On the Minds of Investors

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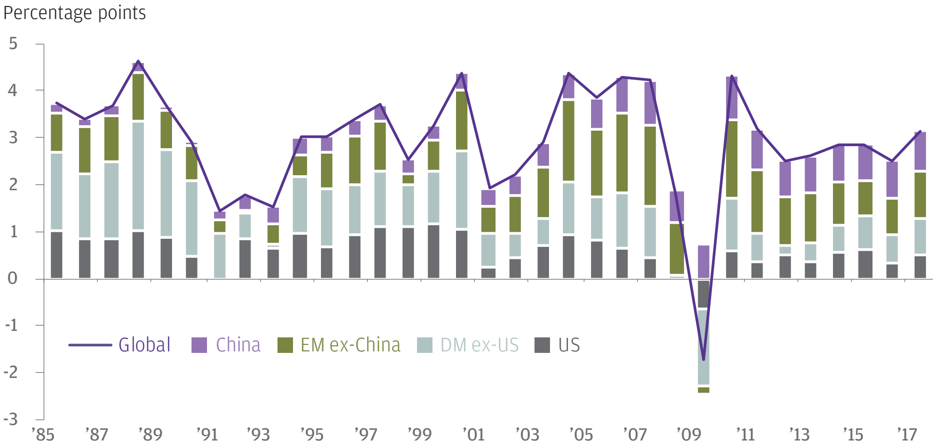
Are emerging market assets worth the volatility?

Emerging market stocks have had a rollercoaster ride in recent years. This is not unusual for an inherently volatile section of the global stock market. However, investors with longer time horizons shouldn't be deterred. As the economic engine shifts increasingly east and south, and capital markets develop in tandem, emerging markets would be expected to offer returns in excess of the developed world.

The global growth engine is shifting

With slowing population growth and declining productivity in the west, one might be tempted to think that the outlook for global growth and market returns is bleak. But a deeper look at the changes happening in emerging economies provides an alternative interpretation of the future. The emerging economies are doing a lot of the heavy lifting in delivering global growth these days (**Exhibit 1**).

EXHIBIT 1: CONTRIBUTION TO ANNUAL GLOBAL REAL GDP GROWTH



Source: Refinitiv Datastream, World Bank, J.P. Morgan Asset Management. Data as of 28 February 2019.

The stronger growth from emerging markets is not because populations are growing much more rapidly elsewhere. Parts of Asia face similar demographic challenges to countries in the developed world. Instead, they are growing because they are increasingly embracing the technologies of developed nations and, as a result, are experiencing a process of economic catch up to the levels of income experienced in the more advanced economies.

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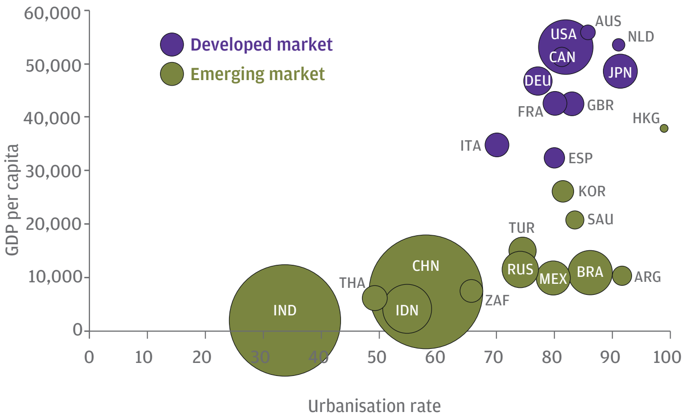
Exhibit 2 uses two measures – income per capita and the proportion of the population living in urban rather than rural areas – as a proxy to highlight how far various emerging economies have caught up. The size of the bubble represents the size of population. The large population behemoths – China and India – are still at a very low stage of development according to these metrics.

EXHIBIT 2: URBANISATION, REAL GDP PER CAPITA AND POPULATION SIZE

GDP per capita is in constant USD, urbanisation rate in %, bubble size is population



Source: World Bank, J.P. Morgan Asset Management. Urbanisation rate refers to the proportion of the total population living within an urban area defined by national statistical offices. Data as of 28 February 2019.

Not all emerging markets are created equal

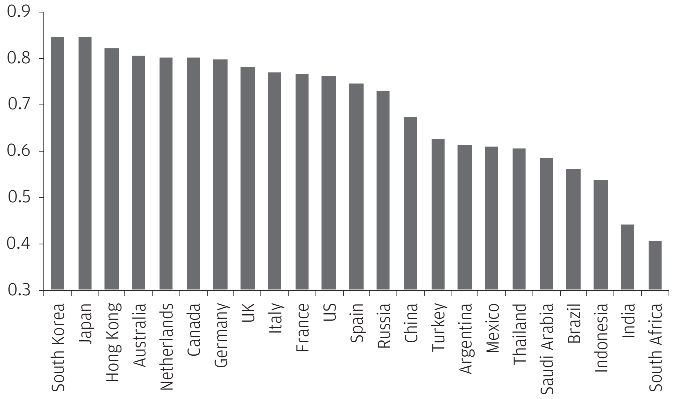
That is not to say all low income countries will necessarily catch up. Considerable parts of Africa have not managed to progress beyond very low incomes and many parts of Latin America have become stuck in a middle income trap.

When economies struggle it can often be attributed to either short-term, or structural, policy deficiencies. Over-borrowing by governments in international capital markets is a short-term policy error that has often resulted in capital outflows, currency depreciations and economic contractions. The experience of Turkey and Argentina in 2018 is a case in point.

Longer-term growth prospects are underpinned by deeper structural factors, such as whether legal and property rights spur or deter investment, and whether education systems are sufficient for workers to adapt to new technologies. The human capital index – compiled by the World Bank – provides some guidance on this latter question. China is now not far from western standards on this metric and yet real income per capita is just 14% of the US (see **Exhibits 3** and **4**).

EXHIBIT 3: HUMAN CAPITAL INDEX

Index level (0-1)

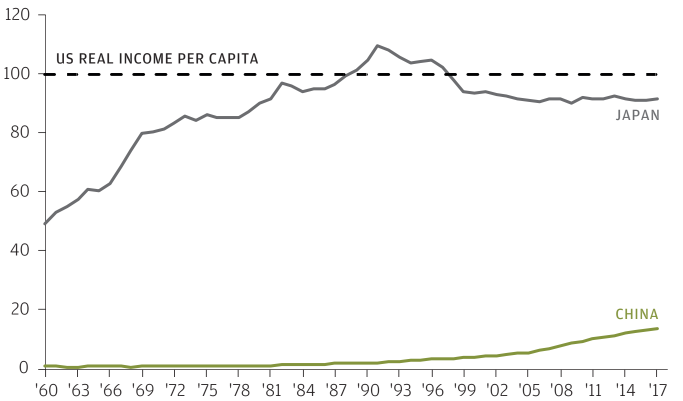


Source: World Bank, J.P. Morgan Asset Management. The Human Capital Index measures the amount of human capital that a child born today can expect to attain by age 18, given the risks of poor health and poor education. Data as of 28 February 2019.

When policymakers do manage to provide the right structural foundations the process of catch up can be swift. This was perhaps best seen in Japan through the 1960s and 1970s. But rapid growth cannot be sustained forever. The market wrongly expected fast growth to continue, resulting in a bubble in Japanese stocks and property prices. When Japan caught up with income per capita in the US in the early 1990s, growth slowed abruptly. The subsequent bursting of Japan's stock and property market bubble has had multi-decade consequences, but income per capita has actually grown broadly in line with the US ever since (see **Exhibit 4**).

EXHIBIT 4: REAL INCOME PER CAPITA COMPARISON WITH THE US

% of US real income per capita in constant USD

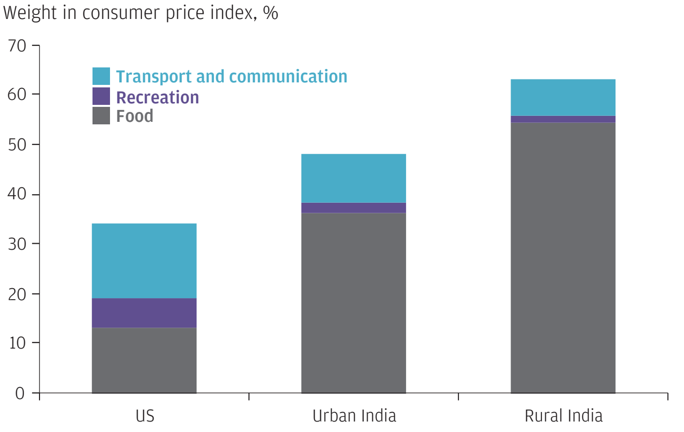


Source: World Bank, J.P. Morgan Asset Management. Data as of 28 February 2019.

As incomes rise spending patterns change

As economies develop and workers move to more sophisticated industries, income per capita rises—which in turn shifts spending patterns. At low incomes, households have to devote a lot of their income to basic goods and services, particularly food. People in rural India spend 55% of all income on food compared to 13% in the US (see **Exhibit 5**). As incomes rise spending on recreational goods and services, and travel and communication, increases. In short, there is more money to spend on having fun.

EXHIBIT 5: CATEGORY WEIGHTS IN CONSUMER PRICE INDEX



Source: National statistics offices, J.P. Morgan Asset Management.
Data as of 28 February 2019.

Rising middle classes and shifting consumer preferences provide new investment opportunities. Gone are the days when emerging market investing was merely about industrials and commodities. The story is now much more about millennial demand and rising e-commerce, and the increased demand for health care and financial services that comes with rising affluence.

This shift towards emerging market consumption is also good news for the global economy, since the US consumer no longer has the capacity to absorb global supply. Emerging market consumers and the demand they provide may help western economies manage the burden of ageing populations and high levels of government debt. To reap these benefits, western policymakers need to resist the recent populist surge towards nationalism.

What about Chinese debt?

Not all investors are convinced that the global engine is shifting on a sustainable basis. The rapid pace of growth in China in recent decades creates anxiety for those scarred by either the experience of Japan, or the broader Asian crisis in the late 1990s. The fact that debt has increased significantly in China also provides ample fodder for doomsayers. Household, corporate and government debt has increased to 250% of GDP from 140% in 2007. It is now approximately equal to the debt level of Italy.

But there are three key differences between the situation in China and the experience of the early Asian tigers.

First, in large part the debt has funded government spending. On the official statistics, the pickup in debt has registered on the corporate sector balance sheet, but the boundaries between sectors are much less distinct in China. Much of the debt has increased in state-owned enterprises and local government related entities that are not officially recognised as the government sector.

Second, the debt has been funded internally by Chinese savings and the Chinese financial system is still to a large degree closed from global markets. With the debt held domestically, Chinese borrowers are not vulnerable to the whim of international capital flows that proved so disruptive in the Asian crisis. Back then concerns about the ability of the Thai authorities to repay the country's debt spread rapidly to neighbouring countries whether they deserved it or not.

Third, as Exhibit 2 shows, the debt is likely to have funded worthwhile investment projects. China remains at a relatively early stage of development despite more than 20 years of rapid expansion. When one has been to either Shanghai or Beijing, it's hard to remember that China is still a low income emerging economy with relatively easy growth to come by as it develops its eastern regions. 16% of the population still works in agriculture compared to 2% in the US. 60% of the population lives in urban areas compared to 80% in the US. The growth in residential construction in China has to be seen in this context. The creation of towns and cities is all part of the long-term development plan, rather than a US-style subprime problem in the making. If the majority of the investment has gone to productive use then China will grow its way out of debt, much as someone early in their career pays off a sizeable mortgage they take on in their early years.

Finally, stock prices do not suggest that equity investors are overly optimistic about the future of the Chinese economy in the way that we saw with the early Asian tigers. In 1989 the Japanese stock market reached a price-to-book ratio of 4.3 times. By contrast the Shanghai stock index currently has a price-to-book ratio of 1.5 times.

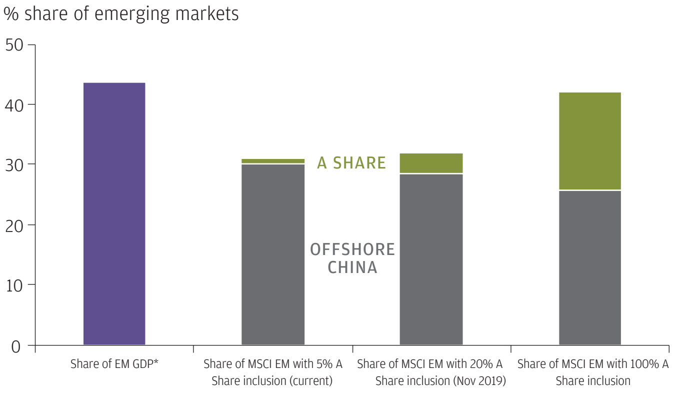
Emerging markets are for the long-term

Overall we see ample room for the emerging market economies to continue the process of catch up and to play an increasing role in driving global growth. To facilitate this ongoing expansion, the global capital markets need to evolve. It is worth noting that the global financial system has not evolved in tandem with the global economy. Emerging markets now account for 40% of global nominal GDP but only 12% of the MSCI All-Country World index.

Investors may in the past have preferred to access the emerging market growth story via developed world stocks that had significant emerging market exposure. Not least because better liquidity in these stocks reduced their volatility.

But the emerging market opportunity set is changing. One particular example is the rise of Chinese A Shares, where MSCI has recently announced an increase in the proportion of companies from the market to be included in the MSCI EM Index. It is expected that this will increase the weighting of the A Shares market in the headline EM index from 0.7% currently to over 3% by the end of the 2019. Nevertheless, this weighting remains well below the relative size of the Chinese economy among its emerging market peers and looks set to increase further.

EXHIBIT 6: WEIGHT OF CHINA IN EMERGING MARKETS



Source: MSCI, World Bank, J.P. Morgan Asset Management. *Share of EM GDP is for 2017 and is calculated as Chinese nominal GDP in USD as a percentage of all emerging markets in the MSCI EM index. 100% A Share inclusion is shown for illustrative purposes only. Data as of 28 February 2019.

Emerging market stocks will likely remain a more volatile section of the global stock market. Those that have a strong preference for assets whose prices slowly and steadily grind higher may not appreciate the additional volatility that emerging markets bring to a portfolio. If, however, investors have a long time horizon and can stomach the volatility, then emerging markets would be expected to pay returns well in excess of developed market equities in the coming decades.

Total annual returns in emerging market equities are expected to be close to 8% on average in the coming decade according to our *2019 Long-Term Capital Market Assumptions*. This compares to 5% in developed market equities.

For those able to lock up funds and stomach the potential volatility, emerging market stocks—and Asian stocks inparticular—may well make a strong addition to a portfolio, particularly given current valuations.

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