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EM: Cyclically challenged, structurally adjusting, secularly promising

Tai Hui | JP Morgan Asset Management | 10 February 2015

IN BRIEF

Despite recent underperformance, emerging markets (EMs) remain an important part of investors' portfolios. Investors, however, need to clearly differentiate among the various EMs and pay more attention to country-specific conditions.

Countries with weak external fundamentals are expected to underperform in 2015 due to both the policy normalisation of the US Federal Reserve (Fed) and other cyclical challenges, including a stronger dollar and softening commodity prices.

EMs that are implementing political and economic reforms to address structural deficiencies are likely to face near-term pains but be rewarded by investors in the long run.

Over the long term, secular investment themes, including demographic changes and EM companies' innovation in their local markets, should improve growth prospects in these markets.

From an asset allocation perspective, investors should remain disciplined in maintaining a well-diversified portfolio. The global economic recovery should favor equities, especially in EMs that are benefiting from better global growth and are attractively valued. Meanwhile, an active and flexible approach is necessary to navigate a more complex fixed income market. Sectors such as high yield corporate bonds and EM debt offer higher yields than those available across the developed world.

OVERVIEW

EM equities and fixed income have enjoyed a boom in the 2000s. Yet, EM equity performance has been lackluster in recent years, and more challenges lie ahead in 2015 with the global monetary policy desynchronisation, a strong USD and soft commodity prices. Not all EMs are created equal, however, and those with strong external fundamentals are likely to perform better. Structurally, many emerging countries are still in need of reforms in their economic structures, fiscal positions and business environments. Countries that are willing to bear the short-term pains are likely to face investor support in the long run. The long-term trends for EMs continue to be favourable. For example, demographic trends, such as increased urbanisation, will generate business opportunities for companies that develop products that can meet local needs.

1. CYCLICAL CHALLENGES: HARD DOLLAR, SOFT COMMODITY PRICES & CENTRAL BANK DESYNCHRONISATION

Since the financial crisis of 2008-2009, the developed world's central banks have generally moved in the same direction, providing monetary easing in a variety of ways. In 2015, this should end, with both the Fed and the Bank of England (BoE), both of which are moving into mature stages of recovery, likely to raise rates. Feeble growth and continued threat of deflation in Japan and continental Europe mean that the European Central Bank (ECB) and Bank of Japan (BoJ) are likely to maintain ultra-loose monetary policy to stimulate growth. The ECB's new programme of asset purchase is a prime example of the central bank's commitment to revive the eurozone's struggling economy. This policy divergence could exacerbate market volatility and require investors pay more attention to risk management.

1.1 Stronger US dollar

This global monetary divergence, coupled with the solid US economic recovery and an improved US current account position, should support USD assets in the medium term. Historically, EMs have underperformed in an environment of US dollar strength (Exhibit 1). This is because a strong dollar has tended to go along with weaker commodity prices and capital outflows from EMs. There is also a currency translation effect, which lowers the dollar value of EM earnings. In such an environment, many investors fear that a strong US dollar and the Fed's normalisation could trigger financial crises in EMs, similar to various balance-of-payments financial crises in the 1990s.

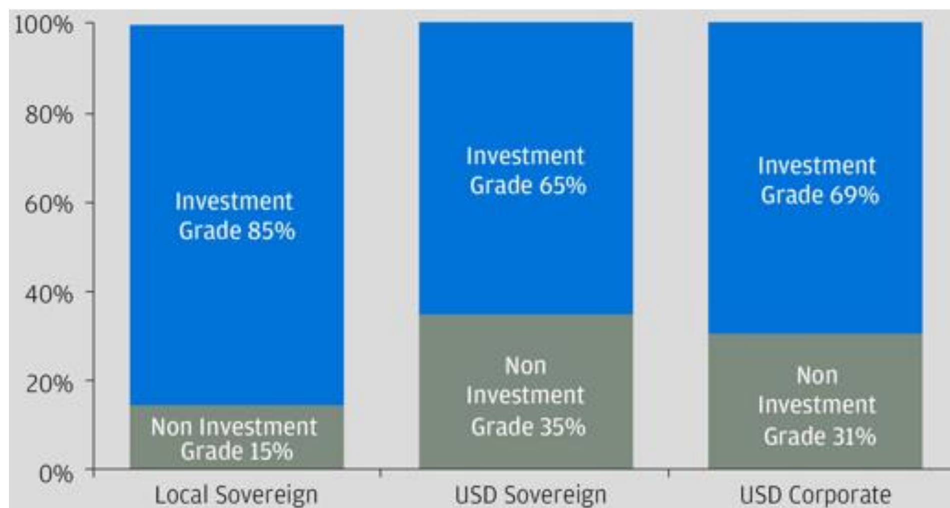
Exhibit 1: Relative EM/DM equity performance and USD REER
Sustained, broad-based USD rallies have historically been a headwind to relative EM performance. (Index, rebased 1993 = 100)

Sources: FactSet, MSCI, J.P. Morgan Asset Management's Guide to the Markets- Asia 1Q 2015; data as of 31 December 2014. Note: The Real Effective Exchange Rate (REER) is the weighted average of a country's currency relative to a basket of other major currencies adjusted for the effects of inflation. The weights are determined by comparing the relative trade balances, in terms of one country's currency, with other countries within the basket.

A number of improvements have taken place to reduce the risk of these crises repeating. Compared with the 1990s, EM countries have adopted a more flexible exchange-rate system, have increased their foreign exchange (FX) reserves and have managed their external debt in a more prudent fashion. These are reflected by the fact that more EM economies have successfully reduced their countries' short-term debt as a percentage of foreign reserves. Exhibit 2, which shows the credit ratings composition of EM debt (EMD) indices, shows that while the composition of each index slightly differs, all of the EMD indices are predominantly rated as investment grade.

Exhibit 2: EMD indices by credit ratings

EMD is predominantly rated as investment grade



Sources: J.P. Morgan Global Economic Research, FactSet, J.P. Morgan Asset Management's Guide to the Markets—U.S. 1Q 2015; data as of 31 December 2014. The local sovereign index is represented by the J.P. Morgan Government Bond Index—EM (GBI-EM), which is a local currency denominated index tracking bonds issued by EM sovereigns. The USD sovereign index is represented by the J.P. Morgan EMBI Global (EMBIG) Index, a USD-denominated external debt index tracking bonds issued by sovereigns and quasi-sovereigns in developing nations. The J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad is a USD-denominated external debt index tracking bonds issued by corporations in developing nations. Past performance is not indicative of comparable future results. Index breakdowns may not equal 100% due to rounding.

Overall, a significant strengthening of the dollar could provide a bumpy ride for EMs in the months and years ahead. It is important to recognise that not all EMs will be equally affected in a strong dollar environment. Many Asian economies have experienced less currency depreciation since the US Dollar Index hit bottom in 2011. Countries with strong current accounts and less dependence on commodities should be more resilient in this environment.

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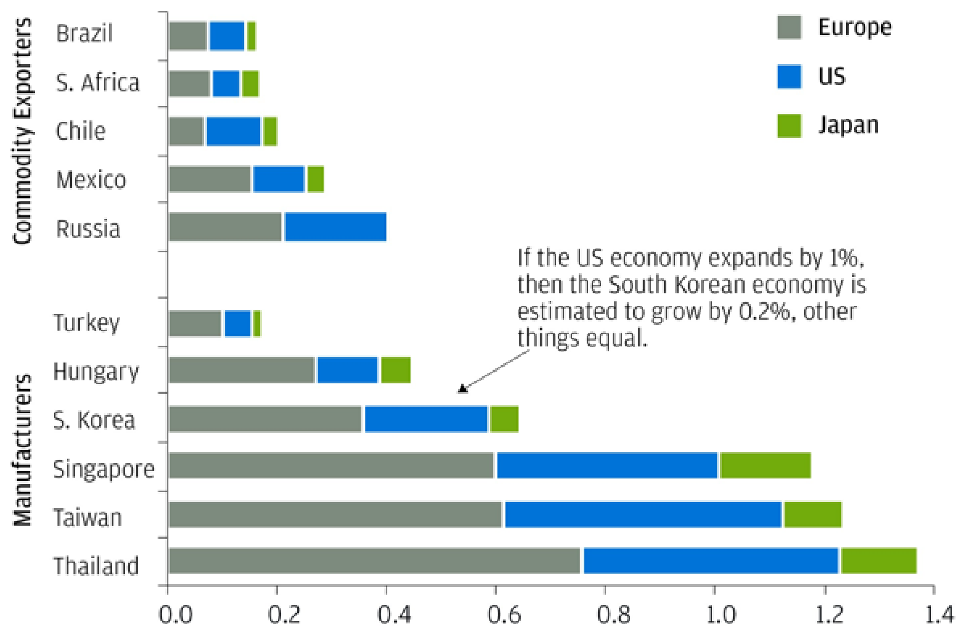
1.2 Softer commodities, falling oil prices create opportunities for differentiation

Broadly, emerging economies can be split into two groups: commodity importers and commodity exporters, where commodity importers are typically exporters of manufactured products. China and India, for example, are commodity importers with more manufacturing or service-based economies, while countries such as Russia and Brazil rely more heavily on natural resources for economic output. Commodity-dependent countries may take longer to benefit from the cyclical upswing in developed markets (DMs) in an environment where the marginal demand for more commodities from countries such as China is still very low and prices remain subdued (Exhibit 3). Along with Russia and Brazil, Chile, South Africa and Indonesia are some of the most commodity-dependent countries. Commodity-driven gains helped these countries achieve higher economic growth rates until 2011, but this source of strength is now fading. The price of a barrel of Brent oil has fallen by nearly 55% over the past year, while iron ore has declined by 45%. The depreciation in the value of the South African rand, Indonesian rupiah, Russian rouble and Brazilian real has helped cushion some of the economic impact of falling commodity prices, but it cannot do so forever.

Exhibit 3: EM sensitivity to DM growth

Commodity exporters are less sensitive to DM growth than are manufacturing exporters



Sources: J.P. Morgan Asset Management, International Monetary Fund, FactSet; data as at 30 Jun 2014. X-axis represents the impact on a country's GDP from a one-percentage-point change in GDP growth of the US, Europe or Japan.

In addition to a sharp drop in commodity prices, lower oil prices could also undermine commodity producers, especially in Latin America, Russia and the Middle East. While some EMs are vulnerable to this backdrop, differentiation is going to be key to capture investment

opportunities. Exhibit 4a shows the relationship between whether an EM country is a commodity importer or a net commodity exporter and whether the country has a current account deficit or surplus. Exhibit 4b shows the 2014 currency performance versus the USD. The key takeaway: EM countries that tend to be net commodity exporters with current account deficits have seen their currencies hurt the most over the past year.

Exhibit 4a: Commodity exposure and external vulnerability
Some EMs will be hurt more than others given softer commodity prices

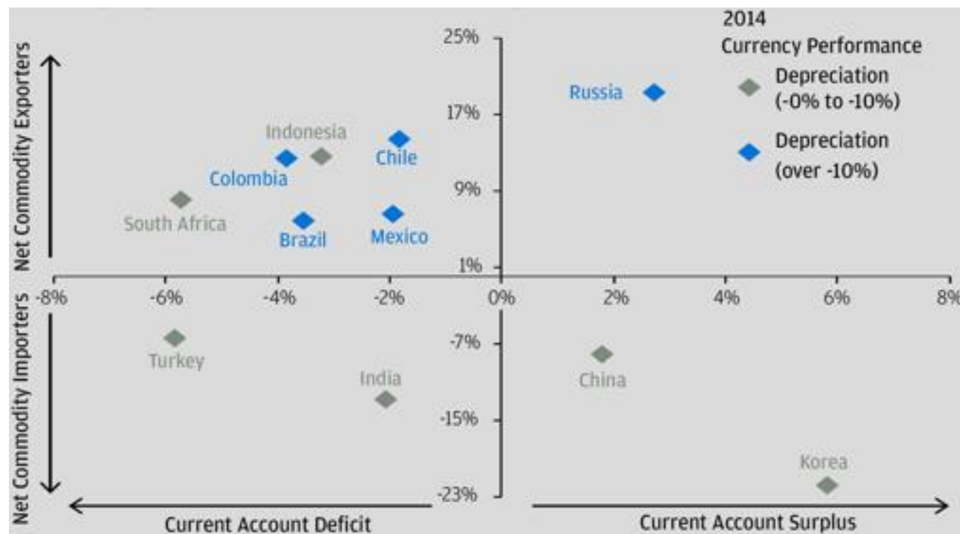
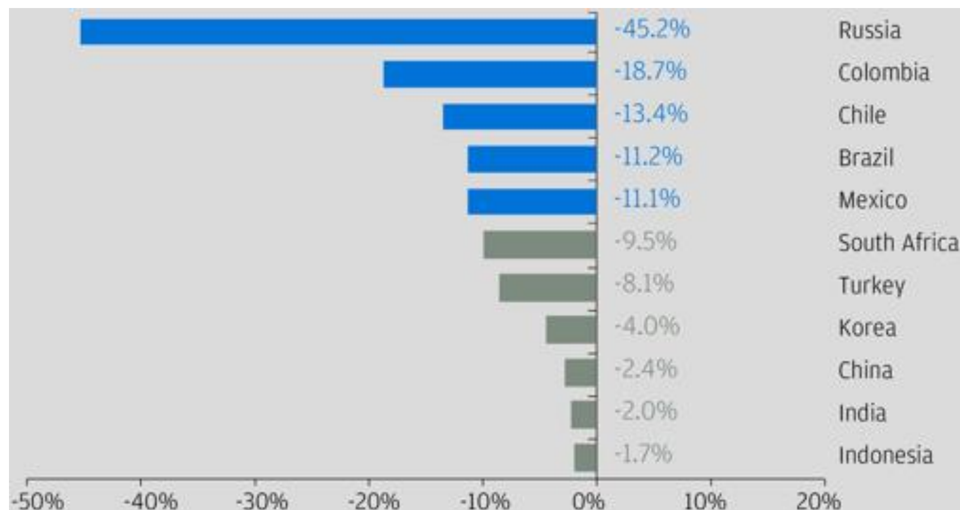


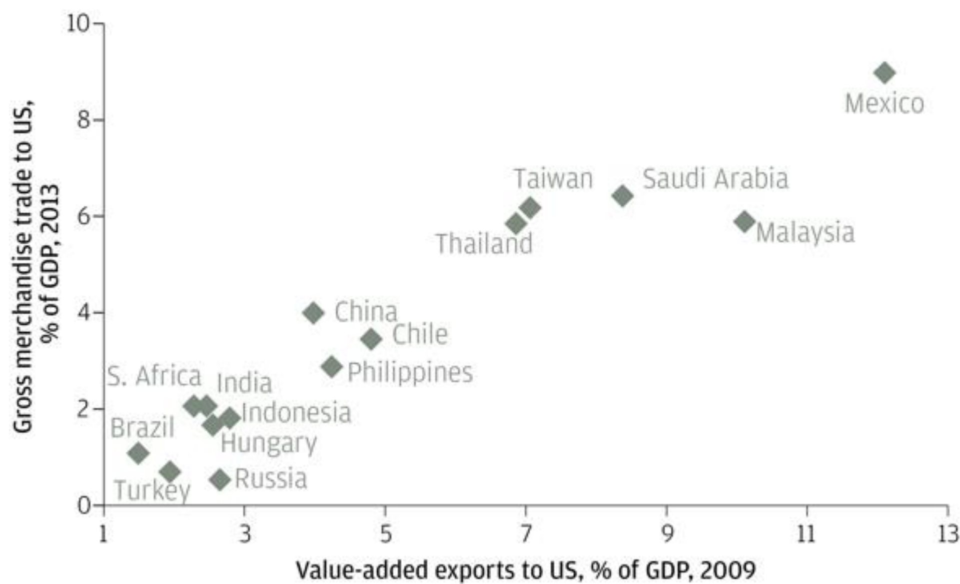
Exhibit 4b: 2014 currency performance
(Performance of foreign currency vs USD)



Sources: IMF, U.N. Commodity Trade Statistics Database, FactSet, J.P. Morgan Asset Management's Guide to the Markets U.S. 1Q 2015; data as of 31 Dec 2014. Commodities defined by the SITC codes 0-4. Net commodity exporters/importers are plotted as % of GDP. Current accounts as % of GDP are IMF estimates for 2014.

While domestic factors such as economic policy, geopolitics and export characteristics could contribute to a divergence in performance in EM currencies, EM countries with strong trade connections are poised to outperform. Markets with a current account surplus and with export exposure to the US—and especially to the US consumer—are expected to see greater stability (Exhibit 5).

Exhibit 5: EM economies' exposure to US via trade
EMs with global connections are poised to outperform



Sources: OECD, FactSet, World Bank, IMF, Lombard Street Research, J.P. Morgan Asset Management; data as of 4 November 2014.

1.3 The silver lining of lower oil prices

A further drop in oil prices is likely to be a net positive for EMs, especially in Asia. To be sure, oil-producing countries would obviously experience lower oil receipts, which are a significant source of fiscal revenue either directly via state-owned companies or indirectly via taxes. Moreover, lower oil revenues could also undermine energy companies' ability to service debt, potentially prompting companies, in turn, to seek financial support from the government, or put stress on the domestic banking sector.

For EMs that are net importers of oil and other commodities, however, cheaper oil prices can deliver a number of benefits. Lower oil prices can help reduce the total import bills of EM countries, ultimately reducing their current account deficits or boosting their current account surplus. This is crucial for countries such as India and Indonesia, which suffer from current account deficits and face downward pressures on their currencies. On the fiscal account, lower crude oil prices can also reduce government spending on fuel subsidies, for example, in Indonesia, Malaysia and Thailand. This would allow these governments to divert more of their resources to productive uses, such as infrastructure or social programs. Some countries

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can also use this as an opportunity to reform their fuel subsidy program. Indonesia is looking to re-link domestic fuel prices to global prices by eliminating fuel subsidies and then use the savings to push for universal health care and other social services.

Cheaper oil prices also help to keep inflation low. This is particularly apparent in low-to-mid-income EMs where a large proportion of household income is spent on fuel. Poor logistics infrastructure also magnifies the inflationary impact from higher energy prices. More benign inflation, in turn, gives EM central banks more flexibility over their monetary policy. Instead of being forced to raise interest rates in response to fuel-price-induced inflation, they can maintain an appropriate interest rate policy to support growth. For consumption, cheaper energy prices also improve household disposable income, as less money is spent on fuel, which is a necessity. Households can either save more or spend it on other discretionary items.

1.4 The changing makeup of EM indices

It is also possible that the magnitude of commodities' impact on EMs will be muted, in part, because the weighting of commodities in EM indices has declined in recent years. At the peak of the commodity supercycle in 2008, commodities represented roughly one-third of emerging markets from a market capitalisation perspective. Since then, there has been a significant reduction in the commodity weighting and a corresponding improving share for domestic sectors, such as the consumer sectors and financials. As such, the commodity sectors, which represent a key risk for EMs during periods of dollar strength, now make up less than 20% of EM indices, a level not seen since the start of the century (Exhibit 6)[1].

Exhibit 6: Commodity sector weight in MSCI EM
Commodities now make up less than 20% of EM indices

Sources: MSCI, FactSet, J.P. Morgan Asset Management. Commodities includes energy and materials; data as of 22 October 2014.

2. STRUCTURAL ADJUSTMENTS: ENGAGING IN MUCH NEEDED STRUCTURAL REFORMS

While there are still many structural deficiencies in EMs, there are some countries that are embarking on much needed structural reforms. Common structural flaws can include excessive bureaucracy or overdependence on a single growth driver such as commodities or infrastructure investments. Alternatively, an EM may have a fragile financial sector. While some countries are slowly moving to address these issues, progress is patchy. Over time, investors are likely to award those countries that have successfully transformed their economies and business environments.

One successful example of reform for many EMs is reflected in the improvements in their external positions to protect their economies from excessive currency fluctuations. This was an experience that Asia embraced after the 1997-1998 financial crisis. Not only did Asian countries build a larger buffer via higher currency reserves, their regulators were more conscious of the necessity to allow exchange rate movements to address imbalances, such as current account deficits. That said, some countries, such as Turkey and South Africa, are still living with insufficient reserves to cover their current account deficits or short-term hard currency debt.

Reform is very much a domestic issue, and there are examples where the market should look for opportunities. There are also those countries that may test the patience of investors.

2.1 India

India has excited many investors as Prime Minister Narendra Modi has been given a strong mandate by voters, with the first outright majority in the Lower House of Parliament since 1984. His track record as the Chief Minister of Gujarat, which had attracted foreign investment and outgrew the country during his 10-year tenure, also gives many domestic businesses reasons to be optimistic. While he has been short on big bang reforms, Prime Minister Modi has been working on areas where quick wins are possible, or important critical points can help untangle problems in other areas. Coal mining is a good example, where a transparent online auction will help to allocate coal blocks that could benefit the power, steel and cement sectors. In addition, deregulation of diesel prices will help to preserve important fiscal resources for investment and other uses, instead of benefiting the middle class and transportation companies.

The government is making more gestures to implement more reform-oriented measures. Land acquisition reforms and a national goods and services tax are on the agenda. These actions are slowly convincing businesses that the administration is serious about reform, spurring an increase in new projects in the government and private sectors, more environmental clearances and improved business expectations. Since Prime Minister Modi took office in May 2014, business sentiment has been improving steadily and the earnings cycle has been gradually progressing.

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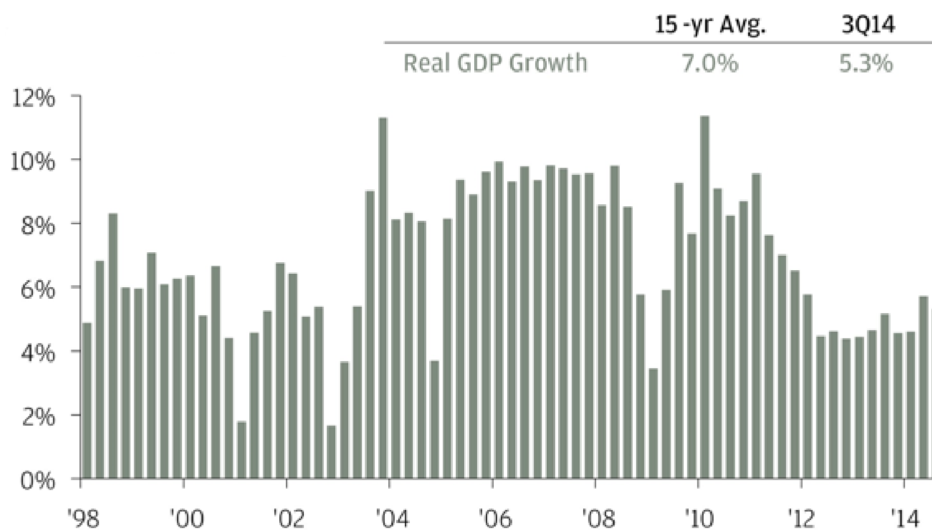
While economic growth has been slow – the 3Q GDP growth of 5.3% year-over-year (YoY) is still well under the 15-year average of 7.0% (Exhibit 7a) – we have started to see changes in recent months. The December Purchasing Mangers Index (PMI) hit a two-year high of 54.5, while industrial production rose to 3.8% in November, the highest in five months (Exhibit 7b). The Reserve Bank of India's surprise cut of 25 basis points (bps) in its policy repo rate to 7.75% from 8% in January should act as a powerful boost to the currently weak domestic demand and reverse the disincentive in production and investment (Exhibit 7c).

Exhibit 7a: Real GDP growth

Economic growth in India is starting to improve

(Year-over-year % change)



Sources: J.P. Morgan Economics, Ministry of Statistics and Programme Implementation, Reserve Bank of India, Society of Indian Automobile Manufacturers, FactSet, J.P. Morgan Asset Management's "Guide to the Markets – Asia 1Q 2015." (Exhibit 7B) India's October industrial production was -4.2% yoy, the value shown in the chart is a 3-month moving average. (Exhibit 7C) Wholesale Price Index (WPI) value shown is year-over-year % change. Consumer Price Index series starts in January 2012. Data in slides are updated and reflect most recently available data as of 25 January 2015 unless otherwise stated. CPI and WPI data is as of 31 December 2014. Repo Rate data is as at 15 January 2015.

Exhibit 7b. Industrial production and PMI
(YoY % change, 3-month moving average)

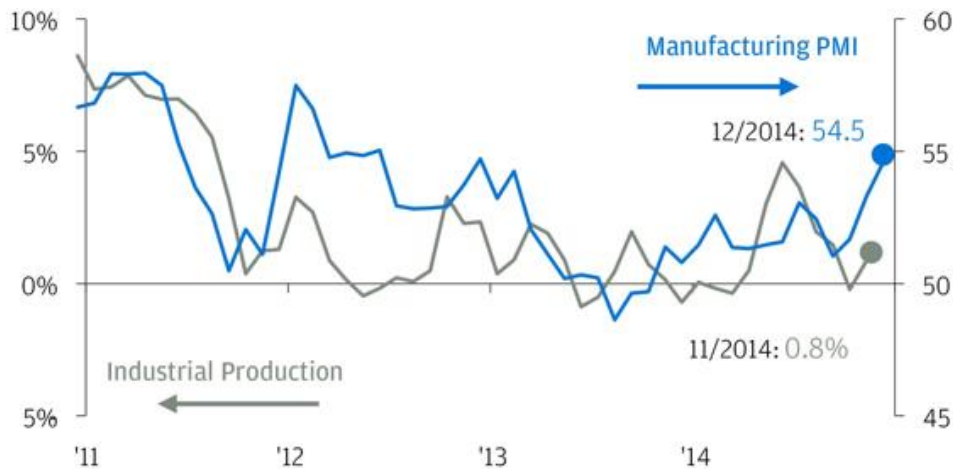


Exhibit 7c. Inflation and repo rate

Sources: J.P. Morgan Economics, Ministry of Statistics and Programme Implementation, Reserve Bank of India, Society of Indian Automobile Manufacturers, FactSet, J.P. Morgan Asset Management's "Guide to the Markets – Asia 1Q 2015." (Exhibit 7B) India's October industrial production was -4.2% yoy, the value shown in the chart is a 3-month moving average. (Exhibit 7C) Wholesale Price Index (WPI) value shown is year-over-year % change. Consumer Price Index series starts in January 2012. Data in slides are updated and reflect most recently available data as of 25 January 2015 unless otherwise stated. CPI and WPI data is as of 31 December 2014. Repo Rate data is as at 15 January 2015..

2.2 Indonesia

Meanwhile, many compare Indonesia's parliamentary and presidential elections last year with India's elections. The new president, Joko Widodo (known as Jokowi), also represents voters' aspirations to reforms and change.

Some of the issues facing Jokowi include various economic challenges, mainly centered on the current account deficit. Indonesia's large fuel subsidies, which result in the cheapest consumer fuel prices worldwide, limit the government's ability to spend on other projects, such as infrastructure. Jokowi did reduce fuel subsidies, as expected. His road to attract more foreign investment, expand manufacturing's role in the economy and reduce reliance on commodities, however, is likely to be much more challenging, since he does not have a majority, even in the form of a coalition. As a result, the lawmaking body could dilute, if not block, his reform plans.

Slower commodity exports and rising imports haven't helped Indonesia's current account deficit. Indonesia's export situation has been complicated by attempts from politicians to stop what they believe are attempts to sell the country's assets cheaply to overseas buyers. Controversial taxes on mining exports and bans on raw mineral ore shipments have played havoc with Indonesia's substantial mining industry, as well as caused disputes between commodity companies and the government. This has damaged Indonesia's image with foreign investors and, in turn, has hurt exports further at the end of the commodity boom.

2.3 China

While China's economy has slowed from its double-digit growth levels of recent years (Exhibit 8), structural reforms and deleveraging are still the central government's priorities. This means the government could be willing to sacrifice some rapid growth opportunities, potentially lowering growth targets for 2015 to a range of 6.5% to 7.0% versus 7.5% in 2014.

Exhibit 8. China's real GDP contribution
China's economy has slowed in recent years
(Year-over-year % change)

Sources: National Bureau of Statistics of China, the People's Bank of China, EM Advisors Group, FactSet, CEIC, J.P. Morgan Asset Management. Values may not sum to 100% due to rounding. J.P. Morgan Asset Management's Guide to the Markets—U.S. 1Q 2015; data as of 31 Dec 2014.

China is looking to implement reforms on many fronts. It is gradually liberalising its exchange rate and interest rates, which will put more pressure on banks' interest margins and profitability. Yet, this also implies that borrowers and depositors should get a better deal. Credit allocation should also be more efficient, in theory, even though the historical problem of corporate overleverage still needs careful management.

Another structural trend that could translate into investment opportunity is the need to clean up the environment and use more alternative and renewable energy. After decades of building transportation infrastructure, clean energy could be the next phase of the building boom. Urbanisation is a secular trend for China, but there are also structural shifts to be considered. Population policy, including adjusting the one-child policy and the social welfare system (linked to an individual's hukou, or social security account) should allow freer movement of the population across the country.

Amid such undercurrents in the Chinese economy and Beijing's ongoing structural reforms, structural growth stories in technology, the internet and areas with policy support (such as environmental protection, renewable energy and health care) are likely to capture more of investors' time and capital. With the concerns over huge amounts of local debt, deleveraging or credit tightening is likely to continue. At the same time, the People's Bank of China (PBoC) will keep injecting liquidity into the banking system and adopting selective monetary easing measures, such as lowering the repo rates to keep the short-term rates at lower levels in

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order to avoid any liquidity squeeze. The government will do its best to maintain growth targets, making a hard landing still unlikely.

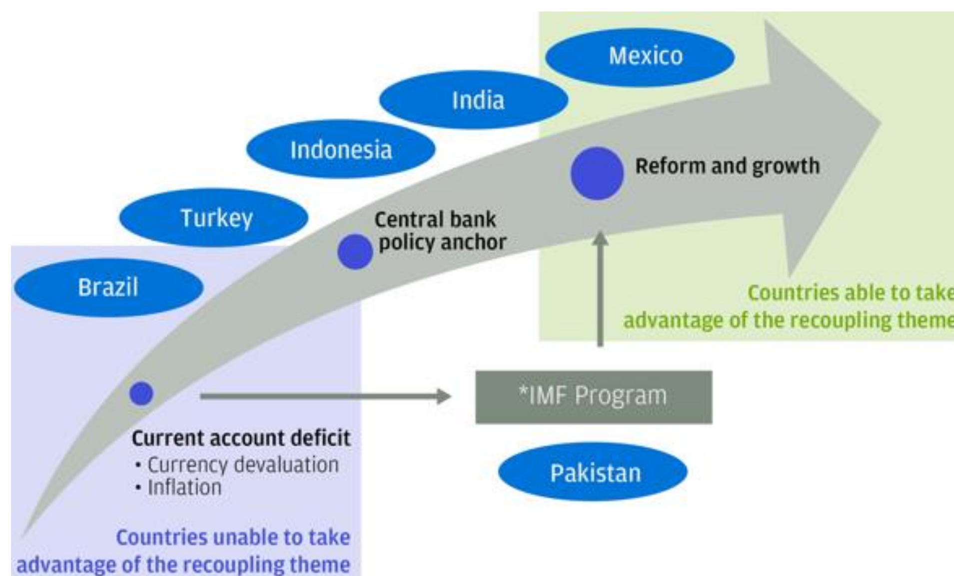
2.4 Patchy progress and slow reforms

While several EM countries have taken actions to reduce both their current account deficits and their reliance on international funding, the current account adjustment is just the first step in the longer-term adjustment process that includes central bank intervention and, importantly, moves by governments to introduce long-term structural economic reforms.

Progress towards economic reform and implementation of pro-growth policies to encourage investment has been patchy. Structural reform and growth policies, which encourage investment, are typically unpopular policies in the short term and difficult to implement. That is why a country such as Brazil, for example, has struggled so far to take action despite sluggish growth. But Mexico, after many years, has finally started to implement some very long-term, positive structural reforms, and therefore the country is better positioned than Brazil to benefit from improvement in the US economic growth outlook.

Exhibit 9 demonstrates the long-term adjustment process that helps identify which countries stand to win or lose from an improvement in global growth[2]. That process begins with a reduction in the current account deficit, followed by sta¬bilisation of a country's currencies through central bank poli¬cies, and then the implementation of structural reform. As the chart illustrates, countries such as India and Mexico, which are in the stage of implementing reforms, are more likely to bene¬fit from improving growth in DMs than are other countries that are still struggling with a large current account deficit, such as Brazil.

Exhibit 9. An illustration of a country's evolution to economic stability
As growth in DMs improve, which EMs will benefit?



Sources: J.P. Morgan. For illustrative purposes only.

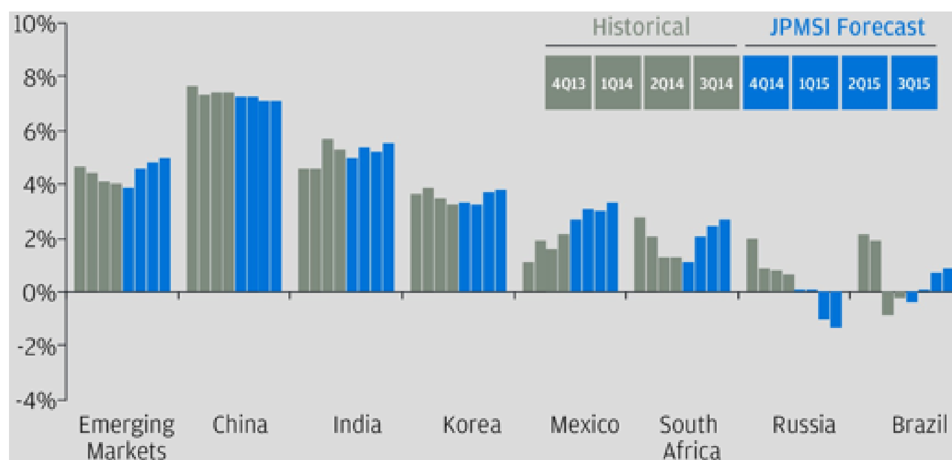
EM countries will be in different positions to take advantage of improving global growth, depending on how far they have moved to introduce reforms. From an investment perspective, this longer-term adjustment process can help identify winners and losers.

3. SECULAR ENCOURAGEMENTS: THE RISE OF EM CONSUMERS AND INNOVATION

3.1 The rise of the consumer

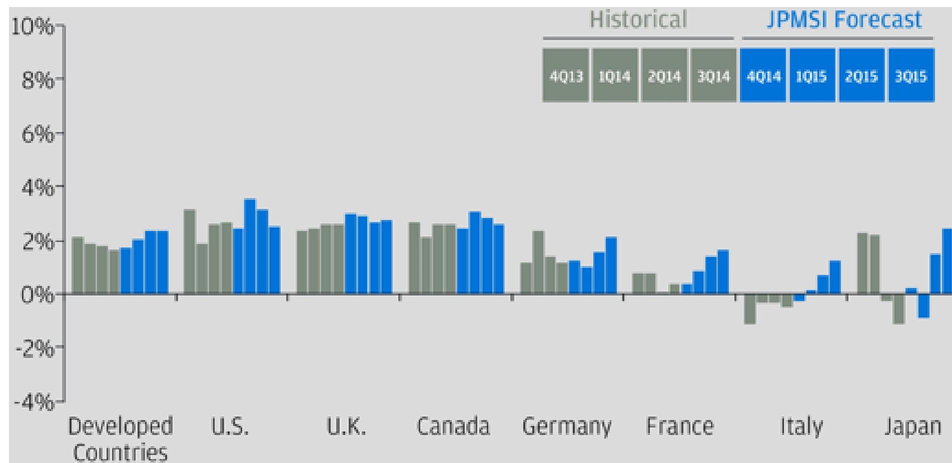
Despite recent cyclical headwinds and structural challenges, EMs have been and will continue to be the leading source of secular global growth. EMs now account for more than half of global GDP from a purchasing power parity (PPP) perspective, but make up only 12% of MSCI's All Country World Index (ACWI), a broad, global index that includes both DM and EM countries. Economic growth in EMs has been almost double that of DMs over the past decade (Exhibits 10a-10b).

Exhibit 10a: EM country real GDP growth
EM growth has been nearly double that of DM growth
(Year-over-year % chg. - forecasts from JPMSI)



Sources: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management's Guide to the Markets - U.S. 1Q 2015; data as of 31 December 2014. Forecast and aggregate data come from J.P. Morgan Global Economic Research. Historical growth data collected from FactSet Economics.

Exhibit 10b: DM country real GDP growth
(Year-over-year % chg. - forecasts from JPMSI)



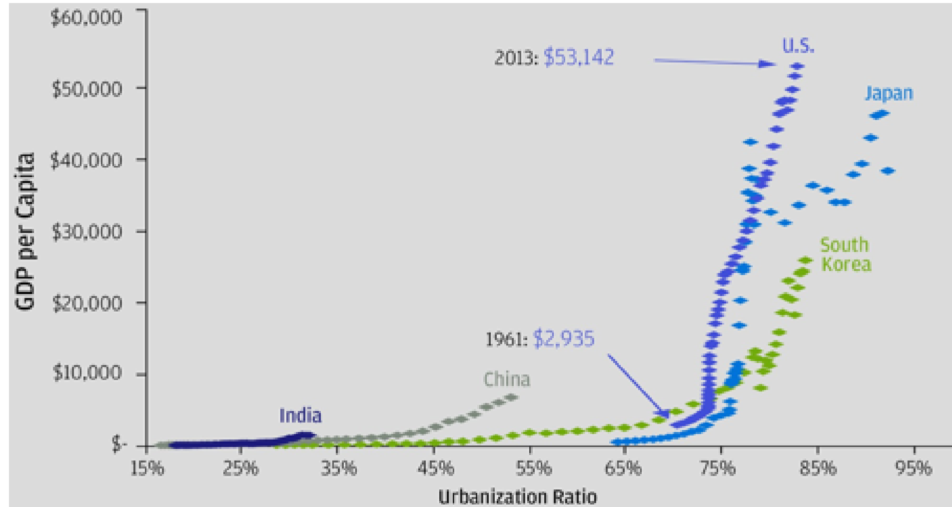
Sources: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management's Guide to the Markets - U.S. 1Q 2015; data as of 31 December 2014. Forecast and aggregate data come from J.P. Morgan Global Economic Research. Historical growth data collected from FactSet Economics.

The old days when the EM asset class represented a homogenous play on commodities and exports have changed. Future EM growth isn't likely to come only from exports—either commodities or manufactured goods—but also from domestic demand. Indeed, the resilience of EM consumers, primarily due to the scale of their spending, can provide a cushion for their local economies against global downturns. At the same time, growing populations, increasing consumption and productivity gains in EMs should continue to support economic growth.

3.2 Long-term urbanisation trends create opportunities

Demographics trends favor EMs. Exhibit 11a, which illustrates the relationship between GDP per capita and the urbanisation ratio (or the percentage of a population that lives in an urban area), shows that while the US and Japan are fairly wealthy and urbanised, trends going forward should allow EM countries, such as India, China and South Korea, to increase their wealth as more people move into urban areas. Exhibit 11b, which provides a demographic snapshot of EMs versus DMs, shows that EMs have a significantly younger labor force and higher rates of investment as a percentage of GDP, which means that their long-term structural growth story remains intact.

Exhibit 11a: Urbanisation ratios and GDP per capita
Urbanisation and demographic trends favor EMs
(Urbanisation ratios and CDP per capital (Current USD), 1961-2013)



Sources: FactSet, WorldBank, United Nations, J.P. Morgan Global Economic Research, OECD, Bureau of Statistics China, Ministry of Statistics & Programme Implementation of India, J.P. Morgan Asset Management's Guide to the Markets – U.S. 1Q 2015; data as of 31 December, 2014. GDP per capita and Investments as % of GDP in the Demographics Snapshot table are IMF estimates for 2014.

Exhibit 11b: Demographic snapshot of DMs vs. EMs

	GPD per Capita $	Population mm	% of Pop. under 20	Investment (% of GDP)
Developed				
US	53,101	316	26	20
Canada	51,990	35	22	24
UK	39,567	64	24	14
Germany	44,999	81	18	17
France	43,000	64	24	19
Japan	38,491	127	18	21
Italy	34,715	60	9	17
Emerging				
Korea	24,329	50	22	26
India	1,505	1,243	38	35
Brazil	11,311	198	33	18
Mexico	10,630	118	38	22
Russia	14,819	143	21	24
China	6,747	1,361	20	48

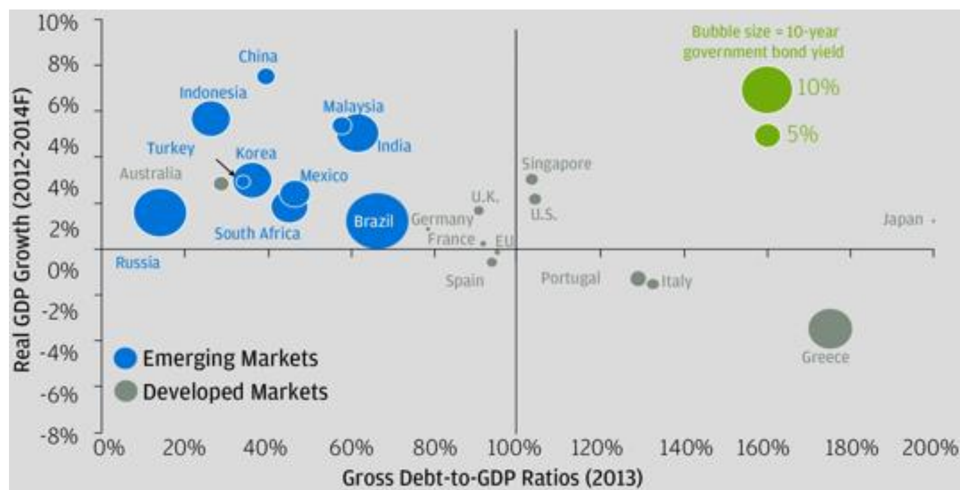
Sources: FactSet, WorldBank, United Nations, J.P. Morgan Global Economic Research, OECD, Bureau of Statistics China, Ministry of Statistics & Programme Implementation of India, J.P. Morgan Asset Management's Guide to the Markets – U.S. 1Q 2015; data as of 31 December, 2014. GDP per capita and Investments as % of GDP in the Demographics Snapshot table are IMF estimates for 2014.

Thanks to both increased population growth and urbanisation trends, EMs are expected to generate more than 50% of global economic growth within the next five years, according to the International Monetary Fund. To put this in a different perspective, China and India are expected to see five million households in each country to move from the countryside to the cities each year over the next 10 years.

Much of this growth will be channelled into the infrastructure of these countries to

accommodate increased demands on essential services, such as water, power and transportation. EM governments are in a strong position to spend, thanks to their stronger fiscal positions, compared with the developed countries. As Exhibit 12 shows, the balance sheets of many EM countries are more sound than those of many DM economies. The chart shows three things: 1) the level of indebtedness of sovereign countries; 2) the countries' growth rate; and 3) the countries' 10-year government bond yields (as represented by the size of the bubble). What should be clear is that many EMs carry less debt and exhibit stronger growth than do the majority of the DMs.

Exhibit 12. GDP growth, gross debt-to-GDP and borrowing costs
Many EMs have lower debt and higher growth rates than DMs



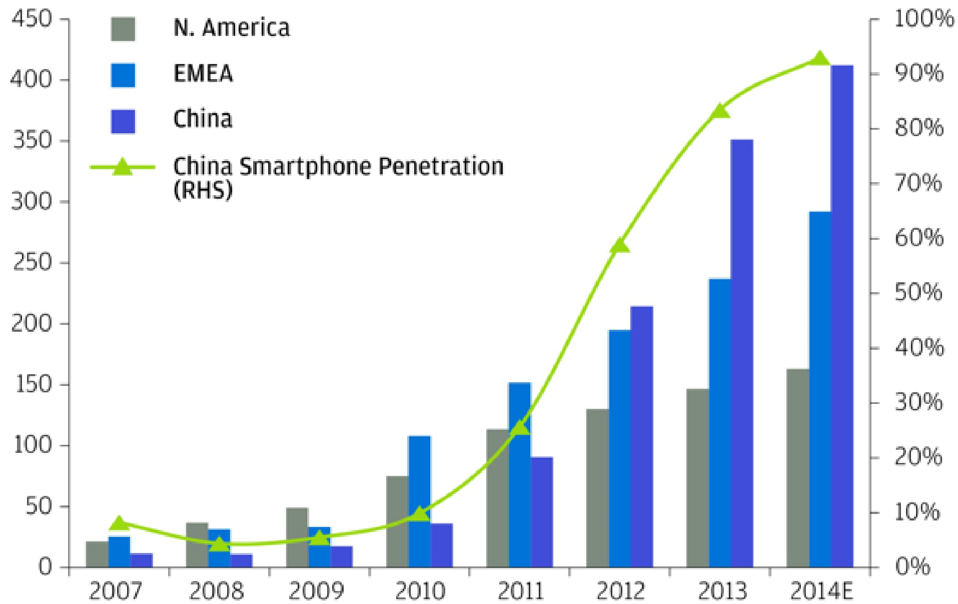
Sources: IMF, FactSet, Bloomberg, J.P. Morgan Economics, Barclays, J.P. Morgan Asset Management's Guide to the Markets - U.S. 1Q 2015; data as of 31 December 2014. Growth and debt data are based on the October 2014 World Economic Outlook. Borrowing costs based on local currency debt. EU overall borrowing cost based on Barclays Capital Euro-Aggregate 7-10 year treasury. South Africa's borrowing cost is based on 7-year government bond yield due to data availability.

Ultimately, demand for services is expected to benefit sectors such as health care, financials and telecommunications. Population and urbanisation trends will increase the need for housing and consumer goods, including consumer staples, as well as discretionary products and consumer services such as finance, health care, education and entertainment. China is a prime example of how the surge in smartphone penetration (Exhibit 13) has coincided with the rise of social media. More Chinese netizens also mean more online shoppers. Exhibit 14a illustrates that China's e-commerce as a share of total retail sales has already overtaken that of the US. Revenue from the biggest day of online shopping in China, "Single's Day" (November 11th), was three times larger than the US's equivalent day, "Cyber Monday" (the Monday after the Thanksgiving holiday), in 2014 (Exhibit 14b).

Exhibit 13: China, North America and EMEA* smartphone penetration

China is the key driving force behind smartphone growth

(mn units)

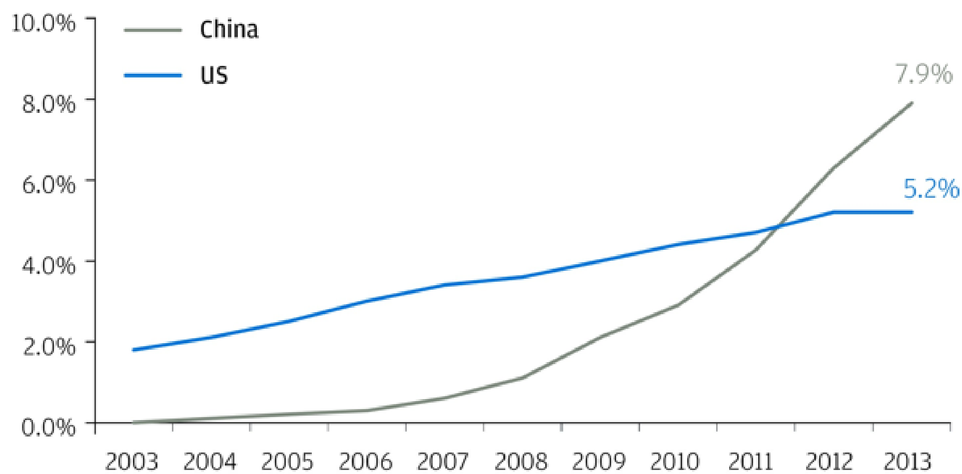


Sources: Morgan Stanley Research; data as of 10 October 2014. E = Morgan Stanley Research estimates. *EMEA stands for Europe, the Middle East and Africa.

Exhibit 14a: China vs. US e-commerce share

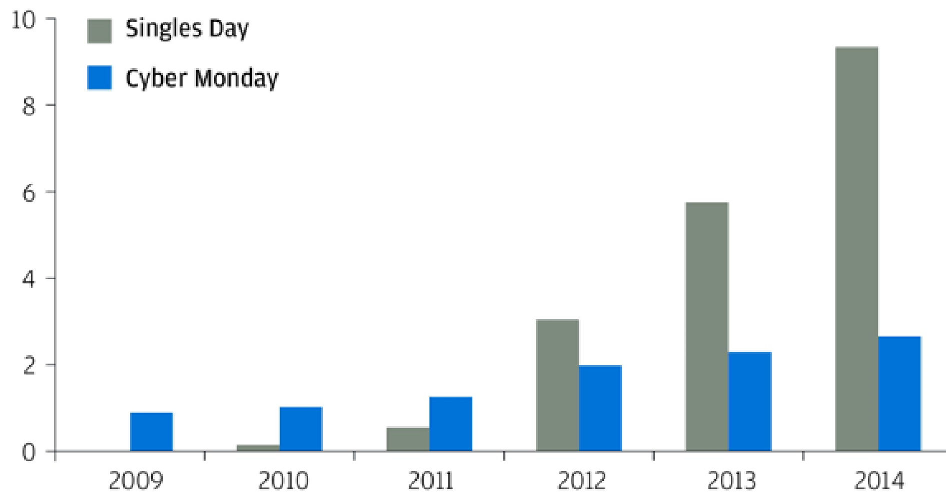
China's e-commerce share has already exceeded that of the US

(as a % of total retail sales)



Sources: iResearch; data as of 9 January 2015.

Exhibit 14b: Sales from China's Singles Day vs. Cyber Monday in the US
Revenue from China's biggest shopping day is three times larger than sales from Cyber Monday in the US
(Revenue USD ban)



Sources: Alibaba, Bloomberg, ComScore; data as of 9 January 2015.

3.3. Innovation

The US and other DMs still lead the way in technological innovation, and it will take many years for EMs to catch up. Domestic and local preferences in EMs, however, including pricing, language and culture, imply that EM companies have an opportunity to generate products and services that can take market share from international brands in domestic markets.

Some EM companies are also in a stronger position to monetise products that DM companies have yet to achieve. For example, Alibaba, China's largest e-commerce company, has been able to use its online shopping platform as a springboard into financial services (Yuebao). Meanwhile, Chinese internet company Tencent Holdings Ltd. has been able to bring social media into gaming and payment services. Given the potential size of the total pool of online citizens in EMs, social media companies are likely to be able to benefit from economies of scale and the resulting networking effect when promoting products and services.

4. INVESTMENT IMPLICATIONS

Amid stronger EM fundamentals, it will be important for investors to differentiate between markets, since not all EMs are created equal. Idiosyncratic factors, such as economic policy and reforms, will be critical in determining the outlook for a particular market. Markets with a current account surplus and export exposure to the US, for example, should see greater stability, while commodity exporters could continue to face headwinds due to sluggish global demand growth for raw materials.

From a portfolio construction perspective, investors should remain disciplined in maintaining a well-diversified portfolio, with both equities and fixed income. Returns from cash are still unlikely to be attractive in real terms, despite a rise in USD interest rates. EM equities, which are currently undervalued, should do well, especially in those markets that are benefiting from a global recovery. While EMs, including China, Indonesia, Brazil and Russia, are going through a cyclical consolidation, we still believe there are structural developments, such as the growth of consumerism and the buildout of infrastructure, that offer opportunities to investors.

4.1 Equities

There are many concerns hanging over EM equities today, including the gradual slowing of Chinese growth, weakness among commodity producers, political drift away from free enterprise and the potential impact of higher US interest rates on EM flows. Beyond this, however, and given a faster pace of economic growth, EM earnings should have strong long-term growth potential. The Asian region, which should be helped by stronger US growth, looks relatively more attractive within the EM equity space.

Meanwhile, EM equities look attractively valued and are trading at the low end of their 20-year valuation ranges. This reflects a conservative view on earnings growth, pessimism on commodities and prospects of a strong US dollar (Exhibit 15a). EM stocks are deeply discounted relative to those in DMs (Exhibit 15b).

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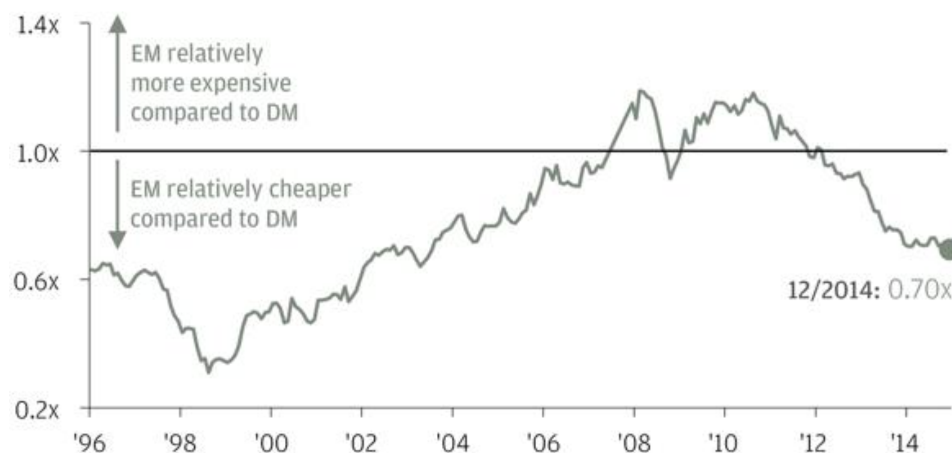
Exhibit 15a: MSCI Emerging Markets P/B* Ratio

EM equities are attractively valued relative to their own history and DM equities

(Trailing P/B ratio)

Exhibit 15b. EMs vs. DMs Relative P/B

(Relative MSCI EM/MSCI World P/B)



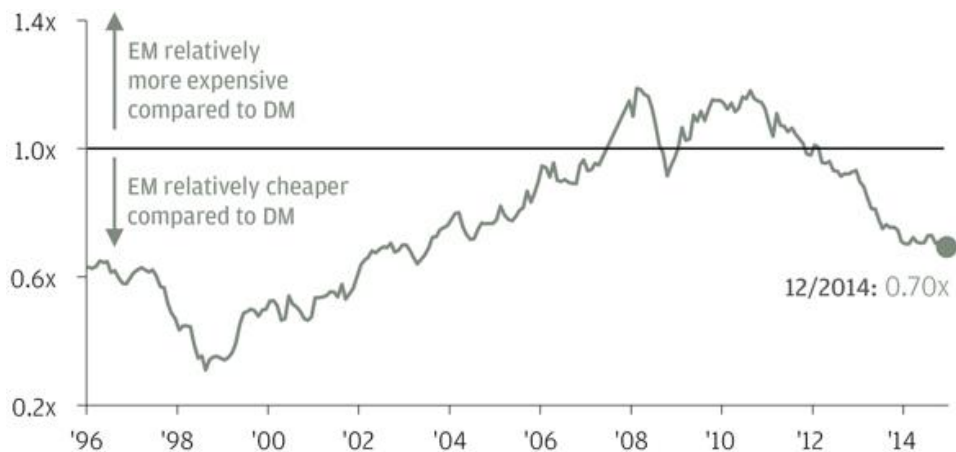
Sources: MSCI, I/B/E/S, FactSet, J.P. Morgan Economics, J.P. Morgan Asset Management's "Guide to the Markets – Asia 1Q 2015"; data as of 31 December 14.

Note – *P/B is defined as the price-to-book ratio (P/B ratio) which is used to compare a stock's market value to its book value.

Meanwhile, as a rising-rate environment continues to challenge the expected return from DM fixed income, investors should look for income opportunities from equity alternatives. Dividends, including re-investment and compounding, have been understated as a contributor to total return. In Asia, there is a trend for companies to increase dividend

payouts given their high cash positions (Exhibit 16). Investors could consider sectors that would benefit from cyclical growth while enjoying a good dividend yield.

Exhibit 16: Total Return*: Dividends vs. capital appreciation
Asian companies are increasing dividend payouts
(Average annualized returns over 10 years)



Sources: MSCI, J.P. Morgan Asset Management's "Guide to the Markets – Asia 1Q 2015"; data as of 31 December 2014.

Note – * Returns are total (gross) returns based on MSCI indices in U.S. dollar terms.

4.2 Fixed income

An active and flexible approach is necessary to navigate a more complex fixed income market. In particular, investors will need to strike a balance among yield, duration and credit risk, as well as exchange rate exposure. Taking into account the possible sources of return, investors should focus on the riskier parts of the debt market, including high yield corporate bonds and EM debt.

EM bonds offer higher yields than those available across the developed world. Compared with an average policy interest rate of 0.27% in DMs, EM policy rates stood at 6.65% as of the end of 2014. Historically, investors demanded higher yield premiums on EM debt to compensate for what was seen as greater macro and political risks, as well as potential liquidity concerns. But today, such compensation seems increasingly out of line with the fundamentals. For example, the average EM country today has a budget deficit and debt (both as a percentage of GDP) roughly half of what an average DM country has. In fact, the majority of issues in EMD indices are investment grade.

While there are plenty of idiosyncratic risks across EMs, countries such as India, where strong central banks are both protecting their currencies and subduing inflation, should

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offer relatively good returns. The Fed's tightening path in 2015 has been very well telegraphed and so should cause less volatility than the "taper tantrum" of 2013.

Overall, exposure to EM equities, bonds and currencies provides opportunities to increase diversification by expanding across borders and asset classes. As Exhibit 17 shows, various types of EM debt are negatively correlated to 10-year Treasuries.

Exhibit 17. Global fixed income

EM debt is negatively correlated to UST, offering diversification

Global Bond Opportunities

	YTM	Duration* (Years)	Correl. to 10-year UST
Asia Corporate HY	7.6%	4.1	-0.09
Local CCY EMD	7.2%	4.3	0.03
U.S. Corporate HY	6.9%	4.4	-0.24
USD EMD	6.2%	7.1	0.23
EM Corporates	6.1%	5.9	0.18
USD Asian Bond	4.7%	5.2	0.23
Pan-European HY	4.6%	3.9	-0.38
DM Government Bond	1.5%	7.3	0.63
U.S. Treasury	1.4%	5.6	0.98
Cash	0.0%	0.2	0.03

Fixed Income Sector Returns

2009	2010	2011	2012	2013	2014	4Q '14	5-yrs ('10 - '14) Ann. Ret.
Europe HY 86.7%	Asia HY 19.4%	U.S. Treas 9.8%	Europe HY 28.5%	Europe HY 9.9%	USD Asian 8.2%	U.S. Treas 1.9%	Europe HY 11.4%
Asia HY 74.3%	Europe HY 16.2%	USD EMD 8.5%	Local EMD 19.9%	U.S. HY 7.4%	Europe HY 7.0%	USD Asian 1.3%	Asia HY 9.2%
U.S. HY 58.2%	U.S. HY 15.1%	DM Gov't 7.2%	USD EMD 18.5%	Asia HY 4.3%	Asia HY 5.5%	Europe HY 1.0%	U.S. HY 9.0%
EM Corp 41.7%	Local EMD 13.1%	U.S. HY 5.0%	EM Corp 16.7%	Cash 0.0%	USD EMD 5.5%	Cash 0.0%	USD EMD 7.3%
USD Asian 28.3%	EM Corp 13.1%	USD Asian 4.1%	U.S. HY 15.8%	USD Asian -1.4%	U.S. Treas 5.1%	DM Gov't -0.7%	USD Asian 7.0%
USD EMD 28.2%	USD EMD 12.0%	EM Corp 3.5%	USD Asian 14.3%	EM Corp -2.4%	EM Corp 4.1%	U.S. HY -1.0%	EM Corp 6.8%
Local EMD 16.6%	USD Asian 10.6%	Cash 0.1%	Asia HY 13.5%	U.S. Treas -2.7%	U.S. HY 2.5%	Asia HY -1.2%	U.S. Treas 3.9%
DM Gov't 1.9%	DM Gov't 6.4%	Europe HY -2.4%	U.S. Treas 2.0%	DM Gov't -4.5%	DM Gov't 0.8%	USD EMD -1.7%	Local EMD 2.5%
Cash 0.1%	U.S. Treas 5.9%	Asia HY -5.9%	Cash 0.1%	Local EMD -5.5%	Cash 0.0%	EM Corp -2.3%	DM Gov't 2.2%
U.S. Treas -3.6%	Cash 0.1%	Local EMD -6.4%	DM Gov't 0.0%	USD EMD -6.6%	Local EMD -5.8%	Local EMD -6.0%	Cash 0.1%

Sources: Bloomberg, Barclays Capital, J.P. Morgan, FactSet, J.P. Morgan Asset Management's "Guide to the Markets – Asia 1Q 2015"; data as of 31 December 2014. Based on Barclays U.S. Aggregate Credit – Corporate High Yield Index (U.S. HY), J.P. Morgan Government Bond Index – EM Global (GBI-EM) (Local CCY EMD), J.P. Morgan Corporate Emerging Market Bond Index (CEMBI) (EM Corp), J.P. Morgan Emerging Market Bond Index Global (EMBIG) (USD EMD), J.P. Morgan Asia Credit Index (JACI) (USD Asian), Barclays Pan European High Yield (Pan-European HY), J.P. Morgan Government Bond Index – Global Traded (DM Gov't), J.P. Morgan Asia Corporate High Yield Index (Asia HY), Barclays Global U.S. Treasury – Bills (3-5 years) (U.S. Treasury) and Barclays U.S. Treasury – Bills (1-3 months) (Cash). Five-year data is used to calculate annualised returns (Ann.). Returns are in USD and reflect the period from 31 December 2009 – 31 December 2014. *Duration is a measure of the sensitivity of the price (the value of the principal) of a fixed-income investment to a change in interest rates. Duration is expressed as number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. 10-year data is used to calculate the correlation to the 10-year UST. Positive yield does not imply positive return.

CONCLUSION

After several years of relative underperformance, EMs appear to be on the cusp of stronger growth. Yet 2015 is likely to bring further challenges, but also creating opportunities for investors. Cyclical factors, such as the stronger US dollar and softening commodity prices, will hurt EMs with weak external fundamentals, but will position stronger EMs for relative outperformance. Structural flaws are being addressed by some EMs through their implementation of business and economic reforms. While progress is slow, those countries that have successfully transformed their economies will prove to be good long-term holdings for investors. Over the long term, secular investment themes, including EM companies' innovation in their local markets, will improve growth prospects in these markets. From an asset allocation perspective, investors should remain disciplined in maintaining a well-diversified portfolio that includes an allocation to EMs.

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FOOTNOTES

1. George Iwanicki and Joanne Baxter, "Investment Insights: From selective recoupling to U.S. Federal Reserve normalisation," (November 2014), p. 5.

2. George Iwanicki and Joanne Baxter, "Investment Insights: From selective recoupling to U.S. Federal Reserve normalization," (November 2014), p. 7.

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