
In addition, in the last few years, the corporate sector has been more involved in the local-currency market, as demand for high-yielding assets has supported robust issuance. This trend has held despite the deceleration induced by recent market volatility.

The variety of international borrowers for emerging market debt is increasing, which confirms the strengthening of the financial and commercial integration that is happening within EM.

An interesting point is that while, historically, the lion's share of EM issuance has been held by what BIS calls *Other nationals* (i.e. borrowers based in DM) as investors were inclined to split the currency risk from the credit risk associated with EM borrowers, in the last few years their share gradually has gradually fallen from above 55% entering the 2000s to 36% in 2013[3].

On the other side, the role of EM companies (EM residents or, even more actively, their subsidiaries abroad) has increased. This suggests that **the number and variety of borrowers in international markets for EM debt is increasing,** which seems to confirm the strengthening of the financial and commercial integration that is happening within EMs.

Debt Securities Denominated in EM Currencies, by Borrower



Source: BIS, Quarterly Review, December 2013.

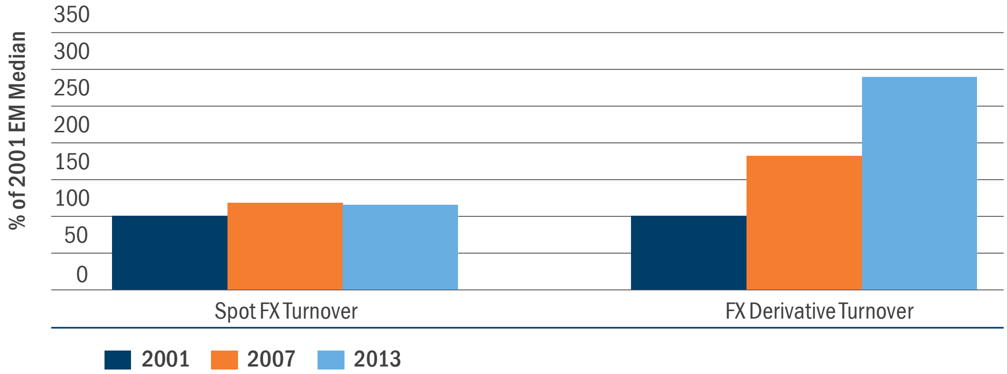
For example, this trend is visible in sustained foreign direct investment inflows and outflows, especially directed into other emerging economies or in surging intra-EM trade. The share of South-South[4] trade in total world exports has doubled over the last 20 years, to over 25%[5]. This is a clear sign of the evolution of EMs, and of further potential, as the shares of manufactures and the value-added are much higher in this kind of trade than in exports to developed countries.

While the market depth is still low compared to DM, huge progress has been made in the last decade in onshore and offshore EM bond markets and in the development of derivative markets.

Another strong signal of the increasing sophistication of EM financial systems comes from the **development of derivative markets.** They have steadily grown since 2010, mostly driven by the expansion of the OTC market. Turnover in EM derivatives tends to be more concentrated in FX derivatives (accounting for half the daily turnover, while interest rates and equity derivatives are around one-fifth each, according to BIS) as most risks are usually associated with currencies.

[3] Source: BIS, Quarterly Review, December 2013.
[4] Trade from a developing country to a developing country.
[5] UNCTAD Handbook of Statistics 2013, December 2013.

EM Financial Deepening Visible in the Development of FX Derivatives

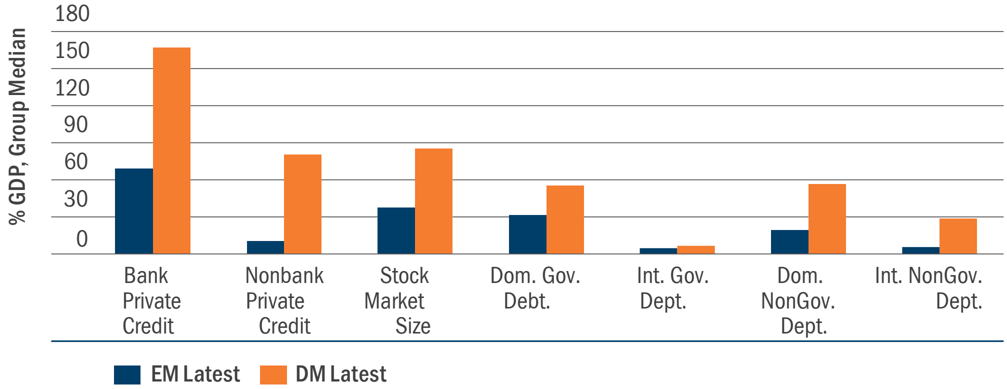


Source: IMF Financial Stability Report, April 2014

The rise in foreign flows has increased the need for foreign investors to hedge positions in local-currency assets or to take positions on currency movements, which triggered the development of this market segment.

Notwithstanding the significant deepening of EM financial systems, they remain thinner than in developed markets. We believe this leaves space for further improvements with potential benefits for better allocation of savings, improved liquidity and macroeconomic resiliency.

Financial Deepening in EM Remains Thinner than in DM



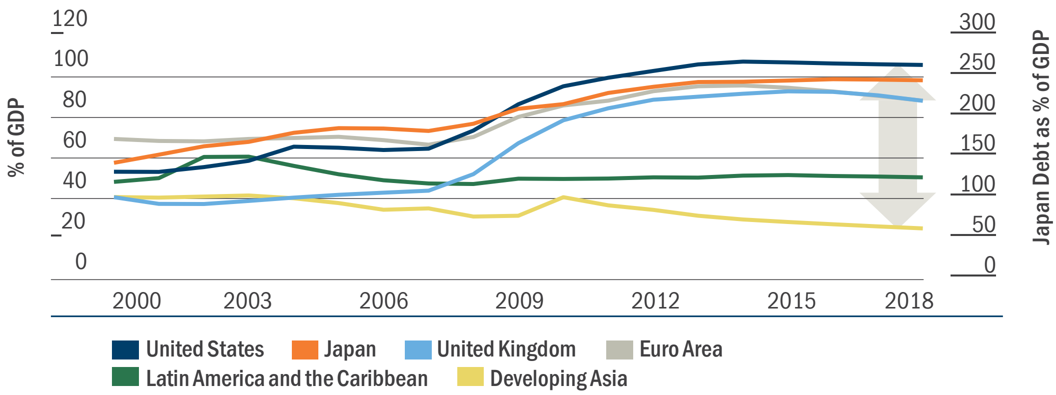
Source: IMF Financial Stability Report, April 2014 . Latest is 2012 for private credit, 2013 for the rest.

Generally, EM benefit from strongly improving macro fundamentals.

2. The Re-rating of the Asset Class

A key development, which has occurred both in sovereign and corporate debt, is an improvement in issuer credit standing.
At the sovereign level, Debt-to-GDP ratios have generally improved and public finances are in relatively stronger shape than in developed markets. This helped the best-run EM countries implement expansionary fiscal policies to during the last global recession.

Debt as % of GDP (Japan on Right Axes)



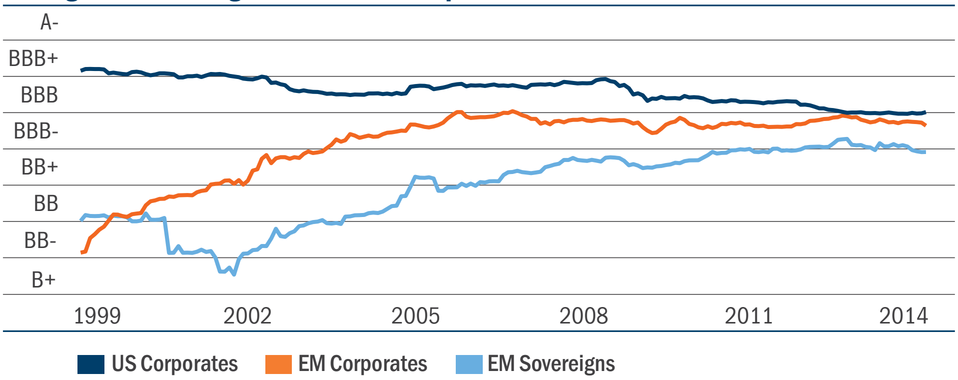
Source: IMF, World Economic Outlook, April 2014. Data from 2013 to 2018 are IMF's forecasts.

Structural improvements in EM are also visible on the side of credit risk, as businesses made progress in optimizing their capital structure.

Structural improvements in EMs in recent years are visible not only on the side of sovereign risk, but also with respect to corporate credit risk. Thanks to buoyant GDP growth, businesses have made good progress in bolstering their capital structures; on average, they operate with more liquid balance sheets and lower financial leverage than US businesses and benefit from high growth and high margins.

The improvement in fundamentals, which has been particularly strong in the 2002-2011 period, has led to higher credit ratings, and upgrades have consistently outpaced downgrades in the last decade.

Average Credit Ratings in Historical Perspective



Source: Bank of America Merrill Lynch. Data as of March 31, 2014. BofA Merrill Lynch Index composite ratings are the simple averages of ratings from Moody's, S&P* and Fitch.

Over the last three years, credit ratings have shown a more stable path, which mirrors the fact that EM economies have continued to increase their bond issuance, taking advantage of cheap financing.

3. Trends in Demand: an Expanding Investor Base

A side effect of maturing EMs has been the build-up of domestic funds in the private sector. Insurance companies have become an important source of stability in the domestic market and their EM assets approached US $3.4[6] trillion at the end of 2012.

[6] Source: JPMorgan, Local Markets Guide, September 2013.

* S&P Rating: Source: Standard&Poor's Copyright © The McGraw Hill Companies (2014)

The investor base is showing structural changes and potential of development, which should be supportive for the asset class in the medium- to long-term.

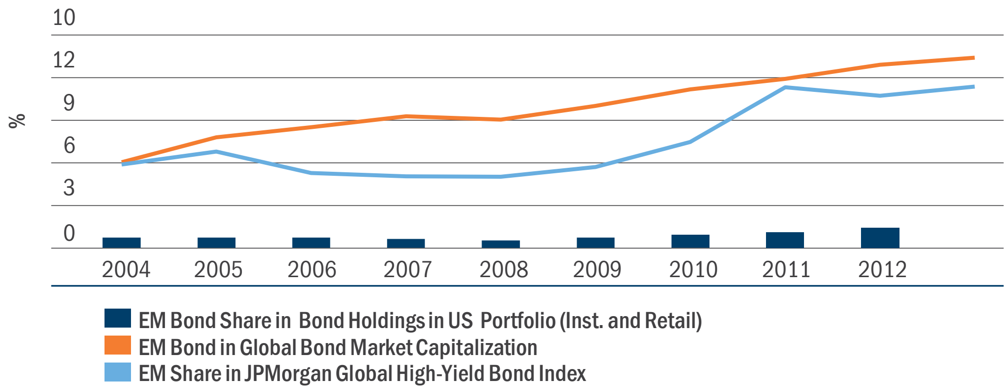
The increase has been particularly pronounced in Asia, and China in particular, where insurer holdings grew at a rate of 24%[7] between 2005 and 2012.
The strong demand for long-dated bonds coming from the recent introduction of risk-based capital accounting practices in some Asian countries has also given strong support to the bond market.
Domestic pension funds are important actors with assets above US $2.1[8] trillion. In Latin America, they are especially heavily invested in fixed income assets.
In Europe Middle East and Africa (EMEA), insurance companies and pension funds are becoming more relevant due to regulatory changes in those countries.

These structural changes in demand also involve foreign investors, which are an increasingly important source of funding for EM debt.

Among institutional investors, insurance companies and pension funds are significant investors in EMB, and their presence is expected to increase according to OECD estimates[9]. Central Bank reserve managers and foreign reserve managers, which tend to be conservative, have cautiously diversified into EMs, as have sovereign wealth funds, although this trend tapered in 2013. Given the strategic nature of their mandates, flows from institutional investors are generally stable, although they may of course recede in the event of a severe crisis or significant downgrade events.
Among retail investors, funds with more globally diversified portfolios have increased their presence in EM in the last decade, but the allocation in EMs continues to be very small compared to DM.

Looking at US investors (retail and institutional), their allocation to EMB doubled from 0.7% in 2006 to 1.4% in 2012. This is still relatively small in the context of EM's share of global market capitalization and leaves potential for future increases.

Allocation to EM from US Investors Increased but Still Relatively Low



Source IMF, Financial Stability Report, March 2014

As the EMB debt universe is evolving, the investor base is showing structural changes and potential developments which should support the asset class in the medium- to long-term.

[7] Source: JPMorgan, Local Markets Guide, September 2013.
[8] Source: JPMorgan, Local Markets Guide, September 2013.
[9] Ref. in IMF, Financial Stability Report, March 2014.

Conclusions

With great power comes great responsibility: EM are now urged to make strong efforts to build more balanced growth models

EMs have gone through important changes in the past decade and have now achieved a central role in the global economy. At the same time, the EMB market has rapidly evolved and become more mature as well as diversified in terms of issuers, currencies and financial instruments. However, we acknowledge that "With great power comes great responsibility." EMs are now urged to show a stronger effort in addressing the imbalances that have built up in the expansion phase and that, over the past few years, have been obscured by excess liquidity and yield-hungry investor inflows. The current cyclical slowdown is helping to bring the focus to domestic issues.

The picture here becomes more complex and varied. We will try to provide a way to understand the sources of volatility to which each country is exposed, the structural imbalances, the legacy of previous growth models with the risks they bring and the steps undertaken – if any – in terms of reforms and policy settings to address those imbalances.

We believe the asset class may continue to offer selective opportunities, benefiting virtuous countries and corporates.

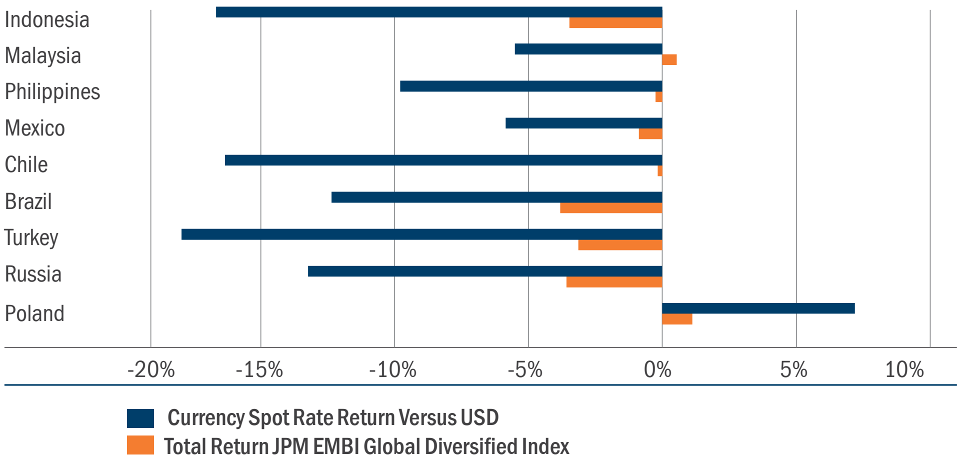
From this perspective, we believe the asset class may continue to offer selective opportunities, with inflows supporting virtuous sovereign and corporate issuers. We expect structural demand for the asset class will continue to be relevant especially from institutional investors, as we highlighted above.

The EM Puzzle and the Case for Selection

Market discrimination in risk-averse times may be evidence of a more mature investor base.

In the past year, even in the most volatile periods, returns have been very diverse in EMB and in EM currencies. We believe this is a sign of the evolution of the asset class we highlighted in previous pages.

EM External Sovereign Debt Total Returns and Spot Rates Returns for Selected Countries in One Year (3/31/2013- 3/31/2014)



Source: Bloomberg, data as of March 31, 2014.

Key Points

→ In our view, selection is today the key to smart investing in EMB, as different dynamics at country and sector levels play a material role in asset class performance.

→ Today, many EM are facing issues, from the legacy of past unstable growth patterns. We focus on three pieces of the EM puzzle: twin deficits, commodities export-led growth models and excessive reliance on credit.

→ We believe that the ability to perform structural reforms is key to resolving the EM puzzle and for a successful outcome of economic transitions.

→ Investors identifying the potential winners of this new game can gain an advantage, and we believe that Pioneer Investments – with its strong focus on research and analysis – will remain in the forefront.

A high dispersion in returns has also been displayed by the corporate sector.

Sector Specificities - 1 Year Returns (3/31/2013- 3/31/2014)

Consumer	-0.5%
Diversified	3.4%
Financial	1.8%
Industrial	2.9%
Infrastructure	-1.5%
Metals & Mining	-1.9%
Oil & Gas	-0.1%
Pulp & Paper	4.2%
Real Estate	0.3%
TMT	2.5%
Transport	0.3%
Utilities	1.8%

Source, JPM Corporate Index Broad Diversified.

We believe that selection is key to smart investing in EMB .

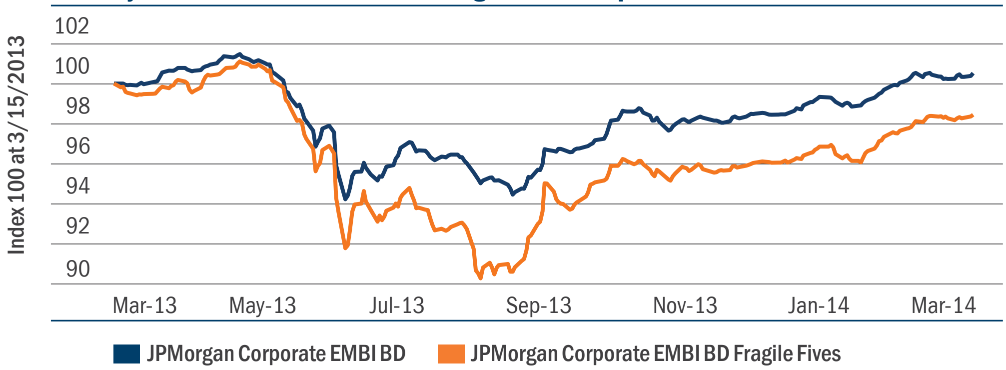
This wide range of returns reflects the fact that EMs are not a homogenous group and different dynamics at the sector and country levels are playing a role. As a result, we believe that selection is key to smart investing in EMB. Being able to identify the underlying trends affecting this asset class may lead more and more to a competitive advantage.

In the following section, we will carefully consider the importance of "selection". For us, this means understanding the different challenges EMs are facing today, monitoring the metrics that may help to identify a country's domestic and external risks, and tracking the measures and reforms these economies are implementing, in order to manage risks and assess potential opportunities for investing in EMB.

Identifying country risks is relevant not only for sovereign debt but also for corporate debt.

First, we place a strong emphasis on assessing country risk, which is particularly relevant not only for sovereign debt but also for corporate debt. In the EM space, the performance of the corporate market is very much linked to macro stability. This is illustrated by the underperformance relative to the overall EM corporate index of corporates in the "fragile five" – Brazil, India, Indonesia, South Africa and Turkey.

Country Risk Counts on Returns of "Fragile Five" Corporate Sector



Source: Bloomberg, data as of March 19, 2014. BD means Broad Diversified.

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We consider the issues resulting from past unbalanced growth models as problems to address, but also as triggers for structural changes.

In putting together the EM puzzle, we have identified three critical issues, resulting from past unbalanced models of growth in many emerging economies. **However, our approach is distinctive in that we look at these issues as potential catalysts for prompting EMs to take decisive action to address past mistakes.**

Specifically, we look at the **twin deficits, at export-led growth models (Dutch Disease) and at the credit boom** as past drivers of economic growth.

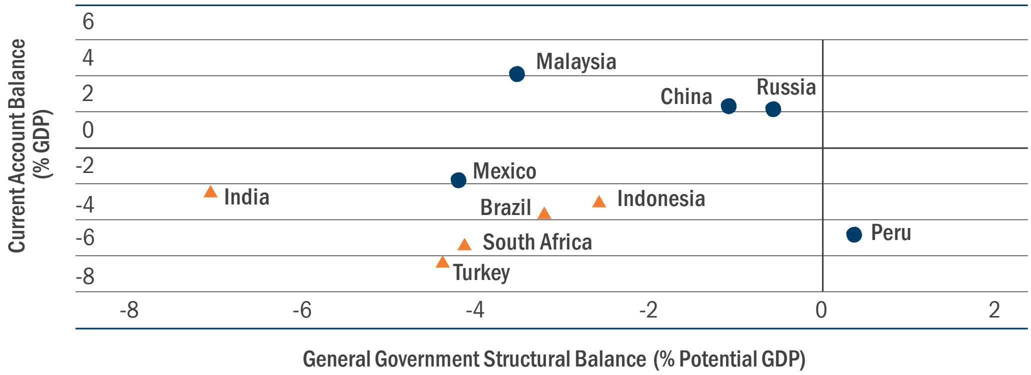
We examine selected countries and areas from these perspectives, and seek to assess each country's exposure to current sources of potential volatility, such as the China slowdown or Fed tapering.

Countries twin deficits rely on external financing; they are vulnerable to depreciation, an abrupt rise in interest rates, and more exposed to Fed changes in monetary policy.

1. Twin Deficits

A first discrimination among EM countries may be based on fiscal and current account balances: part of EMs present a situation in which loose fiscal discipline and often unsustainable expansions have been accompanied by rising import demands and worsening current account deficits, creating the well-known twin-deficits problem. Funding both deficits increases the risk of a currency's depreciation as its value adjusts to attract the required amount of foreign financing needed to even up the balance of payments. Some countries (in particular Brazil, South Africa, Indonesia, India and Turkey, highlighted in the graph below with an orange marker) are raising these concerns.

The Twin Deficits Picture



Source: Data are estimates for 2014 from International Monetary Fund, World Economic Outlook Database, April 2014.

We believe such capital-hungry countries would be the most vulnerable to an acceleration on the part of the Fed towards policy tightening and that they might see, as a consequence, a rapid currency devaluation and a sharp rise in real interest rates.

In a dynamic perspective, we observe significant divergences within the group of most vulnerable economies.

Analyzing the issue from a dynamic perspective, we try to anticipate how this scenario would play out across various EM economies. **We observe significant divergences within the group of the most vulnerable economies.**

The efforts of India and Indonesia to reach some macro stabilization are visible, even though in the short-term, the upcoming elections are likely to postpone radical changes. India has shown a significant improvement in its external position in the data

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for Q3 and Q4 2013. Rebalancing has mainly happened through import compression so far (a material effect came from Indian resolve to curb gold imports). A structural adjustment of the current account would require higher domestic savings which could be pursued through higher real interest rates. An incoming stable and pro-growth government would contribute to unlocking the country's huge potential.

Indonesia has put in place measures to narrow the current-account deficit, including interest rate hikes, administrative restrictions on real estate and higher taxes on luxury-goods. While strong exports in Q4 have been boosted by one-off measures, a gradual improvement is visible to us. Political change may test the sustainability and effectiveness of recent improvements.

On a more downbeat note, Brazil has suffered a progressive deterioration of the current account toward warning levels. Recent trends showed signs of stabilization and a tentative reversion, especially in a context of weakening currency and internal demand. However, we do not see the commitment to a material change of policy sufficient to make this rebalancing convincing there.

Both South Africa and Turkey show structurally high current account deficits. Recent monetary policy tightening, particularly significant in Turkey and less so in South Africa, are encouraging signs towards addressing these imbalances, but current account deficits remain an issue.

Beyond those five countries, there is the potential for significant issues to surface in Russia, which is starting from current account and budget surpluses but lately showing some deterioration. The huge amount of reserves the country has piled up with oil revenues should help protect Russia from external shocks. However, the heightened geopolitical risks related to surrounding countries (in particular, Ukraine) with the increased risk of international sanctions, the weakening of the rouble with its inflationary implications, and a slowdown in Foreign Direct Investments, may call for a cautious position. A short-term opportunistic approach may be helpful in this market, which might offer selective opportunities if it were to be dip sharply on declining investor confidence.

2. Export-Led Growth Models and the Dutch Disease

The Dutch Disease is an issue for most commodity exporters: a high dependence on exports of primary products may have detrimental consequences on the development of broadly diversified economies.

"In the 1960s, the Netherlands experienced a vast increase in its wealth after discovering large natural gas deposits in the North Sea. Unexpectedly, this ostensibly positive development had serious repercussions on important segments of the country's economy as the Dutch guilder became stronger, making Dutch non-oil exports more expensive and, therefore, less competitive." [10]

Since its introduction as a concept in the late 70s, "Dutch Disease" has been commonly used to describe the negative effects of a high dependence on natural resources to develop a manufacturing sector. According to this theory, an over-reliance on natural resources may have detrimental consequences on the development of a broadly diversified economy and put a country with such characteristics under pressure in case of a rapid change in demand trends.

[10] From IMF, Dutch Disease: Wealth Managed Unwisely, Finance & Development by Christine Ebrahimzadeh.

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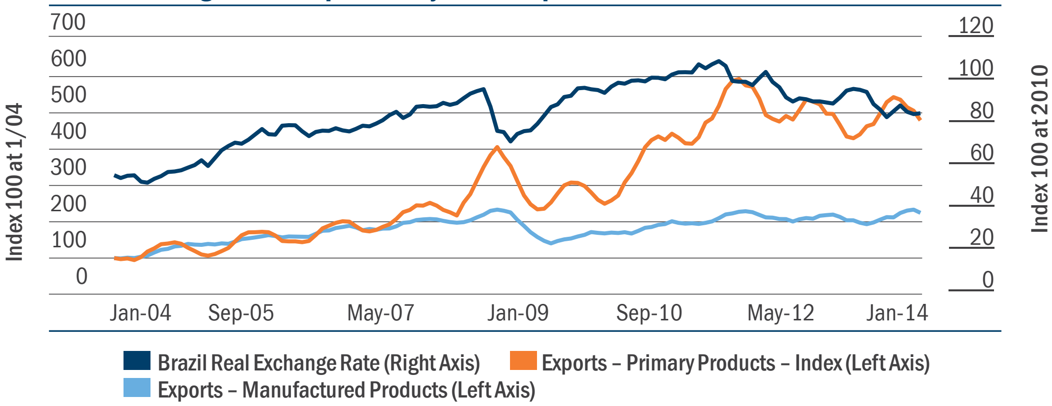
Structural reforms play a crucial role when dealing with the Dutch Disease. From an investment point of view, analyzing a country's progress on structural reforms is an important step in assessing the potential for more balanced and healthy growth.

In the case of Brazil, structural reforms are needed to correct the low competitiveness of the manufacturing sector.

One of the more exposed countries in relation to the Dutch Disease is Brazil, although other Latin American countries share this vulnerability. In Brazil, the boosting of commodity exports, in particular agricultural and metals, contributed to a real appreciation of its currency (the real) which depressed manufacturing exports. Despite some recent depreciation in the real, negative factors such as low productivity, lack of infrastructure and weak investments have, so far, prevented any upsurge in the manufacturing sector.

Manufacturing Sector Depressed by Low Competitiveness



Source: BIS, Bloomberg data as of February 28, 2014.

Structural reforms are needed at this stage to improve productivity and foster investments. So far, the government has made efforts in supporting growth through tax cuts, but has taken no significant steps towards addressing structural issues.

In Russia, the reliance on oil has limited private-sector investments in key sectors and created supply-side constraints. Reforms are welcomed to unlock the growth potential.

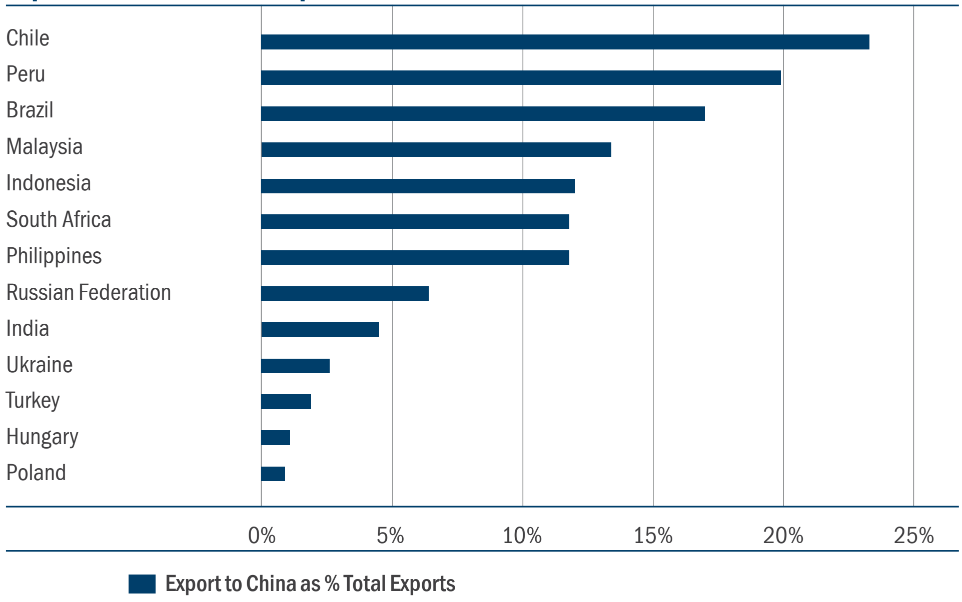
Similar dynamics have been evident with respect to many commodity exporters. High oil prices have boosted Russia's growth for years. However, strong government intervention has limited private-sector investments in key sectors. The low ranking on the "ease of doing business" index (where Russia ranks only 92)[11] seems to mirror the tight regulatory environment local firms face. This has created supply-side growth constraints, such that we believe a strong effort in a focused reform program is required. Indeed, some progress has been made (the introduction of a new oil price-based fiscal rule, a more flexible exchange rate, and operational improvements in monetary policy) but a lot is still to be done, in our view, in order to boost productivity and improve the investment climate, notably through better governance and transparency.

For commodity exporters, the share of exports to China is a yardstick for assessing the vulnerability to a Chinese slowdown.

The reliance on commodity exports in some economies poses further concerns on the vulnerability of such economies if China's materials-intensive growth slows down.

[11] Source: Doing business 2014, www.doingbusiness.org

Exporters to China More Exposed to a Chinese Slowdown



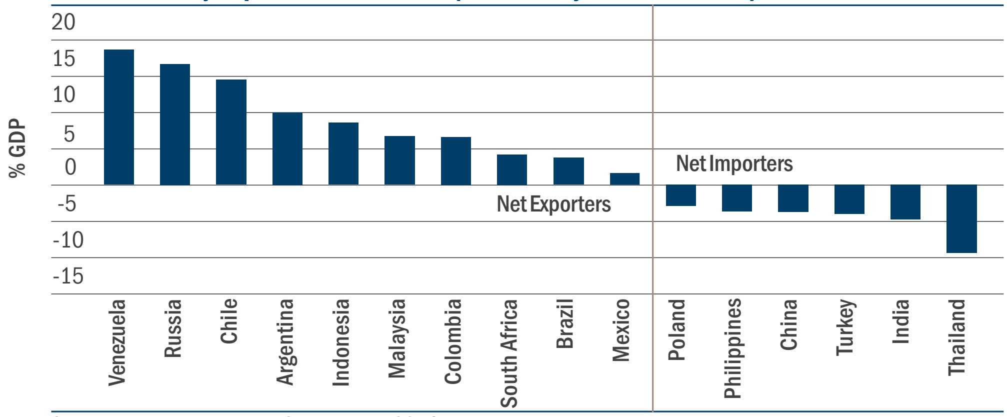
Source: CEIC/Datastream, data as of December 2013.

Commodity exporters may also face a worsening in terms of trade if the lower demand from China weakens commodity prices.

Countries with a high degree of concentration in exports of industrial commodities, such as Chile and South Africa, may suffer the most serious consequences, even more than countries that have a more diversified export mix, like Brazil, whose sales of agricultural products tend to have lower fluctuations in demand than most minerals.

China's slowdown could also affect indirectly other EM economies through commodity price changes. Lower commodity prices, as an effect of lower demand, would worsen the terms of trade of commodity exporters while they would be positive for commodity importers (including India, Turkey and Poland).

Net Commodity Exports as a % of GDP (Commodity Concentration)



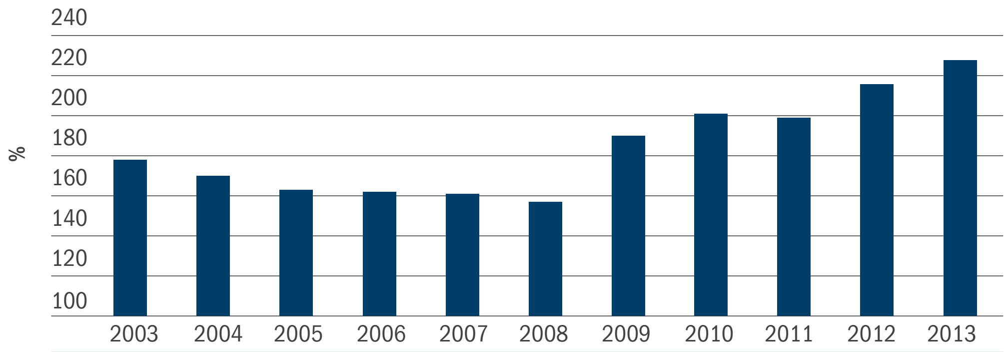
Source: IMF, World Economic Outlook, April 2014.

The rapid increase in Chinese debt represents one of the biggest concerns in the EM space…

3. The Credit Boom

In China, the model of investment-led growth has generated a surge of debt, which has become one of the biggest concerns for EMs and more broadly for financial sector stability at the global level.

China Total Debt/GDP



Source: PBOC, NBS, NAO, CEIC e SG Cross Asset Research/Economics, data as of February 28, 2014.

What is worrying most investors is not only the increase in the total amount of debt as a percentage of GDP (which is also a common trend for many developed economies), but also the structure of the lenders.

The strong reliance on bank loans (which are more than half of all credit) leaves the banking sector as a near-monopolist in handling credit risk, while the development of a "shadow" financial system raises concerns that have to be managed carefully by policymakers.

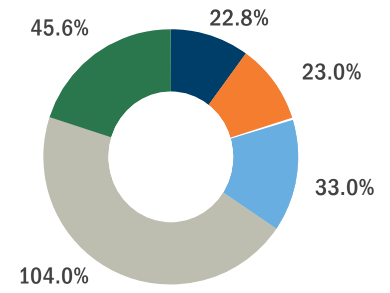
…and requires careful policy management.

This is especially true if we consider that, particularly in the Asia Pacific region, loose credit conditions have boosted property prices and created potential property bubbles, which are becoming an increasing source of risk.

A deleveraging process has started, and is one element of the ambitious reform program set up by Chinese authorities with the objective of a more efficient allocation of capital. A strong effort has been put into smoothing the transition process, curbing excess lending in an orderly way, minimizing the number of Non-Performing Loans and default rates. We believe that the current debt problems in China can be managed without causing excessive turbulence in the system, given the commitment of the current leadership, the high level of concentration of debt in state-owned-enterprises, and the fact that the debt is mainly denominated in local currency. The low level of public debt leaves room to use fiscal policy in the case of crisis.

We believe that current debt problems in China can be managed without causing excessive turbulence in the system, given the commitment of the current leadership and the huge availability of resources.

China Debt by Borrower, % GDP, end 2013



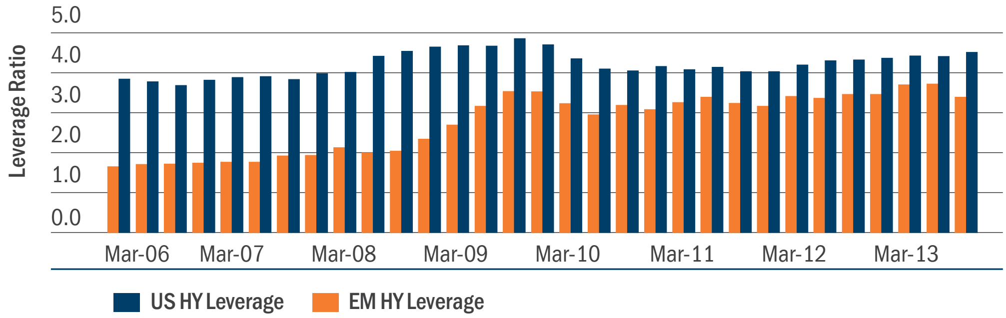
Source: PBOC, NBS, NAO, CEIC and SG cross Asset Research/Economics, data as of February 28, 2014.

Low foreign ownership of China's debt (at 4%[12], among the lowest in EMs), could limit contagion risks and partially insulate China from foreign investors' withdrawals in the event of surging risk aversion.

In the corporate sector, many EM firms have raised their debt ratios, which are nonethless comparable with US firms', even lower in the HY sector.

Increased reliance on credit is not just a Chinese habit. If we consider the corporate sector in EMs, by taking advantage of favorable financing conditions, EM corporates have, in general, raised their debt ratios. However, gross and net leverage ratios are comparable to US corporates, and even lower in the HY sector, and our assessment of EM corporate balance sheets is in general positive.

Historical Evolution of Gross Leverage in EM HY and US HY



Source: BofA Merrill Lynch Global Research, data as of September 30, 2013.

The progressive increase in leverage may be a sign of deeper and more mature markets, but raises concerns about worsening corporate balance sheets notably when currencies depreciate.

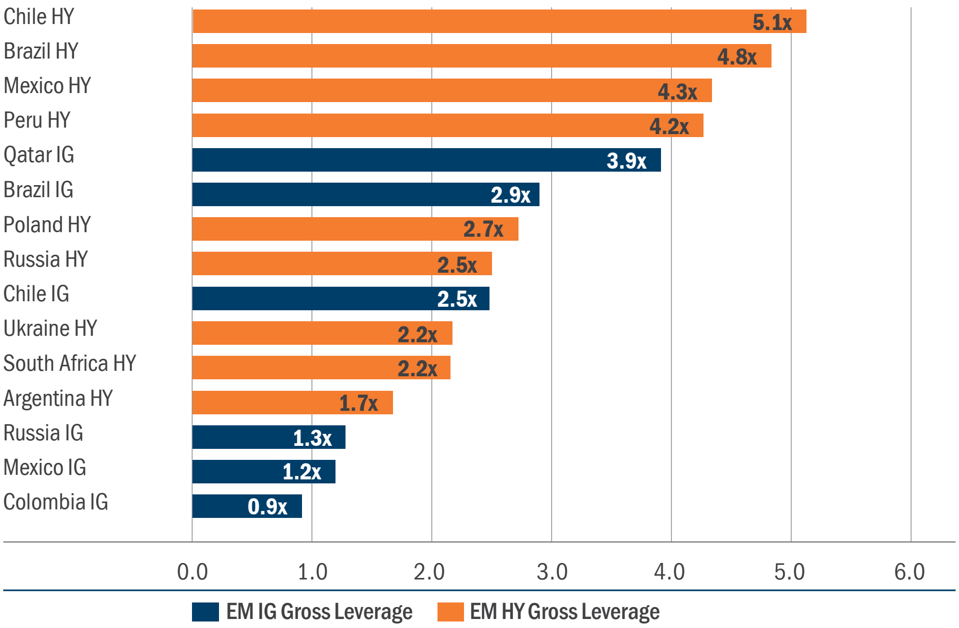
An issue to monitor is the degree to which the reliance on external debt financing impacts currency exposure. In fact, the mismatch between domestic assets and foreign liabilities, which affected sovereign countries in the 90s, could also be a problem for some businesses in case of a sharp depreciation of local currencies.

The spectrum of gross leverage as of 2Q13 from both the country and rating category perspective is wide. The variety in terms of country fundamentals, debt structures, balance-sheet maturities and currency exposures requires, in our view, a highly selective approach to identifying critical issues and the best-run corporates.

[12] JPM Flows & Liquidity, 1/31/2014 (BIS, IMF CPIS).

The variety in terms of corporate fundamentals requires a highly selective approach to identifying the best-run businesses and the ability of each country to manage its debt burden.

A Wide Spectrum of Leverage in EM Corporates



Source: BofA Merrill Lynch Global Research, data as of September 30, 2013.

We believe that a case-by-case approach is important, not only to select opportunities in the market, but also to understand the ability of each business and country to manage its debt burden, taking into account that the foreign ownership of debt in some countries is quite meaningful. This may become a problem in case of increased risk aversion and a rapid increase in US interest rates.

Assembling the Puzzle: The Role of Reforms

Today, the transition of Chinese economy towards a growth model more reliant on consumption and less on investments is one of the most important challenges in EMs.

Today, most of emerging economies are in transition.
We believe the transition of the Chinese economy towards a growth model more reliant on consumption and less on investments is one of the most important transitions, as it has broad implications in the EM world through demand for commodities, exports and, to some extent, geopolitical equilibria.

Such a transition is not easy to implement and it is likely to affect economic growth.

Will the transition toward a lower share of investments be the result of an orderly process (with limited and controlled impact on GDP growth) ? Or will it rather be the effect of a hard landing of the Chinese economy overburdened by imbalances and burst asset bubbles (credit or housing market)?

Even if the short-term reform momentum may be challenged by the growth targets, in the medium- to long-term, China seems pointing to a decisive pro-growth market-oriented direction.

The path the Chinese economy will follow depends on the success of the structural reforms that the leadership is attempting to implement. President Xi Jinping, in our opinion, has the vision and the power to push through the ambitious reform plan. Even if the short-term reform momentum is challenged by growth targets, in the medium- to long-term, China seems to be on a clear market-oriented path to boost growth.
China is the most important example of a transition to a new economic model, due to China's huge contribution to world GDP growth. However, most of the emerging countries are in transition and are facing important challenges of a different nature.

Most of the emerging countries are in transition, and are facing important challenges of a different nature.

The table below maps the position of selected EM countries on the basis of five drivers:

1. Exposure to Fed tapering measured as the impact on EM currency returns, according to our proprietary models
2. Political risk linked to incoming elections or to geopolitical tensions (i.e. Russia), as well as political governance which includes such factors as the rule of law, the regulatory quality, and the ease of starting and doing business
3. External position in terms of current account deficit as a percentage of GDP, the import cover ratio and the external debt/reserves ratio
4. Fiscal position as expressed by the IMF Fiscal Monitor
5. Exposure to the China slowdown — based on the share of exports to China.

EMs in Transition

	Country	Tapering/ Central Banks	Political Risk	External Position	Fiscal Position	China Slowdown
	China	🟢	🟠	🟢	🟠	🔴
	India	🟠	🟠	🟠	🟠	🟢
Asia	Thailand	🟠	🟠	🟠	🟢	🟠
	Philippines	🟢	🔴	🟢	🟢	🟠
	Indonesia	🔴	🔴	🟠	🟠	🟠
	Russia	🟢	🔴	🟢	🟢	🟠
Europe	Poland	🟢	🟢	🟢	🟢	🟢
	Turkey	🟠	🔴	🔴	🟠	🟢
	Brazil	🔴	🟠	🟠	🟠	🔴
Latam	Mexico	🟢	🟢	🟠	🟢	🟢
	Chile	🟢	🟢	🟠	🟢	🔴
Africa	South Africa	🔴	🟠	🟠	🟢	🟠

🔴 High Risk 🟠 Medium Risk 🟢 Low Risk

Source: Pioneer Investments, Elaboration on Bloomberg, IMF, EIU database, as of April 31, 2014.

The key factor for a successful outcome in transition is the ability to perform structural reforms.

As this suggests, there is not a single, predetermined outcome to a transition process. What we consider the key factor for a successful result is the country's ability to perform structural reforms, to correct capital misallocation and boost depressed levels of productivity.

A convergence of situations, such as still fragile growth in developed markets, China in deleveraging mode and the end of the US Fed's QE, have placed the secular trend of EM inflows in doubt and are forcing policymakers to take the required actions to design and implement needed structural adjustments. Elections in many EM countries may have a tangible impact on the process and have to be closely monitored.

The table below lists the main reforms facing different countries and our internal assessment of the probability for these to succeed in the next three years.

Country	Structural Challenges	Main Reforms: Proposals and Progress	Assessment
China	Transition from investment-led to consumption-led model. Address the high credit growth.	Reforms aimed to redefine the functions of the government promoting the role of market in resource allocation. Key reforms include Governance (redefining role of SOE, Liberalize utility prices of utilities), fiscal reform (restructure local government finance), financial reform (interest rate deregulation), land and urban residence reform (allow transfer of rural collective land, gradual residency permit), abolishment of one-child policy.	On Track
India (parliamentary election in May 2014)	Stimulate savings and investments, improve business climate, correct labor market inefficiencies.	Fast track investment projects in the pipeline, but structural reforms postponed until after elections.	Progressing, but Further Acceleration Needed
Russia	Improve productivity of manufacturing sector and increase private sector involvement. Improve corporate governance and include privatization plans for SOEs and banks.	Limited impact of reforms in industrial sector and pension funds due to resistance to carve public dominance. More effective reforms in financial and fiscal sector.	Progressing, but Further Acceleration Needed
Poland	Improve infrastructures, address labor market rigidities.	Progress in implementation of infrastructure stimulus package and pension reform.	On Track
Turkey (presidential election in August 2014)	Address the high credit growth and large current account deficit, and stimulate savings.	Medium-term projects to lower dependency on energy imports and to encourage investments on strategically key sectors.	Progressing, but Further Acceleration Needed
Brazil (presidential and parliamentary election in October 2014)	Increase competitiveness of manufacturing sector, improve infrastructure, correct real exchange rate overvaluation.	Infrastructure package, cuts in electricity tariffs. Low competitiveness due to high labor cost remains unaddressed.	Progressing, but Further Acceleration Needed
Mexico	Reduce the dependency on oil, exploit potential in manufacturing.	Strong emphasis on the approved Energy bill, which allows private companies to explore for and produce oil and gas in the country, important potential change for the large Mexican oil state industry. Large spectrum of reforms approved including fiscal, financial, labor market and telecom reforms.	On Track
South Africa (parliamentary election in April 2014)	Improve productivity and competitiveness in manufacturing sector, exploit mining sectors.	No radical reform process on the way.	No Major Progress

● No Major Progress ● Progressing, but Further Acceleration Needed ● On Track

Source: Pioneer Investments, data as of April 31, 2014.

Conclusions

As cyclical factors supporting EMB are not as strong as they have been, selection becomes, in our view, the key to investing intelligently.

Identifying the potential winners of this new game, discovering countries and corporates able to leave behind the legacies of the past and move to a more balanced growth path is the source of competitive advantage.

With a strong focus on research and analysis, Pioneer Investments is at the forefront. We can rely on an experienced EM investment team and on a dedicated team of credit research and macro analysts.

By looking across the widest possible investment universe, we aim to create more diverse portfolios that reflect the full market opportunity, while managing the risk of permanent capital impairment.

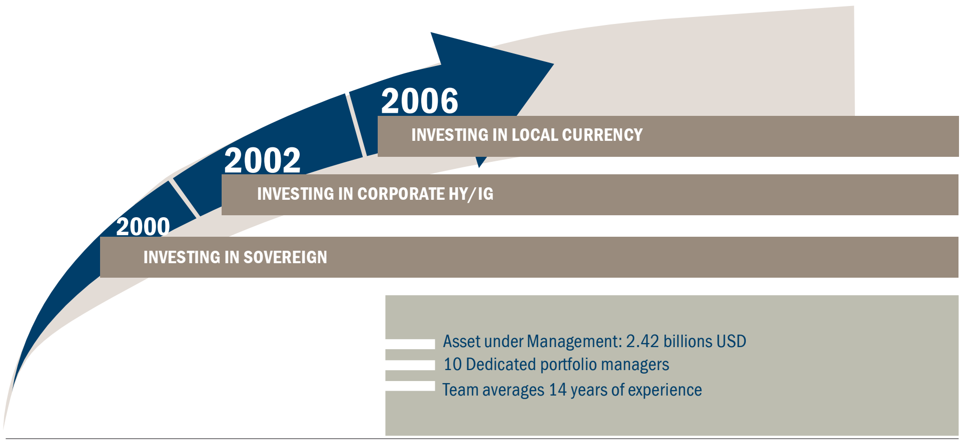
Our Approach: Experienced, Active, Research-Driven and Risk-Aware.

We adopt an active and flexible approach in our search to identify sources of potential return in heterogeneous and semi-efficient markets, within a risk managed framework.

In an effort to successfully exploit the variety and complexity of the EM debt asset class, Pioneer Investments EM Team has built its active management strategy on two cornerstones: extensive experience and rigorous research.

Experience:

With the aim of creating stable alpha* generation, ten Portfolio Managers, averaging 14 years of experience, and ten analysts are dedicated to delivering the best in-house ideas, concentrating on specific segments of the fixed income market.



Source: Pioneer Investments as of April 2014, AuM as of January 31, 2014.

* Alpha – The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager versus the index.

Key Points

→ We believe there are long-term growth opportunities for active managers in Emerging Market bonds.

→ At Pioneer Investments, we rely on a research-driven process that combines in-depth macro and credit analysis with a strong portfolio construction and risk management discipline.

→ Our Emerging Markets investment team was founded in 2000. Our extensive experience in these markets may help investors exploit the opportunities offered by this asset class.

EM team's capabilities benefit from extensive experience and deep knowledge of local markets.

With the strength coming from knowledge and experience, our portfolio managers adopt a flexible investment approach to EM debt, in an effort to exploit the complexity and benefit from the varied sources of potential returns. In fact, flexibility allows the investment team the opportunity to exploit a number of investment strategies outside traditional benchmark constraints, to identify the most attractive opportunities for different time horizons, and to adapt them to the prevailing market environment. Flexible portfolios, reflecting the market opportunity across multiple sources of potential returns are constructed under a rigorous risk-management system, which is embedded in the heart of our investment process and provides a controlled framework for portfolio managers in setting and allocating risks.

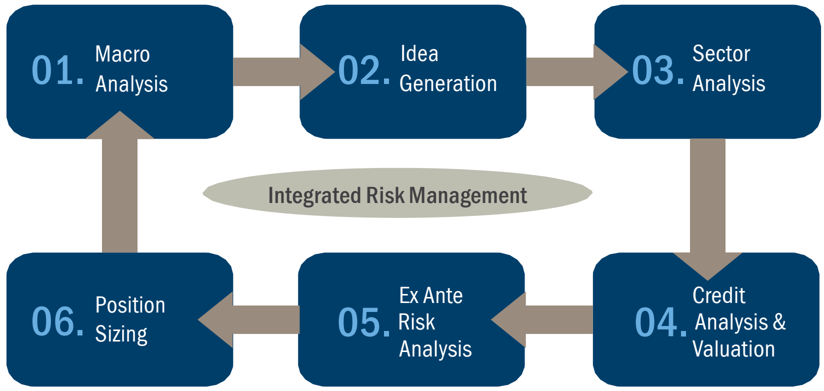
Each stage of our investment process is the result of an in-depth research process.

Research:

Our approach aims to reflect the best possible value that can be found among issuers within countries that we view as strategically advantaged.

Our research-driven investment process is based on six steps, anchored by integrated risk management:

A 6-Stage Process Drives Our Investment Decisions Anchored by Integrated Risk Management



Source: Pioneer Investments as of April 2014.

1. Macro Analysis

The investment process begins with a detailed review of the macroeconomic conditions and outlook for each country. Our research focuses on determining the global economic cycle growth stage in order to assess the relative attractiveness of each country and currency. The macro analysis is based on a combination of top-down analysis of each country's domestic economy and solvency risk and bottom-up analysis of the political situation and the technical picture for each country.

2. Idea Generation

Our macro analysis feeds into the generation of ideas which are channelled into the investment process. Ideas are filtered by preliminary screening for liquidity and transparency of the market. Bid-ask spreads may be so large as to frustrate fundamental valuations: size of issues, liquidity rating by traders, characteristics of issuers and holders are considered to give a correct assessment of liquidity.

3. Sector Analysis

Sector allocation decisions between hard and local currency, and Sovereign vs. Corporate credit risk are driven by the position of each individual country in the cycle. At the credit level, the investment universe is divided into four categories in order of risk: Sovereign, Quasi-sovereign, Companies and sectors of strategic importance (national champions, systemically important, fulfilling a utility role, with or without explicit sovereign guarantee) and companies in domestic sectors (a play on domestic growth and adversely exposed to currency risk). We invest in sovereign and quasi-sovereign credit risk throughout the cycle. The Investment team tends to focus on companies and sectors of strategic importance in late stages of the growth cycle and throughout the recessionary cycle, and invest in companies in domestic sectors in the early stages of the growth cycle.

4. Credit Analysis & Valuation

The Emerging Market Corporate investment universe is scanned and filtered according to the investment criteria and the sector allocation decisions. This research is based on business analysis, financial analysis and capital structure that drive internal credit rating. Based on our internal credit rating, the analyst will assign a recommendation, ranging from “Avoid” to “Strong Buy.”
The Portfolio Managers’ valuation of the single investments recommended by our credit analysts drives the security selection. This valuation is based on absolute return expectations and relative value opportunities. Absolute return expectations are based not only on company fundamentals, but also take into account market technical and liquidity premiums, while spreads versus comparable and possible changes in rating enter in the assessment of relative values opportunities.

5 and 6. Ex Ante Risk Analysis, Position Sizing

These two last stages involve the Portfolio Construction activity. Portfolio Construction is structured within a strong risk management discipline, which we have been enhancing through a broader use of Risk Budgeting. Our Risk Budgeting process is based on a proprietary system customized by the Portfolio Managers. The portfolio is organized by strategy to evaluate the risk contribution each strategy provides. It allows us to make decisions about individual investment strategies based on a clear understanding of the contribution to risk and portfolio return expected from each individual strategy. The aim of this risk analysis is to identify the active sources of risk in order to optimize risk-adjusted returns while taking into account the positive effects of diversification.

Conclusions

To face the current challenges and to benefit from opportunities, we believe it is important to adopt an active management approach combined with a strong focus on proprietary research and risk management.
We adopt a flexible approach, and we consider active asset allocation and bottom-up security selection the key drivers of alpha.
Counting on experienced portfolio managers and a dedicated team of credit research analysts, we believe we can provide our clients with a solid framework to consider investing in this compelling asset class.

Important Information

*Diversification does not guarantee a profit or protect against a loss.

Unless otherwise stated, all information contained in this document is from Pioneer Investments and is as of April 31, 2014. Unless otherwise stated, all views expressed are those of Pioneer Investments. These views are subject to change at any time based on market and other conditions and there can be no assurances that countries, markets or sectors will perform as expected. Investments involve certain risks, including political and currency risks. Investment return and principal value may go down as well as up and could result in the loss of all capital invested. This material does not constitute an offer to buy or a solicitation to sell any units of any investment fund or any services.

JP Morgan Emerging Markets Bond Index (EMBI) Global Diversified Index is an emerging market sovereign debt index used to measure performance of the asset class. It limits the weights of countries with larger debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding. JP Morgan Corporate Emerging Markets Bond Index (CEMBI) is a global, liquid corporate emerging markets benchmark that tracks US-denominated corporate bonds issued by emerging markets entities. JP Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified Index is a global, liquid corporate emerging markets benchmark that tracks US-denominated corporate bonds, issued by emerging market entities, including smaller issues to cover a wide array of corporate bonds and more balanced weightings for countries included in the index. JP Morgan Corporate EMBI High Yield Index is an emerging market index used to measure performance of USD denominated high yield debt issued by emerging market corporations. JP Morgan Corporate EMBI Investment Grade Index is an emerging market index used to measure performance of USD denominated investment grade debt issued by emerging market corporations. JP Morgan GBI-EM Broad Diversified Index is a government bond-emerging market index used to measure performance of government bonds (local currency) issued by emerging market countries. The spot rate, also called a spot price, is the price quoted for immediate settlement on a commodity, a security or a currency; the spot rate is based on the value of an asset at the moment of the quote.
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