INVESTMENT INSIGHTS

Follow-through on the earnings turn

Emerging Market Equities

November 2016

IN BRIEF

- In the third quarter, emerging market (EM) earnings and earnings expectations cycles finally began to turn. Reported profits and margins rebounded off their cyclical lows and earnings estimates moved out of negative territory, diminishing a headwind that had weighed on performance from 2011 through 2015.
- Consensus economic growth projections for emerging markets began to rebound, widening the forward growth premium for emerging vs. developed markets.
- The composition of EM and Asia Pacific (EMAP) indices has shifted away from "old economy" sectors toward "new economy" sectors, including information technology (IT). EMAP indices are now more IT-oriented than other equity indices, including the S&P 500.
- Unfolding growth and earnings momentum could act as the catalyst for new equity gains, especially as EMAP valuations remain below their long-term averages. We believe EMAP shares could further re-rate in the low global interest rate environment, as stocks have done in other segments of the global equity market.

OVER THE PAST FIVE YEARS, EARNINGS AND EARNINGS EXPECTATIONS FOR EMERGING MARKETS HAVE PERIODICALLY FLASHED SIGNS OF A POSITIVE TURN IN MOMENTUM—ONLY TO FLICKER AND FADE. For investors, the pattern became familiar: bursts of renewed enthusiasm for the asset class, followed by stretches of disappointment.

But in the third quarter of 2016, the EM earnings and earnings expectations cycle finally began to turn. Reported earnings and profit margins rebounded off their cyclical lows and earnings estimates moved out of negative territory, diminishing a headwind that had weighed on performance from 2011 through 2015. In the following pages, we explore the causes of this critical turn, consider how the follow-through might unfold and ask whether that earnings improvement could unlock a re-rating of EM equities. We then highlight the sectoral shifts taking place within both EM and Asia Pacific ex-Japan indices and, finally, discuss specific opportunities in the asset class.

In many ways, the third quarter extended trends that began at the start of the year. EM and Asia ex-Japan outperformed other global equity indices for both the quarter and the year to date as currency continued to shift from being a detractor to a contributor in dollar returns and some multiple expansion bolstered performance. Macro growth expectations have turned upward, and we saw the beginning of a restoration of the premium for EM over developed market (DM) growth expectations.

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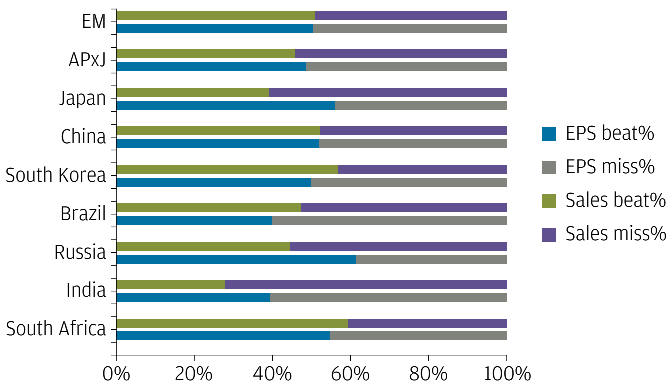
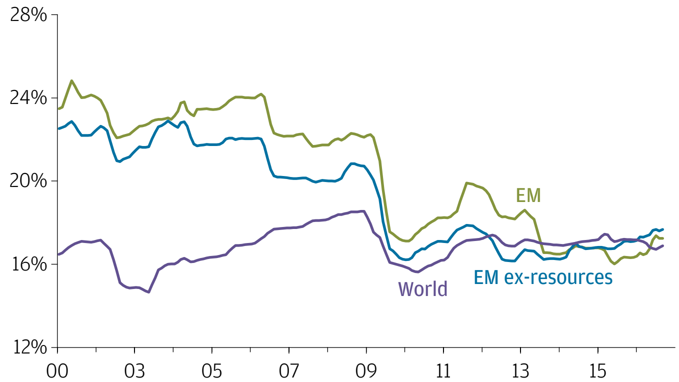
Reported earnings are beginning to improve, in some cases despite disappointing top-line performance; EM profit margins are edging higher

EXHIBIT 1A: EPS AND SALES RESULTS VS. EXPECTATIONS



Source: J.P. Morgan Asset Management. For illustrative purposes only.

EXHIBIT 1B: EBITDA MARGINS, THREE-MONTH AVERAGE, 2001–15



Source: J.P. Morgan Asset Management. For illustrative purposes only.

IMPROVED EARNINGS AMID IMPROVING PROFIT MARGINS

Earnings estimates increasingly reflect this brighter growth outlook. After a multi-year cycle of negative revisions, analysts have begun to revise their earnings estimates upward. While the change in expectations began and is still centered in the commodities space, analysts have slowly broadened their revisions across a range of sectors.

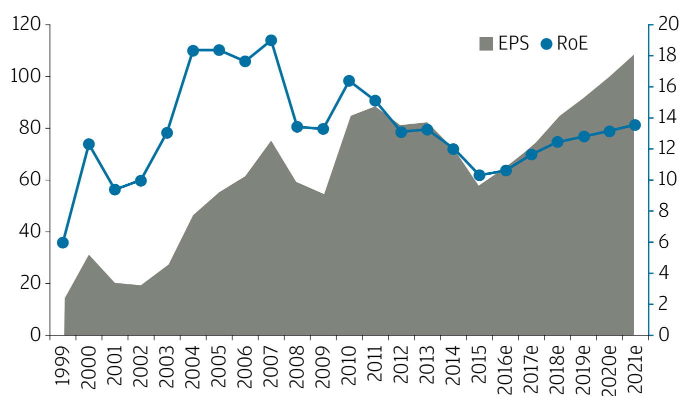
Reported earnings are beginning to improve, and we have seen an increase in positive earnings surprises, in some cases despite disappointing top-line performance. This suggests that companies are achieving greater operating efficiency and improved profit margins (**EXHIBITS 1A** and **1B**). Diminished commodity pressures have also helped, but Ebitda margin improvement can be seen across the EM index—in contrast to DM margins, which have been under pressure for the past few quarters.

Now that both earnings and earnings expectations have turned, what is the potential upside for the asset class? To address that question, we looked at our own J.P. Morgan Asset Management analysts' estimates of cycle-neutral return on equity (RoE), compared with the cyclically depressed levels of recent years. Even with pedestrian commodity price assumptions, our internal bottom-up estimates of fundamental earnings power envision a broad rebound in asset class profitability. As **EXHIBIT 2** shows, most EM sectors are expected to cyclically converge toward higher RoE, resulting in a cycle-neutral RoE closer to 14% than 13% for the asset class—which is simply near its long-term average. Reversion to a near 14% RoE would imply a healthy 13% compounded EPS growth rate over our five-year analyst forecast horizon, about half of which would be driven by the cyclical rebound from very depressed levels in the commodities sectors.

Finally, our analysis of earnings suggests that improvement in EPS momentum makes it more probable that the asset class will participate in the re-rating we've seen in other global equity markets. S&P 500 companies that were able to deliver solid earnings growth—in an environment of exceptionally low interest rates—were rewarded with higher equity multiples. EM companies could finally be positioned to receive a comparable re-rating of their stock prices.

Our analysts' bottom-up estimates of fundamental earning power envision a broad rebound in asset class profitability

EXHIBIT 2: EPS AND ROE FORECASTS, 1999–2015; ESTIMATES 2016–2021



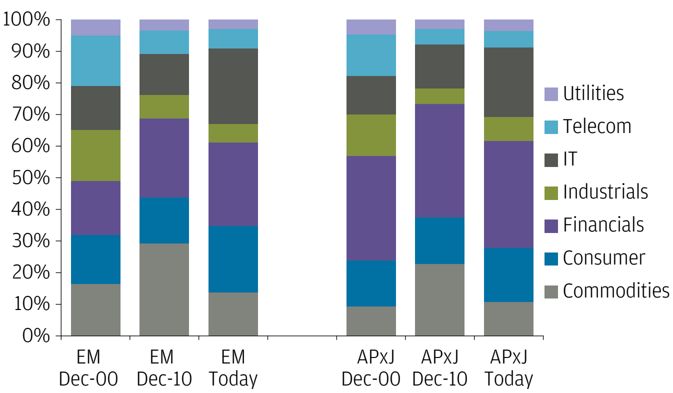
Source: J.P. Morgan Asset Management. For illustrative purposes only.

CHANGING COMPOSITION OF EM INDICES

At this juncture, we shift our perspective and consider the changed composition of the EM indices. To put it plainly: These are not your father's (or even your older sibling's) emerging markets. Fostered by broadened index inclusion rules from MSCI, the shift can be seen most clearly—but by no means exclusively—in China's equity market, where growth leadership has dramatically rotated from industrial "old economy" stocks to services-led "new economy" names like Alibaba, Tencent and JD.com. As new economy companies have reported better earnings, their stocks have re-rated, resulting in a sharp shift toward IT in the Chinese index. This rotation in sector mix is not limited to China—the same pattern can be seen in the broader EM and Asia Pacific ex-Japan indices (**EXHIBITS 3A** and **3B**).

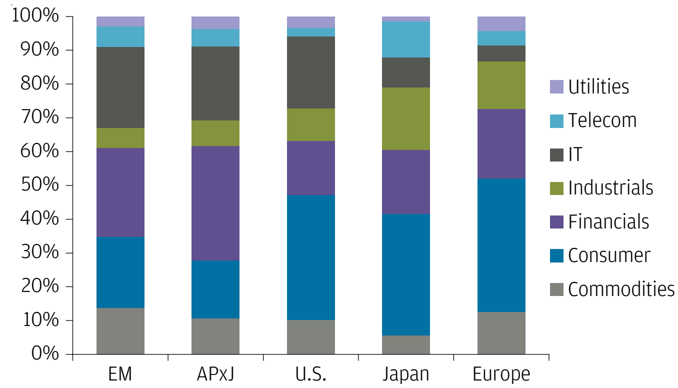
The emerging market and Asia Pacific indices are now more IT-oriented than other global equity indices, including the S&P 500

EXHIBIT 3A: BENCHMARK COMPOSITION BY SECTOR WEIGHT, EMAP INDICES



Source: J.P. Morgan Asset Management. For illustrative purposes only.

EXHIBIT 3B: BENCHMARK COMPOSITION BY SECTOR WEIGHT, GLOBAL INDICES



Source: J.P. Morgan Asset Management. For illustrative purposes only.

Most investors have been conditioned to think of emerging markets (and to a lesser degree Asia Pacific ex-Japan) as commodity-dominated economies and indices: Consider that the commodity sector in the MSCI EM index, which accounted for 15% to 20% of the index in 2000, surged to nearly 40% at its peak in 2007-08 and remained almost 30% of the index at the end of 2010. That share is now in the low teens, while the information technology sector has risen as it has broadened its composition from hardware companies to include software outsourcers and, more recently, consumer-oriented software firms. Indeed, the EM and APxJ indices not only have more new economy exposure than Japan's TOPIX and the Stoxx Europe 600, they also have slightly more exposure than the S&P 500.

CURRENCIES AND VALUATIONS: AN UPDATE

Finally, we turn to a broader consideration of what is happening within the emerging market asset class, beginning with currency. The U.S. dollar has been range-bound this year and is still roughly 10% expensive using our real effective exchange rate (REER) framework; we continue to believe slow policy normalization by the Federal Reserve should prevent a renewed bull market in the USD. As a whole, EMAP currencies remain moderately but not decisively cheap. We are monitoring volatility in the Mexican peso (MXP) as it has touched more meaningful undervaluation lows amid the U.S. election season, and note that China's renminbi (RMB) has drifted lower in a fashion that has been much quieter for risk assets than seen during 2015.

Among EMAP equity markets, we look, as always, for cheaper markets with positive trends. Both Russia and Korea offer attractive combinations of value and momentum, while the China market is divided between cheaper old economy stocks and richer but higher momentum new economy names. Although selected "reform markets" (India, Mexico, the Philippines, Indonesia) still appear expensive in local currency terms, we have tactically sought Mexican companies that would benefit from a rebound in the Mexican peso when that currency is hit by election fears. Elsewhere in Latin America, Brazil looks increasingly like a pure momentum play, as valuations do not appear compelling relative to the EMAP investment universe and the currency has fully recovered from early 2016 lows.

CONCLUSION

After a five-year period in which episodic EM equity rallies were short-circuited by ongoing growth and earnings deterioration, we are very encouraged by the more definitive turns that have unfolded over the past several months. While we acknowledge that our fundamental valuation metrics show that the asset class has moved off of cyclical lows, current valuation readings still remain below historical norms. We are accordingly more constructive on the asset class, given a balance of reasonable valuations and improving momentum rather than the imbalanced deep value but deteriorating momentum seen early this year. Put simply, the "triumvirate of headwinds" that plagued asset class performance from 2011 through 2015 (falling commodity prices, lackluster earnings and a rising U.S. dollar) has been stilled, and may be shifting toward modest tailwinds.

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