

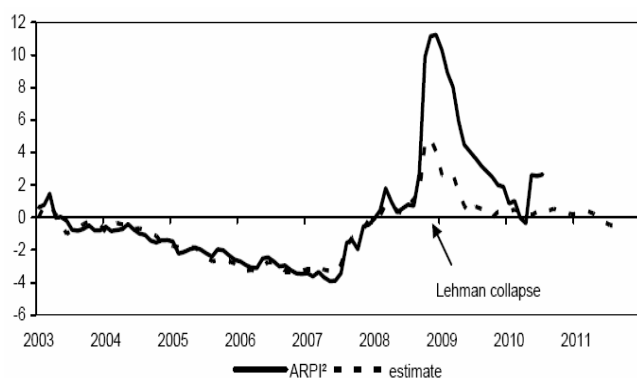
Market Focus – GEM – Well-supported by fundamentals

August 2010

GEM to see increased capital inflows in 2H 2010

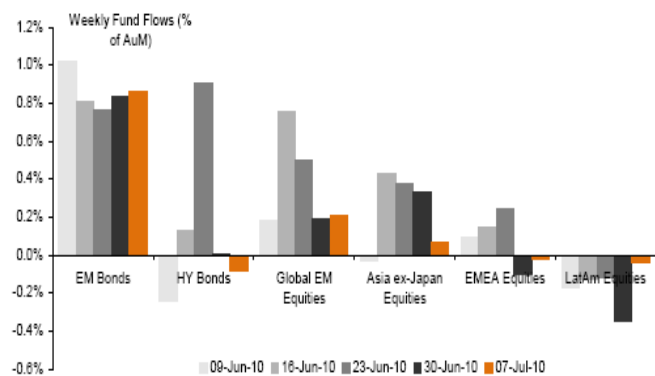
- ◆ Given the market turmoil and loss of global risk appetite in much of 1H 2010, we thought it useful to give you our thoughts on the outlook for Global Emerging Markets (GEM) in the second half of the year. Basically, they haven't really changed that much – we remain as positive towards the asset class now as we were in January, regardless of the strife in Europe and the weaker-than-expected US recovery.
- ◆ A soft landing in China remains key to a continuation of the GEM's superior fundamentals relative to OECD economies. Once a soft landing scenario for China becomes accepted by international investors, portfolio capital flows into GEM will return, with upward pressure on both currencies and equities. Problems posed by excessive capital inflows - potential asset price bubbles - could quickly reappear – a problem that most investors in GEM equities might not mind suffering.
- ◆ Global investors in 1H 2010 focused less on valuations and fundamentals and more on position squaring, risk reduction and when possible, profit taking. The latest bout of risk aversion (neatly illustrated in Chart 1 by Commerzbank's risk perception index) centred on concerns over sovereign solvency and excessive private sector credit in the peripheral Eurozone.
- ◆ It is highly unusual for investors to experience a public sector solvency crisis simultaneously in a number of developed markets. But that is the state of the world today. This latest bout of global risk aversion/contagion affected all asset markets at times in 1H 2010, with equities falling sharply, commodity prices correcting and Treasuries, Bunds and the US dollar (but not the euro) acting as the 'safe havens' of choice.
- ◆ Despite better fundamentals, the emerging markets could hardly expect to be spared. GEM equities followed the developed markets lower while EM bond spreads widened out to 350 bps by end-June from a year tight of 240bps. We think EM debt suffered mostly from a fear of illiquidity rather than sovereign debt or bank worries. Although they got off relatively lightly, EM spreads in our view still expanded by more than fundamentals warranted.
- ◆ FX rates also reacted quickly to increased risk aversion, with most GEM currencies falling towards their lows of the year by end-June. This was not unexpected as generally FX is more liquid and investors can use FX to hedge out their exposure. EM bonds have sold off with yields off their lows, but are still in the middle of their range YTD.

Aggregate Risk Perception Index



Source: Commerzbank, Economic Briefing, 6 July 2010.

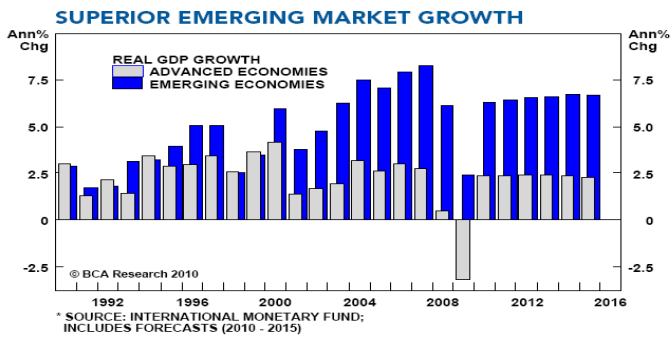
Positive GEM weekly inflows in June



Source: Commerzbank EM Supply/Demand 9 July 2010.

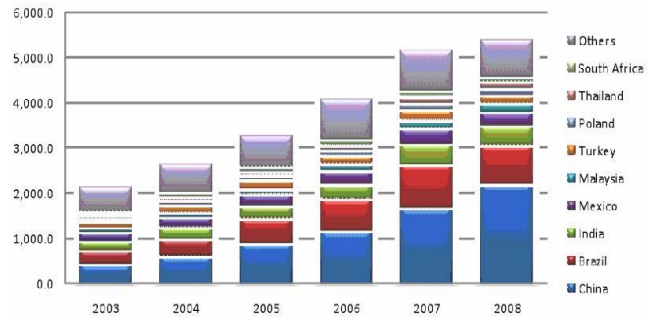
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Superior GEM growth



Source : BCA Research, IMF May 2010.

Deeper, more liquid EM debt markets



Source: I Dalla & H Hesse, VOX 13 October 2009.

A more favorable environment for GEM

- ◆ We believe that the fear and generalised global risk aversion that prevailed in 1H 2010 will soon start to subside – indeed there are already some signs that this may be starting to happen. International equity investors in coming months will begin to refocus more on the fundamentals of the markets they invest into.
- ◆ GEM countries possess undeniably stronger expected growth rates than the OECD economies and on average are expected to grow by over 5% in 2010, over 6% in 2011. Developed market countries should show positive growth this year, but we expect growth will be sluggish for the foreseeable future as governments attempt to deal with large fiscal deficits and bring public debt burdens under control.
- ◆ GEM countries also have sounder public sector financial positions, with general government borrowing requirements on average only 3% of GDP, compared to the developed G20 where the average is closer to 8% of GDP. Public debt to GDP levels are also significantly lower in GEM at around 40%, compared to developed G20 closer to 100%.
- ◆ Moreover, since 2007/08 we would argue that there has been an improvement in the perception of GEM financial institutions by investors that is likely to persist. GEM central banks were also considered by many western investors as lagging behind those in developed countries in terms of their operational efficiency, sophistication and transparency.
- ◆ But they have exited the crisis in far better shape than their advanced G20 counterparts. Perhaps less sophisticated financial markets is actually an advantage in the current environment!

Conclusion

- ◆ Over the next two to three years the GEMs' relatively low credit-to-GDP ratios should shield them from the deleveraging pressures that are now becoming a growing headwind for the developed economies. This will help the emerging market countries to sustain their economic outperformance versus their OECD/G7 peers. The higher economic growth in emerging markets will likely translate into both superior earnings growth and increased capital flows from G7 investors.
- ◆ While it is true that valuations of GEM and developed market equities have converged since 2007, this re-rating is supported by a persistent improvement in relative fundamentals. In our view, we expect emerging market equities to be able to sustain their outperformance provided only that higher real GDP growth translates into higher EPS growth.
- ◆ Current index weightings could well prove to be a very misleading guide to future potential for the GEM asset class. More and more, G7 investors may come to regard themselves as being structurally underweight a 'growth-weighted' MSCI global index. Under an optimistic scenario, EPS growth plus capital flows become twin drivers for GEM PE ratios.