

MARKET INSIGHTS

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Emerging markets strategy: Evaluating inflation and commodities



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Introduction

With the recent momentum in earnings estimates for developed markets now appearing to have come to an end, George Iwanicki, emerging market macro strategist, examines the value story for the emerging markets asset class against the current global cyclical backdrop and re-caps on the inflation issues that have occupied investors over recent months. In the context of the commodity volatility experienced over the last few months, George also digs deeper into the commodity-currency nexus and examines how a super cycle in commodities is interplayed with currencies.

Emerging markets no longer have a monopoly on inflation

Until recently, concerns about inflation have been focused on the emerging world, while the developed world has been plagued by fears of deflation. It's therefore worth noting that headline inflation numbers in the developed world have now not only stabilised, but they have begun to turn upward, as have core inflation measures. This upturn in developed market inflation suggests inflation is no longer just an emerging market story.

A further look at the global backdrop shows the economic expansion is continuing. Although purchasing managers' indices in the developed world have bounced off recent highs, they remain in expansionary mode. Amid sluggish but ongoing expansion in the developed world, the underperformance of the Japanese recovery has become more pronounced, with the effects of the tsunami now taking a toll on some of Japan's industrial sectors.

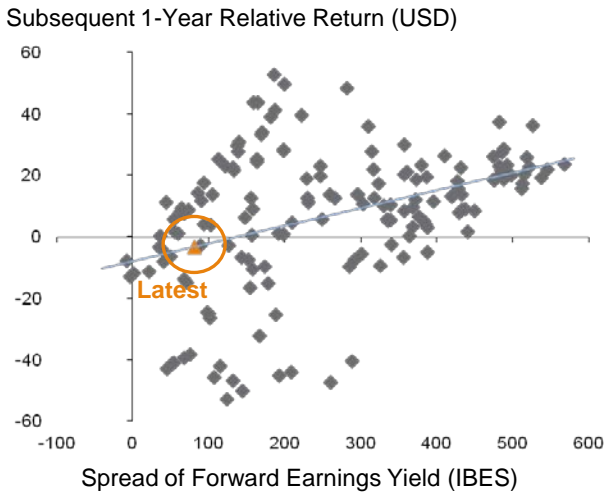
Emerging markets versus developed markets

This year developed markets have so far outperformed emerging markets in a notable catch-up rally. But, what does that mean for the emerging market versus developed market cycle? Has the fuel that drove the catch-up rally burnt out? We approach these questions using our typical value and momentum framework for equities.

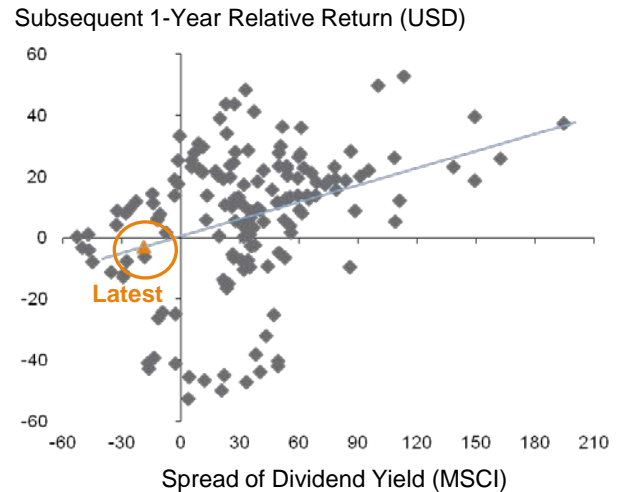
The two scatter charts in **Exhibit 1** show the historical relationship between the spreads in forward earnings yields and dividend yields between emerging and global markets (horizontal axis) and the returns that have been realised from that point forward (vertical axis). The orange dot shows where we were at the end of April on the line of best fit. What is noticeable is that we are still in the realm, as we were three months ago, where emerging market valuations relative to developed market valuations are more or less in a 'dead heat'. That is to say, the historical relationships imply similar return profiles from emerging markets and developed markets in the near-term and one would therefore be indifferent between the two.

Exhibit 1 – GEM valuations relative to Global equity

Forward earnings yield spread and subsequent GEM performance relative to ACWI, 1996–2010



Dividend Yield Spread and Subsequent GEM Performance relative to ACWI, 1996-2010



Source: BLS, as of April 2011

However, long-term consensus earnings estimates suggest that momentum has peaked for developed markets, while long-term expectations for emerging markets appear decidedly normal. During 2009 and much of 2010 we saw an acceleration in earnings estimates that was led by emerging markets, or put another way, long-term earnings optimism was more apparent in emerging markets. This strong earnings momentum coincided with sharp outperformance from emerging markets. However, last quarter the earnings numbers began to rebound for developed markets, while emerging markets growth expectations stabilised around a level of 18% (which is the top end of our comfort zone for excess exuberance).

The acceleration of long-term earnings optimism in the developed world meant the momentum factor was positive for developed markets relative to emerging markets. More recently, consensus estimates for developed markets have begun to revert back toward historical norms and the earnings momentum story from here on a long-term basis actually looks more positive for emerging markets. In summary, the value story looks neutral for emerging markets versus developed markets, while momentum leadership for developed markets has ended.

Investment outlook: Valuations are not excessive

Absolute valuations for the emerging market asset class are also not excessive. Whether viewed on an asset multiple or earnings multiple basis it is evident that valuations for the asset class remain at long-term averages. On a price-to-book (P/B) basis, we are still hovering around 2x, as we have for the last eight to ten months. Our rule of thumb remains the same. Historically, you were paid to own the asset class at a P/B of 1.5x or below and were paid to be cautious 2.5x or higher. At the moment, we are sitting right in the middle of that range so P/B levels still look decidedly neutral.

Meanwhile, forward price-to-earnings (P/E) multiples have been hovering around 11x, which is slightly below the recent average, well below the long-term average and below the 14.5x P/E level that we view as a fair value multiple for the asset class.

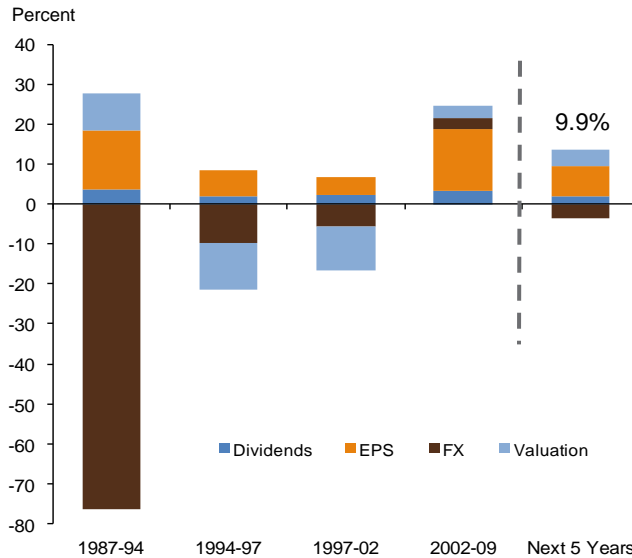
Importantly, the multi-year improvement in corporate capital discipline still looks largely intact, looking at returns on equity (ROE) relative to other segments of the global equity market. Breaking things down using a modified DuPont analysis¹ to look at the drivers of corporate profitability in emerging markets, capital expenditure (capex) to sales ratios remain down at the 10-11% level, off the high teens we saw in the 1990s; asset terms remain in line with what we see in the developed world; financial leverage remains low; and there has been some bounce back in profit margins. As a result our optimism on the long-term earnings trajectory for emerging markets remains broadly intact.

Our strategic sources of return framework neatly summarises our view on the overall asset class. Based on a five-year time horizon, we ask, "what happens from today's prices and today's exchange rates if we converge to fair value and earnings grow along the lines that we expect, given the previously discussed improvement in capital discipline and the trajectory of profitability for emerging corporates?" Then we solve for the potential return will could derive.

¹ DuPont analysis is a method of performance measurement first used by the DuPont Corporation in the 1920s. The analysis breaks ROE into three distinct factors in order to see more clearly how a business is performing.

As **Exhibit 2** shows, we're still looking at approximately a 10% US dollar return from here on a trend or a sustained basis. Not the super cycle rebound returns that we saw in 2009, but in our view still very healthy returns in a low nominal world.

Exhibit 2 – GEM valuations: Still at long-term averages



Source: J.P. Morgan estimates. Data as at April 29 2011.

Illustrates the contribution to total index return of earnings growth (EPS), dividends and changes in local currencies and valuation multiples (forward looking price/earnings ratio).

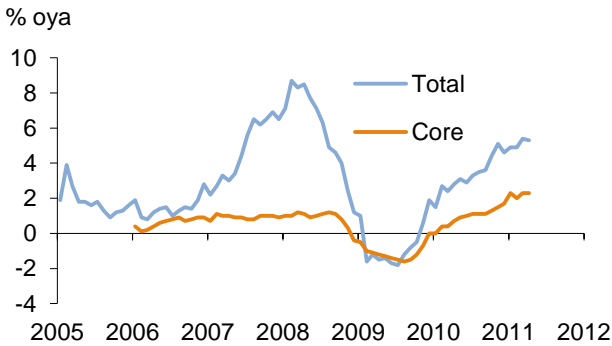
Inflation risk is selective rather than systemic

As discussed in detail in previous papers, we continue to see inflation risks for the asset class as a selective risk than a systemic risk. The good news is that we think there are just four countries that we cover where inflation pressures have become more embedded and more cyclically driven, as opposed to those countries that are just experiencing the food price or energy price inflation that most of the world is experiencing.

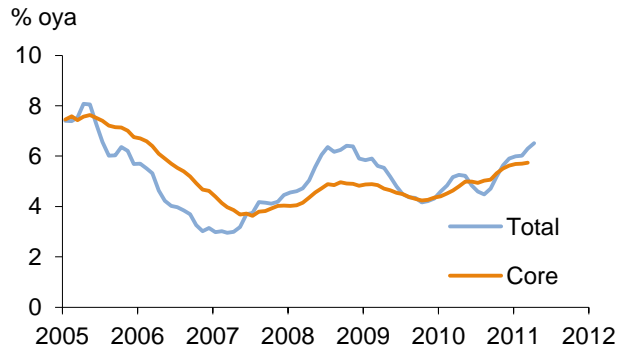
The bad news is that the four markets where inflation pressures are more embedded are our larger markets, namely Brazil, Indonesia, India and China. If we take a look at how the inflation outcomes are unfolding in each of these markets, both on a headline basis as well as on a core basis, we see suggestions that inflation may be peaking in China and that inflation is fairly well contained in Indonesia, but that India and Brazil still look troubling.

Exhibit 3 – Suggestion of inflation peaking in China, but India and Brazil more troubling

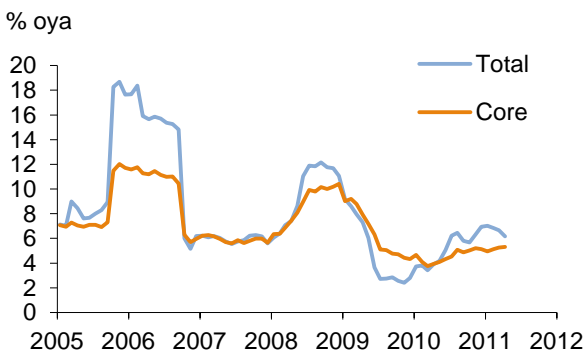
China CPI



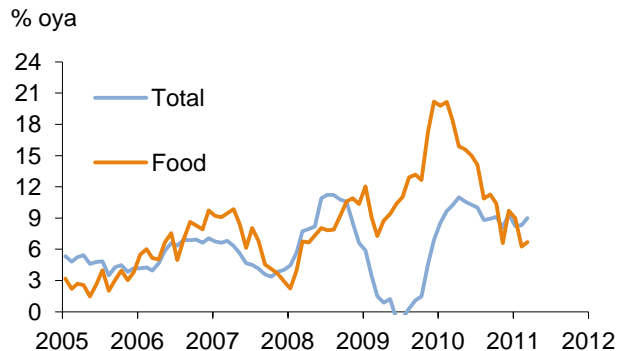
Brazil IPCA



Indonesia CPI



India WPI



Source: J.P. Morgan Asset Management, latest data available

We are most positive on China, where it looks as though both the headline and core numbers have begun to flatten out at manageable levels. This easing of inflationary pressures is coming amid signs from both the PMI data and also on the import growth front that China's slowdown is now unfolding. We believe we are seeing good evidence that China is paving the way towards a soft landing, which probably means we are towards the end of the tightening cycle that has now carried on for over a year.

By contrast, inflation in Brazil and India is still trending higher in the headline numbers, particularly in India (see **Exhibit 3**). Note the scale on the charts because the lines don't look that disturbing until you look at the scale. The good news in India is the big shock from food inflation has now eased. The bad news is that the overall numbers, and by inference the ex-food numbers, are now running at 9% if not slightly higher. So what originally looked like just

a food price inflation shock in India now looks like it has become more of an embedded inflation problem.

Over the course of the past month the Indian central bank finally moved from what we thought was a very complacent response towards a more aggressive tightening stance. We think we're now in catch-up mode in India but that monetary tightening is likely to be a headwind for the next several months in addition to the valuation issues that we will discuss later in the paper.

Finally for Indonesia, the inflation situation looks relatively well contained. Indonesia has had one benefit in containing the headline inflation numbers at levels that still look manageable and that is the fact that the Indonesian government has been willing to accept some broadening of the subsidy costs associated with containing energy prices in the economy. In effect, fiscal policy slippage has made it easier for monetary policy to deal with the inflation pressures.

Actionable ideas – Adding back to China and Korea remains in the sweet spot

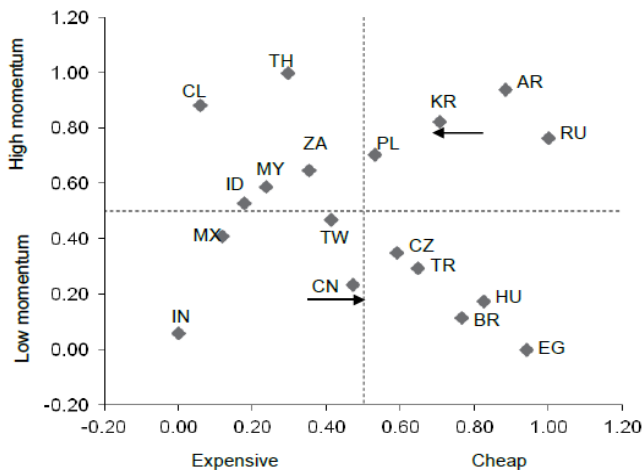
On a country basis, our tactical views are always informed by the value/momentum overlap. Our value/momentum screen, shown in **Exhibit 4**, suggests that improving valuations in China argue for adding back to this market following its underperformance in 2010. Unspectacular but steady Chinese underperformance amid monetary tightening over the past year has resulted in neutral valuations relative to the rest of the asset class.

A market that we've liked for sometime is Korea, which remains in the sweet spot of positive value and momentum. However, we acknowledge that strong performance has started to diminish Korea's valuation discount and, as such, we are probably in the second half of this tactical trade.

Within commodity markets, we would note that Russia looks more attractive than Brazil. Both markets look cheap, although Russia looks cheaper. Furthermore, it's worth noting that when we dig deeper within Brazil it looks as though the cheap valuation is flattered by the cheapness of its two index heavyweights. The rest of the market looks decidedly fair valued.

Finally to return to India, the striking thing is that the market still looks richly valued by emerging market standards despite the inflation problems discussed earlier. However, what had been a rich market with positive earnings momentum has now become a rich market with negative momentum as the monetary tightening and inflation fears have begun to take their toll on corporate profits. As such, we still think it is too early to go back into India. We would look for further underperformance to present an opportunity to buy what remains a very good long-term growth story.

Exhibit 4 – Tactical country views: seek value and momentum



Source: J.P. Morgan estimates. Data as at May 1, 2011.

- 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.

The commodity-currency nexus

Given the past decade's commodity supercycle and the recent volatility in commodity prices, we wanted to spend some time dissecting the fundamental factors that could spark a reversal for commodities and the associated strength in commodity prices.

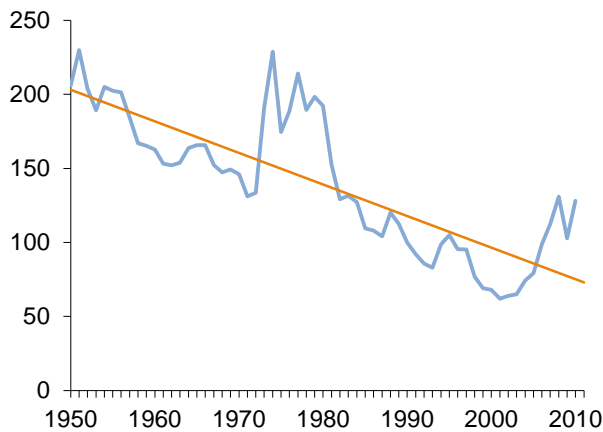
In order to do this we took the long-term non-energy commodity price index and deflated it by overall price levels (in other words we deflated by the CPI) to give us a relative price, or a real price, of commodities. The good news with commodity prices is that they have a long history and they don't get revised. Industrial commodity prices, (non-oil and non-energy) have a history maintained by the World Bank that goes back over a hundred years. We've taken the last 60 years on the left-hand chart in **Exhibit 5**.

The striking thing is if we showed the last 110 years rather than just the last 60, we see big cycles around the trend line, but importantly the trend line falls. One explanation for this fall in prices is that over time human ingenuity generally outpaces the scarcity issues relating to commodities. However, the recent super cycle has basically reversed this rule and moved commodity prices from below to above the trend line.

The same relationship is now also true for energy prices. As we can see in the right hand chart, the trend line is actually sloping upwards and that's the case even if you just start fitting the line from 1970 onwards. The left-hand chart, which is where we have an even longer history, confirms the upward price trend.

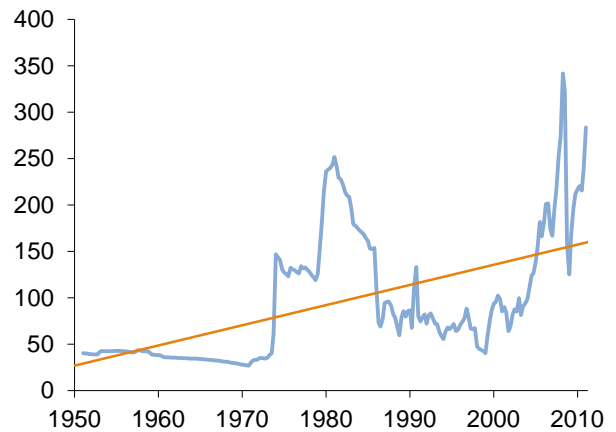
Exhibit 5 – Commodity price trends – the long view

Real Non-Oil Commodity Prices
index, 1990=100



Source: JPM. BLS. Data as at end 2010

Real OPEC Crude Basket Price
index, 1990=100

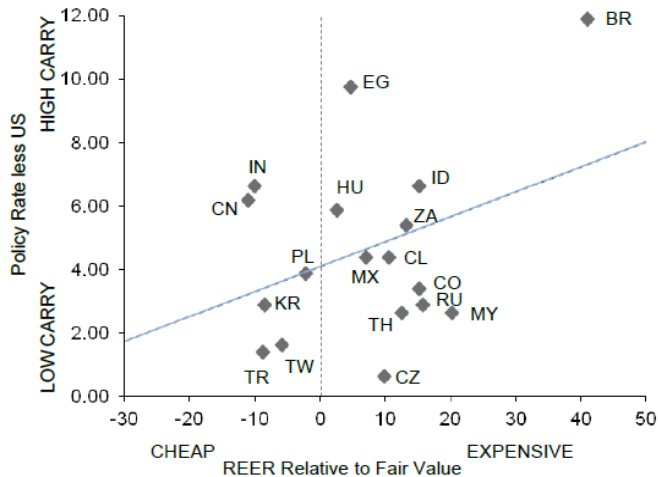


The impact of commodity price changes on currencies

The commodity supercycle has ultimately played out in the currency space quite clearly. The scatter chart in **Exhibit 6** shows currencies relative to our estimates of fair value – the right-hand side being expensive, the left-hand side being cheap. The vertical axis measures the difference between short-term policy rates in that local country relative to US rates, effectively the carry rate. On the horizontal axis we have the real effective exchange rate (REER) relative to our notion of fair value.

Exhibit 6 – EM currency evaluation

REER vs CARRY: 29 April 2011



Source: UBS. Data as at January 2010.

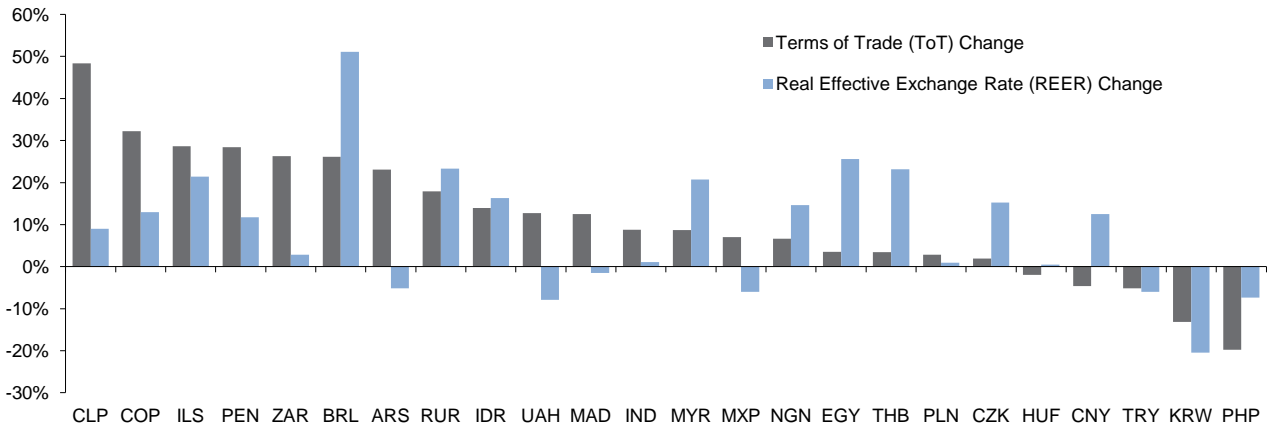
What has stood out for some time is that the more expensive currencies include the Brazilian real (BR), the Indonesian rupiah (ID), the South African rand (ZA) and the Russian rouble (RU). The clear message is that it is the commodity exporter currencies that are rich. If you look on the left-hand side you can see commodity importer currencies (i.e. either manufacturing or services economies) where currencies appear cheap. For example, the Chinese yuan (CN), Korean won (KR) and Indian rupee (IN).

Clearly there is a link between commodities and currency performance. The question is, how much can the rise in commodity prices explain the performance of different currencies? One way to approach this question is to look at past shifts in the terms of trade² to unveil currency over- and undershoots.

² Terms of trade in effect measures the price of exports relative to the price of imports. So commodity exporting countries have experienced a much stronger rise in export prices compared to import prices over the last several years and, as a result, they have experienced a positive terms of trade shock.

Exhibit 7 shows the shift in terms of trade in the grey bars. The blue bars represent the performance of emerging currencies over the past five years in real effective exchange rate terms. This analysis clearly shows how much the commodity price movements seen in **Exhibit 5** have contributed to currency movements.

Exhibit 7 – Country: Value and Momentum
Terms of Trade vs. Foreign Exchange Movements, 2005-2010



Source: IIF, JPM. Data as at end December 2010

Terms of trade provide some clues to currency valuations

If we focus first on Brazil and look at the terms of trade and currency response, we can see that the currency rallied by about 50% in real terms. However, the shift in terms of trade justified only 25-30% of that move. So it is clear that the real has risen in value by much more than is implied by the shift in the terms of trade. To some degree the same is true for the Russian rouble.

The biggest positive terms of trade shock has been for Chile. Yet the peso actually hasn't rallied that much over the past five years. The terms of trade shock in Chile has been driven by a surge in copper prices relative to virtually all other prices. Arguably, the peso has not risen much because of the success of Chile's Sovereign Wealth Fund in managing some of the impact of currency inflows on the economy.

If we turn to the right-hand side of the chart in **Exhibit 7**, we can see the currencies that are oversold due to the negative terms of trade shock. For example, the Korean won (KRW) has actually been weaker than would have been justified, due to the fact that it is predominantly an energy importer and, as a result, has had the headwind of rising energy prices added to its terms of trade.

In summary, this currency analysis gives us some indication of where the main currency overshoots and undershoots are. The Brazilian real looks like the big overshoot currency.



How long will the commodities supercycle last?

To help understand where we are in the supercycle we can perform the same DuPont analysis that we looked at earlier, but broken down by economic sector. What is evident from this analysis is that the capital discipline improvement that we saw earlier among emerging market companies is very apparent in the non-resources sectors; however there are indications that capital discipline is slipping in both resources sectors (materials and energy).

We are starting to see rising capex-to-sales ratios in these commodity sectors, suggesting that companies are conducting an aggressive pursuit of supply driven by the desire to capitalise on higher commodity prices. It is possible that we are finally starting to see what may be the beginnings of a supply response that could begin to dampen the commodity supercycle and, ultimately, result in a weakening of some of the commodity currencies.

So when should we begin to get more cautious on the commodities side? We believe that the answer to this question lies not just in the supply-demand fundamentals. Investors also need to look at exchange rate fundamentals in the world's reserve currency, the US dollar. This is because the US dollar is one of the drivers of commodity prices and its fundamental bottom will have important implications for emerging currencies.

The movement of the US dollar real effective exchange rate is closely linked to changes in the commodity price index. In other words, despite the protestations of Federal Reserve chairman Ben Bernanke, it looks to us like there is a currency element involved in driving commodity prices. In addition, a look at the relationship between the real Fed Funds rate and the real effective exchange rate of the dollar, shows that the dollar tends to respond after the Fed has started its tightening, particularly after the Fed has begun to re-establish positive real interest rates.

However, past dollar supercycles have not really been established until the real Fed Funds rate has reached a level of around 2%. As a result, we believe that the monetary conditions are not yet in place to spark any sustained rollover in commodity prices.

Conclusion

In our view the global expansion is continuing but the inflation issue is no longer just monopolised by emerging markets. Valuations and potential returns still appear reasonable for emerging markets as a whole and the momentum in long-term earnings expectations that helped fuel the developed market catch up rally earlier this year has now dissipated.

Tactically we are covering the remainder of our underweight in China given improved valuations and what looks like optimism on a soft landing story unfolding. We are holding onto overweight positions in Korea and Russia. In both cases we've seen some diminishment of that valuation discount but think there's still further to go with those trades.

Finally, given the commodities supercycle seen over the past decade and the recent volatility in commodity prices, our dissection of the nexus of commodities and currencies suggests that fundamental factors to motivate reversal are starting to materialise. However, developed world monetary conditions remain supportive for commodities and thus the associated strength in commodity currencies.

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