

Emerging Markets: Too Big to Ignore

June 2009



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Too Big to Ignore? It might not be fashionable to say this today, given the upheaval in financial markets over the past year, lingering economic uncertainties, volatility in most asset classes, and plenty of seemingly still-cheap assets around the globe.

But at a time when investors are still licking their wounds and questioning their appetite for risk, we believe emerging market equities are, ultimately, too big for investors to ignore.

In the following, we argue why investors should have a structural allocation to the asset class, while understanding the need and opportunity to position around this structural allocation tactically.

Supporting our view are two key tenets; and one very significant assumption. The first is increasingly well recognized and largely irrefutable: namely, that emerging markets (EM) are already a significant part of the global economy and one which is almost inevitably poised to become even more so over the coming years given their faster rates of expected economic growth. The second tenet is more definitively financial: EM will finally become as important to global capital markets as they are currently to global economic growth. This should lead to a dramatic narrowing of the substantial gap between EM share of global GDP and EM market capitalization as a percentage of total world market cap. Our underlying assumption? The worst global downturn in over 70 years will result in, at most, only a limited reversal of long-term globalization trends

Indisputable Economic Relevance

There is, in our view, a demographic inevitability to EM claiming a rising share of global GDP and growth.

The ascent of Anglo-Saxon capitalism over the past 200-plus years has provided a framework whereby the "players" within that model (generally North America and Western Europe) built up and retained significant shares of global GDP. However, an even broader sweep of history reveals that some economies currently classified as "emerging" were, in fact, previously globally dominant. Therefore, this bloc of the developing world might better be termed "re-emerging" economies (see Exhibit 1).

The story of the rise and fall of dominant economic (and military) empires provides rich fare for economic and political historians. However, what recent economic history makes clear is that countries which "join" the capitalist model enjoy steady convergence in GDP per capita toward developed world levels. This is a natural phenomenon of development and has been seen in previous emergent economies (not least of which was the industrialization of the U.S. in the late 19th Century). In our view, it is the "dividend" from globalization that is the "enabler" of such catch-up

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strategies. This development typically starts with urbanisation, which leads to manufacturing growth and infrastructure demand, ultimately paving the way to rising incomes and thereby changes in consumption patterns.

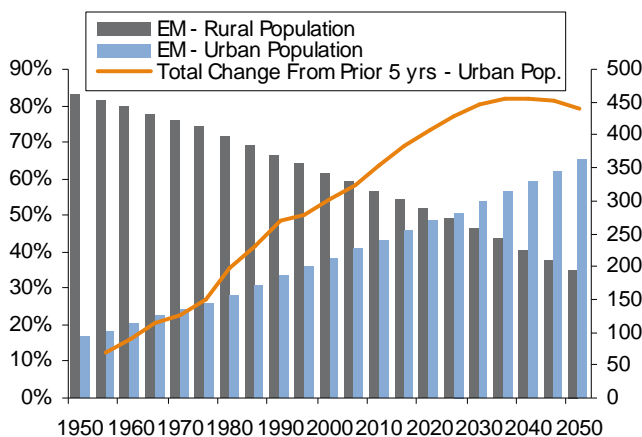
Exhibit 1: Share of world GDP (%)

	US	W. Europe	GEM	Brazil	Russia	India	China
1500	0.3	18.7	75.1	0.2	3.4	24.5	25.0
1700	0.1	25.3	68.8	0.3	4.4	24.4	22.3
1820	1.8	28.8	66.0	0.6	5.4	16.0	32.9
1870	8.9	42.7	46.3	0.7	7.6	12.2	17.2
1913	19.1	41.8	33.6	0.7	8.6	7.6	8.9
1950	27.3	32.8	36.6	1.5	9.6	4.2	4.5
1998	21.9	23.9	43.3	2.6	3.4	5.0	11.5
2007	21.2	19.1	48.1	2.8	3.1	5.3	12.7

Source: A. Maddison, OECD; World Bank; JPMorgan

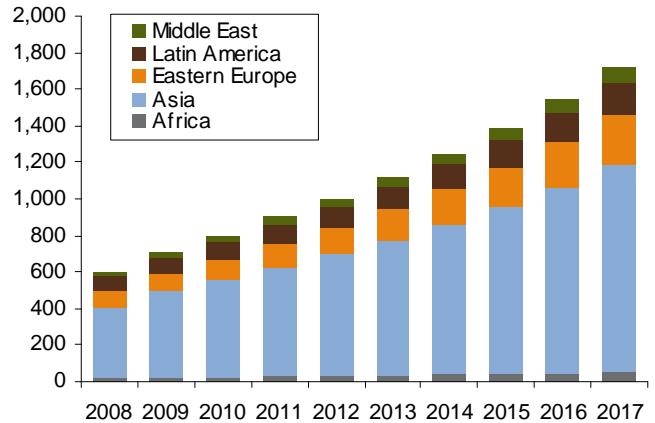
Each of these phenomena has been clearly observable within developing markets over the past decade. Urbanization rates are exploding (see Exhibit 2). As a result, infrastructure demand and scheduled spending on it are substantial, and growing (see Exhibit 3). If anything, the pace of this expenditure will only be quickened by the global downturn. Consumption is also evolving in a natural shift from “production” economies to “consumption” economies as incomes rise. This last development is a secular trend that current cyclical conditions merely highlight the need to accelerate, and one that EM governments increasingly seem to appreciate, given their policy responses so far. All of the above is reasonably well understood by global investors. However, two important questions remain: First, will increased economic relevance be paralleled by increased financial relevance, and second, does the current global downturn threaten to halt or reverse these trends?

Exhibit 2: Urbanisation trends



Source: World Bank data

Exhibit 3: EM Infrastructure spending



Source: Morgan Stanley Research, World Bank, Global Insight e = Morgan Stanley Research Estimates

Deepening Financial Relevance

The EM share of global equity indices still notably trails its share of GDP, population, energy consumption, etc. But a pair of significant developments, one the result of a shift toward sustainable macroeconomic policies, the other the result of microeconomic reform, demonstrate that the financial relevance of EM already is starting to catch up with its increasingly obvious economic relevance.

On the macroeconomic side, the shift toward more sound macro policies that J.P. Morgan Asset Management and others have trumpeted over the past several years, including fiscal probity, inflation targeting replacing exchange rate targeting, and external balances steered toward surplus, is not only largely intact, but has left EM in an unusually strong position in the current global cycle.

Having largely been on the “lending side” of global macroeconomic imbalances, in the aggregate EM have avoided the private sector leveraging cycle now plaguing much of the developed world. As EM debt investors know, governments from Brazil to Indonesia to Turkey have been steering public sector debt/GDP ratios lower over the past several years. In many cases, this has been the result of hard lessons learned from localized financial crises in the 1990s and early 2000s. Moreover, even as local interest rates have declined and credit markets deepened, overall levels of private leverage for the countries that comprise the MSCI Global EM index have stayed roughly flat over that time frame, largely as a result of aggregate de-leveraging of corporate balance sheets during the period (see Exhibit 4).

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Exhibit 4: Private debt (% GDP)

	2003	2004	2005	2006	2007
Asia	13.4	15.3	16.0	15.6	15.2
LatAm	164.5	146.1	136.6	142.5	144.0
EMEA	71.5	64.2	62.1	65.4	63.5
Total	62.0	57.4	56.5	58.5	57.9

Source: IFF and IMF

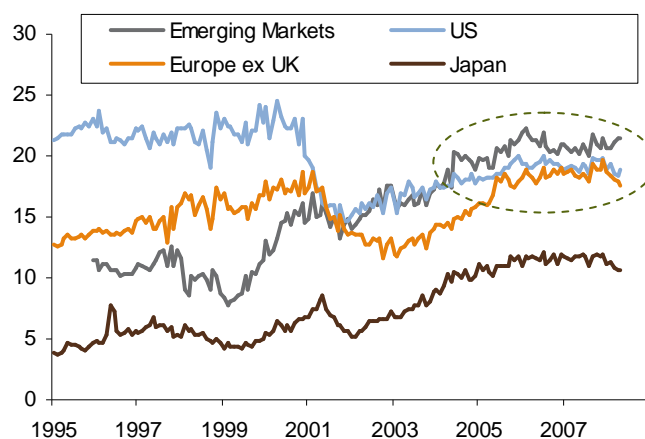
Externally, not only did sovereign debt levels decline, but their current account surpluses have left EM armed with a much larger share of global FX reserves. This stock of reserves, largely recycled into the bond markets of current account deficit countries, effectively renders EM a very important “banker” for a developed world with banking woes. A component of the reserves directed to sovereign wealth funds (SWFs) has been mooted as a source of eventual recapitalization of impaired developed market banks. Indeed, the U.S. Federal Reserve has studied the impact of Asian buying of Treasuries on interest rates and the effectiveness of monetary policy over the past several years¹. Beyond the build and disposition (both current and future) of massive reserves, macroeconomic orthodoxy means EM possess much more latitude to pursue countercyclical monetary and fiscal policies in the face of global economic weakness.

Much of this unusual policy latitude is already on display, be it rate cuts that initially swept across Asia and which have now spread to Latin America, or fiscal easings announcements from China to South Africa to Chile, to name but a few examples. The point being that an unusual share of global policy stimulus is likely to come from EM; a point not lost on politicians and policymakers worldwide. This was evidenced by the fact that the initial forays into coordinating a global policy response have convened in the Group of 20 (G-20) rather than the usual G-7 of developed countries. Their ability to spur “home-grown” domestic spending should limit the degree to which EM will need to rely on exports to the developed world to recover. Accordingly, this should also limit the degree to which currency devaluation is either imposed upon or desired within EM. Might this move towards greater domestic spending, over time, lead to Asian currency revaluation? Such thoughts are certainly not “current” thinking.

From a microeconomic perspective it is worth noting that this decade’s improvement in EM corporate performance has blunted the most fundamental justification for why financial relevance has not matched economic relevance: namely, that rapid economic growth failed to lead to sustained profit growth. Improved operating

leverage (amid reduced financial leverage) led to a sharp rise in EM profits, boosting returns on equity (ROE) to globally competitive levels and forcing the EM share of global corporate profits to new highs (see Exhibits 5 and 6). The current global downturn is surely forcing a cyclical correction in EM ROE, just as surely as it is in developed market ROE. But there is little reason to think the improvement in capital discipline underlying the secular rise in ROE will be reversed by the current cycle.

Exhibit 5: Return on Equity (%)



Source: Thomson Datastream, JPMAM as of May 2008

Exhibit 6: Global EM EPS Share of MSCI All Country World Index

12/87	2.6	12/98	4.1
12/88	2.0	12/99	2.8
12/89	2.7	12/00	4.2
12/90	3.8	12/01	5.5
12/91	5.1	12/02	6.3
12/92	7.8	12/03	7.2
12/93	9.2	12/04	7.9
12/94	7.2	12/05	9.7
12/95	7.3	12/06	9.9
12/96	9.2	12/07	10.2
12/97	6.5	12/08	10.2

Source: Factset as of December 2008

Other, Bigger Risks and Revelations From the Current Cycle?

If the lone risk to developing economy equity posed by the current cycle was a deep but temporary compression of earnings, the case for significant permanent allocations to EM would be almost irrefutable. The only questions remaining would simply be 1.) How large a strategic allocation? and 2.) How

¹ See for example “International Capital Flows and US Interest Rates,” F. Warnock and V. Warnock, FRB Working Paper, September 2005.

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should investors position tactically around a strategic allocation in view of current valuations? But before turning to those issues, considerations of the risks and revelations unfolding in the current cycle need to be revisited.

The first and most overarching consideration resulting from the current cycle is the political sustainability of globalization. The secular benefits of globalization—measured in terms of more rapid aggregate economic growth and the resulting rise in living standards—have been apparent during the past half-millennium and have accelerated during the past half-century. Politically, however, the risk of creeping protectionist policies on cross-border trade and capital flows has been undeniably heightened by the severity of the current cycle.

Ironically, there is little disputing that globalization has been and remains a facilitator for much of the opposition to it. At its most basic level, the wheels that comprise the “virtuous circle” of economic development—urbanization, industrialization and infrastructure development—have been greased by the ability to export goods, import inputs and technological know-how (via foreign direct investment), and invest excess savings in foreign assets. A breakdown in the commitment to globalization (as institutionalized in the World Trade Organization) represents the biggest risk to the EM growth story (as well as future global prosperity). Our admittedly critical assumption is that a backward creep towards economic and financial protectionism will be limited.

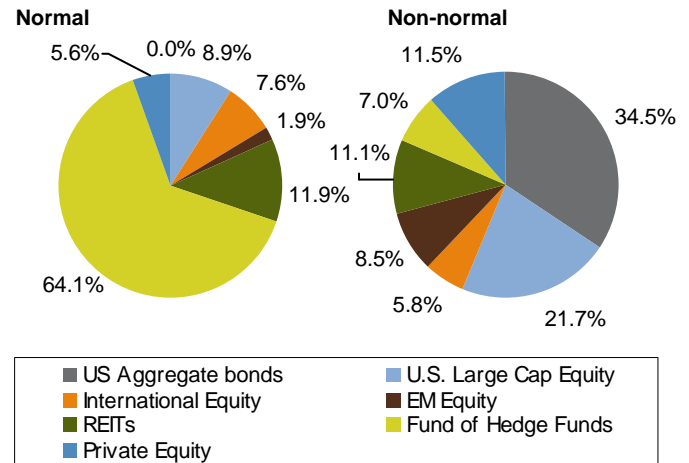
The second consideration evidenced from the current cycle is that EM economies and equity have not avoided the fallout from what is widely viewed as a financial crisis epicentred in the developed world. Early hopes of “decoupling” proved to be elusive as soon as the hoped-for soft landing in the U.S. devolved into a hard landing. Economies across all regions of the emerging world slowed, in some cases precipitously, and while improved fundamentals limited the damage in the bulk of the asset class, isolated instances of structural deficiencies (Eastern European external positions, Russian currency overvaluation, leverage in Chinese property companies) were exposed. Most importantly to investors, global equity correlations tightened amid the sharp equity downdraft during 2H08, leaving no place to hide.

Properly Sizing and Expressing the Strategic Allocation

The unmistakable disappearance of diversification benefits from any segment of global equity (let alone risk assets, including credit products) over the past several months reveals the two flaws that haunt conventional mean-variance (i.e. efficient frontier) allocation methodologies. The first involves non-normal distributions of returns within asset classes, and the second concerns unstable correlations during so-called “fat tail” (i.e. extreme) events. While the challenge of overcoming these “heroic” assumptions may incline some investors to think that strategic allocation is truly guesswork, state-of-the-art methodologies are being developed to deal with these issues, including promising work by J.P. Morgan Asset Management².

Notably, these more sophisticated methodologies that account for “non-normalities” in financial market returns define a strategic “normal” level of allocation to EM equity quite similar to those seen in conventional models. In fact, they meaningfully raise the EM share of the global equity portion of their optimised portfolios². It is worth noting that in both the standard and enhanced portfolio optimization exercises the allocation to EM equity is well above what most institutional investors are believed to currently target. While most investors typically trade actual positions around such “strategic normal” allocations, valuations remain at levels that suggest, at a minimum, closing any underweight allocation to the asset class (see Exhibit 7).

Exhibit 7: Hypothetical “un-constrained” optimisations using a normal and non-normal framework



Source: J.P. Morgan Asset Management. For illustrative purposes only.

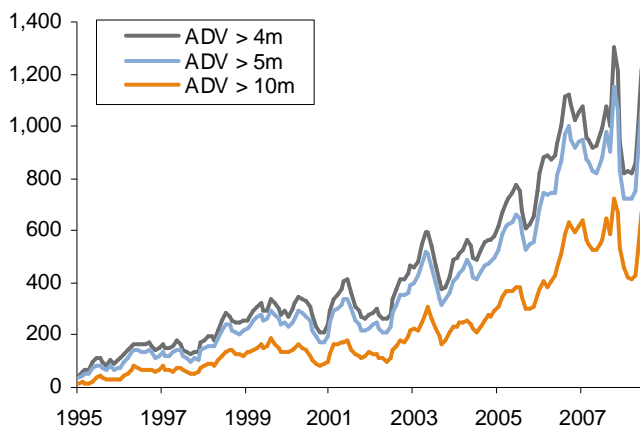
² See “Non-normality of Market Returns: A Framework for Asset Allocation Decision-Making,” A. Sheikh and H. Qiao, J.P. Morgan Asset Management, May 2009.

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So, how to most effectively access the opportunity in EM equity? Previously, we argued that the expansion of the investable developing world opportunity set had broadened the methods for investing in the asset class to include thematic, style-specific, quantitative and long-short approaches (i.e. those that have proliferated in developed markets over the past 20 years). At first glance the events of the past year could be viewed as reversing this opportunity and, accordingly, make generic and/or cheap allocation vehicles like exchange traded funds (ETFs) or index tracker funds a more viable option for investors. However, we would warn against drawing such a hasty conclusion for four reasons.

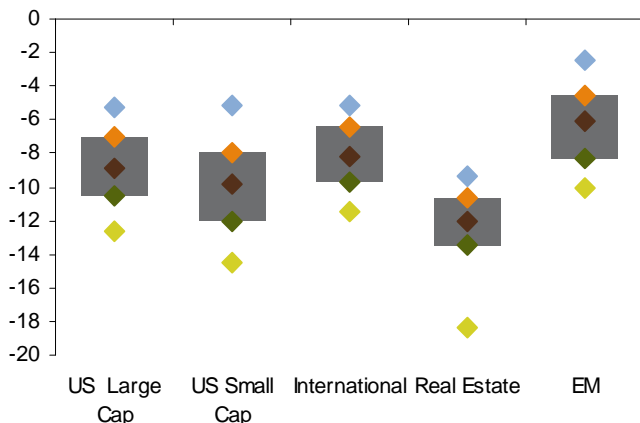
First, using average daily volume (ADV) as a liquidity metric, the reduction in the number of names available for investment using varying levels of minimum liquidity has been notably modest and short lived amid the global correction (see Exhibit 8).

Exhibit 8: Investable market cap



Source: Factset as of December 2008

Exhibit 9: Distribution of returns



Source: eVestment, based on monthly returns as of December 2008

Second, the index represents what is known today, rather than what will be in the future. Given the lasting economic trends we see unfolding in developing economies, the make-up of EM indices will likely change significantly in the coming years. The main beneficiaries of these trends, from an earnings rather than economic perspective, are not necessarily going to be those companies that currently dominate the index, offering significant forward-looking opportunity to stock pickers.

Third, using the distribution of manager returns as a proxy for asset class inefficiency (given the constantly changing nature of the asset class), EM equity remains at the upper end of that spectrum within global equity, highlighting the ability of talented managers to add alpha (see Exhibit 9).

Lastly, the sharp widening in valuation spreads during the global equity correction is setting the stage for valuation-aware active managers, who suffered during that widening, to outperform materially over coming years once valuation spreads begin reverting towards a more normalized state.

This combination of factors suggests that we are at a "sweet spot" for allocations to actively managed funds in EM equity. Coming at a time when overall valuations have been compressed to levels that historically offered favourable strategic allocation opportunity, and with little material damage to the fundamental investment case J.P. Morgan Asset Management (and others) have emphasized for years, EM equity certainly looks too big to ignore for long-term investors.

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