MARKET INSIGHTS

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Emerging markets strategy: Maintaining the growth advantage

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Introduction

Emerging markets macro strategist George Iwanicki takes a closer look at the implications of sluggish growth and quantitative easing in the developed world for emerging markets. George presents his constructive view on the asset class, focusing on valuations and flows as well as highlighting selective tactical investment ideas at the country level.

A fragile expansion with lingering potential for relapse

This year's established storyline continues to play out – one of a sluggish expansion in the developed world, which has followed a sluggish recovery from a very deep recession. As a result, this is a fragile recovery with the risk of relapse and, more importantly, even presuming the recovery continues there is a lingering risk of deflation. Nonetheless, we believe the most likely outcome is for continued sluggish growth, supported by accommodative, if not extraordinary, monetary policy, including the most recent round of quantitative easing.

Decoupling 2.0

Most investors will remember the great decoupling debate of 2007. The hope was that, as the developed world slowed, emerging market growth would hold up. With benefit of hindsight we know that this confidence was misplaced: a hard landing in the developed world meant a sharp slowdown for the emerging world. However, we have seen a marked differential in growth between the G-7 and the emerging world.

The question today is, given the widespread expectations (including our own) for very slow developed world growth over the next few years, how much can emerging markets 'delink' or decouple and sustain superior growth over the developed world?

Notably, consensus expectations, including those of the International Monetary Fund, are that a gap in growth between the emerging and the developed world of 4% or more can be sustained over the next three to five years. We're inclined to agree with this view; however, we wanted to investigate further – looking not only at the commercial links but also at some of the financial links between these two economic blocks to see whether emerging markets can sustain such a large growth advantage.

1. Commercial links

Exhibit 1 looks at global trade trends, and highlights that over the last 20 years we've seen one of the most rapid periods of trade intensification – or tightening of commercial links – witnessed in history. Global trade has exploded since 1990, reaching more than 25% of global GDP and, within that surge, exports from emerging markets have led the way, rising to 30% of global exports. This rapid deepening of trade would seem to suggest limits to the decoupling story.

However, if we dig a little deeper into emerging market exports, we see that trade links *within* emerging markets are deepening fastest. The destination of exports is beginning to shift fairly rapidly away from developed economies and toward emerging market economies – in the past five years alone there has been a 10% increase in the share of exports going from emerging markets to other emerging markets, relative to what was the case as recently as 2005. Of course, this growth in intra-emerging market exports partly reflects faster demand growth in the emerging world than in the developed world – a factor that has also benefited developed economy exports. But it primarily illustrates that economic links have tightened most rapidly between emerging markets.

2. Financial links

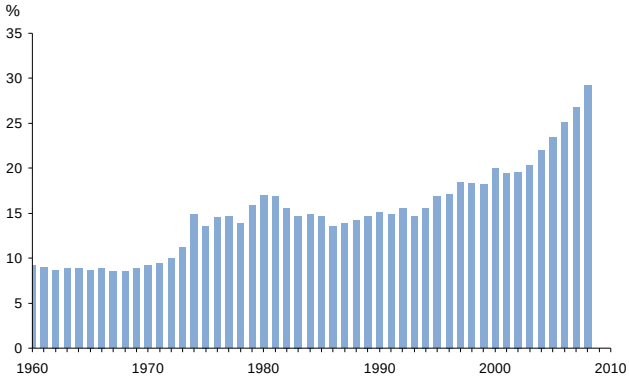
Financial links also point to the increasing importance of emerging markets. Half of global foreign direct investment (FDI) now flows into emerging markets, while emerging markets are now the source of almost a fifth of FDI flows. This is evident in some of the headlines in recent years: India's Tata Motors buying up Jaguar and Range Rover, for example.

In essence, financial flows are beginning to mimic global trade patterns – emerging markets becoming significant in their own right not only as recipients but also as generators of FDI flows. So viewed through the lens of either commercial or financial links, it's increasingly evident that there are strong supportive factors for the growth outperformance that is expected for the emerging world relative to the sluggish developed world.

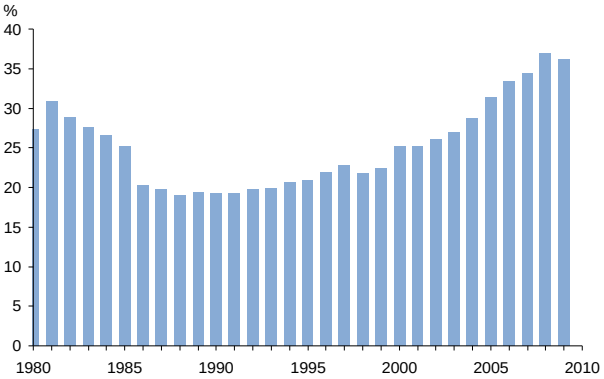
Lastly, it's notable that after a decade of widening global imbalances between surplus emerging market and deficit G-7 blocs, the developments above are finally beginning to steer current account positions back toward historically more normal levels. We are now three to four years into the corrective process. This is good news from the point of view of financial market volatility, insofar as these imbalances represented a primary focus for worry among global policymakers and investors, acting as a source of volatility.

Exhibit 1 – **Rising trade intensity – particularly for EM**

Global exports – Share of GDP



Emerging and developing economies exports – Share of global



Source: IMF Direction of Trade Statistics

QE2 presents challenges for emerging market policymakers

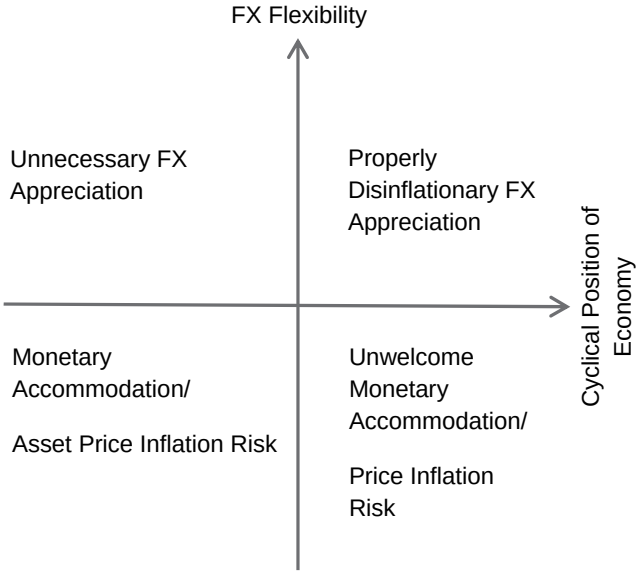
Amid sluggish developed world growth, the second round of quantitative easing in the US (known as 'QE2') is exerting downward pressure on the US dollar, forcing choices on emerging market central banks that could result in a variety of outcomes.

Exhibit 2 is a stylised grid that can be used to determine the potential effect of QE2 on emerging market economies. The vertical axis ranks countries on the basis of the flexibility of their exchange rate policy. A fixed rate regime or a managed float regime appears on the bottom half of the chart, whereas a floating exchange rate regime appears in the top half of the chart. The horizontal axis represents where an economy is within the business cycle.

Countries that fall on the left of the chart are operating below full capacity and as a result have little in the way of price inflation pressures. Those on the right hand side of the chart are more advanced in their local cycle and as a result face potential price inflation pressures.

Exhibit 2 – **QE2 presents challenges for EM policymakers**

QE2 exerts downward pressure on the USD, forcing choices upon EM central banks



For countries with a floating exchange rate regime and operating above potential (ie the upper right quadrant), the ideal policy solution in response to the downward pressure on the US dollar from QE2 would be to allow some currency appreciation. This would not only help to slow the economy and contain inflation pressures, it would also provide some immediate inflation containment via pass-through effects.

For countries in the bottom right quadrant, maintaining their fixed exchange rate strategy implies mimicking quantitative easing to some degree, creating excess liquidity. As a result these countries, which are already advanced in the business cycle, are the prime candidates for upside price inflation risks.

Countries in the lower left section have an easier time (for now) maintaining fixed exchange rate regimes as they benefit from the fact that they are operating below potential GDP. These countries are the prime candidates for asset price inflation as a result of monetary accommodation amid lingering economic slack.

Finally, countries in the upper left quadrant, where economies are operating below potential but tolerate foreign exchange (FX) flexibility, may choose to accept appreciation but are not in need of such disinflationary impetus given the presence of local economic slack.

How will individual countries fare?

It is relatively simple to determine the FX flexibility of various emerging market economies. To assess the potential impact of QE2, we therefore need to make a judgement of where economies are in their respective cycles.

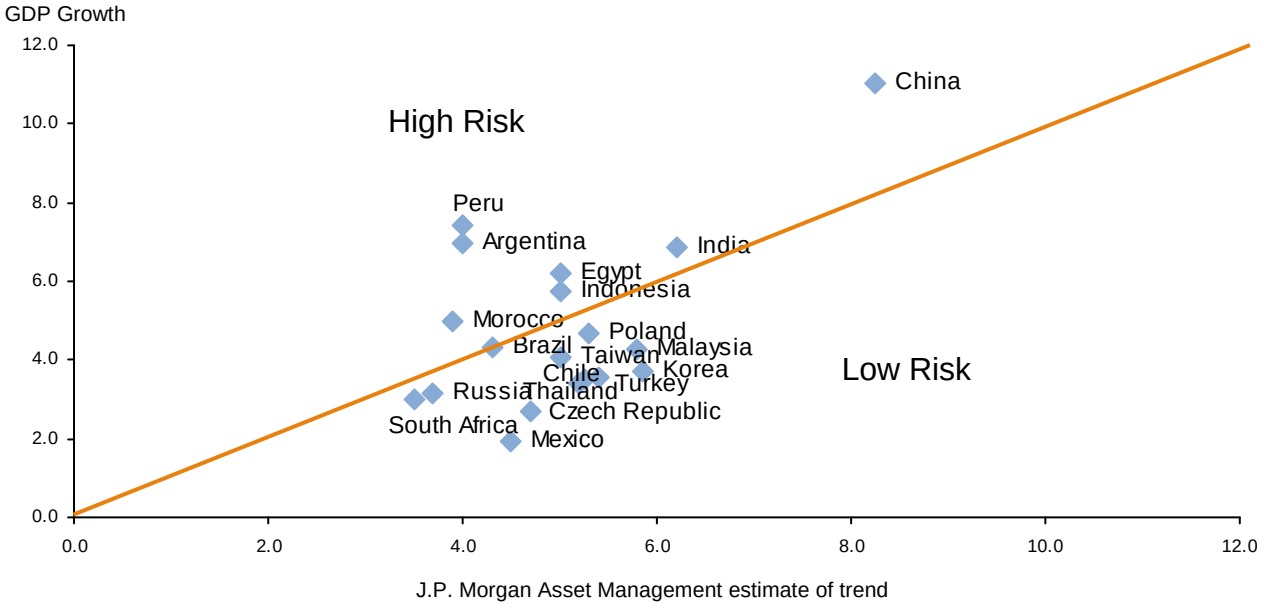
In the developed world, this is a far easier exercise – the Organisation for Economic Cooperation and Development (OECD) comprehensively estimates output gaps using relatively harmonised data. In the absence of such formalised estimates for emerging markets, we have taken an alternative approach by comparing realised GDP growth over the past five years with our best estimates at the time of potential economic growth (as judged by the growth in labour, the growth in capital, and productivity growth).

This comparison shows which economies have been chronically outgrowing their potential and as a result are running positive (or potentially inflationary) output gaps and which countries have been operating below potential and as a result still have disinflationary slack. The good news, as **Exhibit 3** shows, is that most emerging market economies still seem to be operating with some slack.

However, there are some notable markets that appear to have sustainably outrun potential and face inflation risks. China has been significantly outpacing the 8-8.5% growth rate we viewed (and still view) as trend growth; India has slightly overshot the 6%+ rate we saw as trend, while Indonesia has also begun to outperform our long-term trend figures. However, Brazil has grown at trend rate, and most other significant markets have lagged trend and thus should retain disinflationary slack. Therefore price inflation looks to be a selective rather than a systemic risk within emerging markets.

Exhibit 4 on the next page summarises the likely implications of QE2 pressures for the more significant emerging markets. The risk of economic overheating and price inflation is most severe in China, probably explaining why some of the loudest protests of the Fed's quantitative easing policy is coming from Chinese policymakers. India and Indonesia are also places where the overheating and price inflation risk is prevalent; for both of these more flexible FX regimes the question is how much additional FX appreciation policymakers will tolerate.

Exhibit 3 – **Five-year annualized GDP growth vs. trend estimates**



Sources: Economy Ministry, IBGE, CBC, DANE, INEGI, BCRP, BCV, Derived by JPMorgan HK-CSD, Statistics Office, BPS, BOK, Department of Statistics, NSCB , DGBAS, NESDB , CSU, CAPMAS, KSH, CBS, IMF-IFS, Direction de la Statistique, GUS-JPM , Goskomstat, SIS, SARB

Exhibit 4 – **The impact of QE2 on selected EM countries**

	Brazil	Russia	India	China	Indonesia	Turkey
FX appreciation	?	✓	?		✓	✓
Capital controls Inflow taxes	×			✓		
Economic overheating/ price inflation			✓	✓	✓	
Asset inflation	✓	✓				✓

Source: J.P. Morgan Asset Management

Conversely, Brazil and particularly Russia and Turkey are better positioned to avoid near-term inflation risks as they all are growing at or below their respective trend growth levels. These are the markets that could see currency appreciation if QE2 puts further downward pressure on the dollar, or more likely they are candidates to experience local currency asset inflation as a result of the QE2 effects.

Still constructive on the asset class

While inflows have been strong enough to prompt some to wonder whether the 'EM story' is already priced in, we believe emerging markets still offer plenty of potential. The most impressive reforms in the asset class over the past decade were not necessarily the macro reforms we're all familiar with – lower inflation, better budget positions etc – but rather the improvement in corporate capital discipline and the resulting improvement in operating efficiency, reduced financial leverage and returns on equity (ROEs).

These improvements are allowing profits to 'participate' in more rapid emerging market economic growth, leading a secular rise in the share of global profits that are accruing to emerging market companies. In our view, this rise best explains why investors the world over are reassessing their strategic allocations to emerging market equities with an eye to raising targets.

In view of ongoing inflows, we carried out a simulation of the effects of rotating 1% of assets across developed world portfolios into emerging market equities, to show the potential impact on flows into emerging markets. Importantly, just this small shift would produce a larger flow than any annual flow we've ever seen. This allays our concerns that the inflows seen to date are reflective of 'hot money' chasing returns. Rather it suggests that the flows so far may simply be the front end of a strategic reallocation that has much further to go. Hence it's premature to be intimidated by the inflows into the asset class.

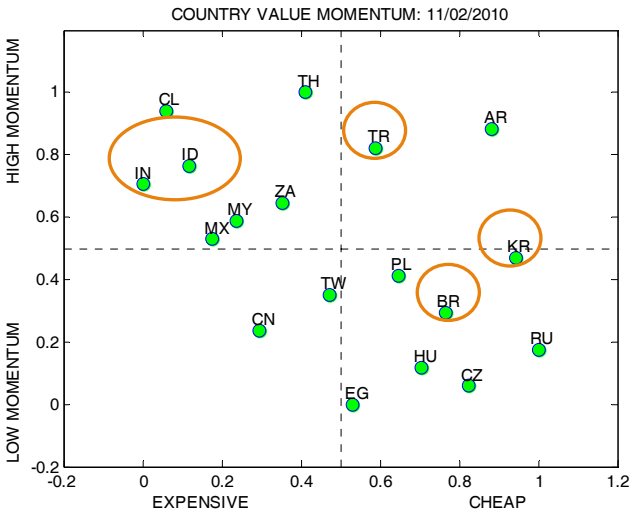
Similarly it is premature to be concerned by valuations, which still look to us to be definitively fair, if not slightly cheap. Our rule of thumb on price-to-book ratios stands: at 1.5x or below, history has shown that it's time to buy: at levels of 2.5x or 3x mean it's time to be cautious. We're currently right in the middle of that band at 2x. The forward price-to-earnings ratio is back to around 12x to 12.5x as at the end of November, near the five-year average, but below the very long-term average and below our fair value long-term estimate of 14.5x.

In summary, if we assume convergence of valuations to fair value and earnings growth in line with improved corporate capital discipline, and even if we allow for a retracement of commodity-oriented exporter currencies back towards fair value, our trend return estimates remain in the low double digits in US dollar terms. Therefore, we remain constructive on emerging market equities.

Actionable ideas: pay attention to unloved Korea and stick with Brazil and Turkey

On a sector basis, both our top-down and our bottom-up measures suggest we're in the mid-cycle period, or expansion phase, of the global economic cycle. At this stage, signals for sector rotation tend to be more modest and differentiation among sector returns tend to be narrower than in the early cycle or late cycle/recession periods. As a result, our sector views on a cyclical basis are relatively muted. On a secular basis, we retain a leaning against materials, where we've seen what appear to be the beginnings of a deterioration in capital discipline (whereas the rest of the asset class appears to be holding up well on that front).

Exhibit 5 – **Country: Value and momentum**



Source: J.P. Morgan estimates. Data as at 2 November 2010. Countries ranked on last 12 months price movement on the y-axis and a composite of valuation metrics on the x-axis. Units are percentile ranks which go from 0 to 1.

On a country basis, our tactical instinct is always to look at the value/momentum overlap. According to our value/momentum screens (**Exhibit 5**), Indonesia and India, which we have already highlighted as facing some inflation risk, are also beginning to look expensive. The situation in India is perhaps more stretched than in Indonesia, and is compounded by the fact that India has also seen some compression in return on equity.

On the positive side, and notwithstanding recent tensions on the peninsula, Korea looks very cheap and should benefit from the end of the global growth scare. Recent purchasing managers' indices suggest that the global industrial cycle, after some slowing over the last few months, has found bottom. If the global growth scare is now over and investors are again accepting sluggish but continued growth, Korea looks attractive. The Korean won also looks cheap, and its position as a consensus underweight means it has upside potential as investor hostility begins to wane.

Brazil, meanwhile, still looks cheap, although it is not yet screening particularly strongly on momentum. We maintain our tactical overweight, believing that the rotation among investors from neutral back to overweight still has further to run. We are continuing to monitor political developments to gauge the degree of the shift from 'pragmatic' left to 'ideological' left under the incoming Dilma administration to determine whether the attraction of Brazil is tactical or strategic.

Finally, we maintain our longstanding overweight in Turkey, which has consistently screened well for both value and momentum. We do need to note, however, that Turkey has had a strong period of outperformance, meaning that while valuations remain attractive, discounts to the broader emerging market universe have begun to narrow. We don't see near-term inflation risks in Turkey, according to our output gap measure mentioned earlier, but the market is a consensus overweight, all of which highlights that we are nearer the end of the outperformance cycle than the beginning.

Conclusion

While developed economies are still mired in a sluggish expansion, emerging growth remains structurally strong. We believe that this strength can largely be sustained given the deepening financial and commercial links within emerging markets.

As such, the key focus for investors now is the impact of QE2 on emerging markets. In some cases it means currency appreciation, in some cases it means asset price inflation and in some cases it presents local price inflation risks. This varies by country. The important point is that price inflation risk within emerging market looks to be a selective problem (in China, India and Indonesia, for example) rather than a systemic one.

We remain comfortable with current valuations for emerging market equities as a whole. We're also comfortable with the inflows the asset class has seen, especially in light of what we see as well-judged interest among global investors to increase strategic allocations to the asset class. At the country level, we believe investors should pay attention to the unloved Korean market and maintain, for now, overweights in Turkey and Brazil.