MARKET INSIGHTS

October 2011

Emerging markets strategy: Can emerging markets do it again?

George Iwanicki
Managing Director
Macro Strategist
Global Emerging Markets Equity

George Iwanicki, who has held previous positions as J.P. Morgan's US economist and then co-head of global economics, has been with the Emerging Markets team since 2000. In his current role he is the team's dedicated macro strategist responsible for Global Emerging Markets Portfolios and chair of the Asset Allocation Committee.

Introduction

Somewhere between Greek default and Eurobond issuance lies 'constructive ambiguity'. This is a term coined by an official of the German central bank (the Bundesbank) to describe the policy in the core of Europe that welcomed a certain amount of volatility in risk assets because such volatility would pressure southern Europe to impose austerity on itself. It's a world of renewed recession fears in the developed world and because of the uncertainty of policy, an environment where we have chronic risk asset indigestion.

It's in this context that George Iwanicki, emerging market macro strategist, asks whether emerging markets can do it again? Can they help lead the world through another tumultuous period as they did in the 2008/2009 global financial crisis? To answer these questions, George re-examines the decoupling story and the consequences for commodity prices (and commodity-exporter currencies) of an extended zero interest rate policy. As always, George also focuses on some of the tactical views that have become exciting within the emerging markets asset class.

Memories of 08/09

With memories of 2008/09 fresh in investors' minds, some of the trading sessions over the last two months or so and the read through in risk appetite indices clearly show we've moved back into an environment where caution is again the word of the day.

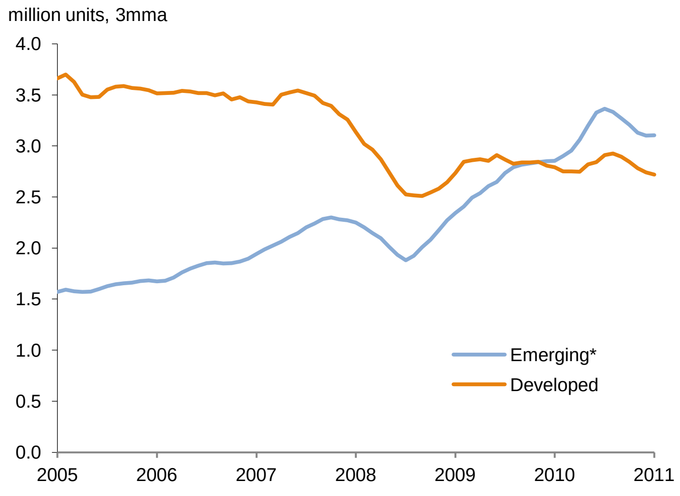
This is an environment where, even in emerging markets where growth downgrades are really not that significant, investors are shooting first and asking questions later. If you look over the last several weeks we've seen net outflows in emerging market equities. Interestingly, it appears to be more regional funds and ETFs seeing the outflows, as tactical allocations are cut. For now, strategic allocators in the institutional space appear to still be moving into the asset class.

Decoupling – emerging market alpha and beta

To begin with, let's take a look at developments in emerging market alpha and emerging market beta. Emerging market alpha refers to the incremental growth we can achieve from emerging markets in general, while emerging market beta refers to the degree that markets remain correlated.

From an emerging market alpha perspective, there is no doubt that the long-term emerging market growth story is positive relative to the developed world. But even over the nearer term, we've seen emerging markets still maintaining relatively high levels of growth. One proxy that illustrates the strength of emerging market growth is auto sales. **Exhibit 1** shows comparative vehicle sales trends in the emerging universe relative to developed markets, where sales have essentially been flat over the last four years.

Exhibit 1 – **Monthly motor vehicle sales**



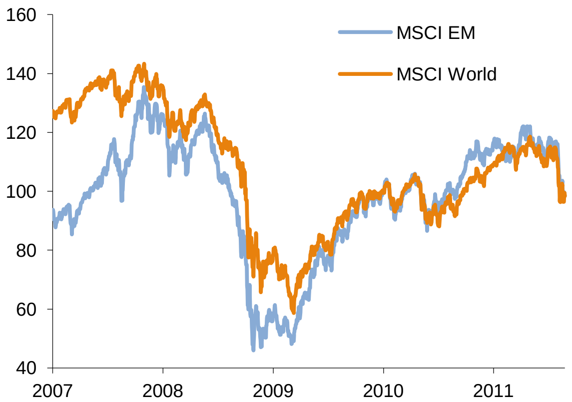
Source: CEIC, Haver, UBS estimates. * Top 25 Emerging Markets. Data as at August 2011

With emerging market auto sales 40% higher than the absolute pre-crisis peak and auto demand in the developed world still nearly 20% below the average level of the first half of the 2000s with little sign of regaining past ground, there is little doubt that emerging markets are currently outpacing developed world growth. As such, the question is how much can emerging markets continue to outpace developed markets, particularly if developed markets are stuck in a low growth environment or if they relapse into recession?

Exhibit 2 – **Equity markets remain highly correlated**

Stock market index

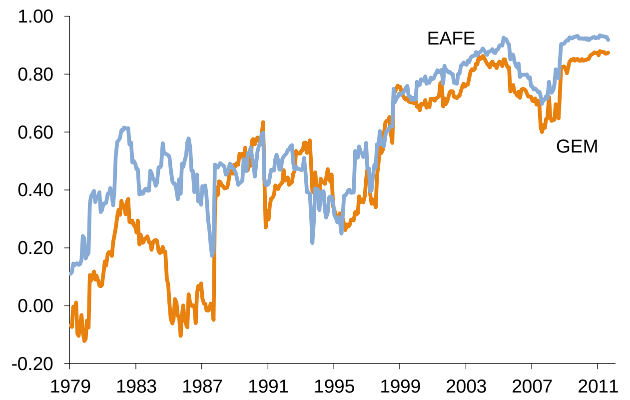
(USD Jan 2010 = 100)



Source: UBS, JP Morgan. Data as at end August 2011

Correlation of Monthly Global Equity Returns

3-year rolling correlation with S&P 500 total returns



Source: S&P, MSCI, JP Morgan calculations. Data as at end August 2011

The answer, in our view, is that emerging markets can sustain about a 4-to-5% growth premium over developed markets on a sustained basis, which is consistent with the view of the International Monetary Fund. It's probably going to be difficult to sustain anything more than that when you think about the trade linkages between the emerging and the developed world. But nonetheless we think a 4-to-5% differential is sustainable.

So that's the good news on the growth side. Emerging market alpha is high. However, we live in a globalised world, so when we think about how emerging markets perform when global markets are correcting, it's clear that emerging market beta remains high as well. **Exhibit 2** shows how emerging market equities have closely tracked the performance of developed markets, not only in 2008/09 but also since then.

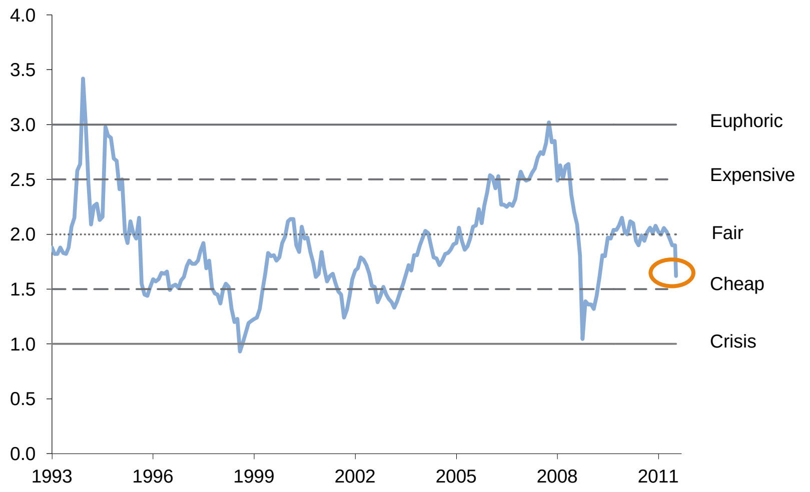
As asset allocators are well aware, the correlation of global equity returns is very high. Whether you look at emerging markets versus the US, or any other peer-wise segment of the global equity space, it's very difficult to find regions where correlations are not effectively 0.8. Unfortunately, we're in an environment where the asset allocation diversification benefit of investing across different regions has gone from being a free lunch to providing mere crumbs. We'll return to this point about correlations later because we've done some work that looks at why correlations have remained at such high levels over the past few years.

An unfolding buying opportunity?

What has the stubbornly high correlation of emerging market equities with global financial markets done in terms of valuations? In the last few papers, we've focused on a crude but nonetheless useful measure, looking at the price-to-book (P/B) level for global emerging markets. Historically, we have found that investors have been paid to own the asset class at a P/B of 1.5x or below, while it has been beneficial to be cautious when the P/B has been at 2.5x or higher. As **Exhibit 3** shows, on a P/B basis emerging market equities had been stuck in the neutral 2.0-2.1x range for most of the past year, which we viewed as fair value for the asset class.

Exhibit 3 - Markets have discounted a recession, but not a crisis

GEM Price to Book



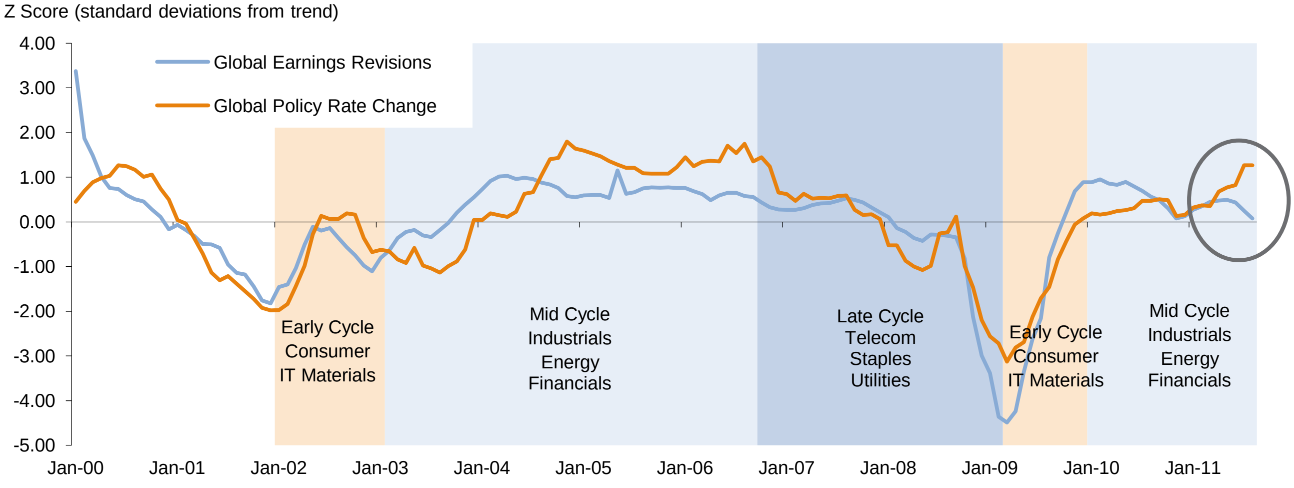
Source: Bloomberg, Factset, UBS, Data as at end August 2011

The breakdown that we've seen in global equity markets over the last three months has resulted in emerging market P/B valuations flirting with the 1.5x level. A further correction from here would move us into an unequivocal buying opportunity from a valuation perspective over a one-, three- or five-year horizon.

The message is consistent if you look at price-to-earnings (P/E) multiples, including forward P/E measures as well as those based on trailing earnings. All suggest that emerging markets are trading at discounts to the historical average.

Exhibit 4 – Bumping along in a low growth world – still mid-cycle but downside risks evident

Global cycle indicators: change in global earnings revisions and policy rates



Source: J.P. Morgan Asset Management estimates; as at end August 2011.
Earnings revisions are for MSCI ACWI over 6mths. Policy rate change covers over 50 central bank policy rates

Emerging markets retain the flexibility to pursue conventional monetary easing

One of the advantages that emerging markets retain is the ability to use conventional monetary policy to ease the blow from weaker developed world growth. A willingness to cut rates has already been demonstrated in Brazil and also, one could argue, in Turkey. Nominal rates still have a fair amount of room to be cut in the emerging markets, unlike in the developed world.

To some investors, this easing looks premature as it may actually inflame the inflation problems that have been experienced in some emerging economies over the last couple of years. We do not deny that this is a possibility, particularly if we see a hard landing in the developed world which forces an extreme policy response from the emerging world.

However, it's important to keep a global perspective on any emerging market easing and to focus on why it is happening. **Exhibit 4** shows the two indicators we use to capture where we are in the global business cycle. First, we look at estimate revisions by analysts globally, and second, we look at the change in interest rates across both emerging and developed economies. The chart shows z-scores so policy tightening and upward revisions can be seen as a positive reading on the chart, and vice versa.

The thing that stands out from Exhibit 4 is the gap that has opened up between these two indicators recently. The orange line says that monetary policy in the aggregate has been tightening over the last year or so, but note how analyst revisions are now starting to rollover, which suggests that the monetary tightening has succeeded in slowing economic growth. Historically, when this happens it means that policy interest rates globally will probably have to be cut again soon in order to boost growth. So the shift towards easier policy in Brazil (and potentially in other emerging markets) actually looks more reasonable when viewed against the global backdrop than against purely domestic considerations.

Estimate revision cycles are increasingly global

Looking further at estimate revisions, we know that forecasters have virtually unanimously reduced their estimates for developed world GDP growth over the last two to three months. In contrast, forecasters have generally made minimal revisions to emerging market GDP forecasts. However, while the reductions in GDP growth expectations have been concentrated in the developed world, it would be wrong to think that emerging market earnings expectations will be immune. It is striking to us how the correlation between estimate revisions in the developed world and the emerging world has tightened fairly dramatically.

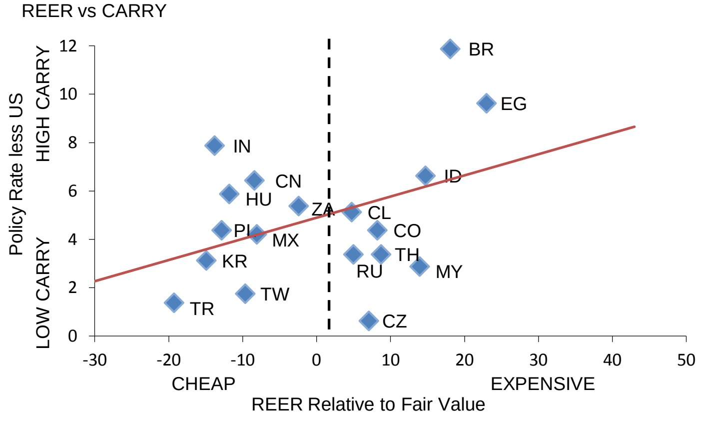
Estimate revisions are therefore a largely global phenomenon and are not unique to the region where GDP is being revised up or down. This phenomenon not only helps explain why global equity markets have become so correlated, largely because estimate revision cycles have become so correlated. It also suggests, insofar as developed world expectations are now being marked down because of the reductions in GDP expectations, that the unfolding estimate revision cycle will include downward revisions to emerging market expectations as well. As such, the tactical view on the asset class from a value and momentum perspective suggests that while valuations are improving meaningfully, from a momentum perspective estimate revisions are likely to be a headwind over the next two-to-three months.

Emerging market currency valuations

Attention has recently turned to emerging market currencies, in particular several of the commodity exporter currencies where we have long detected overvaluation.

Exhibit 5 shows the commodity-export currencies on the right hand side are still looking rich relative to our estimates of fair value. In contrast, the commodity importers (i.e. the exporters of manufactured goods or services) tend to be trading cheaply.

Exhibit 5 – **Currency valuation and support**



Source: J.P. Morgan estimates. Data as at 13th September 2011. REER relative to fair value (export-adjusted 10 year average REER) on the x axis and policy rate on the y axis. Countries over the line of best fit provide good carry for their currency valuation

A meaningful currency correction will take one of two things – either a significant breakdown of global economic growth, which would prompt a fundamental slowdown in demand for commodities, or an increase in US policy rates, probably to the point where real rates became positive, as this would help provoke a sustained rally in the US dollar and put downward pressure on commodity prices.

The US Federal Reserve (Fed) isn't likely to raise rates any time soon, having explained to markets recently that keeping rates close to zero for an 'extended period' actually means two years of unchanged policy. In other words, the zero interest rate policy will be kept in place until mid 2013. Any economist who's been in the forecasting business knows that two years is about as long a horizon as you can see. So effectively Fed chairman Bernanke is saying that as far as the eye can see, US rate will be kept at zero. This means that, unless we get a big breakdown in global growth, it's going to be hard to see a major breakdown in commodity prices or a major reversal in commodity currencies.

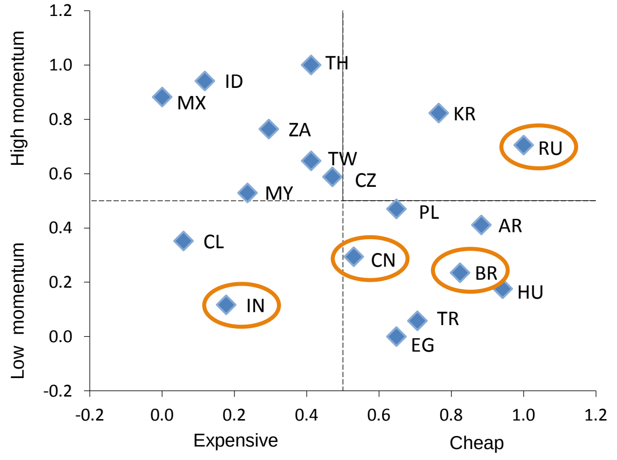
This doesn't mean that we won't see some weakness in some of the commodity currencies, particularly those that had overshot in terms of valuation – Brazil's Real being a good example. Following the recent Brazilian interest rate cut, we've seen a pullback in the Real from very rich levels. It's worth noting that the Real was one of the currencies where the five-year appreciation through the end of last year was went well beyond what could be justified by the improvement's in Brazil's terms of trade. Nonetheless, we think the fundamental breakdown in commodity prices and in commodity currencies by extension has been delayed, given that the developed world, particularly the Fed, has positioned itself for an extended period of zero interest rate policy.

Actionable ideas: Remember the BRICs?

In 2006/07 everybody got very excited about Brazil, Russia, India and China – collectively known as the BRIC economies. For many investors, the emerging market story was really just the BRICs story. However, over the last several years, as the BRIC markets became increasingly expensive, we consistently told investors to focus on global emerging markets as a whole rather than on just the BRICs, because we were seeing good opportunities in the rest of the emerging markets asset class that BRIC investors were missing out on.

Our tactical views are always informed by the value/momentum overlap. The interesting point on our value/momentum screen, shown in **Exhibit 6**, is that the BRICs have struggled over the last several quarters, particularly those that don't start with the letter "R". Our analysis suggests that Brazil is now looking decidedly cheap as a market. China is now looking fair value, or even slightly cheap, following extended underperformance. Even India, which is a premium long-term growth story that has traded consistently at a premium valuation, has started to look cheaper at the margin.

Exhibit 6 – **Country: value and momentum**



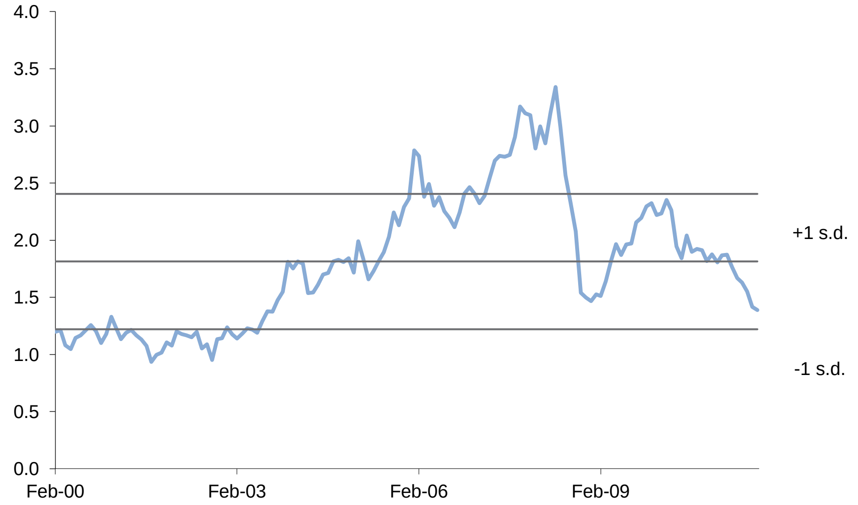
Source: J.P. Morgan estimates. Data as at 1st September 2011. This information reflects JPMAMs opinion and goals and is subject to change. Countries ranked on last 12 months price movement on the y-axis and a composite of valuation metrics on the x-axis. Units are percentile ranks which go from 0 to 1.

Cheaper BRICs present interesting opportunities for investors, even in the current environment. The BRIC economies are continental size markets that are large enough and have a big enough base of domestic demand to generate internal growth, even if the developed world slows dramatically. So let's drill down and look more closely at three of the BRICs in turn – Brazil, China and India.

China: A look at China suggests that we are witnessing a soft landing. We've seen the impact of increases in the reserve requirement (the preferred measure of policy tightening by the Chinese) back in 2007/08, and going back further we also saw increases in 2004/05. The reserve requirement has now got to levels where it has started to prompt a rollover in Chinese growth. Crucially, we have also now begun to see headline inflation numbers begin to roll over. As such, a soft landing appears to be unfolding, with growth slowing rather than collapsing and inflation responding positively. In our mind, this is putting in place the preconditions to allow policy to begin moving back towards normal, i.e. moving in an easing direction from a tight stance. Clearly, the global growth concerns that we're seeing could hasten that move. However, we're hoping that we will still see a gradual, rather than an urgent move.

Brazil: Brazil's valuation chart is perhaps one of the most striking. **Exhibit 7** shows the price-to-book valuation of Brazil going back to when Luiz Inácio Lula da Silva was first elected (in late 2002). The huge re-rating in valuation terms that Brazil experienced over his two terms in office is clearly evident. However, what is notable today is how much valuations have now reversed.

Exhibit 7 – **MSCI Brazil Price to Book**



Source: Bloomberg, Factset, UBS, Data as at 14th September 2011.
This information reflects JPMAMs opinion and goals and is subject to change
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There are, of course, some question marks around the Brazil story, in particular (as we have discussed before) the government appears relatively activist and the pre-emptive easing that took place is considered by some to have been politically influenced. Having said that, we've now gone back towards the kind of valuation levels that are not only close to the 2008 lows, but that prevailed before the Brazil story really took off. In other words, the 1.2x P/B valuation that marked the Cardoso period before the Lula presidency unfolded. At this point, the de-rating has taken Brazil down to levels that valuation-wise look attractive even given some of the political and policy question marks that we have.

India: Intentionally last, as the least favourable of the stories, is India. We look at India relative to Indonesia because these are the two markets we would perceive as global growth defensive countries – they have strong demographics, strong domestic demand and, as a result, they are somewhat more insulated from the developed world's current travails. At this point India has dramatically underperformed Indonesia and as a result, valuation-wise, it is actually starting to look competitive. However, India's business cycle is, in our view, more complicated than the China story. We have seen slowing in virtually all economic activity measures, including for example the auto sales numbers in India, which have effectively flat lined. Particularly worrying has been the somewhat belated policy tightening by India's central bank. If you look at where inflation run rates are, even if you strip out food from the numbers, they remain stubbornly high. This means it's premature to declare that India's tightening cycle is over. It's also premature to declare that we're seeing a soft landing in India.

In summary, of these three BRIC markets, we've been willing to move back into China and Brazil. We are still biding our time on India, waiting for valuations to improve a bit more and hopefully for more clarity on the Indian business cycle, given the risks that remain.

Conclusion

We believe emerging markets can carry global growth. However, the most desirable path would be to see a moderate or gradual, rather than an urgent, shift from the tightening we've seen back towards normal policy rates or even towards stimulus. An urgent shift might re-inflame some of the inflation or credit pressures in selected markets. We believe it's time to put some of the concerns about a big reversal in commodity or commodity currency prices on the back-burner, given that the developed world is set for a period of prolonged low interest rates, particularly in the US.

We remain constructive on emerging market fundamentals and think the window for either accumulating or adding to emerging market equities has now been opened by cheaper valuations. Tactically, within the asset class we like continental-sized economies so we're focused on the BRICs. We like China, where global worries may hasten the end of policy tightening, and Brazil, which has already cut rates. Among the markets that are typically defensive in the face of global growth fears, India has significantly underperformed Indonesia and now looks the more attractive market. However, we do acknowledge there's a momentum headwind from the estimate revision cycle that emerging markets will not be immune to, and so further short-term volatility can be expected despite the long-term positive fundamentals.