We have long acknowledged the presence of imbalances in China, and slowing nominal GDP growth and the first-half deployment of part of the huge FX reserve base have raised our concerns about the risks of a hard landing. In addition, we have been disappointed by the speed of state-owned enterprise (SOE) reform implementation to date. However, we still believe that the most likely outcome is an environment in which Chinese policy easing (beginning with the rate cuts and deposit band expansion undertaken recently) puts a floor under growth and prompts some weakening of the currency, allowing the economy to muddle through over coming quarters.

Our own summary indicators on domestic growth are flat, and we note that the very weak industrial indicators (manufacturing PMI, industrial production, imports) are to some degree countered by healthy readings on services (services PMI) and accumulating signs of stabilization in housing prices. In the slower top-line growth environment that China has entered, we are seeing private-sector companies investing more in productivity enhancement than scale enhancement, which should help sustain corporate competitiveness.

Beyond understanding and sizing the challenging fundamentals for the asset class, the investment implications we draw look to consider three additional factors: first, investor sentiment and positioning; second, valuations within emerging market equities and emerging market debt; and third, catalysts that would improve the backdrop.
SENTIMENT

1) The weight of the triumvirate of pressures on emerging markets and the underperformance of EM equities over the past few years has long taken its toll on investor sentiment. The latest readings from survey data show that sentiment has fallen to levels last seen during the Global Financial Crisis in late 2008.

2) Flows have turned decidedly negative of late, adding to the large net outflow of the past two years. Although institutional positions have remained stickier, cumulative retail outflows have measurably reversed the big inflow into both emerging markets and emerging market debt seen during the boom periods ahead of, and then immediately after, the Global Financial Crisis.

3) The “term structure” of implied volatility has moved to crisis levels in EM equity. Near-term implied volatility has shot up well beyond longer-term implied volatility in a manner similar to that seen in 2008, revealing extreme investor caution on the near future.

VALUATIONS

1) EM equity valuations have moved from marginally attractive to unusually attractive using historical norms. Amid earnings uncertainty, our focus on price/book (P/B) value ratios shows that EM equity is trading close to 1.3x. Although short of the absolute lows seen at the bottoms in 1998 and 2008, this level is at the 98th percentile of the range seen over the past 20 years.

2) As a mirror image to the strengthening US dollar, most EM currencies have de-rated to levels below our best estimates of fair value. However, we remind that while the decline in EM currencies has been broad-based, few have reached the degree of undervaluation that has provided a floor in past currency cycles.

3) Within EM debt markets, yields in all sectors have backed up sufficiently to reach the high end of the past five-year range. US dollar spreads have finally moved to attractive levels, but higher spreads can’t be ruled out, given the evolution of the three main headwinds noted above.
4) Sovereign spread appears the most attractive at roughly 260 bps on investment grade and 660 bps on high yield paper. Despite widening by 90 bps from the recent bottom to reach 400 bps over US Treasuries, corporate spreads are less compelling in our view, given the significant cheapening of US investment grade and high yield debt.

EXHIBIT 4: SOVEREIGN SPREADS

Source: J.P. Morgan Asset Management. Data as of 27 August 2015.

5) Local market debt looks attractive from a rate perspective, at roughly 7.1% average yield, also back to its post-2008 highs. This is attractive in a world in which deflation forces will keep real rates high; however, the lack of catalysts and cost of hedging EM currencies remains the main impediment.

CATALYSTS

1) More aggressive stimulus from China to stem the slowdown in nominal growth should help alleviate the immediate concerns about a hard landing. We focus on nominal growth, as the slowdown in real growth has been echoed by a decline in inflation; such a combination threatens to exacerbate whatever pressures arise from the large stock of private-sector debt that has accumulated since the Global Financial Crisis. It is worth noting that such easing could prompt a gradual weakening of the Chinese currency and, accordingly, prompt echoes in other Asian exporter currencies. That said, we suspect markets would favor the benefits over these potential costs—and the initial reaction to the recent easing by the People’s Bank of China backs this up.

Signs of stabilizing or improving global economic growth, improved real economy data would begin to allay concerns of a China-centric global growth slowdown. In addition, stabilization (if not a bounce) in oil and/or industrial commodity prices would likely have a similar effect. It would evidence not only stabilizing global growth, but also some export and public-sector balance sheet relief for the commodity exporters.

Indications that the US Federal Reserve (the Fed) will stay its hand, after spending the past few months emphasizing the commencement of a (slow and deliberate) normalization of policy rates. There is little evidence that the combination of weak global growth and a rising US dollar have taken any steam out of US growth. However, the reversal of early signs of wage inflation in recent readings is evidence that global deflation pressures persist, even in a country whose recovery has pushed the unemployment rate back to the range of full employment. We suspect that the Fed’s emphasis will shift further toward achieving its inflation objectives, and this could be used as cover to deemphasize the arguments put forth for beginning rate normalization. Of course, such an argument will have to be carefully packaged to avoid inflaming concerns that the US (and the world) are stuck in a Japan-like mode of stagnant growth and deflation.

2) A rejuvenation of structural reforms in select EM countries. Although we view the bulk of the pressures in emerging markets as a reflection of unfavorable cyclical circumstances, we acknowledge that some EM countries have lagged in the area of structural reforms. Specifically, both Russia and Brazil failed to use the commodity boom earlier this century to diversify growth, upgrade infrastructure, introduce flexibility to labor markets, or establish properly insulated sovereign wealth funds. The promise of budget and infrastructure reforms has also disappointed so far in Indonesia. A broadening of structural reforms beyond those seen in countries like Mexico, Philippines, Peru and India would begin to reverse the current tendency of investors to perceive cyclical pressures as structural shortcomings for the asset class as a whole.

SUMMARY

The challenging fundamental environment for emerging markets will linger, given our expectation that the triumvirate of pressures (slow growth, rising US dollar, falling commodity prices), along with slow growth in China, has yet to run its course.

The market de-rating is raising opportunities within the EM space, across equity, debt, and FX, and our investment strategies across the EM platform will continue to seek to capture favorable entry points.

We are paying close attention to the profile of global growth (and commodity prices as one proxy), policy responses in both China and the US (particularly the Fed) and a resumption of structural reforms within emerging markets, as these would be the best catalysts to prompt a re-rating of EM assets.

We retain a moderate bias in favor of EM equities, given the more attractive valuation case, while we are exposed more defensively within EM debt, based on our more favorable view on sovereigns.