Emerging Market Equity Views

Favorable global cycle and USD outlooks create a positive environment

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IN BRIEF

- While tariffs remain a concern, the key issue for emerging market (EM) equities is the degree—which we deem moderate—of U.S. recession risk, given the late-cycle environment.
- The current global backdrop makes the U.S. dollar unlikely to strengthen, and that is one of the ideal preconditions for emerging market equities.
- Earnings growth expectations are modest, valuations are undemanding, and expected returns are above average: a positive picture.
- We see opportunities in relative value trades, some due to politically driven market fears and euphoria in Asia.

A STABLE-TO-POSITIVE OUTLOOK AMID MODERATE RECESSION RISK

As we assess the outlook for EM equities, we focus on where we are in the economic cycle. That's true every quarter, but perhaps we focus a little more keenly at this particular juncture. One macroeconomic question is key: How close is the U.S. to a recession? Our U.S. equity colleagues' assessment is that recession risk in the second half of the year is moderate. That's important not only for corporate earnings and risk appetite but for the direction of the U.S. dollar—and the USD, as always, is critical for emerging markets. Overall, our dashboard shows a range of stable-to-positive metrics (**EXHIBIT 1**).

Key issues for 2019

EXHIBIT 1: MACRO, GROWTH AND VALUATION

Issues	Ranges	2017	2018	1H 2019	2H 2019
Late cycle	U.S. recession indicator	Mid cycle	Late cycle	Late cycle	Late cycle: recession risk moderate
USD cycle (USD REER Index)	90 to 120 Current: 115	Falling	Rising	Stable	Stable
Emerging markets growth alpha	0% to 4% Current: 2%	Improving	Stable	Stable	Stable
Earnings	-20% to +25% 2019: +2%	Strong	Flat	Positive	Positive
Valuation: price-to-book	1x to 3x Current: 1.6%	Attractive	Average	Attractive	Below average
Research signal: expected return	9% to 19% Current: 14.5%	High	Low	High	Above average

Source: J.P. Morgan Asset Management, MSCI, Standard & Poor's. EM growth alpha: Consensus Economics; data as of May 15, 2019. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met. REER = real effective exchange rate. Ranges: last 20 years.

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NEGATIVE PRESSURE ON THE USD

A strong U.S. dollar is almost invariably a negative for EM equities. Fortunately, two scenarios associated with a strong dollar do not seem likely over a near-term horizon. One is a risk-off environment in which investors see the USD as a safe haven. While we do not see this as likely, resumption of the trade disputes between the U.S. and China has certainly made this scenario more possible. The other strong-dollar scenario is the U.S. economy growing faster than the global economy, as was the case in 2018, prompting greater demand for U.S. assets. We do not anticipate that scenario over the next half year.

We see U.S. growth returning to a more normalized trend, with growth in the rest of the world "catching up" to U.S. levels (**EXHIBIT 2**). That growth differential will put negative pressure on the USD, creating an ideal environment for EM equities. Furthermore, the Federal Reserve's recent dovish policy shift has turned what had been a headwind into a neutral, from an EM perspective.

GROWTH, EARNINGS AND VALUATIONS

We are further encouraged, after a very disappointing 2018, by modest EM earnings growth expectations. (The consensus puts them flat for the year; unusually, our analysts' forecasts are slightly higher.) Valuations are an undemanding 1.6x book value. Our internal five-year expected return signal anticipates 14.5% returns this year in USD terms, which would be just above the midpoint of EM equities' historical range—neither cheap nor expensive. In this environment, even single-digit earnings would beat expectations. Overall, we consider this a positive picture.

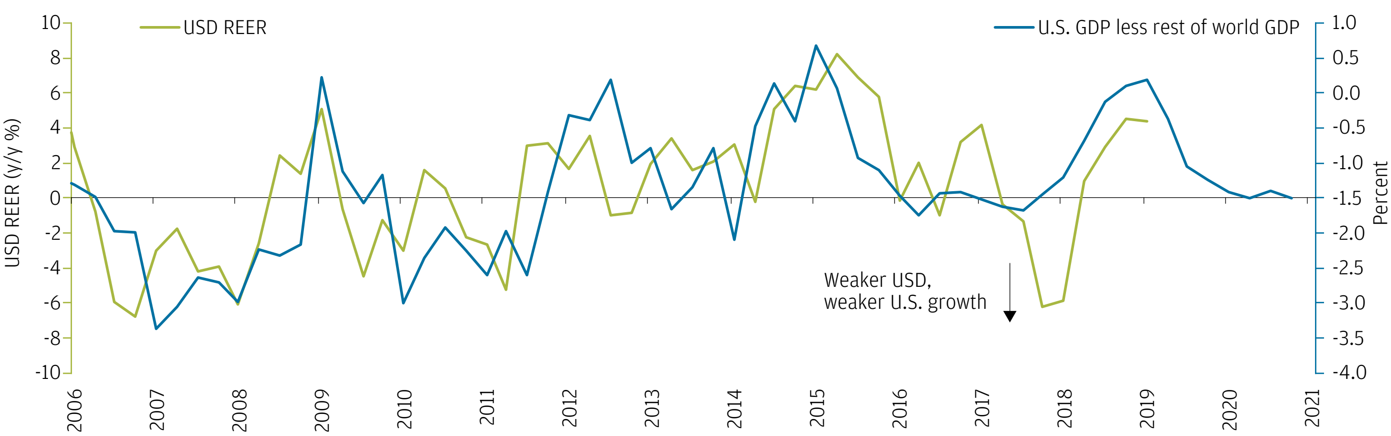
OPPORTUNITIES

So where do we see opportunities within emerging markets today? Financials and IT stocks have consistently been at the top of our research universe, and that continues to be reflected in our portfolios. At a country level, Korea has begun to look more attractive, as the market has sold off sharply in response to trade and weak macro indicators.

Overall, we see more stock-level opportunities than country-level ones, which is reflected in overweight positions in consumer discretionary (the large internet companies) and financials. Korean banks, Chinese insurance and Indian private sector banks look particularly attractive.

A move back to trend growth in the U.S. removes upward pressure on the U.S. dollar

EXHIBIT 2: EMERGING MARKET EQUITIES SUPPORTED BY RELATIVELY WEAKER USD

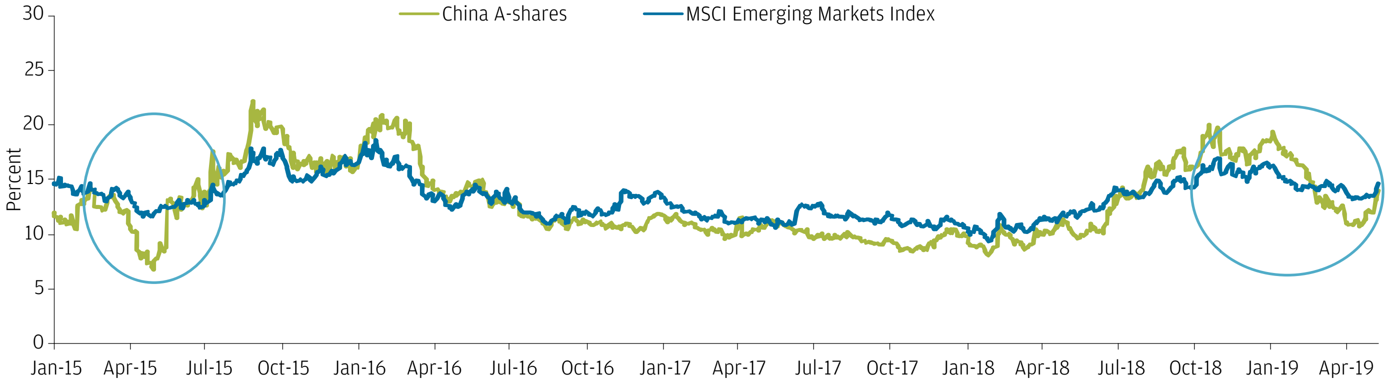


Source: Bloomberg, economic growth estimates from J.P. Morgan Securities, J.P. Morgan Asset Management; data as of April 30, 2019.

ACWI = All Country World Index. EMF= Emerging Markets Free Index. REER = real effective exchange rate. Past performance is not a reliable indicator of current and future results.

Where do we see the opportunity now?

EXHIBIT 3: EXPECTED RETURN FOR CHINA A-SHARES VS. MSCI EMERGING MARKETS



Source: J.P. Morgan Asset Management; data as of May 10, 2019. Forecast is not a reliable indicator of future results.

CHINA A-SHARES

Another politically driven standout opportunity in late 2018 was China A-shares, as investors feared the worst from trade wars and an economic slowdown. Our signals found the onshore market cheap last October, when our aggregate expected return was a quite bullish 19%, and our funds took the opportunity to add to their China equity holdings, including A-shares. China is still a focal point—unsurprisingly, given that it's the largest emerging equity market, accounting for one-third of all EM market capitalization. But as a consequence of China A-shares' outperformance to date (13% higher than the broad emerging markets index), that segment of Chinese equities looks slightly expensive vs. all EM regions (**EXHIBIT 3**). Still, we continue to find specific stock-picking opportunities and China A-shares remain an important part of our portfolio.

RELATIVE VALUE AMID VOLATILITY

With EM equities up nearly 10% this year, valuations are less attractive than when the year began. But if earnings continue to grow, EM equities can continue to perform. Politics in emerging markets are a constant risk, as we have just seen with the unexpected resumption of trade tensions between the U.S. and China. But more often than not, when a political discount emerges, much of the time it is a risk you are rewarded for taking. For investors with a disciplined process, volatility can often throw up investment opportunities.

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