MARKET INSIGHTS

Market Bulletin

May 12, 2017

Investing in Emerging Markets: Why EM and which EM?

In brief

- Emerging market (EM) assets currently represent only a small portion of global portfolios, following their underperformance from 2011 into early 2016.
- However, both external and domestic conditions have improved markedly since then, and investors should consider whether they have appropriate exposure to this EM rebound.
- Investing in EM can come in different forms; it is important to consider which EM assets, regions and sectors stand out.
- Given the improving growth picture and valuations, we prefer EM equities to EM debt.
- Within EM debt, our preference is for local currency over U.S. dollar-denominated bonds.
- Regional preferences vary by asset class: EM Asian equities stand out, while commodity exporters offer the most attractive fixed income opportunities.

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That was then: Global investors underweight EM

From 2011 to early 2016, EM economic growth, earnings and returns were under pressure. The headwinds for EM were significant, and included collapsing commodity prices (first for industrial metals and then energy), rapidly depreciating currencies and uncertainty surrounding economic growth in China. Investing in EM began to be thought of as merely a reach for yield, and expectations were that EM asset classes would continue to disappoint. Over time, investors significantly pared down their exposures to EM assets, notably in local currency-denominated fixed income and equities. In January of 2016, EM

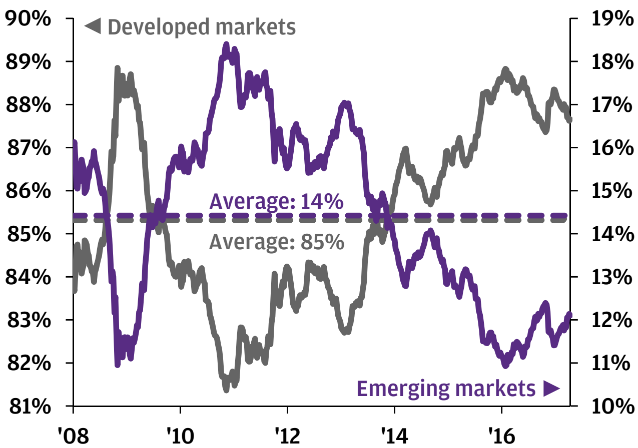
J.P.Morgan
Asset Management

fixed income and equities together represented only 10.9% of global allocation, compared to an average of 14.4% since 2008 **(Exhibit 1)**. Since early 2016, investors have been slowly adding back exposure, but remain underweight EM, especially on the equity side.

Global investors remain underweight EM assets

EXHIBIT 1: GLOBAL ASSET ALLOCATION FUND WEIGHTS IN EM AND DM

BONDS AND EQUITIES, % WEIGHT IN GLOBAL FUNDS*



Source: IIF, J.P. Morgan Asset Management. *Data includes mutual funds and ETFs and comes from the IIF's Portfolio Allocation April 2017 report. Data are as of May 12, 2017.

This is now: EM deserves a closer look

By maintaining limited exposure to EM, investors are missing out on the brightening outlook for EM economies and companies. External conditions are very different than they were 11 months ago; the dark clouds hanging over the asset class are now beginning to dissipate. Since the lows of January 21, 2016, EM returns have been sizable: equities have risen 47.8%, U.S. dollar sovereign debt is up 18.2% and local currency sovereign debt is up 16.7%. Crucially, the improving external backdrop and accelerating growth picture suggest that this is not a temporary bounce.

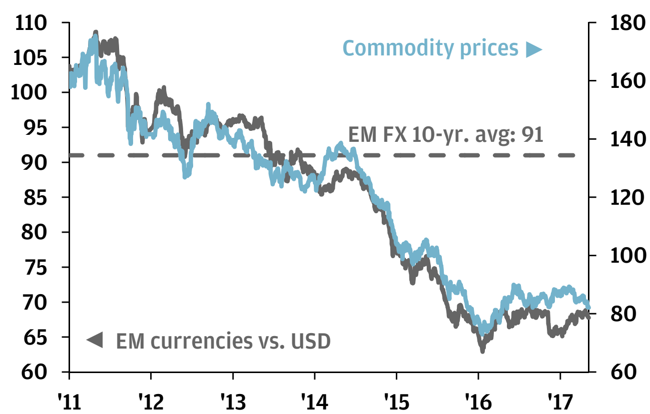
There are three relevant external factors driving EM: commodities, currencies and Chinese growth. Commodity prices are largely finding a floor as supply and demand come into better balance. Although prices for key commodities such as energy, copper and iron ore began to fall again in March, these declines are likely best seen as corrections following strong gains in the second half of 2016 and not as a resumption of the chronic and steep declines of the past few years.

This overall stabilization in commodity prices is helping support EM currencies **(Exhibit 2)**. EM currencies tend to track commodity prices, as several large EM economies are commodity exporters. In addition, movements in commodity prices reflect an underlying perception of the strength of the global economy and investors' appetite for risk.

Stable commodity prices and depressed valuations should keep EM currencies supported

EXHIBIT 2: EMERGING MARKETS' CURRENCY

COMMODITY PRICES AND EM FX



Source: J.P. Morgan Global Economic Research, Bloomberg, J.P. Morgan Asset Management. EM currency is the J.P. Morgan Emerging Market Currencies Index and commodity prices is the Bloomberg Commodity Price Index. Data are as of May 12, 2017.

Improvements in some of the external vulnerabilities of EM countries should also help support EM currencies. The "Fragile Five" (Brazil, India, Indonesia, South Africa and Turkey) have meaningfully reduced their current account deficits, from over 4% of GDP in 2013 to below 2% in 2016. Lastly, following years of depreciation, EM currencies are now quite undervalued; an EM basket vs. the U.S. dollar now trades at more than one standard deviation below its 10-year average. These factors all argue against an indiscriminate renewed surge in the U.S. dollar. A stronger EM currency outlook boosts the appeal of EM equities and local fixed income securities and should help investors feel more comfortable taking on EM FX exposure.

The third relevant external variable finding its footing is the Chinese economy. With fiscal support, Chinese economic indicators, such as the Caixin/Markit Purchasing Managers' Index (PMI), began to accelerate in mid-2016. Crucially, the Chinese government was successful in decoupling the Renminbi from the U.S. dollar and stemming capital outflows. This year, the Chinese government has begun to withdraw some stimulus and focus on needed reforms. As a result, we may see some slowing of the Chinese economy in the second half of the year. However, this should be seen in the context of a moderate slowdown, rather than a "hard landing" (or an abrupt slowdown).

In addition to these factors, EM countries also stand to benefit from the broad improvement in global growth. This includes the rebound in Europe and Japan, the steady U.S. economy and the improvement within EM countries themselves. The open economies of Asia are already feeling the benefits, with export growth at its highest in five years. A potential risk is the return of protectionist fears, which would break the link between better global growth and EM export growth. However, for now, these concerns have been kept at bay.

Global growth upswing: EM is also participating

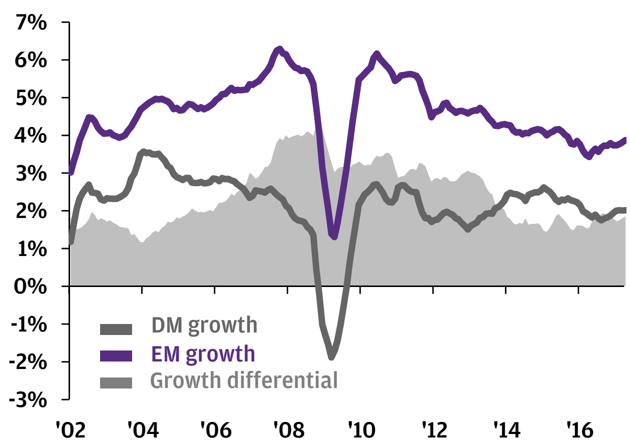
With external headwinds turning into tailwinds, and domestic reforms continuing in several countries[1], EM growth has been improving since early 2016. A twelve-month average of the Institute of International Finance's EM growth tracker points to a move up in growth from a low of 2.7% in February 2016 to 5.3% in April 2017. In developed markets (DM), survey data has been leading the charge over the past few months, raising fears that the hard data will not live up to such high expectations. The acceleration in EM growth, however, is being led by the hard data itself, pointing to its sustainability. Lastly, what began as an EM commodity exporter story, with the expectation that Brazil and Russia would exit recessions this year, has broadened out to include other EM economies as well, with EM Asia indicators also turning up.

EM will almost always grow faster than DM; the crucial question for EM performance is: "how much faster?" Since the peak of the commodity supercycle a few years ago, the gap between EM and DM economic growth steadily shrank, narrowing from a high after the financial crisis of 3.5% to just 1.4% in early 2015, and moving up to 1.9% in early 2017 **(Exhibit 3)**. The good news for investors, therefore, is not only that EM growth is picking up, but also that it is picking up relative to DM growth.

The continued improvement in the EM growth alpha should help support EM assets

EXHIBIT 3: EM VS. DM GROWTH

MONTHLY, CONSENSUS EXPECTATIONS FOR GDP GROWTH IN 12 MONTHS



Source: Consensus Economics, J.P. Morgan Asset Management. "Growth differential" is consensus estimates for EM growth in the next 12 months minus consensus estimates for DM growth in the next 12 months, provided by Consensus Economics. Data are as of May 12, 2017.

Which EM: Strong argument for equities

When investing in EM, it's important to consider the various asset classes: equities, local currency debt and U.S. dollar debt. Against the backdrop of stronger growth and better risk appetite, and taking relative valuations into account, EM equities stand out as the

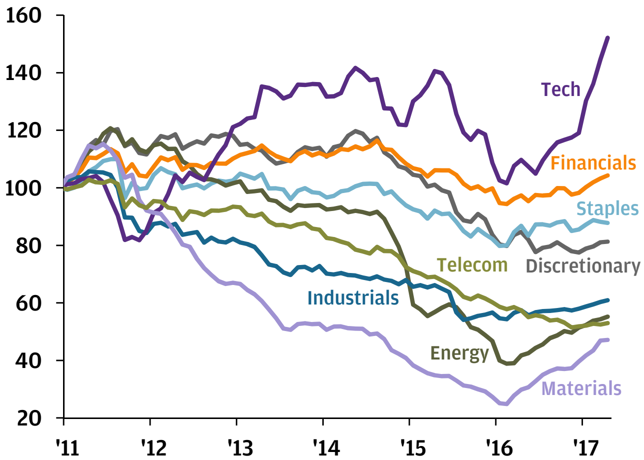
[1] Latin America in particular has been making progress on several fronts, including fiscal balances and long-term competitiveness. For more, please see Latin America: A turning of the tide.

front runner.

The improvement in EM economic growth is feeding through to a significant pick-up in earnings expectations. From 2011 to early 2016, EM U.S. dollar earnings per share fell continuously; however, expectations have been moving up consistently since then. This improvement was initially concentrated in the energy and materials sectors, but it is encouraging to see that positive earnings revisions have now broadened out to include several other sectors, such as technology, industrials, consumer discretionary and financials **(Exhibit 4)**.

EM earnings pick-up is becoming more broad-based

EXHIBIT 4: EM EPS BY SECTOR
NEXT TWELVE MONTHS' ESTIMATES, U.S. DOLLAR, DEC. 2010=100



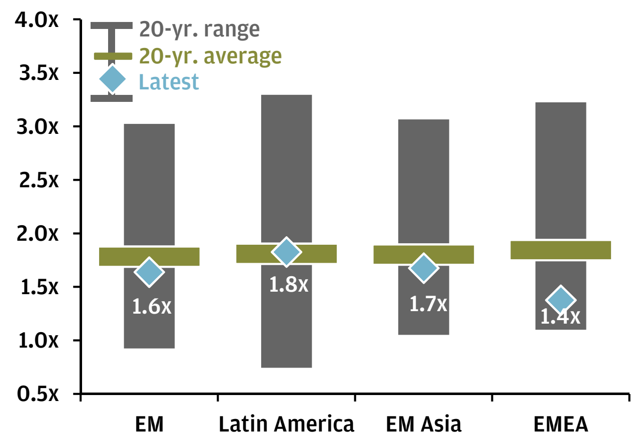
Source: MSCI, FactSet, J.P. Morgan Asset Management. Data are as of May 12, 2017.

EM equities also appear attractively valued. In the midst of the storm for EM, price-to-book ratios reached a low of 1.3x in early 2016. Following the double-digit performance of EM equities in 2016 and so far in 2017, price-to-book ratios have moved up, but at 1.6x they are still below their 20-year average **(Exhibit 5)**.

Within EM equities, investors should consider which sectors and regions stand out. In the context of better DM and EM growth, cyclical sectors are poised to benefit most. These include industrials, which should benefit from a pick-up in global trade, as well as technology and consumer discretionary, which should benefit from recovering domestic demand. Indeed, all three sectors are showing improving earnings expectations.

EM equity valuations look attractive overall, but vary across regions

EXHIBIT 5: EM VALUATIONS BY REGION
PRICE-TO-BOOK RATIO, LAST 12 MONTHS' ACTUAL



Source: MSCI, FactSet, J.P. Morgan Asset Management. Data are as of May 12, 2017.

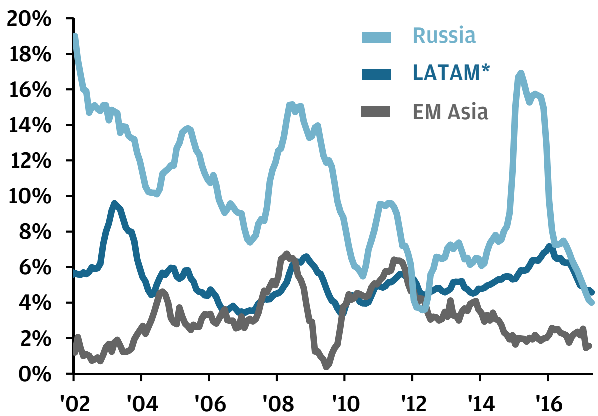
These sectors tend to be heavily weighted in EM Asia, representing a combined 51% of the MSCI EM Asia Index, compared to 22% of the MSCI EM EMEA (Emerging Europe, Middle East and Africa) Index and 15% of the MSCI Latin America Index. In addition, the regional argument for Asia is strong on the valuation side, with EM Asia price-to-book levels below 20-year averages, compared to more expensive levels in Latin America **(Exhibit 5)**. Valuation levels stand out as exceptionally cheap in EMEA, but investors should remember the political risks in the two largest countries: South Africa and Russia.

Which EM: Idiosyncratic argument for local bonds

Following EM equities, EM local currency fixed income stands out as the second most attractive EM asset class. The main argument for local bonds centers on shifting inflation dynamics in certain EM countries such as commodity exporters in Latin America and Russia **(Exhibit 6)**. These countries saw their inflation levels shoot up from 2014 to 2016 because their currencies depreciated meaningfully and imports became more expensive. In addition, an El Niño-driven shock to agricultural prices last year also pushed up inflation in some countries. Lastly, several countries have wages and certain local prices indexed to inflation, which creates a vicious cycle as inflation levels creep higher. Importantly, more currency stability, lower food prices and better fiscal discipline have helped to lower inflation in these "highflation" countries since 2016.

"Highflation" countries are starting to see inflation subside, leading to central bank rate cuts

EXHIBIT 6: HEADLINE INFLATION
YEAR-OVER-YEAR % CHANGE



Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management.*LATAM index excludes Argentina, Ecuador and Venezuela. Data are as of May 12, 2017.

With lower inflation levels, these countries' central banks are now able to cut interest rates. While equity opportunities may be primarily in EM Asia, the opportunities in local bonds lie in Latin America (in particular Brazil and Colombia) and Russia. The Central Bank of Brazil is expected to cut interest rates by 300 basis points this year, Colombia's by 100 basis points and Russia's by 75 basis points. There is potential for even deeper rate cuts if the external backdrop remains supportive and inflation comes down further. In contrast, major central banks in Asia are expected to remain on hold for the foreseeable future since their inflation levels have been much more stable.

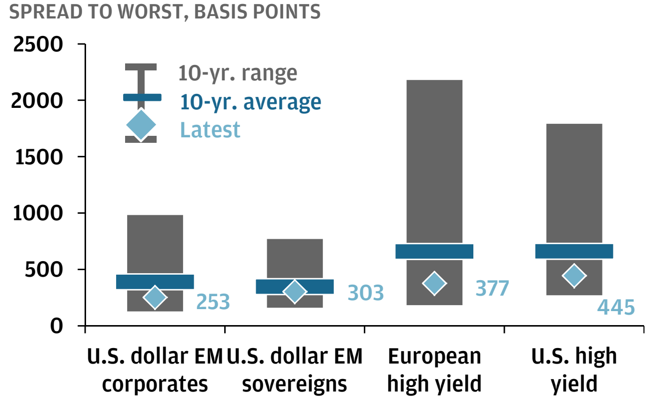
Lastly, EM local bonds still provide an attractive yield differential compared to DM fixed income, with the current yield pickup at 520 basis points (bps) compared to a ten-year average of 420bps. The positive news is that this yield comes with an improvement in perceived risk in EM, with EM average credit default swap spreads at 152bps over DM, compared to a high of 378bps in 2015.

Which EM: Moderate argument for U.S. dollar bonds

The reduction in risk in EM countries, coming from more political stability, fiscal improvements and better growth, is also supportive of EM U.S. dollar debt. However, the argument for U.S. dollar debt is more moderate compared to equities and local fixed income, due to valuations. EM U.S. dollar debt was the first step back into the EM pool for global investors, as it did not require FX exposure and provided attractive yields. As a result, spreads have tightened over the years, and are now trading below ten-year average levels, especially on the corporate debt side **(Exhibit 7)**. Meanwhile, European and U.S. high yield bonds offer higher spreads in comparison, in tandem with improving fundamentals.

DM high yield looks more attractive than EM sovereign and corporate debt

EXHIBIT 7: SPREAD BY FIXED INCOME SECTOR
SPREAD TO WORST, BASIS POINTS

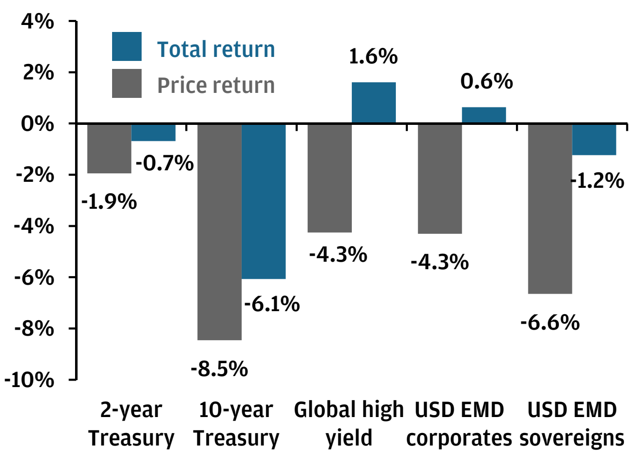


Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management. U.S. dollar EM sovereigns, U.S. dollar EM corporates, U.S. high yield and Euro high yield are based on EMBI Global Diversified Index, CEMBI Broad Diversified Index, J.P. Morgan U.S. High Yield Index and J.P. Morgan Europe High Yield Index, respectively. Data are as of May 12, 2017.

A second constraint for EM U.S. dollar debt is its exposure to U.S. interest rate risk. We expect that the Federal Reserve will continue to raise interest rates over the next few years, posing a challenge to U.S. dollar-denominated fixed income. EM bonds offer decently high coupons, which help cushion some of the impact of rate hikes; however, EM sovereigns, in particular, do have high duration and may be challenged in this environment **(Exhibit 8)**.

U.S. dollar EM debt (EMD) provides a cushion to absorb higher U.S. rates

EXHIBIT 8: IMPACT OF A 1% RISE IN INTEREST RATES
ASSUMES A PARALLEL SHIFT IN THE YIELD CURVE AND SPREADS ARE MAINTAINED



Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management. 2 and 10-year Treasury, Global high yield, USD EMD corporates and USD EMD sovereigns are based on the Bloomberg Barclays U.S. Treasury indices, Bloomberg Barclays Global High Yield, Bloomberg Barclays Emerging Markets USD Aggregate - Corporate and Bloomberg Barclays Emerging Markets USD Aggregate - Sovereign. Change in bond price is calculated using both duration and convexity. Data are as of May 12, 2017.

Investment implications

The persistent underperformance of EM assets from 2011 to 2016 resulted in global investors' limited exposure to EM assets. However, the horizon looks brighter for EM than it has in years, and we believe these markets warrant a closer look. With an improving outlook for EM external and domestic variables, investors should no longer think about EM asset classes as only a yield play.

Reduced external vulnerabilities, attractive valuations and stable commodity prices should provide a supportive backdrop for EM currencies, which bodes well for both EM equity and local debt.

Overall, EM equities stand to benefit the most given improving EM growth translating into better earnings coupled with reasonable valuations. Sectors that are cyclically tilted should benefit from the upturn in global growth. This leads to a regional bias toward EM Asia given its heavy exposure to such sectors.

Following equities, EM local debt looks attractive. Local debt provides a significant yield carry over DM fixed income, with lower risk than before. However, this is not the only appeal; falling inflation in commodity exporting countries provides an idiosyncratic opportunity, as these central banks continue cutting rates. Brazil, Colombia and Russia stand out.

While valuations are not the most compelling relative to DM high yield, EM U.S. dollar debt could see some upside given improving fiscal dynamics in certain countries. However, there is duration risk given the rising interest rate environment in the U.S.

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