Maintaining the Growth Advantage

by George Iwanicki, Emerging Markets Macro Strategist
Richard Titherington, Head of Emerging Markets Equity Team

Last year’s established storyline continues to play out—one of a sluggish expansion in the developed world, which has followed a sluggish recovery from a very deep recession. As a result, this is a fragile recovery with the risk of relapse and, more importantly, even presuming the recovery continues, there is a lingering risk of deflation. Nonetheless, we believe the most likely outcome is for continued sluggish growth, supported by accommodative, if not extraordinary, monetary policy, including the most recent round of quantitative easing.

Decoupling 2.0

Most investors will remember the great decoupling debate of 2007. The hope was that, as the developed world slowed, emerging market growth would hold up. With benefit of hindsight we know that this confidence was misplaced: a hard landing in the developed world meant a sharp slowdown for the emerging world. However, we have seen a marked differential in growth between the G-7 and the emerging world.
The question today is, given the widespread expectations (including our own) for very slow developed world growth over the next few years, how much can emerging markets “delink” or decouple and sustain superior growth over the developed world?

Notably, consensus expectations, including those of the IMF, are that a gap in growth between the emerging and the developed world of 4 percentage points or more can be sustained in the next three to five years. We’re inclined to agree with this view; however, we wanted to investigate further—looking not only at the commercial links but also at some of the financial links between these two economic blocks—to see whether emerging markets can sustain such a large growth advantage.

1. Commercial Links

Exhibit 1 looks at global trade trends and highlights that over the last 20 years we’ve seen one of the most rapid periods of trade intensification—or tightening of commercial links—witnessed in history. Global trade has exploded since 1990, reaching more than 25% (Exhibit 1A) of global GDP and, within that surge, exports from emerging markets have led the way, rising to 30% of global exports (Exhibit 1B). This rapid deepening of trade would seem to suggest limits to the decoupling story.

However, if we dig a little deeper into emerging market exports, we see that trade links within emerging markets are deepening faster than anywhere else. The destination of exports is beginning to shift fairly rapidly away from developed economies and toward emerging market economies—in the past five years alone there has been a 10 percentage points increase in the share of exports going from emerging markets to emerging markets, relative to what was the case as recently as 2005. Of course this partly reflects faster demand growth in the emerging world than in the developed world, which has also benefited developed economy exports. But it primarily illustrates that economic links have tightened most rapidly between emerging markets.

2. Financial Links

Financial links also point to the increasing importance of emerging markets. Half of global foreign direct investment (FDI) now flows into emerging markets, while emerging markets are now the source of almost a fifth of FDI flows. This is evident in some of the headlines in recent years: India’s Tata Motors buying up Jaguar and Range Rover, for example.

In essence, financial flows are beginning to mimic global trade patterns—emerging markets becoming significant in their own right, not only as recipients but also as generators of FDI flows. So viewed through the lens of either commercial or financial links, it is increasingly evident that there are strong sup-
Portative factors for the growth outperformance expected for the emerging world relative to the sluggish developed world.

Lastly, it is notable that after a decade of widening global imbalances between surplus emerging market and deficit G-7 blocs, the developments above are finally beginning to steer current account positions back toward historically more normal levels. We are now three to four years into the corrective process. This is good news, insofar as these imbalances represented a primary focus for worry among global policymakers and investors, acting as a source of financial market volatility.

QE2 Presents Challenges for Emerging Market Policymakers

Amid sluggish developed world growth, the second round of quantitative easing in the U.S. (known as “QE2”) is exerting downward pressure on the U.S. dollar, forcing choices on emerging market central banks that could result in a variety of outcomes.

Exhibit 2 is a stylized grid that can be used to determine the potential effect of QE2 on emerging market economies. The vertical axis ranks countries on the basis of the flexibility of their exchange rate policy. A fixed rate regime or a managed float regime appears on the bottom half of the chart, whereas a floating exchange rate regime appears in the top half of the chart. The horizontal axis represents where an economy is within the business cycle. Countries that fall on the left of the chart are operating below full capacity and as a result have little in the way of price inflation pressures. Those on the right-hand side of the chart are more advanced in their local cycle and as a result face potential price inflation pressures.

For countries with a floating exchange rate regime and operating above potential (i.e., the upper right quadrant), the ideal policy solution in response to the downward pressure on the U.S. dollar from QE2 would be to allow some currency appreciation. This would not only help to slow the economy and contain inflation pressures, it would also provide some immediate inflation containment via pass-through effects.

For countries in the bottom right quadrant, maintaining their fixed exchange rate strategy implies mimicking quantitative easing to some degree, creating excess liquidity. As a result, these countries, which are already advanced in the business cycle, are the prime candidates for upside price inflation risks.

Countries in the lower left quadrant have an easier time (for now) maintaining fixed exchange rate regimes as they benefit from the fact that they are operating below potential GDP. These countries are the prime candidates for asset price inflation as a result of monetary accommodation amid lingering economic slack.

Finally, countries in the upper left quadrant, where economies are operating below potential but tolerate FX flexibility, may choose to accept appreciation but are not in need of such disinflationary impetus given the presence of local economic slack.

How Will Individual Countries Fare?

It is relatively simple to determine the FX flexibility of various emerging market economies. To assess the potential impact of QE2, we therefore need to make a judgement of where economies are in their respective cycles.
In the developed world, this is a far easier exercise—the OECD comprehensively estimates output gaps using relatively harmonized data. In the absence of such formalized estimates for EM, we have taken an alternative approach by comparing realized GDP growth over the past five years with our best estimates at the time of potential economic growth (as judged by the growth in labor, the growth in capital and productivity growth).

This comparison shows which economies have been chronically outgrowing their potential and as a result are running positive (or potentially inflationary) output gaps and which countries have been operating below potential and as a result still have disinflationary slack. The good news, as Exhibit 3 shows, is that most emerging market economies still seem to be operating with some slack. However, there are some notable markets that appear to have sustainably outrun potential and face inflation risks. China has been significantly outpacing the 8% to 8.5% growth rate we viewed (and still view) as trend growth; India has slightly overshot the 6%+ rate we saw as trend, while Indonesia has also begun to outperform our long-term trend figures. However, Brazil has grown at trend rate, and most other significant markets have lagged trend and thus should retain disinflationary slack. Therefore price inflation looks to be a selective rather than a systemic risk within EM.

The checklist below summarizes the likely implications of QE pressures for the more significant emerging markets. The risk of economic overheating and price inflation is most severe in China, probably explaining why some of the loudest protests of the Fed’s QE policy is coming from the Chinese policymakers. India and Indonesia are also places where the overheating and price inflation risk is prevalent; for both of these more flexible FX regimes, the question is how much additional FX appreciation policymakers will tolerate.

Conversely, Brazil and particularly Russia and Turkey are better positioned to avoid near-term inflation risks as they all fell at or below their respective trend growth levels. These are the markets that could see currency appreciation if QE2 puts further downward pressure on the dollar or, more likely, are candidates for local currency asset inflation as a result of QE2.

**Mixed blessing: EMs growing above trend faced heightened inflation risk from DMs aggressive monetary easing**

**EXHIBIT 3: FIVE-YEAR ANNUALIZED GDP GROWTH VS. TREND ESTIMATES**

![Graph showing GDP growth vs. trend estimates](image)

**Best guess: QE2 will likely have varying impacts on leading EMs**

**EXHIBIT 4: PROBABLE OUTCOMES OF SUSTAINED QE2**

<table>
<thead>
<tr>
<th>Country</th>
<th>Brazil</th>
<th>Russia</th>
<th>India</th>
<th>China</th>
<th>Indonesia</th>
<th>Turkey</th>
</tr>
</thead>
<tbody>
<tr>
<td>FX appreciation</td>
<td>?</td>
<td>✓</td>
<td>?</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Capital controls inflow taxes</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Economic overheating/price inflation</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Asset inflation</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management.
Still Constructive on the Asset Class

While inflows have been strong enough to prompt some to wonder whether the “EM story” is already priced in, we believe emerging markets still offer plenty of potential. The most impressive reforms in the asset class over the past decade were not necessarily the macro reforms we are all familiar with—lower inflation, better budget positions, etc.—but rather the improvement in corporate capital discipline and the resulting improvement in operating efficiency, reduced financial leverage and returns on equity (ROEs). As this is allowing profits to “participate” in more rapid EM economic growth, it is motivating a secular rise in the share of global profits that are accruing to emerging markets companies. In our view, this rise best explains why investors the world over are reassessing their strategic allocations to EM equity with an eye to raising targets.

In view of ongoing inflows, we carried out a simulation of the effects of rotating 1% of assets across developed world portfolios into emerging market equities, to show the potential impact on flows into emerging markets. Importantly, just this small shift would produce a larger flow than any annual flow we’ve ever seen. This allays our concerns that the inflows seen to date are reflective of “hot money” chasing returns; rather it suggests that the flows so far may simply be the front end of a strategic reallocation that has much further to go. Hence, it’s premature to be intimidated by the inflows in the asset class.

Similarly, it is premature to be concerned by valuations, which still look to us to be definitively fair, if not slightly cheap. Our rule of thumb on price-to-book ratios stands: At 1.5x or below, history has shown that it is time to buy, while levels of 2.5x or 3x mean it is time to be cautious. We are currently right in the middle of that band at 2x. The forward price-to-earnings ratio is back to around 12x to 12.5x as of the end of November, near the five-year average, but below the very long-term average and below our fair value long-term estimate of 14.5x.

In summary, if we assume convergence of valuations to fair value and earnings growth in line with improved corporate capital discipline, and even if we allow for a retracement of commodity-oriented exporter currencies back toward fair value, our trend return estimates remain in the low double digits in U.S. dollar terms. Therefore, we remain constructive on emerging market equities.

Actionable Ideas: Pay Attention to Unloved Korea and Stick with Brazil and Turkey

On a sector basis, both our top-down and bottom-up measures suggest we are in the mid-cycle period, or expansion phase, of the global economic cycle. At this stage, signals for sector rotation tend to be more modest and differentiation among sector returns tend to be narrower than in the early cycle or late cycle/recession periods. As a result, our sector views on a cyclical basis are relatively muted. On a secular basis, we retain a leaning against materials, where we’ve seen what appear to be the beginnings of a deterioration in capital discipline (whereas the rest of the asset class appears to be holding up well on that front).

On a country basis, our tactical instinct is always to look at the value/momentum overlap. According to our value/momentum screens (Exhibit 5), Indonesia and India, which we have already highlighted as facing some inflation risk, are also beginning to look expensive. This is truer for India than Indonesia, and is compounded by the fact that India has also seen some compression in ROEs.

Tactical appeal: Our screens show both Turkish and Korean stocks undervalued and poised to benefit from positive momentum

**EXHIBIT 5: COUNTRY VALUE AND MOMENTUM**


Note: 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.
On the positive side, and notwithstanding recent tensions on the peninsula, Korea looks very cheap and should benefit from the end of the global growth scare. Recent PMI numbers suggest that the global industrial cycle, after some slowing over the last few months, has found bottom. If the global growth scare is now over and investors are again accepting sluggish but continued growth, Korea looks attractive. The Korean won also looks cheap, and its position as a consensus underweight means it has upside potential as investor hostility begins to wane.

Brazil, meanwhile, still looks cheap, although it is not yet screening particularly strongly on momentum. We maintain our tactical overweight, believing that the rotation among investors from neutral back to overweight still has further to run. We are continuing to monitor political developments to gauge the degree of the shift from “pragmatic” left to “ideological” left under the incoming Dilma administration to determine whether the attraction of Brazil is tactical or strategic.

Finally, we maintain our longstanding overweight in Turkey, which has consistently screened well for both value and momentum. We need to note, however, that Turkey has had a strong period of out performance, meaning that while valuations remain attractive, discounts to EM have begun to narrow. We don’t see near-term inflation risks in Turkey, according to our output gap measure above, but the market is a consensus overweight, all of which highlights that we are nearer the end of the out performance cycle than the beginning.

**Conclusion**

While developed economies are still mired in a sluggish expansion, emerging growth remains structurally strong. We believe that this strength can largely be sustained given the deepening financial and commercial links within emerging markets.

As such, the key focus for investors now is the impact of quantitative easing on emerging markets. In some cases, it means currency appreciation, in some cases it means asset price inflation and in some cases it presents local price inflation risks. This varies by country. The important point is that price inflation risk within EM looks to be a selective problem (in China, India and Indonesia, for example) rather than a systemic one.

We remain comfortable with current valuations for emerging market equities as a whole. We are also comfortable with the inflows the asset class has seen, especially in light of what we see as well-judged interest among global investors in increasing strategic allocations to the asset class. At the country level, we believe investors should pay attention to the unloved Korean market and maintain, for now, overweights in Turkey and Brazil.

**Strategic Risk in Emerging Markets**

The emerging markets’ phenomenal rise since 2000 begs an important question: Why are the emerging nations of a century ago still emerging today? There are two fundamental reasons: political upheaval and inflation. The economic consequences of the former are clear. The impact of the latter is less obvious but more pernicious. The example of Brazil offers as vivid an illustration of the tragedy of inflation as the examples of China and Russia do of the tragedies of war and revolution.

Over the last 100 years Brazil GDP has grown at an annual real rate of 4.9%, far in excess of the U.S., which expanded at 3.5%. Yet Brazil, which never endured the upheavals of revolution or war, fell behind due to inflation. From 1958 to 1968 and again from 1975 to 1994, Brazil suffered high and hyper inflation. Inflation that chronic and of that magnitude increases inequality, impoverishing the majority of the population. It debases the currency. It is the reason why for most of the last 100 years emerging market currencies have been so undervalued against G-7 currencies.

While emerging market opportunities have expanded dramatically, the strategic risks have changed little in their nature, even if one, political risk, has changed in its impact. The danger of the violent expropriation of assets may have diminished, but like inflation, political risk today, through pervasive corruption and a disregard of the rule of law, may gradually but insidiously erode their value.
This material is intended to report solely on the investment strategies and opportunities identified by J.P. Morgan Asset Management. Additional information is available upon request. Information herein is believed to be reliable but J.P. Morgan Asset Management does not warrant its completeness or accuracy. Opinions and estimates constitute our judgment and are subject to change without notice. Past performance is not indicative of future results. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. J.P. Morgan Asset Management and/or its affiliates and employees may hold a position or act as market maker in the financial instruments of any issuer discussed herein or act as underwriter, placement agent, advisor or lender to such issuer. The investments and strategies discussed herein may not be suitable for all investors. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Changes in rates of exchange may have an adverse effect on the value, price or income of investments.

The value of investments (equity, fixed income, real estate, hedge funds, private equity) and the income from them will fluctuate and your investment is not guaranteed. Please note that investments in foreign markets are subject to special currency, political, and economic risks. Exchange rates may cause the value of underlying overseas investments to go down or up. Investments in emerging markets may be more volatile than other markets and the risk to your capital is therefore greater. Also, the economic and political situations may be more volatile than in established economies and these may adversely influence the value of investments made.

All case studies are shown for illustrative purposes only and should not be relied upon as advice or interpreted as a recommendation. Results shown are not meant to be representative of actual investment results. Any securities mentioned throughout the presentation are shown for illustrative purposes only and should not be interpreted as recommendations to buy or sell. A full list of firm recommendations for the past year is available upon request.

JPMorgan Distribution Services, Inc., member of FINRA/SIPC.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited which is regulated by the Financial Services Authority; in other EU jurisdictions by JPMorgan Asset Management (Europe) S.à r.l., issued in Switzerland by J.P. Morgan (Suisse) SA, which is regulated by the Swiss Financial Market Supervisory Authority FINMA; in Hong Kong by JF Asset Management Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited, all of which are regulated by the Securities and Futures Commission; in Singapore by JPMorgan Asset Management (Singapore) Limited which is regulated by the Monetary Authority of Singapore; in Japan by JPMorgan Securities Japan Limited which is regulated by the Financial Services Agency, in Australia by JPMorgan Asset Management (Australia) Limited which is regulated by the Australian Securities and Investments Commission and in the United States by J.P. Morgan Investment Management Inc. which is regulated by the Securities and Exchange Commission. Accordingly this document should not be circulated or presented to persons other than to professional, institutional or wholesale investors as defined in the relevant local regulations. The value of investments and the income from them may fall as well as rise and investors may not get back the full amount invested.

© 2011 JPMorgan Chase & Co.