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MARKET FACTS

A Historical Look At The Markets
September 19, 2000

Emerging Markets Debt versus U.S. Domestic High Yield Debt: What is the Bigger Risk?

Chart 1 shows the yield of the Merrill High Yield Master 2 Index (Merrill Index) and the yield of the J.P. Morgan Emerging Market Bond Plus Index (EMBI+).

As we note on this chart with a circle, last week was the first time the yield of the Merrill Index exceeded the yield of the EMBI+ Index. On Friday, September 15, the EMBI+ Index was again yielding more than the Merrill Index, but by only 32 basis points (12.24% to 12.56%).

This is a dramatic change of events for these indices. Between December 31, 1996 and September 15, 2000, the EMBI+ Index averaged a yield 4.07% higher than the Merrill Index. On September 10, 1998, the EMBI+ index yield was 11.21% more than the Merrill Index (21.68% versus 10.47%).

Chart 2 shows the relative performance of the EMBI+ Index and the Merrill Index. A rising line means that EMBI+ index is outperforming the Merrill Index. Thanks to the dramatic narrowing of spreads via the EMBI+ yield falling as the Merrill Index yield was rising, the EMBI+ index has vastly outperformed the Merrill Index over the past two years.

Which is Riskier?

Since these two yields are converging, the marketplace seems to view the risk of domestic high yield debt as equivalent to, or greater than, the risk of emerging market debt. Why does the market view both these markets as having the same risk?

We believe all U.S. domestic debt markets have been pricing in ever increasing amounts of "systemic risk." This risk centers on the fear that the U.S. stock market is grossly overvalued and, via the wealth effect, could sink the entire U.S. economy. Emerging market debt is largely immune from this risk (as most of it is Government debt), therefore, spreads have been narrowing against U.S. domestic market debt.

Many might view as absurd the assessment by the market place that emerging market debt has the same degree of risk as high-yield debt. We would not disagree. However, the normal relationship, where emerging market debt yields hundreds of basis points more than high yield debt, may not return anytime soon. We believe such an occurrence will happen only when the fear of the stock market sinking the economy dissipates.

Chart 1

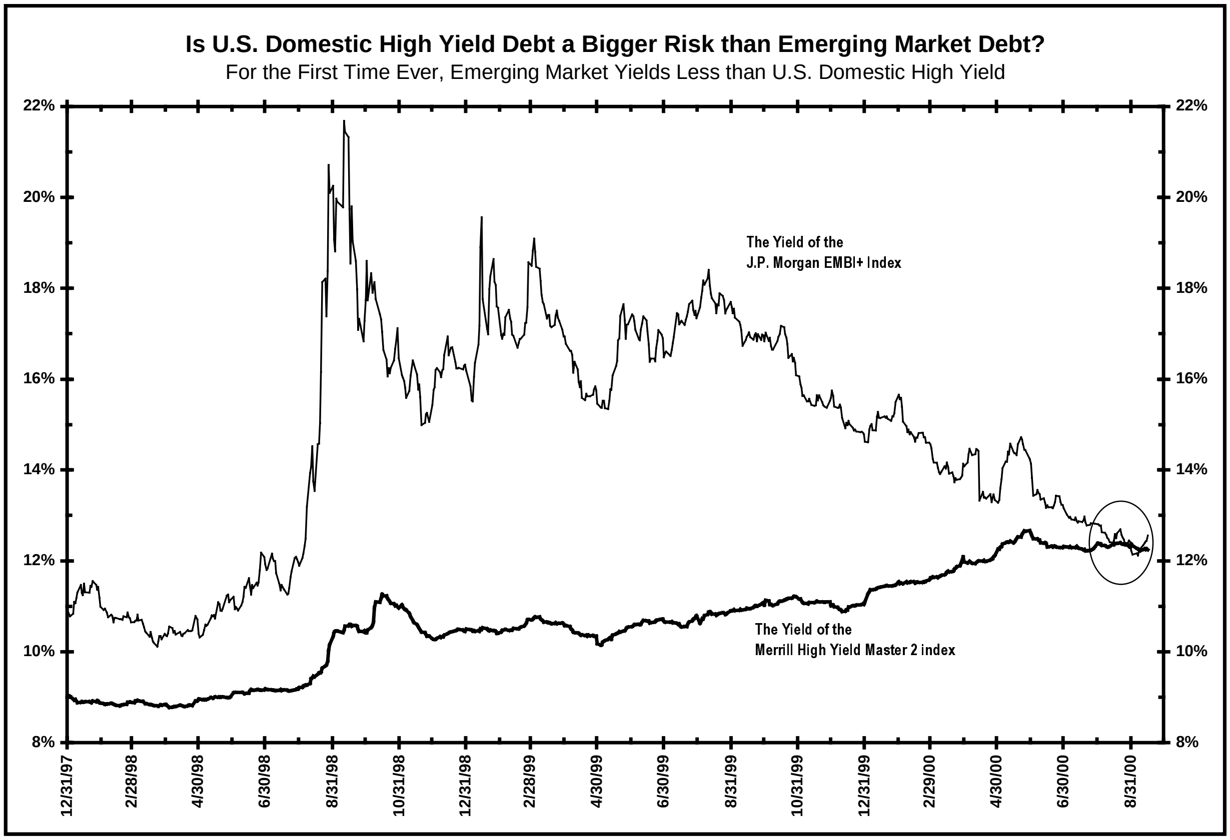

Chart 2