

February 2012

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For emerging market equities, as for many other asset classes, the current situation can best be described as value awaiting momentum. Emerging market equities are cheap, but the catalyst to unlock this value has yet to materialize.

In this paper, **George Iwanicki**, emerging market macro strategist, discusses the global backdrop and looks at how it relates to emerging markets. He then considers a special topic within the asset class, that of overinvestment, contrasting China with Brazil. And, as always, George also focuses on some of the tactical opportunities that have become exciting within emerging market equities.

### Decoupling Within the Developed World

In our last paper, we looked at the economic decoupling between emerging and developed markets over the last few years, and discussed the fact that, sadly, little of that decoupling had been reflected in equity market performance. In this paper, we shift our attention to another economic decoupling, this time within the developed world, and discuss the implications this has for emerging markets.

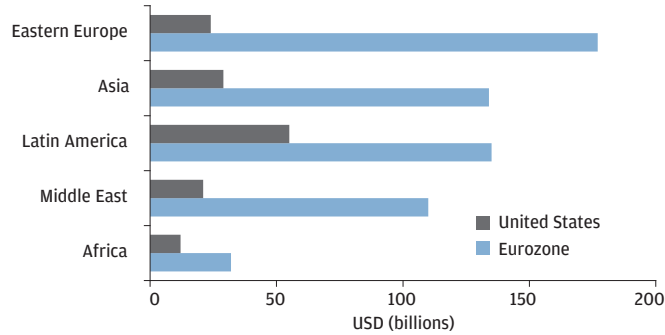
A look at economic performance for the U.S. versus the eurozone points to a clear decoupling trend. While the eurozone appears to have slid back into a renewed, albeit mild, recession, the U.S. economy is actually starting to show some signs of life. Divergence between the two economies is appearing in a variety of indicators—manufacturing data, unemployment rates, auto sales, surveys of lending conditions, to name some of the most marked.

The question we want to explore is to what extent individual emerging markets are exposed to this decoupling trend, and, in particular, to the renewed credit constraints appearing in the European banking system. An initial glance at the exposures of Eastern Europe, Asia, Latin America and even some of the frontier regions suggests that every one of these regions sources much more of its external lending from European banks than from U.S. banks (**Exhibit 1**).

# Emerging Markets

Every region in emerging and frontier markets appears to be exposed to European banks.

EXHIBIT 1: BORROWER BY REGION



Source: Dealogic (Nov 2011), HSBC.

- Asian and Latin American banks have a liquidity buffer: loan/deposits < 100%
- Eastern Europe has already seen an end to FX lending – a high risk activity
- Trade finance would be at risk in a 2008 scenario
- It is not easy for stressed parent banks to withdraw capital from EM operations

This initially appears very worrisome. However, while every market is exposed to some degree, differentiation is possible.

Exhibit 2 shows bank borrowing from European banks as a share of GDP. This is a way of examining the scale of loans from European banks to local economies. As would be expected, the countries most exposed to potential deleveraging and credit tightening from European banks are the eastern European countries. There is also some exposure in Chile, Mexico and Brazil. However, this is generally to one large Spanish bank, Santander, which, although not immune to some of the pressures in Spain or in the eurozone more generally, is widely perceived as one of the stronger banks.

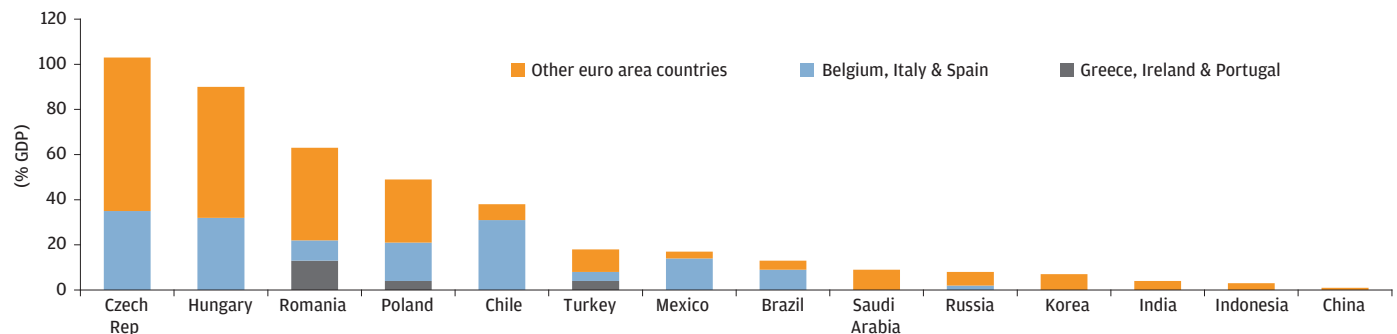
In summary, when country exposures are viewed by rank, eastern Europe is most clearly exposed to the credit tightening that could unfold in the European banking system, followed by Latin America. Asia is the least exposed.

## Valuations Appear Attractive

While emerging markets were unable to decouple from their developed peers in the second half of last year, the effect has been beneficial from a valuation standpoint. Amid global market turbulence, emerging market valuations were pulled down to historically attractive levels. After hovering around fair values of roughly 2x during much of 2010 and the first half of 2011, our preferred measure of valuation, price to book value, was pushed down to 1.6x by the start of the fourth quarter and remains there. While we have not reached the screamingly cheap (sub 1.5x) multiples seen after prior crises, it is clear that ongoing developed market uncertainties are creating an opportunity to re-enter the asset class.

Eastern Europe most at risk from the eurozone capital crunch.

EXHIBIT 2: TOTAL BIS REPORTING BANKS CLAIMS ON EM COUNTRIES\*

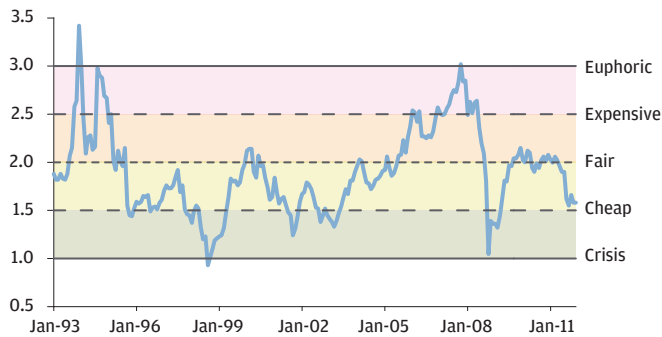


\* Ultimate risk basis. NB includes assets of foreign-owned banks funded by local deposits in country.

Source: BIS and Fitch. Data as of Q411.

**Developed market uncertainties are creating an entry point.**

**EXHIBIT 3A: GEM PRICE-TO-BOOK: 1993 THROUGH DECEMBER 2011**



Source: Bloomberg, Factset, UBS, Data as of end December 2011.

In **Exhibit 3**, the scatter plot on the right hand side shows the subsequent one-year returns realized from previous episodes when price-book traded at 1.6x or less. What is notable is that in almost all cases absolute returns were positive, and in every case relative returns were positive.<sup>1</sup> Therefore, despite some of the uncertainties that remain, we appear to be at a good entry point for the asset class.

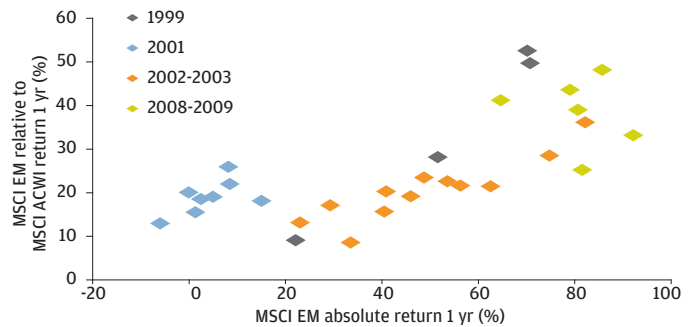
Not only does the asset class overall appear to be offering value, but valuation spreads within the asset class widened measurably in the second half of 2011, creating a value opportunity within the asset class. Investors with value managers in their portfolios will recognize this was quite a headwind over the past six months. However, it now creates opportunities for value-oriented investors to buy cheap names with the potential to outperform. Value strategies tend to struggle when valuation spreads widen, but this creates pent-up alpha for value-oriented managers.

**Actionable Ideas: Sticking With Cheap BRICs**

Let's return to the concept of value awaiting momentum. **Exhibit 4** shows our usual grid for juxtaposing value and momentum at the country level. Value is measured on the horizontal scale, so cheap countries appear on the right-hand side, and momentum, as proxied by price action, is captured on the vertical scale. The sweet spot is in the top right—cheap assets with positive trends. The quadrant to avoid is the lower left—expensive assets with negative trends. What is striking in the current environment is that there is very little overlap in terms of value and momentum.

<sup>1</sup> Absolute returns are in U.S. dollar. Relative returns are relative to global equity.

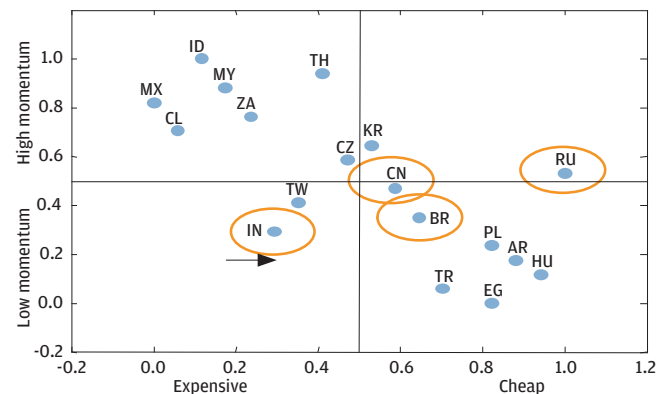
**EXHIBIT 3B: ONE-YEAR ABSOLUTE AND RELATIVE RETURNS SUBSEQUENT TO MONTHS WHEN PRICE/BOOK <1.6X, JANUARY 1999-JULY 2011**



The risk on/risk off environment is prompting performance to toggle between two large baskets of countries. On the lower right hand side, there is a basket of cheap but troubled markets, including Poland, Hungary, Egypt and Turkey, which have performed well in periods when risk appetite has picked up. Then in the upper left corner, the expensive, defensive markets such as Indonesia, Mexico and Malaysia have been the performers in risk-off periods. For as long as the “risk on/risk off” environment continues, nimble tactical investors may try to exploit this trade. Rather than try to trade tactically between these two baskets, which we think is difficult, we prefer to focus on markets that are relatively cheap but with visible catalysts to support them. These are largely the BRIC markets, in particular China and Brazil.

**Buy cheap markets with improving trends.**

**EXHIBIT 4: VALUE/MOMENTUM OVERLAP**



Source: J.P. Morgan estimates. Data as of January 9, 2012. This information reflects J.P. Morgan Asset Management's 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.

## China special topic: Who's overinvesting now?

China is perhaps one of the most controversial topics today. Amid what we believe is a soft landing, there are lingering concerns that China has a large imbalance deriving from overinvestment.

Investment as a share of GDP in China has not only been high by global standards; it has been as high as was seen in the biggest investment booms of the past 150 years. China invests more than double the share of its GDP compared to Brazil and has consistently done so for over 25 years. Everybody knows this and everybody thinks they know the risks, namely a potential housing bubble, as well as profitability pressures because of too much capital chasing too small a profit pool.

However, amid all of the worries about a real estate bubble, bank lending and property prices have generally trended more or less in line with nominal GDP. As Exhibit 5 shows, the real volatility, and the real formation of bubbles, has been in the A-share market. This does not mean that Tier One cities don't have some pricing problems in their property markets, but the data does not bear out the bubble story suggested by the high investment ratio and the media stories about the housing risks in China.

Furthermore, it's important to remember what we invest in. As equity investors, we don't invest in GDP, we invest in companies. As regular readers will be aware, we spend a

lot of time thinking about not only the levels of profitability and return on equity (ROE) in emerging markets, but also the drivers of ROE. We have carried out extensive DuPont analysis to ensure that those drivers are intact. One area of focus is the capital expenditure (capex) to sales ratios. Exhibit 6 shows the capex-to-sales ratios for non-financial sectors in Brazil, China and emerging markets overall. For emerging markets overall, the ratio has displayed a marked decline, from 15-20% a decade ago to about 12% today. What is notable is that over the last couple of years the listed sector in China has displayed an improvement in capital discipline, with the capex-to-sales ratio beginning to normalize closer to the level of the broader asset class. In Brazil, by contrast, the ratio has actually begun to deviate to the upside, driven largely by a government-motivated increase in the capex budget for Petrobras, raising some profitability concerns among our sector analysts in Brazil.

In our view, even though China is widely seen as an overinvestment story, it is not clear that talk of the "mother of all bubbles" in real estate is justified. Meanwhile, for those of us investing in H-shares, it is significant that the listed sector in China is actually showing an improvement in capital discipline that is not apparent in the national investment-to-GDP numbers.

### Some perspective on the Chinese real estate "bubble."

**EXHIBIT 5: CHINESE BANK LENDING, NOMINAL GDP, PROPERTY PRICES AND THE SHANGHAI A-SHARE MARKET\***

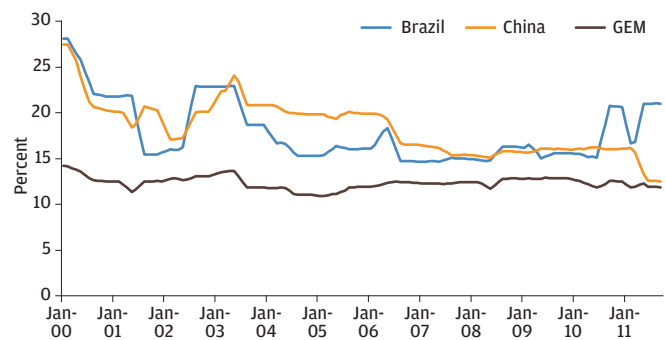


Source: CEIC, Haver, Morgan Stanley Research. For illustrative purposes only.

\* Rebased to December 2004 in log terms.

### Capital discipline in China is converging to emerging market norms, while Brazil is starting to diverge.

**EXHIBIT 6: CAPITAL EXPENDITURE TO SALES (NON-FINANCIAL SECTOR)**



Source: J.P. Morgan Asset Management. As of end September 2011.

In China and Brazil, monetary easing is unfolding. Brazil cut rates again in mid-January and the language in the accompanying statement suggested there is potential for further easing. China's easing has been less explicit recently, but open market operations suggest a tilt toward liquidity provision by the authorities. These are cheap markets where we think the growth slowdowns are nearing their end, and importantly that the catalyst in the form of monetary easing is becoming market friendly.

Turning to the rest of the BRIC markets, we would note that Russia remains a cheap market, supported by energy prices of USD 100 per barrel or more on oil. India is starting to look interesting. The market has been out of favor in our country model for years due to high valuation multiples across the board; consequently India has been a long-standing underweight in our top down-informed portfolios. However, severe underperformance has rotated this market from the extreme upper left corner of our grid counterclockwise toward positions approaching the vertical axis. Put simply, longstanding valuation premiums have largely dissipated in India.

## China: Accumulating Evidence of a Soft Landing

In our "special topic," we discuss the question of overinvestment in China; what we want to turn to now are our signposts for a soft landing. The first signpost to look for is a slowdown in economic growth, because that is what policymakers desire when they tighten policy. This began to materialize around this time last year, when the purchasing managers' index rolled over, giving us confidence that we were nearing the end of the tightening cycle. The second important signpost to look for is a sign that inflation is peaking and beginning to respond to the slowing activity. This gives the central bank the freedom to begin to respond to the growth slowdown without reigniting inflationary pressures. The headline inflation numbers rolled over in August, and, in fact, the non-food numbers had already turned. The final signpost is for growth to stabilize at lower levels.

This looks very much like a soft landing, and our confidence has grown as each of these signposts have been realized. In the portfolios informed by our top-down view, we are near maximum overweight in China, and beginning to enjoy the benefits of this position.

## India: Moving Back On to the Radar Screen

As noted above, valuations in India have moved closer to global emerging market norms than we have seen in a long time, and, amid a still-difficult business cycle, we are now beginning to look for signs of investor capitulation in this market. We start by focusing on currency valuation.

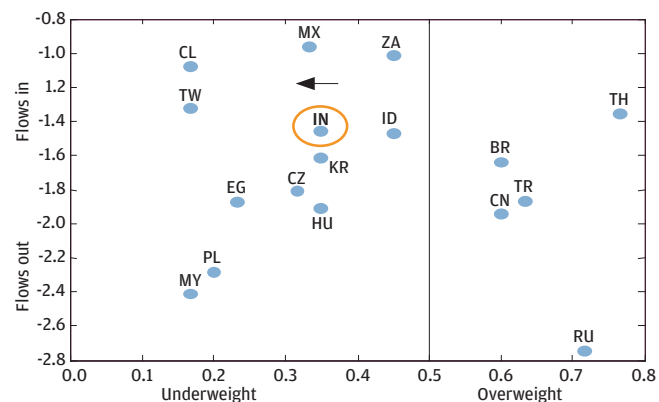
Lingering eurozone debt concerns have prompted not only a softening of the euro but a redistribution of emerging market currency valuations, with net rich and net cheap currencies now more evenly distributed. There were two significant movers in the past few months: the Brazilian real, which had been one of the richest currencies in the universe, and the Indian rupee, which fell at a speed and extent that left it looking as cheap as almost any currency in our universe. In our mind, the rupee is potentially signaling investor distress or at least investor concern. We began to ask whether this was a sign of potential capitulation by investors.

To answer this question, we looked at investor positioning among emerging market portfolios. There is a lag to the data but nevertheless it is something we pay attention to in order to understand which markets are in or out of favor with investors.

Notice where India is on the chart in **Exhibit 7**. In an environment in which emerging markets generally have been experiencing outflows, India—long a darling of emerging market investors—has been participating in the outflows, despite

### India is becoming a consensus underweight in emerging market portfolios.

**EXHIBIT 7: COUNTRY POSITIONING AND INVESTOR FLOWS**



As of December 28, 2011. X-axis: % of funds over-weight/under-weight a country relative to index; Y-axis: Cumulative flows into the country over the last 1 month. Data from EPFR. Allocation is as of 2 months ago, while flows are rolling 1 month cumulative.

being less trade-exposed to developed economies. As such, India is becoming a consensus underweight in emerging market portfolios. While we might not call this capitulation in the true sense of the word, what is clear is that the weight of money among emerging market managers has shifted away from this market. India is therefore an out of favor market with an out of favor currency and valuations that look relatively attractive (India has now underperformed Indonesia, a similar defensive growth story, by more than 40%, for example). As a result we are beginning to warm up to India.

The final point to make on India is that while we are starting to warm up to the market, we do not believe the Indian cycle is now definitively in a soft landing. There is good news and bad news. The bad news is we know that the economy began to break under the tightening undertaken by the Reserve Bank of India (RBI). The good news is that inflation appears to have formed a top and may be poised for deceleration over the coming months. The level of inflation is still troublesome: it is well above the RBI target range and well above what we think the RBI will tolerate in the long term. Nonetheless, the tightening has ended for now—but it remains premature to declare the onset of a soft landing, let alone a recovery.

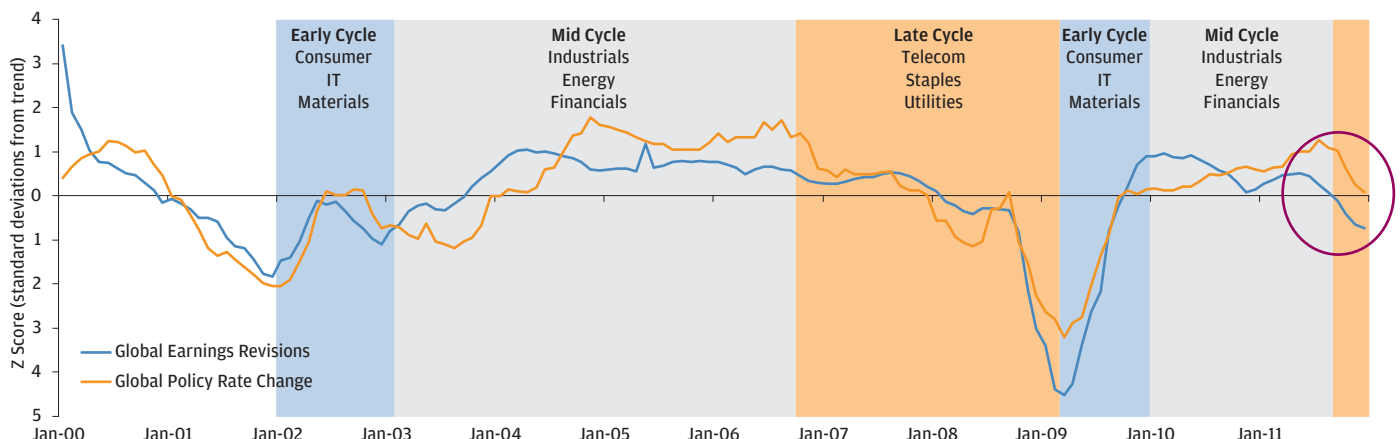
## Actionable Ideas: Preparing to Rotate to Early Cyclical

Our final tactical view is that we are on the verge of a rotation in sector leadership toward cyclicals. The signals we have long used to capture the business cycle (earnings revisions, policy rate cuts) and help us determine sector positioning are now moving in a direction that will soon encourage a rotation into front-end cyclical sectors.

As **Exhibit 8** shows, earnings estimate revisions have been falling or negative for several months. Monetary easing is catching up, led not only by the European Central Bank rate cuts but also by the easing in emerging markets, from rate cuts in Brazil and Chile to the reserve requirement cuts in China. As these rate cuts accumulate (i.e., our indicator turns negative), it will signal, as it did in early 2009, that it is time to start buying front-end cyclicals. For us that generally means consumer discretionary, IT and basic materials. Of these three, the sector we currently favor is consumer discretionary, because it is the one that most immediately responds to the rate cutting cycle in emerging markets.

**Global estimate revisions are seeking a bottom, with policy rates not far behind.**

**EXHIBIT 8: GLOBAL CYCLE INDICATORS: CHANGE IN GLOBAL EARNINGS REVISIONS AND POLICY RATES**



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

## Conclusion

Decoupling in the developed world between Europe and the U.S. heightens the risks to eastern Europe within emerging markets, given the higher exposures to unfolding European bank deleveraging.

While the developed market (and specifically European) uncertainties that plagued markets last year remain, emerging market valuations have been pushed down to historically attractive entry-point levels.

The universal consensus that China overinvests and Brazil underinvests—and accordingly the conclusion that Chinese profitability will lag Brazil's—should recognize that capital discipline within the respective listed sectors are moving in exactly the opposite direction. Capital discipline is actually improving in the Chinese listed corporate sector, whereas there are signs of deterioration in Brazil, something that we are monitoring.

The risk on/risk off environment is prompting performance to toggle between expensive defensive markets and cheap but troubled markets. Rather than choose between these two baskets, we prefer to own relatively cheap markets such as China and Brazil, where positive catalysts (monetary easing and stabilizing growth expectations) are unfolding to prompt performance. Despite lingering concerns about the contours of the Indian business cycle, our longstanding concerns on the Indian market are beginning to moderate given significant underperformance and some signs of capitulation among investors.

Finally, as our global business cycle proxies begin forming a bottom, we are nearing the point of rotating towards front-end cyclical sectors (consumer discretionary, IT and basic materials), remembering that markets lead economies rather than the other way around.

## AUTHOR



**George Iwanicki**  
Managing Director  
Macro Strategist  
Global Emerging Markets Equity  
george.iwanicki@jpmorgan.com

**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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