

MARKET INSIGHTS

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Emerging markets strategy: Lingering macro uncertainty and opportunities



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Introduction

Emerging markets macro strategist George Iwanicki takes a closer look at the outlook for emerging market equities given ongoing global macroeconomic uncertainty. Focusing on earnings and valuations, the improvement in capital discipline, and tactical investment ideas, this paper shows why emerging market equities remain an attractive choice for long-term investors.

Global backdrop – the double-dip recession debate

There is good and bad news when it comes to the global backdrop. The good news is that the developed world is showing signs of recovery and in our view the likelihood of a double-dip recession is slim. The bad news is that the recovery continues to be modest relative to the depth of the recession that the developed world experienced. That modest recovery leaves us with plenty of unwelcome economic slack and a persistent deflationary bias. As a result, central banks are worrying about deflation and considering additional monetary measures.

Whether or not the developed world experiences a double dip or continues to grow, the important point is that we've already seen the best of industrial production growth. The end of easy comparisons and a maturing of the inventory-rebuilding cycle suggest global industrial production growth has probably seen its peak for the next few quarters. From here, such a deceleration implies that cyclical headwinds have developed for commodity prices.

Also, from a fiscal policy perspective there are clearly constraints on developed world governments in terms of how much fiscal firepower is still available. Not only in Europe but even in the US, questions are being asked about whether there is room to provide fiscal stimulus or whether tightening is actually needed. Should the global growth picture deteriorate further it is worth noting that emerging markets retain far greater fiscal firepower to respond. It is currently very hard to find an emerging market with a level of debt that would be considered a constraint on growth by most academics.

Furthermore, a look at policy interest rates suggests that central bankers in the emerging world also retain a similar level of flexibility. The absence of deflation risk means there is still room in virtually every emerging market to cut nominal policy rates and push real rates to even more stimulative levels, should more action be needed.

“valuations... are at or below what we consider fair value”

‘The summer of growth fears’ – earnings and valuations

Earnings momentum in the emerging markets asset class has been competing with renewed macro uncertainties throughout the so-called ‘summer of growth fears’. Earnings expectations lost momentum during the global growth markdowns seen over the course of the summer. As such, the significant tailwind for emerging markets from upward revisions to earnings estimates is now beginning to moderate. This slowdown in earnings momentum is not unique to emerging markets and is occurring in developed markets as well.

The good news, though, comes from valuations, which are at or below what we consider fair value. Therefore, as a result of the doldrums that markets have experienced in recent months, valuations have become more attractive. Asset multiples are hovering near their long-term average of 2.0x price-to-book. A look at earnings multiples tells a similar story. Although we are starting to shed some momentum on earnings estimates, emerging markets are still trading at 10.5x - 11.0x on a forward price-to-earnings basis. This is below the very long-term average and below the more recent average (ie the last five years). It is also below what we think of as a notional fair value – approximately 14.5x for the asset class as a whole. In short, from an earnings perspective the asset class still looks somewhat cheap and from an asset multiple perspective, it looks around fair value.

Bringing all of these factors together, if we take our best estimates of each of the four sources of return, namely dividend yield, foreign exchange movement, earnings growth and valuation, what we get is our best estimate of what we think trend returns from the emerging markets asset class will be. Currently we get an attractive 11.5% in US dollars at an annualised rate – a double-digit return in our current low single-digit nominal world. Therefore, from our perspective, returns look attractive. In terms of the distribution of returns, valuation provides a boost but we still expect the dominant driver for emerging markets to be earnings growth, which calls for a deeper dive into the drivers of profitability in the asset class.

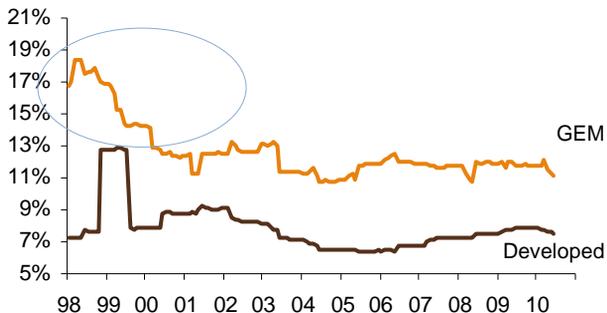
Fundamentals of profitability

For all the positive macro developments that have unfolded over the past decade, such as improved fiscal stances, lower inflation, and the replacing of unsustainable currency pegs, there have also been significant improvements at the micro level, specifically the improvement in corporate capital discipline. Emerging market profitability, as measured by return on equity, has shifted from challenging Japan for the bottom of the global league tables a decade ago, to successfully competing with Europe and the US. What drove this dramatic change? And are the drivers still in place across the board for emerging markets?

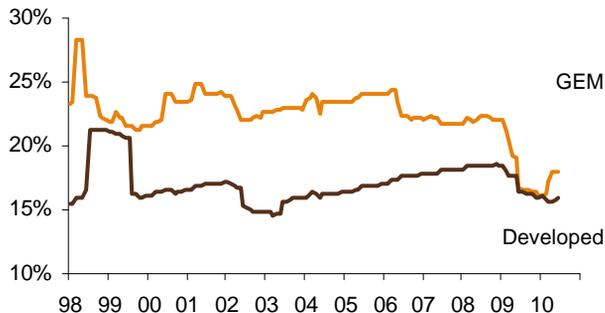
Exhibit 1 – Fundamentals of profitability

Capital discipline is restoring secular profitability improvement after recession damage

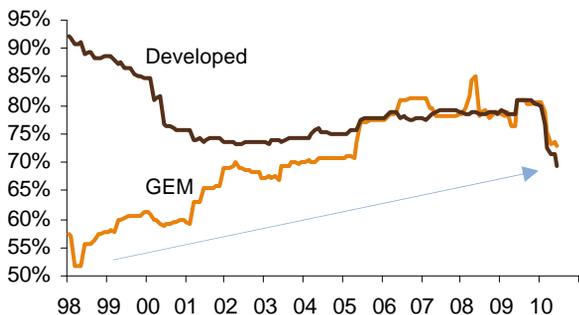
Capital Expenditures/Sales, %



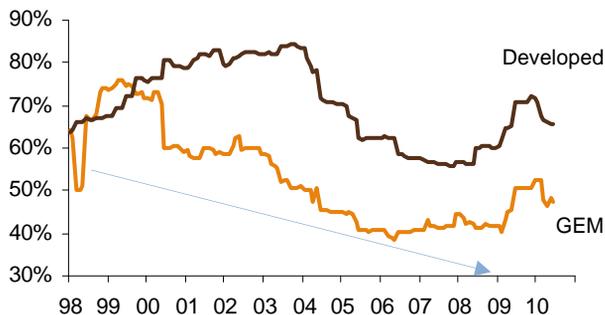
Profit Margins, %



Asset Turnover, %



Leverage, %



Source: J.P. Morgan, USD aggregations from corporate reports. Data as at June 2010.

A look at the fundamentals of profitability, effectively a modified DuPont Analysis, allows us to compare the late 1990s to where we are today. What is clear is that as of the late 1990s the reinvestment rate, that is the capital expenditure (capex) to sales rate, in emerging markets was running in a 15-20% range, while the developed world was in a 7-8% range. Heavy investment undoubtedly drove economic growth to some degree, but for investors the rapid asset growth that resulted from the vast amount of capex drove down emerging market asset returns (or operating efficiency) as shown in the lower left hand chart in **exhibit 1**. In addition, a lot of the capex was funded with debt. Therefore, even though emerging economies were more volatile than developed economies they had as

much financial leverage on corporate balance sheets. Not a favourable combination.

If you look at what has happened over the course of the past decade we have seen the capex-to-sales ratio converge towards developed world levels. As a result, we have seen asset turnover move up to effectively converge with the developed world and corporate balance sheets have been deleveraged more so in emerging markets than the developed world. Obviously the recession put a kink in some of the story. The upper right chart in **exhibit 1** shows some good news as it demonstrates that the margin compression emerging market corporates have experienced is beginning to unwind as the recovery unfolds.

The regional breakdowns suggest that while Asia is sustaining the improvement in capital discipline, Latin America is showing signs of slippage. Particularly in terms of asset turnover, but also in terms of the behaviour of margins – the last few years appear to be indicating that in Latin America complacency is setting in.

However, closer examination suggests that sector developments are what we should be focusing on. We believe there are only two sectors that create some cause for concern in the context of what is otherwise a very strong case for continued profitability and capital discipline in the asset class. The first is materials, where there is evidence of a three-to-four year breakdown in terms of asset turnover, and it is coming amid what is now an outright rising reinvestment rate, judging by capex-to-sales ratios. To us, this looks like the beginnings of complacency setting in, in a sector that has enjoyed extensive pricing power and the strongest profitability levels that have been experienced for a few decades.

The second sector to focus on is telecommunications, where we have witnessed a five-to-six year down-drift in margins as penetration rates for mobile telephony in much of the emerging world have begun to mature. In our view, telecommunications is facing what appears to be the end of the road and as these stocks move from growth to ex-growth, there is some risk here that they get repriced.

Actionable investment ideas

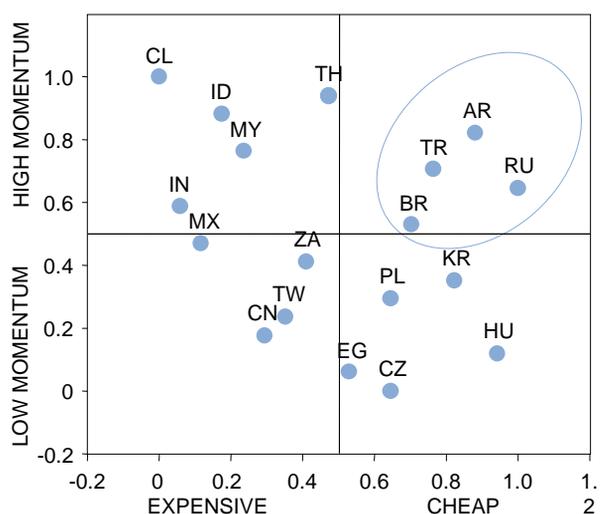
We highlight three actionable investment ideas based on the output of our tactical models, which look for cheap value with positive momentum (see **exhibit 2**). First, Brazil (BR) has begun to move into the favoured quadrant with both value and momentum becoming more supportive. After lagging year to date, a diminishment of some of 2010's uncertainties the country has been facing suggests we are at a point where tactically it looks interesting to go back into Brazil. We will address these uncertainties later in the paper.

The second actionable idea is Korea (KR), which remains cheap albeit with less momentum than Brazil. A cheap currency also lends support. Because of its cyclical nature this market will be a strong player on the 'end of the growth scare' story – when the market gives up on the possibility

of a double-dip recession and reverts back to the sluggish growth story. We believe there are early signs of this happening now, so we are warming up to Korea.

The third market to highlight is Turkey (TR), which continues to screen very well tactically on both valuation and price momentum. We still think that Turkey is secularly a strong story, so this is a market we want to stay with from a value and momentum perspective.

Exhibit 2 – Country: Value and Momentum



Source: J.P. Morgan Asset Management

A look at portfolio positioning in international emerging market mutual funds shows that Brazil, which had long been a consensus overweight among emerging market investors, continues to hover around neutral at this point. We think the combination of diminishing headwinds and many investors looking to move back into the market should drive near-term performance. In the same vein, Korea remains a heavy consensus underweight, but again we think that this is a good play on the 'end of the global growth scare' story that is currently under owned. By contrast, we recognise that Turkey remains a well-owned market. Our view is that the fundamentals and valuations remain sufficiently attractive that we cannot identify a catalyst that would encourage us to move out of the market. There are election issues and some monetary tightening may take place, but in our view these concerns appear to be a few quarters out and as a result we remain positive on Turkey.

Rotation back into Brazil

The key focus should be the rotation back into Brazil. We were overweight Brazil for a long time and then over the course of this year we have generally shied away from the market. However, we now believe the short-term risks of rising rates, elections and the large Petrobras offering are better understood and, as such, see this as a good re-entry point into the market.

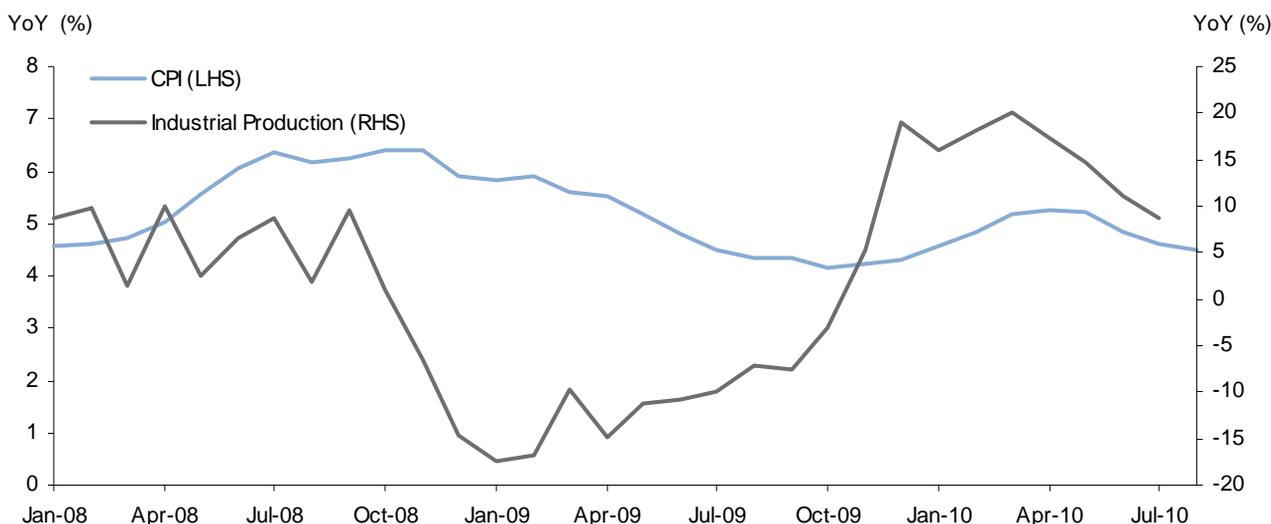
In Brazil, the story for 2008 and 2009 was the crisis and subsequent recovery. The crisis was extreme, but this is not unusual for Brazil. What was unusual this time was that Brazil was able to implement counter cyclical policies to fight the crisis. This marked the first time that Brazil has had the complete financial toolkit, ranging from monetary to fiscal policies, to help overcome a crisis. Now, in 2010, the story is of rising rates. The government has had to start to cool the economy by withdrawing stimulus and starting a tightening cycle of interest rates. In 2010, Brazil is set to grow by approximately 7.5% and is expected to grow by 4.5% in 2011. Brazil's potential GDP is between 4% and 5%, which explains why the government started the tightening cycle. However, recent data suggests that

of the three major headwinds facing Brazil this year, the economy now appears to be temporarily under control, with inflation now moderating (see **exhibit 3**).

The second important development this year is the elections. As the year has progressed the political arena has settled and the market has become more confident over the direction in which Brazil is heading. The presidential elections were held on Sunday 3 October 2010. They will be subject to a second round of voting. Despite what could be seen as a disappointing result for Dilma Rousseff, she maintains a large opinion poll lead (**Exhibit 4**) and we continue to expect that she will be the next president.

As such, the market is now comforted by a sense of continuity albeit with some twists in the new administration. For example, current president Lula is much more of a politician than candidate Rousseff – Lula is a highly charismatic man who tends to be led by consensus. By contrast, Dilma is very project-driven and practical. The new president is likely to provide a new dimension to the government. However, the comfort is that Rousseff has Lula's support and backing.

Exhibit 3 – Brazil: Inflation is moderating as economic activity peaks

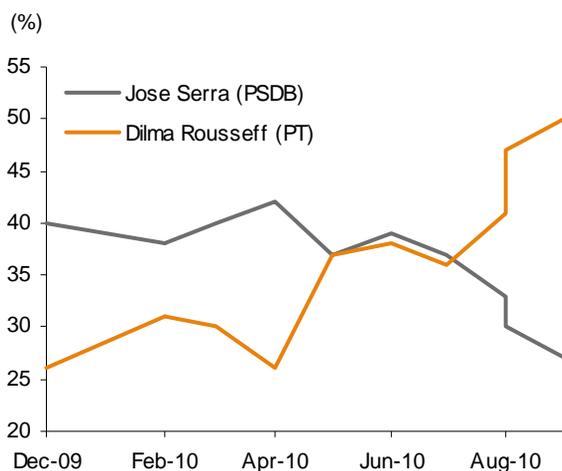


Source: J.P. Morgan. Banco Central Do Brasil, as at end August 2010

The third issue Brazil faced this year was the Petrobras deal. One of the largest deals ever, this was on investor radars for a while and is now finally over. We found several issues with the transaction, but considering the size and involvement of the government, and what was raised, it can be seen as a successful deal. So while we may find fault with some of the details, we think the overhang for now is over.

As such, the resolution of these three outstanding issues (the rising cycle of interest rates, the uncertainty around elections and the overhang of Petrobras) should now allow the market to flow in a more natural fashion. What 2011 and beyond is going to tell us is whether the secular story is still on in Brazil or whether the government continues to become more activist and, as a result, poses risks to investors and the growth story. We will carefully monitor the level of government intervention and, for now, we have tactically warmed up to the market.

Exhibit 4 – Voting intentions to 22 September 2010



Source: J.P. Morgan. Datafolha, as at end August 2010

Conclusion

We believe the developed world is transitioning to a half-speed expansion from a half-speed recovery. However, even within that recovery we believe industrial production has already peaked in terms of the rate of growth and as a result the tailwind for commodity prices is now over, if not in reversal. If we do see double-dip recession fears materialise for the developed world, we are comfortable that emerging market governments still have more firepower, not only fiscal but also monetary, should it be needed.

Global market turbulence over the second quarter restored valuations to moderately cheap and, as such, our estimates of trend returns for the asset class look favourable, particularly against the backdrop of a low nominal growth world.

We retain our secular optimism for emerging market profitability overall, however, further investigation into regional and sectoral profit raises caution flags for materials and telecommunications. The former is a worry because of evidence of slipping capital discipline, while the latter is beginning to suffer from margin pressure as penetration rates mature.

Finally, our value and momentum screens suggest it is a good time to go back into Brazil. In addition, we continue to look for a bottom in global growth expectations before moving overweight Korea and we remain overweight in Turkey, recognising that while it is a well owned story, it is a good story at still very reasonable valuations.

George Iwanicki, Jr., *managing director*, is the global macro strategist within the Global Emerging Markets Equity Team based in New York. An employee since 1992, he is responsible for all Macro Strategy, including Asset Allocation. Prior to that, he served several years as the U.S. Economist as well as the North American representative in the firm's Macro Research Group, (a trans-Atlantic team formed in 1995 to manage the global asset allocation process). Prior to joining the firm, he spent five years as an economist at Kidder, Peabody & Co., Inc. He holds a B.A. in mathematics and economics from the State University of New York and an A.B.D., Master of Philosophy, in economics specializing in macroeconomics, econometrics, and international trade and finance from Columbia University.

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