CAPITAL MARKETS PERSPECTIVES

Insights & Outlook 1ST QUARTER 2010

SUMMARY

ECONOMIC OUTLOOK

Developed markets

- Output may not return to pre-recession levels until the middle of 2010
- Improving corporate profits should stimulate renewed business investment and hiring
- Central banks will likely raise rates in the second half of the year, but with ample warning for the markets

Emerging markets

- Growth should outstrip that of more advanced economies
- Asset prices, while reflecting optimism, remain within reason
- Dips in prices will likely represent buying opportunities

EQUITIES OUTLOOK

- Valuation metrics, secondary offering data and insider selling activity signal that high quality stocks are likely to outperform lower quality issues both domestically and internationally in 2010

FIXED INCOME OUTLOOK

- Emerging market (EM) debt appears ripe for continued gains, buoyed by strong economic growth and broadly improved governance
- Dollar-denominated EM debt could face headwinds
- The muni recovery poised to continue in 2010

Our Top Investment Themes for 2010

The books have closed on a volatile 2009. OppenheimerFunds' most senior investment officers now look to the year ahead, and share their views on what to look for in 2010.

Jerry Webman
Chief Economist

- Emerging economies likely to outpace developed world in a synchronized global expansion
- Fed focus turns to "exit strategies," but sharp rate hikes not imminent
- Cyclical rally in equities is likely to continue; selectivity will be key

Chris Leavy
Chief Investment Officer for Equities

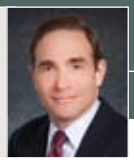
- High quality stocks are likely to outshine lower quality issues globally

Art Steinmetz
Chief Investment Officer for Fixed Income

- Emerging market debt presents significant opportunities in the coming year—and beyond
- The muni recovery poised to continue in 2010 (special commentary from Senior Portfolio Manager Dan Loughran)

OppenheimerFunds®
The Right Way to Invest

Dr. Jerry Webman is a Senior Investment Officer and OppenheimerFunds' Chief Economist.



Where Next for the Global Recovery?

To merely say that the world economy is much better than it was just 12 months ago would be to greatly understate how far we've come in stabilizing the global financial system. Policymakers constructed aggressive, unconventional and often controversial programs with longer term implications but palpable near-term results.

Today, the banking system is better capitalized, thanks to a mammoth taxpayer bailout. In addition, the U.S. housing market has shown signs of stabilization, thanks in part to the Fed's willingness to expand its balance sheet to drive down mortgage rates. Global asset markets have rallied, and every major economy in the world is poised to grow in the coming year.

Investors, however, remain skeptical, keeping $3.3 trillion in money market funds and purchasing over $400 billion in domestic high grade bond funds during the year. And why not? After all, short-term interest rates can't go lower, and budget deficits already approach unsustainable levels. An investing class that has experienced two liquidity-induced bubbles over the last decade must tremble to watch the Federal Reserve create over a trillion dollars out of thin air. Weakness in the U.S. dollar and an extreme rally in the price of gold have only heightened concerns. We naturally ask how, when and whether economic life-support policies should be removed, and whether the economy is ready to proceed without them.

Economic Forecast

The economic recovery is underway. While growth in developed markets may not return to pre-recession levels until mid-2010, emerging markets should continue to grow strongly.

Positive	**Interest Rates**	Though central banks globally prepare to start or continue tightening policy, interest rates for sovereigns, businesses and households remain accommodative
	Price Stability	Certain emerging economies (esp. those with U.S. dollar currency pegs) may face inflation, and deflation still haunts Japan, but prices are stable in the U.S. and most other developed economies
	Corporate Earnings	Earnings estimates continue to increase, reflecting improved demand and remarkable productivity improvements. Restrained leverage and long-deferred investment will moderate the trajectory of earnings growth
	Global Growth	With the chronic exception of Japan, most developed economies appear to have passed the trough of their recessions. Emerging markets generally have returned to a sustainable growth path
	Manufacturing	Pent-up consumer and business inventory demand, plus a weak-dollar boost to U.S. competitiveness, stimulate moderate growth in U.S. manufacturing
Neutral	**Trade Balance**	A weakened dollar and faster growth in emerging markets should balance the tendency of U.S. imports to increase with an improving economy
	Housing	As prices stabilize and unsold inventories approach long-term average levels, housing ceases to impede economic growth, but it is not yet a significant positive
	Employment	Unemployment remains near a 17-year high, but layoffs appear to be declining, and hiring increasing. Employment should become an economic positive by the end of the first quarter of 2010
	Credit Environment	Interest rates are attractive for financially strong business and households, but lenders continue to hoard capital. Growing federal debt threatens to "crowd out" private borrowing
Negative	**Consumer Spending**	High unemployment, flat real earnings and credit restrictions continue to restrain consumption
	Budget Deficit	A growing federal deficit, potentially worsened by state and local governments' financial straits, threatens to push both taxes and interest rates higher, weakening growth

Developed markets

For all the upward revisions to growth forecasts, consensus expectations are that the U.S. Gross Domestic Product will grow only 2.71% in 2010, with even slower growth in Europe and Japan. Given that the U.S. economy shrunk about 3.8% from peak to trough and only began recovering in the third quarter of 2009, we may not return to pre-recession levels until the middle of 2010—not much comfort for the millions still unemployed. All the king's central bankers and all the king's fiscal-stimulus spenders simply cannot put the Humpty Dumpty of leverage back together again. There is just not enough borrowing or lending and capacity to generate the growth we've learned to expect during periods of economic recovery.

Every major economy in the world is poised to grow in the coming year.

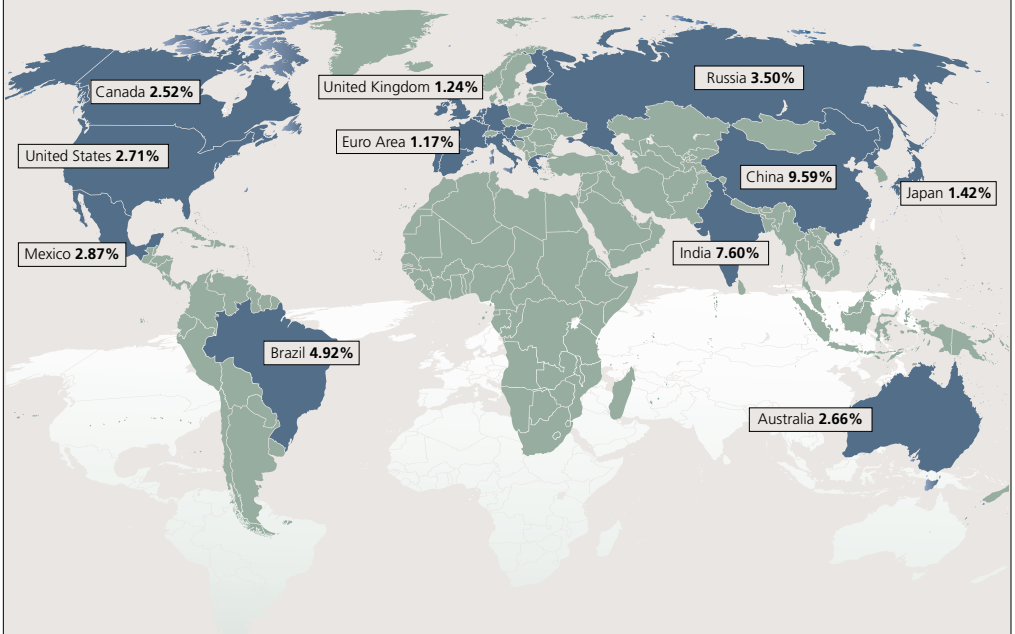
Fortunately, however, the business cycle still exists. Corporate profits are improving as businesses make do with less, take advantage of growth around the world, restock each other's shelves and resupply cautious consumers. A profit-led recovery foreshadows renewed business investment and hiring, although both still lag. Companies slashed employment during the recession, probably eliminating even more jobs than the contraction warranted. Jobless claims in the U.S. have been trending lower since the beginning of March, and leading indicators for full-time employment in the U.S. suggest that positive job growth is likely early in 2010.

The economic and psychological impact of the improving jobs picture should help drive private consumption at the same time that public spending (roughly 40% of the American Recovery and Reinvestment Plan will be spent in 2010) further props up total output. Investors should recognize that the over 60% rally in the stock market since March 2009 already prices in the markets' anticipation of this pending economic growth.

A return to job creation may be the impetus policymakers need to embark on the long path back to "normal." Central bankers will surely breathe more easily as interest rates and balance sheets retreat from crisis formations. Statements from the European Central Bank sound increasingly hawkish, recent Fed minutes suggest a growing desire to end the U.S. zero interest rate policy, and several smaller countries have already increased policy rates. Make no mistake: I do not believe that market- or economy-crushing action is imminent, not with the global recovery still tenuous, unemployment rates still high and with the growth rate of money in circulation actually declining in both the U.S. and the Eurozone. I expect the Fed and the European Central Bank to raise rates in the second half of the year but at a very deliberate pace and with ample warnings for the financial markets. Investors should nonetheless be cautious on interest rate risk.

World Growth Domestic Product Estimates for 2010

Every major world economy is expected to grow in 2010, with emerging markets outpacing developed markets.



Source of data: FactSet, 11/30/09. Chart reflects "Real" Gross Domestic Product, which accounts for inflation.

2010 will be a "transition" year in the developed world—the middle of the growth phase between recovery and expansion. The pace of the rally in the broad equity markets is almost certain to moderate, with higher quality and possibly more defensive investments returning to the fore. A slower, unlevered growth environment rewards investors who compound dependable income streams, including investments in dividend-paying companies and corporate and municipal bonds.

Emerging markets

The renewed growth cycle promises slower growth across most corners of the globe, but with emerging markets generally growing faster than the more advanced economies. Although the recent crisis reminded us that global shocks will still jolt emerging market economies, it also demonstrated that the increasingly domestic-oriented economies are better positioned than in the recent past to absorb tremors emanating from the developed world. Call it decoupling if you will. Although exports still serve as a major driver of their economic activity, the deepest collapse of trade and capital flows since World War II saw emerging market economies not only better withstand the crisis, but then lead the world into recovery. Thanks to a long and painful period of debt restructuring following the excesses of the 1980s and 1990s, many governments in the emerging world were armed with fiscal surpluses (that the U.S. might envy) and ready with public stimulus as private demand waned during the worst of the global downturn.

The pace of the rally in the broad equity markets is almost certain to moderate, with higher quality and possibly more defensive investments returning to the fore.

Despite emerging market balance sheets generally improving over the past decade, recent events in Dubai remind us that excesses remain. The lesson offered by the Dubai crisis is to always be wary of debt-fueled growth and always to focus on true fundamental expansion. As panic and euphoria moderate, capital will flow towards the regions, countries and companies whose growth creates true economic value for their citizens and investors.

Of course, investors can get exuberant, and concern is already growing about a new bubble in emerging markets. The prerequisites for a bubble are evident—global interest rates are low, risk appetites are returning and every pundit sees a yawning gap in growth potential between the emerging and developed worlds—but asset prices, while reflecting optimism, remain within reason. Inflows into the regions are moderate compared to past cycles and already certain emerging markets are running tighter monetary policy than much of the developed world.

The secular bull market in the emerging world, much like the 1982–1999 bull market in the U.S., feeds on falling interest rates, improving business conditions and a young and growing workforce. The emerging markets will suffer the usual ebbs and flows in global risk appetite, but any dips will likely represent opportunities to buy into longer term growth.

Christopher Leavy is a Senior Vice President and OppenheimerFunds' Chief Investment Officer for Equities.

Global High Quality Stocks Poised to Outperform in 2010

The 2009 stock market rally was clearly a relief for investors, both here and abroad, but watching the riskiest companies soar highest has left many investors perplexed. Did the "wrong" investments outperform? And will the markets get it "right" in 2010?

Quality is cheap at a time when investors should be paying a premium for it.

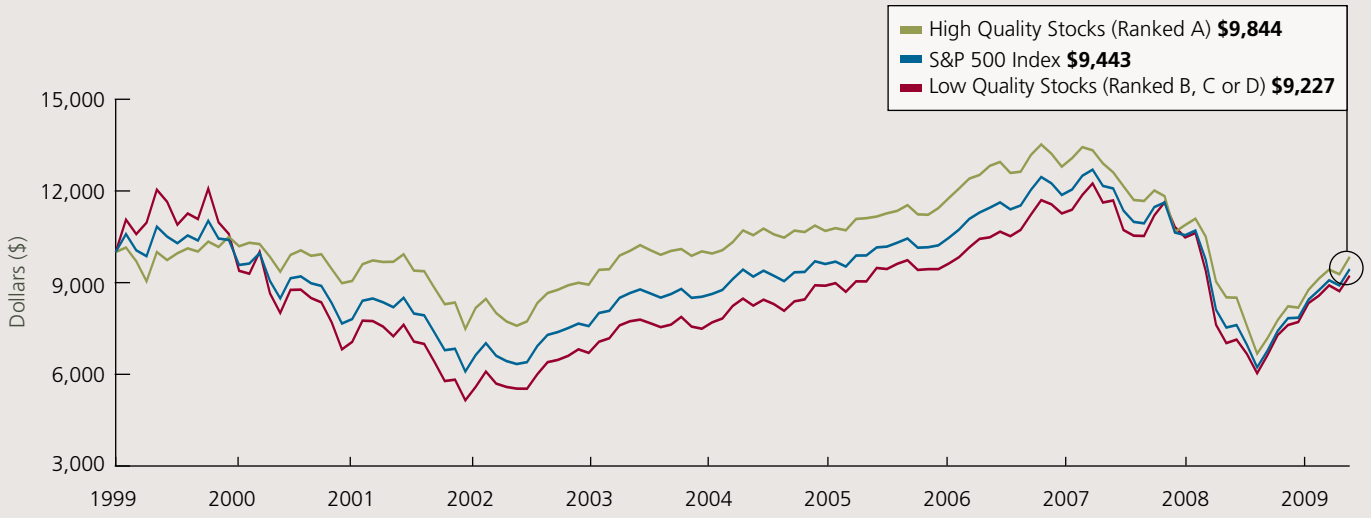
Last quarter, I wrote that stocks of high quality companies—those whose competitive advantages and favorable industry structures enable them to sustain attractive returns on capital—represented a particularly alluring opportunity compared to stocks of lower quality companies. Based on strong evidence that quality stocks are relatively undervalued around the globe, and on the telling behavior of corporate management teams in the U.S., I believe this broad theme will continue to play out in 2010.

How Do We Determine a Stock's "Quality"?

While there's no hard-and-fast definition of "quality" when it comes to analyzing stocks, there are a number of ways to separate what we consider to be high and low quality issues. For example, Standard & Poor's assigns quality rankings to stocks. These rankings measure a company's earnings stability and dividend history, which tend to represent the interaction of factors like product mix, industry position, corporate resources and financial policy over time. We also look at factors such as Return on Equity (ROE) and the trend in ROE.

S&P Quality Rankings GROWTH OF $10,000 • 11/30/99 THROUGH 11/30/09

High quality stocks have outperformed over time. However, after getting hit hardest in the financial crisis, low quality stocks have outperformed in 2009.



	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	YTD as of 11/30/09
A's Total Return (High Quality)	8.98%	1.53%	–5.62%	–17.70%	23.50%	8.33%	3.74%	15.41%	–1.66%	**–32.53%**	**15.73%**
B's Total Return (Low Quality)	33.10	–12.91	–16.00	–25.94	–33.03	12.58	7.46	16.32	11.83	**–38.52**	**29.31**
C's & D's Total Return (Low Quality)	95.71	–60.86	–45.54	–50.69	41.30	–0.53	–5.04	7.54	–2.23	**–60.76**	**59.13**
S&P 500 Index	21.04	–9.10	–11.89	–22.10	28.68	10.88	4.91	15.79	5.49	**–37.00**	**24.07**

Source of chart data: FactSet and Standard & Poor's, 11/30/09. The Quality Rankings System attempts to capture the growth and stability of earnings and dividends record in a single symbol. In assessing Quality Rankings, Standard & Poor's recognizes that earnings and dividend performance is the end result of the interplay of various factors such as products and industry position, corporate resources and financial policy. Over the long run, the record of earnings and dividend performance has a considerable bearing on the relative quality of stocks. The rankings, however, do not profess to reflect all of the factors, tangible or intangible, that bear on stock quality.

Indices are unmanaged and cannot be purchased directly by investors. Performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. **Past performance does not guarantee future results.**

A global look at quality

In my commentary for the fourth quarter of 2009, I noted how comparatively cheap most domestic high quality stocks had become in the wake of lower quality stocks' post-crisis outperformance. It's important to note, however, that this performance differential has been a global phenomenon, creating a compelling opportunity in high quality stocks both here and abroad.

The chart below compares the "forward" price-to-earnings (P/E) ratio (using earnings estimates for the twelve months starting 11/30/89) of high quality developed-market stocks to that of low quality developed-market stocks. The bottom line: Quality is cheap at a time when investors should be paying a premium for it.

Why do high quality companies warrant a premium? Against today's slow-growth backdrop, many industries around the world face excess capacity, creating a tough environment for merely average companies to earn solid returns on capital. In contrast, companies with competitive advantages and attractive industry structures are much better positioned to do so against such economic headwinds.

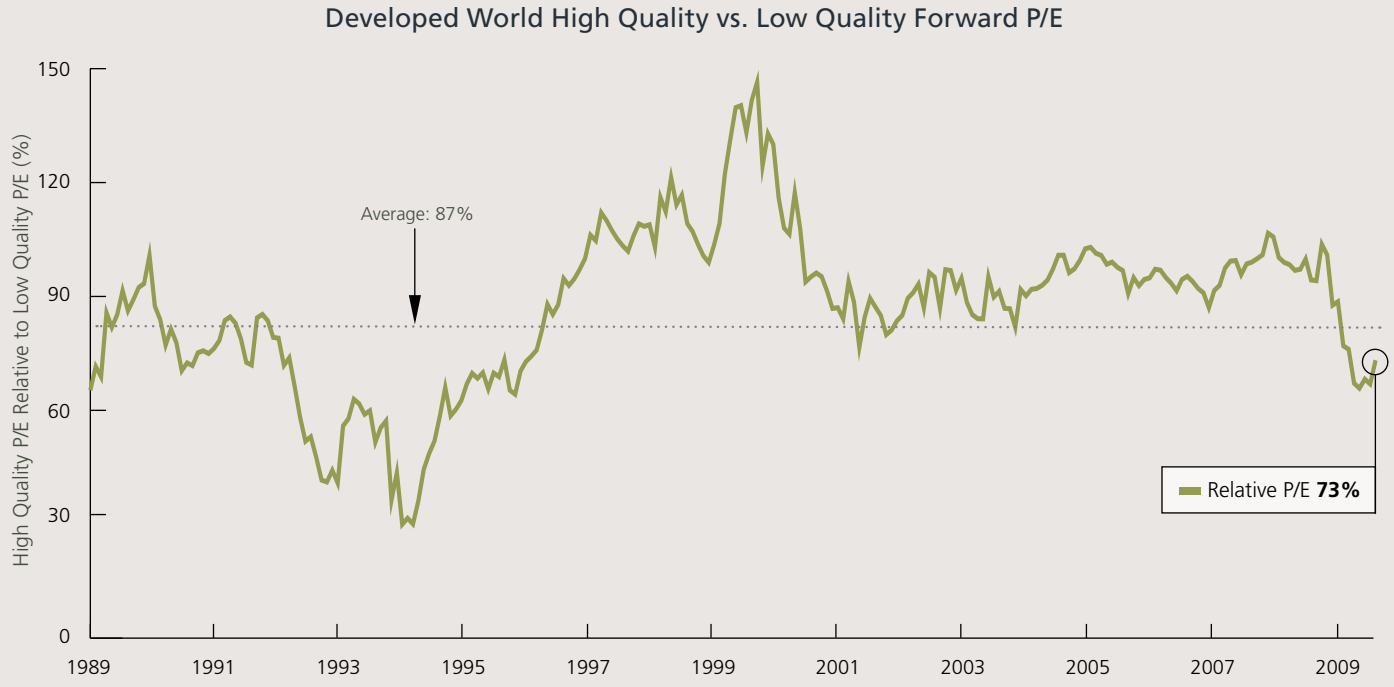
Corporate managers: Taking the money and running?

The value differential between high quality companies and lower quality companies is the most compelling broad opportunity I see in the equity markets today. But don't take my word for it; simply look at what corporate managers are doing.

Many publicly traded U.S. companies decided to raise equity capital through "secondary offerings" in the third and fourth quarters of 2009, meaning that senior management teams have been issuing new shares in their companies while demand was strong. Which types of companies are doing this? The median return on equity

High and Low Quality Stock Relative Valuations 11/30/89 THROUGH 11/30/09

Following 2009's "dash to trash," high quality stocks appear significantly undervalued relative to their lower quality counterparts.



Source of chart data: Sanford C. Bernstein and Co., 11/30/09. Chart reflects universe of publicly traded companies within the developed world. A company's quality can be measured by a variety of factors, including sales growth, net margins (how much of each dollar earned by a company is translated into profits), and for this chart, the sequential trend of Return on Equity (ROE)—which is an indicator of how well a company used reinvested earnings to generate additional earnings. A trend of steadily rising ROE may indicate a higher quality company. Conversely, a trend of steadily falling ROE may indicate a lower quality company. The trending ROE, however, does not profess to reflect all of the factors, tangible or intangible, that bear on stock quality. Price-to-Forward Earnings is a valuation ratio used to compare a company's current share price to estimated future earnings over the next 12 months. Performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. **Past performance does not guarantee future results.**

(a measure of how much profit a firm generates with investors' money) of U.S. companies issuing new shares during the third quarter of 2009 was actually *negative*. In other words, it was predominantly the management teams of low quality companies who see the recent rally in their stock prices as an opportunity to issue additional shares.

Another way to observe what executives are doing is to monitor "insider" selling—selling by a company's officers, directors and similarly well-connected personnel. Insider selling has picked up broadly during the second half of 2009, but this activity has been particularly prevalent in companies that are also doing secondary offerings. In fact, as of the end of the third quarter, corporate insiders of companies that issued secondary shares were selling their personal holdings *at more than 20 times the rate* of insiders at companies that are not issuing shares.

The value in high quality companies relative to lower quality companies is the most compelling broad opportunity I see in the equity markets today.

These two factors—new share issuance and heavy insider selling—are occurring extremely disproportionately among lower quality companies. The strong implication is that the people with the best information about their companies (the senior management teams) believe that the recent rally in low quality stocks presents a good time to lock in gains while they can. In contrast, such activity is far more limited among high quality companies.

Putting it all together

Whether we look at valuation metrics, secondary offering data or insider selling activity, the evidence overwhelmingly points in the same direction: Going into 2010, investors should overweight high quality companies.

Many of OppenheimerFunds' equity funds are currently favoring high quality businesses. We believe this posture will potentially reward shareholders on both a risk and return basis going forward.

The "Dash to Trash"

Performance of high and low quality stocks, 3/31/09–11/30/09

	High Quality	Low Quality	High–Low
U.S.	46.0%	69.8%	–23.8%
Global	47.6%	60.2%	–12.6%

Source of chart data: Standard & Poor's and Sanford C. Bernstein, 11/30/09. U.S. companies are represented by the S&P Composite 1500, which combines the S&P 500 Index, the S&P MidCap 400 Index and the S&P SmallCap 600 Index to cover approximately 90% of the U.S. market capitalization. U.S. High Quality companies are rated as A and A+, while U.S. low quality companies are rated B– and below. Global companies within the developed world can be measured by a variety of factors, including sales growth, net margins (how much of each dollar earned by a company is translated into profits), and for this chart, the sequential trend of Return on Equity (ROE)—which is an indicator of how well a company used reinvested earnings to generate additional earnings. A trend of steadily rising ROE may indicate a higher quality company. Conversely, a trend of steadily falling ROE may indicate a lower quality company. The trending ROE, however, does not profess to reflect all of the factors, tangible or intangible, that bear on stock quality. Price-to-Forward Earnings is a valuation ratio used to compare a company's current share price to estimated future earnings over the next 12 months. Indices are unmanaged, include the reinvestment of dividends, and cannot be purchased directly by investors. Performance is shown for illustrative purposes only and does not predict or depict the performance of any Oppenheimer fund. **Past performance does not guarantee future results.**

Art Steinmetz is a Senior Vice President and OppenheimerFunds' Chief Investment Officer for Fixed Income.

Emerging Market Debt: Can Outperformance Continue in 2010 and Beyond?

The snap-back in emerging market debt prices has been spectacular and satisfying for those who, like us, stuck to our guns in the dark days of 2008. As with any number of asset classes in this apparent "V-shaped" recovery, it is reasonable to wonder whether to take profits at this point. The strategic answer is "no."

The ongoing recovery puts emerging market debt back on track to continue its long-term repricing trend. This trend has been playing out for several years, and I believe we may still have several more years of gains to come.

Let's take a step back to understand why.

What's the next big shift?

When I was in college in the 1970s, the reading for my course in American defense policy included a book called *America as an Ordinary Country.* The premise of the book was that the Cold War had reached a permanent stalemate in which the U.S. would have to recognize that confronting the Soviet Union could have no upside. A scant 12 years later the Soviet Union collapsed. Some scholars then proclaimed "the end of history," and the U.S. became the lone military superpower.

The ongoing recovery puts emerging market debt back on track to continue its long-term re-pricing trend.

Economic power was a different matter. *Newsweek* magazine heralded the imminent "Pacific Century," arguing that Japan had solved the puzzle of how to create a perpetually growing economy. This was just before the Japan bubble burst and threw the country's economy into a funk from which it has yet to recover.

The foregoing illustrates both that seismic shifts in the world order occur quite frequently, and that forecasting them is well-nigh impossible. In the current moment, many of us suspect that we are facing another big shift—but will it be the obvious one?

It is tempting to borrow a quote and say that history is not repeating, but rhyming. Can it be that this really is the "Pacific Century" but with China, not Japan, as perpetually ascendant? Predictions are rife, yet again, that America will become an "ordinary" country as Brazil, Russia, India and China (the BRICs) "feel their oats" and start to assert their economic interests against a weakened U.S. I suspect events will unfold in a less straightforward manner, but I'll hazard some observations on the course that events may reasonably take.

Pulling the world out of recession

China is changing for the better. The great global imbalances in savings and consumption that developed over the last 15 years are being unwound. The financial crisis of 2008 finally started what policymakers could not, and Americans are now consuming less, while the Chinese are consuming more. Some people doubt whether Chinese domestic consumption can make up for the drop in exports to the West, but that is the wrong question to ask.

Muni Recovery Poised to Continue in 2010

Dan Loughran, CFA *Team Leader of the Rochester Investment Team, Senior Vice President and Senior Portfolio Manager*

The municipal bond market recovered strongly in 2009, and we believe the factors at play in 2009 are likely to persist in 2010.

- Investors returned to munis in 2009, more enamored by attractive yields than they were scared of perceived risk. Many realized that U.S. Treasuries, though relatively safe, offered low after-tax returns and will face headwinds once the Federal Reserve eventually starts raising rates
- The Build America Bonds program will continue to offer municipalities the opportunity to save on debt service payments in 2010. The two-year initiative gives municipalities a 35% yield rebate on taxable bonds and has helped rebalance supply and demand in the muni sector by adding much-needed capital to the credit markets. To date, higher quality muni bonds have benefited the most from the program, and that trend should continue
- After a lengthy cycle of credit spread widening, spreads started to tighten again in 2009. As a result, prices for BBB-rated, lower rated and unrated muni bonds have risen more than those of higher rated munis. However, spreads remain historically wide, so further tightening is likely in 2010
- State and local governments may be forced to raise taxes soon to help offset budget gaps, and the federal government is slated to raise taxes on capital gains and dividends when the Bush tax cuts expire at the end of 2010. Barring unexpected legislative remedies, tax rates will increase for many Americans, and the demand for munis and muni funds should rise

Instead, the question is whether emerging markets growth will be the engine that pulls the world out of recession. Consumer spending in the developing world made up the bulk of global GDP growth in 2008, and will have done so again in 2009. The emerging markets obviously benefit from this, but so does the world as a whole.

Of course, it's important to remember that trees don't grow to the sky. China likely faces some imbalances of its own, brought on by the country's massive fiscal stimulus. And, business cycles do happen, after all. We will revisit such issues frequently as 2010 wears on, but I am nevertheless confident that incomes will continue to rise in emerging markets. Consumption will grow, and so will demand for raw materials to build infrastructure and make products. As this happens, the worldwide pace of growth will quicken, not slow.

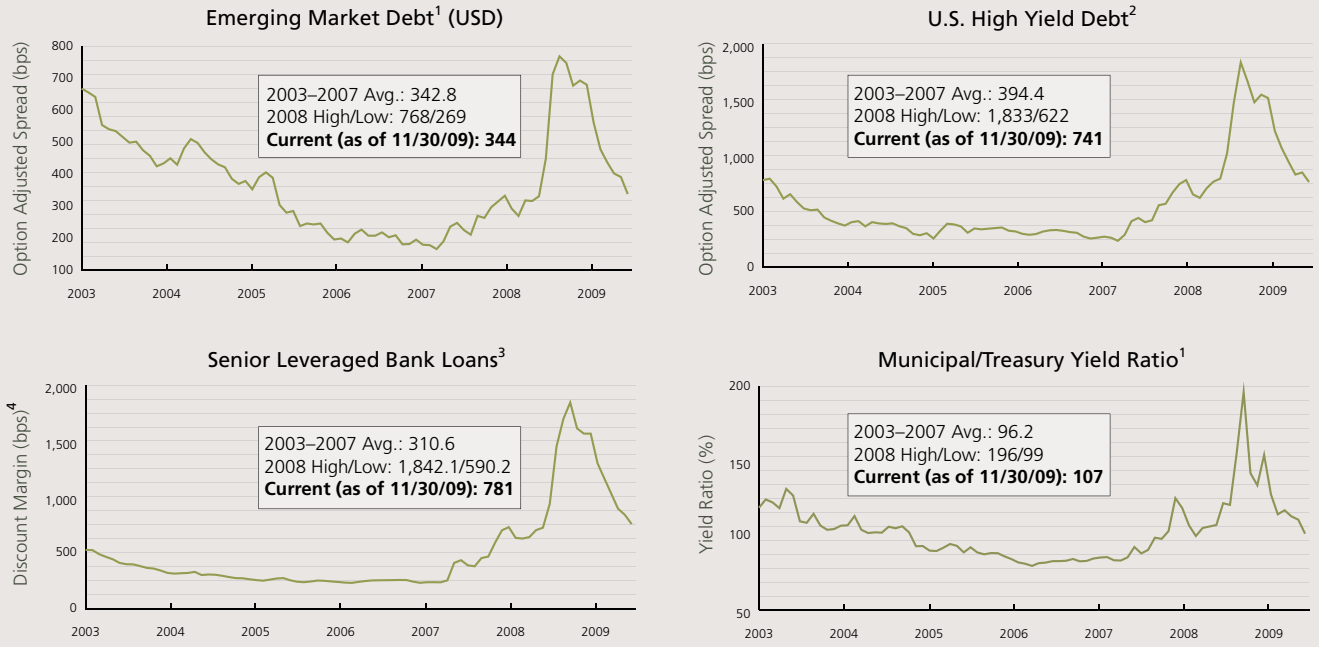
Emerging markets fared well in the financial crisis

We saw emerging market economies fare very well through the recent crisis. No, they were not immune to the flight of the "animal spirits" that gripped the developed markets. Consumption and credit growth crashed to a halt last year. Still, a funny thing happened after the dust settled. Banks in emerging markets remained standing on their own—unlike those in the U.S. Emerging market governments could still access capital markets. Export markets were knocked for a loop, but local consumers quickly started to return.

There were some good reasons for this resilience; reasons that are durable. At the risk of over-generalizing, we can identify some common factors.

Fixed Income Over Treasuries 1/31/03 THROUGH 9/30/09

Credit-driven spreads to treasuries have narrowed since the height of the financial crisis, but remain historically wide. Opportunities still exist, even if the biggest moves are behind us.



1. Source of chart data: Bloomberg, 11/30/09.
2. Source of chart data: Barclays Capital Live, 11/30/09.
3. Source of chart data: Credit Suisse Research Online/Bond.hub, 11/30/09.
4. Loan spread is typically defined as the discount margin under the assumption of a three-year average life. Discount margin is the yield-to-refunding of the facility less the current 3-month LIBOR rate. We compute the yield-to-refunding by modeling the facility as a fixed rate quarterly pay bullet bond where price is the current price of the facility, coupon is set to the stated spread of the facility plus the current 3-month LIBOR rate, and maturity is set to a fixed number of years from the end date of the measurement period. We compute four discount margins for the index, fixing the maturity to be two, three, four or five years from the end date of the measurement period.

Past performance does not guarantee future results.

First, the quality of developing countries' policy-making institutions has improved. Gone are the days when their central banks were more like piggy banks for populist governments to use for making handouts. Governments have realized how corrosive inflation is to the poor, who have no ability to squirrel money abroad in "hard" currencies.

High yielding countries will be growing well—and still have high yields.

Second, successive foreign debt crises of the 1980s and 1990s finally encouraged governments to wean themselves from excessive foreign borrowing. Countries like Brazil and Russia have even become net foreign lenders at the sovereign level. Many nations used commodity price-rise windfalls to reduce debt rather than increase spending.

Finally, governments vastly improved tax regimes and reduced laws protecting state-owned monopolies, allowing private business to flourish.

The payoff for all this virtue was evident in the most recent crisis. Capital inflows allowed central banks to bolster foreign currency reserves. We saw the benefits of this in Brazil, for example. Henrique Mereilles, the head of the Central Bank of Brazil, was coy when he was frequently asked in 2007 to explain why Brazil was building up such large reserves in low yielding U.S. dollars. "When we have enough, we'll let you know," was his typical answer. His strategy was prescient. As markets imploded in 2008, Brazil's currency at first suffered a great deal, as local corporate borrowers got caught flat-footed without enough dollars. But thanks to the country's large foreign reserves, the damage was short-lived and the Brazilian currency has since recovered almost completely.

This quick recovery is even more remarkable when you consider that Brazil, like most of the countries we follow, has been drastically cutting interest rates. In the old days, rate *hikes* would have been needed to prevent capital from flying out of the country. Now, for the first time, most developing countries have been able to run "counter-cyclical" monetary policies. They cut rates in response to a slowdown in order to stimulate their economies—and the capital markets let them!

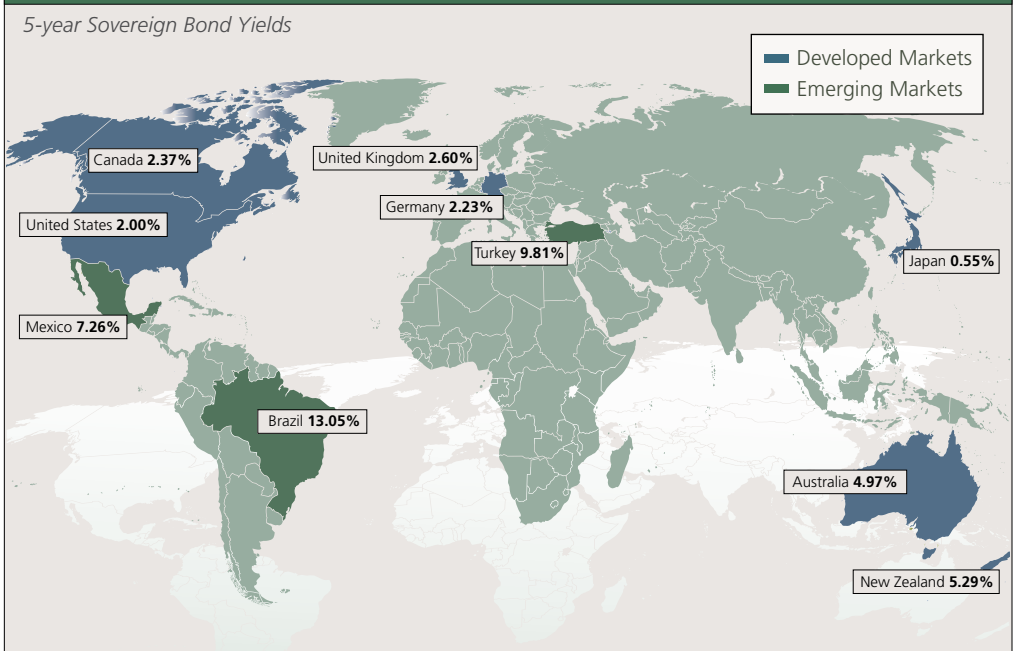
Looking to 2010: Solid growth and high yields

Now what? Interest rates have fallen and currencies have risen against the U.S. dollar. Will we have more of the same in 2010? We don't believe the dollar will fall forever. When the Federal Reserve removes some of its economic stimulus measures, the dollar is likely to rise. While this will push many foreign currencies lower, some will fare better than others.

If interest rates in the U.S. go from zero to 1% and long-dated U.S. bond yields rise to 5%, aren't you still interested in a country with good prospects and yields at 12%? If inflation in the U.S. rises to 3%, but inflation is 5% in a country where yields are 12%, does that diminish your interest? This is the landscape we will face.

Emerging Market Debt Offers Attractive Yields AS OF 11/30/09

5-year Sovereign Bond Yields



Source of data: Bloomberg, 11/30/09. Yields listed are that of each country's "on-the-run" (most recently issued) 5-year government bond except for Brazil's, which was interpolated using 4- and 7-year "on-the-run" bonds.

High yielding countries will be growing well—and still have high yields. What's more, we believe that most emerging market central banks will demonstrate their inflation-fighting credentials with rate hikes that match those in the U.S. This may limit the rise in the dollar against such currencies. By contrast, yields in Europe and Japan will not attract investors, and those currencies will fare worse.

Dollar-denominated emerging-market debt could face headwinds

The prospects for emerging market debt denominated in U.S. dollars (so-called "external debt") are less clear, however. Such bonds will be victims of their own success. Credit spreads are tighter because of great economic performance and debt reduction, which have shrunk the supply of sovereign debt.

Since these bonds trade at narrow spreads over U.S. Treasury debt, their performance will correspond more closely with U.S. rates than to emerging-market credit when U.S. rates start to rise—and that will hurt prices. The treatment for this kind of pain is to specifically hedge the Treasury risk inherent in bonds of any issuer. Doing so allows one to separate credit quality issues from interest rate concerns, protecting against the bad while keeping the good.

U.S. interest rates heading higher—but not just yet

What about U.S. interest rates? Forecasting rates is often a fool's game, but we think that when the Fed puts us on notice that tighter monetary policy is coming, we are in for a sustained rise in rates. Fortunately, we don't think this is imminent, at least not while employment and housing in the U.S. remain so depressed.

Global markets have been on a roller coaster ride over the last year, with all the cars linked together. First there was a dizzying drop, followed by a giddy rise for virtually every asset class. In the coming year, we foresee a more nuanced environment. Investors in emerging market debt will have to pick the countries with the right combination of attributes to continue performing well as the global monetary regime changes, and they will have to separate the individual risks of securities to hedge problematic features. Happily, we continue to see many opportunities in emerging markets.

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