MARKET INSIGHTS

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Emerging markets: understanding the risks

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Introduction

Emerging markets offer compelling long-term return potential, but continue to present risks that every investor should understand. In this paper, Richard Titherington, CIO of the Emerging Markets Equity Team at J.P. Morgan Asset Management, discusses the risks inherent to emerging markets and looks at the effect they have had on economic and investment performance. He also explains why globalisation and urbanisation mean that, for long-term investors who are aware of the risks, there is considerable reason for optimism about emerging markets.

I believe in the long-term outperformance of emerging market equities as an asset class: if I didn't, I wouldn't be working as head of J.P. Morgan Asset Management's Emerging Markets Equity team. However, it is important for us and our clients to understand the risks inherent in the asset class.

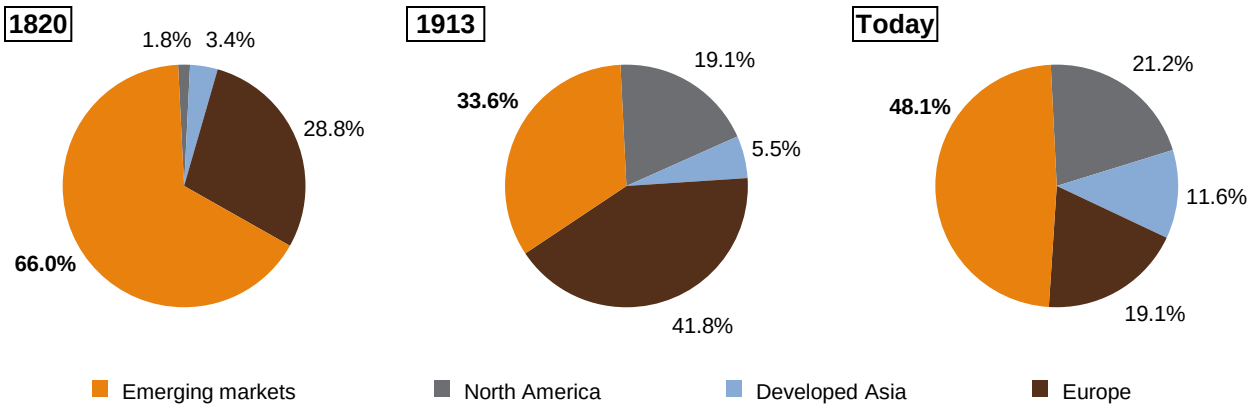
The fundamentals driving emerging market equities

First, it is worth restating the two fundamentals driving the development of the emerging market asset class.

The first is the rebalancing of the world economy from the extreme of concentration of economic power typified by the creation of the G7 (the group of seven industrialised nations) in 1976, which meant that by the end of the Cold War in the early 1990s the developed world of North America, western Europe, Japan and Australasia, approximately 12% of the world's population, represented 77% of global GDP. It is this extreme degree of economic imbalance that is unusual, not the more balanced world we are moving back towards.

Exhibit 1 – **The really big picture**

Emerging markets' rising share of global GDP



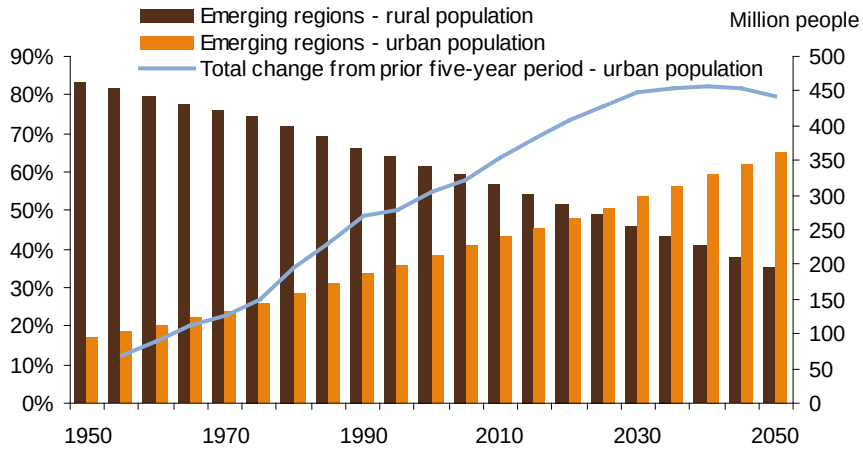
Source: J.P. Morgan Asset Management, Angus Maddeson 2001, IMF as at end 2009, GDP in PPP terms

The second key driver is urbanisation – the continuing move of population from the countryside to cities – which drives both productivity and consumption. Approximately 50% of the world's 6.8 billion people currently live in urban areas. However, more than 95% of the population of developed countries are already based in urban areas. In consequence, close to 100% of the productivity and consumption growth derived from urbanisation lies in the emerging world, sustaining faster economic growth.

"The equivalent of half the population of Europe moving from the countryside to the city"

Exhibit 2 – **Urbanisation: the big move**

350m people forecast to move from rural to urban locations between 2010 and 2015



Source: World Bank Data. Data as at January 2008. For illustrative purposes only.

Strategic risks to monitor

Having described the key positive drivers, let us look at the risks, and specifically at why many of the emerging nations of 100 years ago are still emerging today. There are two key reasons: revolution and inflation. The chart below lists the ten largest emerging markets and highlights their experience with these two destructive phenomena.

Exhibit 3 – **Ten largest emerging markets: Revolution and inflation**

	Proportion of the MSCI All-Countries World Index (%)	Revolution	Inflation
China	2.47	1911, 1937-1949	1990-1995
Brazil	2.14		1979-1993
Korea	1.80	1910, 1945, 1950-53	1998
Taiwan	1.45	1911, 1949	
India	1.08	1947	
Russia	0.84	1917-1922, 1991	
Mexico	0.57	1910	1980-1988
Malaysia	0.41	1963-1965	
Indonesia	0.31	1945-1949	1998
Chile	0.24	1973	1970-1975
Turkey	0.24	1918-1923	1973-2004
Thailand	0.22		1998
	11.76		

Source: MSCI, World Bank, IMF, CIA World Factbook, September 2010

The economic consequences of political revolution are clear, with the Russian and Chinese examples of the twentieth century not requiring further elaboration. Many countries in the emerging world have witnessed less well known but equally damaging political upheavals, which make political and legal institutions less reliable and predictable than in the developed world.

The impact of inflation is less obvious but more pernicious in preventing development and especially in perpetuating poverty. Over the last 100 years, Brazil has grown on average at 4.9% in real terms. This is considerably better than the USA, which grew at 3.5% over the same period.

However, Brazil remains an emerging market, while the USA is the world's leading economy. Unlike most of the top ten emerging market countries, Brazil, despite periods of military rule, has not suffered from political revolutions, partition or war. Consequently, it should be a candidate for graduation from emerging to developed status.

The reason that Brazil has not emerged is inflation. From 1958 to 1968 and again from 1975 to 1994, Brazil suffered from high and even hyper inflation. In only 12 of the last 65 years has inflation been below 10%, and seven of those years have come in the last eight years. It is this change from high to low inflation that has allowed the Brazilian market to return 16% per annum since 1995: twice the return per annum of US equities over the same period.

Inflation increases inequality, impoverishing the majority of the population. It also undermines currency values, explaining why for most of the last 100 years emerging market currencies have been weak against G7 currencies. In consequence, the biggest financial risk we face as investors in emerging markets is a return to an environment of fixed exchange rates and high and rising inflation. We expect average inflation in the emerging world to be 5.5% over the next five years, based on our internal macroeconomic work. If that assumption is correct then, except for individual countries such as Venezuela, the inflation risk in emerging markets is low and on a completely different scale to that experienced in the period from 1970 to 2000.

Therefore the two strategic risks that we need to understand and monitor are political upheaval, which leads to the appropriation of assets via revolution as in Russia, China, Turkey, Egypt, Chile, Cuba, Iran, Algeria and Vietnam, among others, and inflation, which destroys the real value of assets, as seen in Argentina, Brazil, Zimbabwe, Russia and Indonesia. Political risk need not be as dramatic as some of the revolutionary examples given, but may involve an undermining of the rule of law and a pervasive culture of bureaucratic and corporate corruption that siphons wealth from shareholders to domestic power brokers. As such, we should broaden our monitoring of political risk to governance in general rather than just revolution.

Exhibit 4 – **Brazil inflation 1949 – 1979**

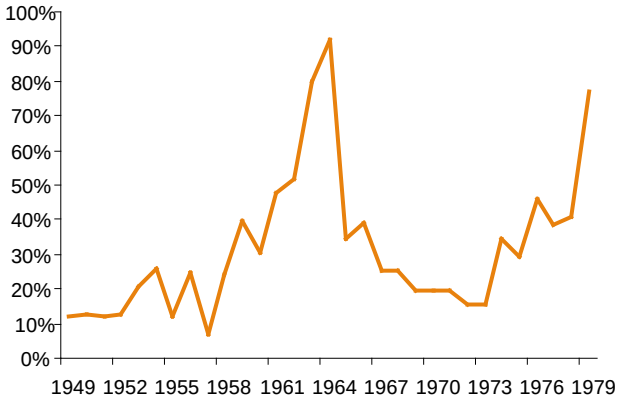


Exhibit 5 – **Brazil inflation 1979 – 1994**

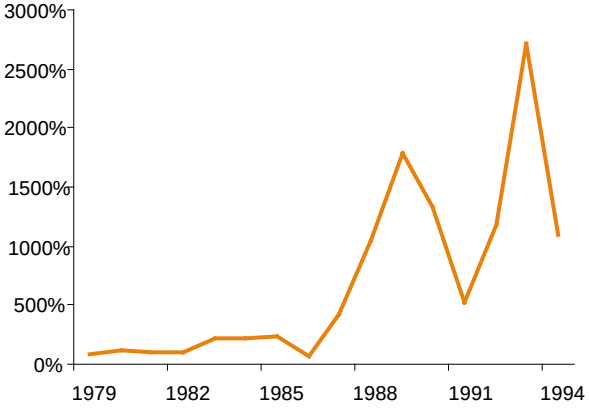
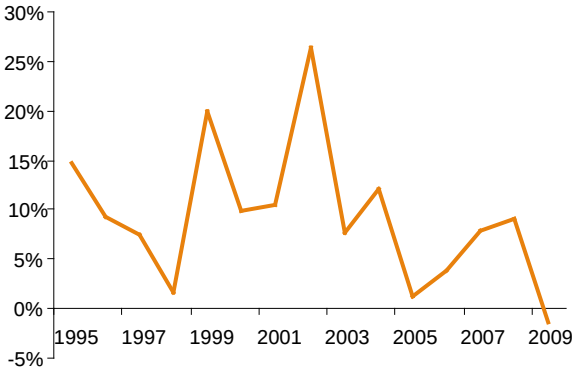


Exhibit 6 – **Brazil inflation 1994 – 2009**



Source: J.P. Morgan Asset Management

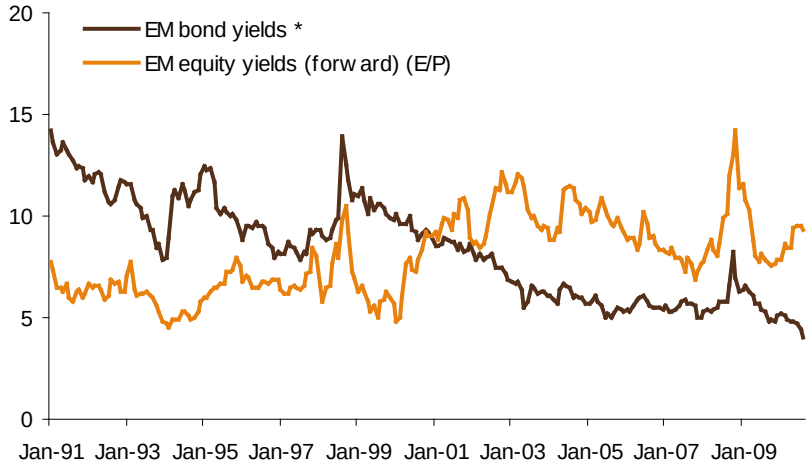
Tactical issues

Alongside the two strategic risks are the two tactical issues that should inform any equity investment, emerging or developed: earnings and valuation.

- *Emerging market equities look cheap relative to emerging market debt*

Exhibit 7 – **Comparing emerging market equity and bond yields**

Emerging market earnings and bond yields, 1991 – August 2010



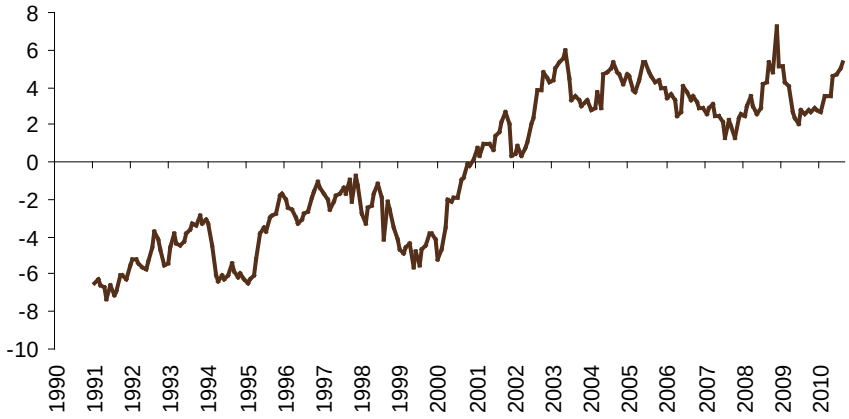
* Re-weighted bond yields with equity weightings to make these two yields comparable

Source: J.P. Morgan Asset Management, Factset, Bloomberg, Data as at end August 2010

Over the last ten years, emerging market debt has re-rated, reflecting a dramatic improvement in credit quality as the asset class approaches investment grade. Equities, in contrast, trade at levels similar to those of a decade ago, meaning emerging market equities currently appear cheap against emerging market debt.

Exhibit 8 – **Comparing emerging market equity and bond yields**

Emerging market equities relative to debt, 1991 – August 2010

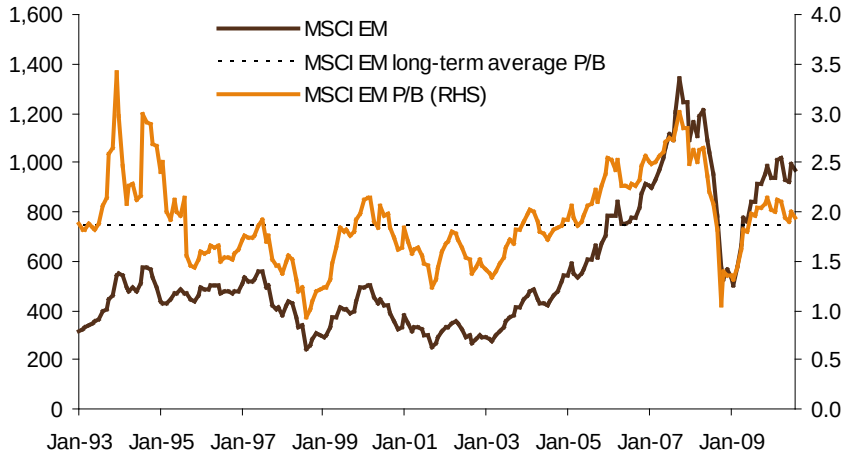


Source: J.P. Morgan Asset Management, Factset, Bloomberg, Data as at end August 2010

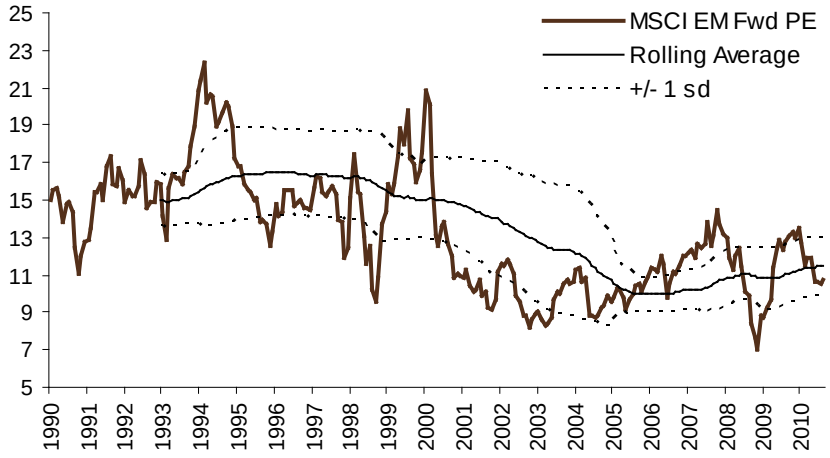
- *Asset multiples are hovering near long-term averages; earnings multiples have fallen back below average*

Exhibits 9 & 10 – **Valuations**

GEM price to book: 1993 to August 2010



GEM price to forward earnings: 1993 to August 2010



Source: J.P. Morgan Asset Management, Factset, Bloomberg, Data as at end August 2010

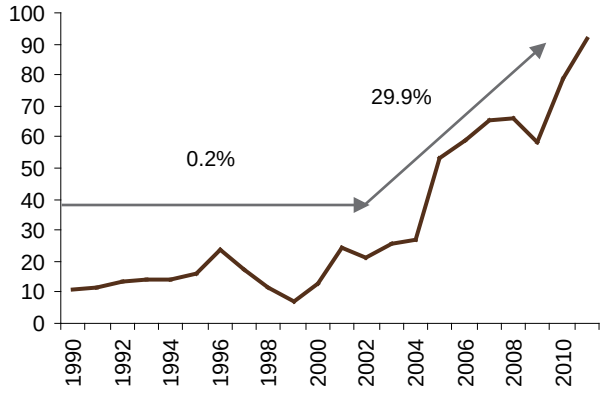
On an earnings and asset basis, emerging market equities also appear to be trading close to long-term averages.

The great difference between bonds and equities is that the former trade on perceptions of solvency, the latter on perceptions of future profitability. Valuation is therefore not a concern on a tactical basis as long as market expectations for earnings and dividend growth are not unrealistic.

Following the cyclical collapse of 2008, earnings have grown very strongly, with the market expecting earnings growth of over 30% in 2010. More important for future returns is the long-term outlook for earnings per share, which is the return enjoyed by shareholders rather than the GDP growth that most commentators focus on. The Emerging Markets Equity Team at J.P. Morgan Asset Management currently expects average earnings per share growth for the companies we cover to be over 15% per annum for the next five years. If this expectation is right then the combination of earnings per share growth at twice the global level, modest currency appreciation and a current dividend yield of 2.5% (likely to grow at 12% per annum) should give investors an attractive return from these levels over the next five years.

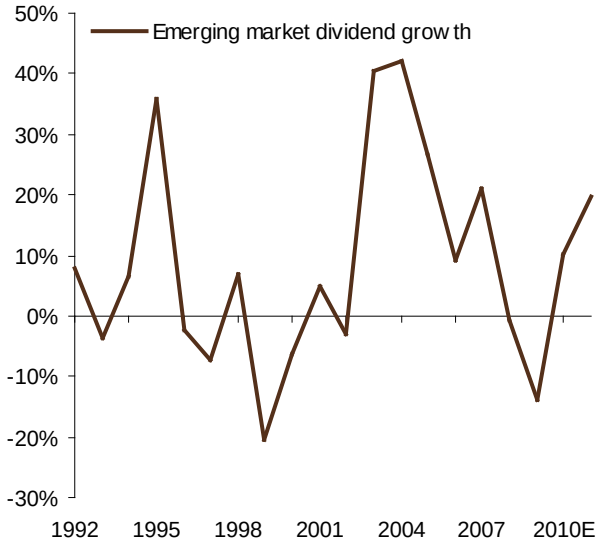
Exhibit 11 – **GEM earnings per share growth**

USD per share



Source: MSCI, J.P. Morgan Asset Management, 2010/11 J.P. Morgan Asset Management estimates

Exhibit 12 – **Long term dividend growth tested by crisis (% p.a.)**



Source: MSCI, IBES, Morgan Stanley as at May 2010, GEM universe.
E = MS estimate

Exhibit 13 – **Dividend growth of key sectors (% p.a.)**

	Cons Disc	Cons Staples	Finan-cials	Info Tech	Tele-coms
2006	2.2	39.7	11.3	13.1	19.3
2007	5.5	16.6	33.4	35	47.5
2008	-12.6	10	5.6	27.4	-3.6
2009E	16.4	-0.9	-3.3	-33.9	9
2010E	14.9	15	21.1	14	17.2
2011E	15	16.5	26.6	27.8	0.6

Source: UBS as at 28 February 2010

Emerging markets offer a combination of:

- Attractive growth and dividends
- Maturing growth and rising dividends

Four key sectors:

- Consumer (discretionary and staples)
- Financials
- Information technology
- Telecommunication services

Conclusion

The emerging markets story is by no means without risk, including the strategic risks of governance and inflation and tactical risks around earnings growth and valuation. Our current view on these risks is summarised in the table below.

STRATEGIC

Governance risk	Inflation
Low at the national level among the larger countries. Ever present at the stock level, although rising average ROE suggests a positive trend.	Low by historical standards but cyclical pressure is upwards. Currency flexibility and economic orthodoxy are key to continued success.
Valuation	**Earnings**
In line with historic averages, although high relative to developed markets. Wide company and sector variance makes stock selection crucial.	A strong cyclical recovery is being followed by robust secular growth. Reduced dependence on G7 trade gives greater confidence in the sustainability of EPS and DPS growth rates.

TACTICAL

However, for investors who are comfortable with these risks, we believe there is considerable reason for optimism around emerging markets, driven by global rebalancing and by the long-term urbanisation trend, which is spurring dramatic improvements in productivity and consumption.

Richard Titherington, *managing director*, is the Chief Investment Officer and Head of the Emerging Markets Equity Team. An employee since 1986, Richard transferred to the Pacific Regional Group in 1994. He was appointed as a managing director in April 2001 and appointed head of the global emerging markets business in December 2001. Prior to 1994 Richard was a US and international pension fund manager, working in the UK until he transferred to Hong Kong in 1992. Before joining the firm, Richard spent two years as an analyst with UKPI in London. Richard obtained an M.A. in politics, philosophy and economics from Oxford University.