While not immune to the global financial crisis, emerging markets (EM) have recovered faster and shown greater resiliency than many developed economies over the past year. Strong fundamentals, sound policymaking, lower solvency risk and a broadening investor base have all helped consolidate the asset class.

We believe emerging markets will gain a greater strategic role and weight in global asset allocations over the coming quarters as investors look for sources of excess return. Furthermore, we believe investors should target EM local and credit exposure to achieve better EM diversification and higher return.

Emerging Markets Driving Global Growth

2009 will likely be remembered as the year that emerging markets drove global growth. Over the course of the year, these economies contributed more than 2% to global GDP, while growth in advanced nations declined (see Exhibit 1). The importance of emerging economies to global growth was also clearly acknowledged by the G-20 and the IMF during the year, with strong international financial support extended to these markets to ensure liquidity.

With many emerging markets now fundamentally on more solid footing than their developed counterparts, growth in these economies is expected to outpace the developed world in the years ahead. We believe this is perhaps the single most important factor consolidating emerging markets as an asset class.

Exhibit 1: Contribution to Global GDP Growth, 2000-2014

Source: IMF World Economic Outlook 2009.
Note: Data for 2009-2014 are forecasts. Forecasts are based on current market conditions and are subject to change without notice.
The process of rebalancing—with net savers (emerging markets) consuming more and net debtors (developed countries) deleveraging—should also benefit the domestic capital markets of emerging economies and help improve the depth and liquidity of their respective local and corporate markets. Furthermore, cleaner balance sheets and better growth prospects should foster currency appreciation and facilitate domestic real rate compression to developed market levels. Strong growth, stable commodity prices, and higher inflows should keep EM currencies well supported over the medium term.

Demographics should also favor emerging economies in the coming years. Unlike developed nations, emerging economies are not constrained by rising costs associated with an ageing population. In Mexico, for example, a large portion of its population will reach the peak earning and spending phase (mid-40s) in the next decade. We believe these favorable demographics will act as an important catalyst for i) higher and sustained domestic demand, ii) continued accumulation of pension fund assets and iii) strong productivity trends. All of these factors are beneficial to the development and growth of capital markets, corporate bond issuance, and increasing appetite for local currency bond markets.

**Sound Policymaking Fostering Stability**

Over the past decade, and as a result of a series of self-inflicted crises, emerging economies have gained significant experience in developing macroeconomic policies that combat tumultuous market conditions (Exhibit 2). Policymaking in these countries has evolved, with fiscal responsibility becoming an important anchor, central banks gaining significant credibility, and exchange rates becoming highly flexible. The fact that most emerging economies were able to apply counter-cyclical policies during the most recent global financial crisis shows sound policymaking and judgment.

Emerging economies have experienced remarkable and lasting improvements in macroeconomic fundamentals over the past 10 years. Macroeconomic stability and pragmatic policies have put emerging markets in a much stronger position to withstand a long period of de-leveraging and low global growth. EM government debt/GDP has dropped below 40% (from the mid-50s a decade ago), primary surpluses have moved from roughly flat to about 2% of GDP, and interest rate expenditures have shrunk 2 points of GDP to about 2.5%. Even the often times loose Latin America has saved a substantial portion of the commodities bonanza to post a historic reduction in external debt ratios, and reserves have skyrocketed.

Perhaps more importantly, fiscal and monetary reforms have strengthened monetary targets and fiscal responsibility, paving the way not only for regional convergence but also convergence to orthodox policies. Well anchored inflation, reduced FX risk, improved fiscal institutions, and more solid grounds for growth should support the continued development of this asset class. In addition, tighter foreign credit conditions should elevate the importance of local sources of funding.

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**Exhibit 2: EMD Spreads and Credit Ratings Throughout Various Crises**

Source: J.P. Morgan Asset Management.

Note: The J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) is representative of the sovereign debt market.
Monetary policy
A decade ago, monetary policy in most emerging economies was focused on maintaining some type of exchange rate peg. The exact nature of these regimes varied. Many Asian economies tended to peg their exchange rates tightly to the dollar to promote a stable environment for exporters. Other countries used a fixed exchange rate as an anchor to lower inflation rapidly. And, some used crawling pegs to steady the real exchange rate when domestic inflation was well above industrial-country levels. All of these pegs are thought to have contributed to the financial crises that hit emerging economies over the past 10 years by contributing to overvaluation, vulnerability related to swings in capital flows and increased exchange rate risk.

Today, central banks in most major emerging economies do not explicitly target exchange rates. Instead, their stated objective is to achieve and sustain low inflation against a backdrop of reasonable GDP growth. In fact, many have now formally adopted a version of inflation targeting and abandoned exchange rate commitments altogether.

These monetary policy changes have increased economic stability in the emerging economies. Inflation has moderated and its volatility has declined. Lower and more stable inflation has facilitated the deepening and broadening of domestic financial markets, helping to reduce reliance on external financing and to lower the potential for instability.

This policy shift has also reduced vulnerability in other ways. Along with more effective supervision and regulation, the move away from currency pegs has reduced the buildup of currency exposures on domestic balance sheets. Larger foreign exchange reserves give policymakers more options in responding to adverse market conditions like those in 2008 and 2009.

Perhaps most importantly, exchange rates are simply at more sustainable levels. This improvement strengthens current accounts: most emerging economies should generate a surplus next year, with about one-third likely to produce surpluses in excess of 4% of GDP. Surpluses also make these economies less vulnerable to a reversal of capital flows.

Overall, the breaking of currency pegs, both fixed and managed, has left the local currency markets less vulnerable than before to shocks that could reduce returns sharply and lead to contagion. Floating currencies ensure that central banks are not forced to raise rates excessively to preserve reserves and allow the exchange rate works as a safety valve.

Fiscal policy
Like developed economies, emerging markets will become marginally more indebted in the years ahead (with eastern Europe significantly more indebted). Despite these short term increases, however, debt ratios over the past few years have been improving gradually, signaling significantly stronger fiscal performance (see Exhibit 3). Governments have shown that they are willing to raise fiscal performance amid market stress and political frictions, helping to steady investor expectations and limit interest rate increases under adverse circumstances.

The changing composition of public debt is important. Increasingly, debt issued in domestic markets is being denominated in domestic currencies. In fact, local currency debt accounts for roughly 80% of the total debt issued within emerging economies. Going forward, we expect this trend will continue, as emerging economies issue local currency debt to, among other things, satisfy the growing needs of local and international pension funds.

The cost of servicing debt is also a key factor affecting fiscal performance. For many countries, local currency real interest rates are the primary driver of debt service. Keeping these rates low is crucial to ensuring fiscal sustainability. In some cases, such as Turkey and Brazil, however, the legacy of past inflation keeps real interest rates high.
Encouragingly the liability management/financing strategies being employed by emerging economies bode well for the development of local markets. In many countries, authorities are taking advantage of local liquidity and the growing local investor base to extend the yield curve. Given the need to extend duration, we think this strategy will continue.

Local Currency and Corporate Markets Surging

Emerging markets debt can be divided into three key segments: sovereign (external) debt, local debt and corporate debt. During 2009, sovereign debt, the most well established and mature segment of the market, experienced a strong rebound in spreads. This rebound was the result of increased external demand, most likely triggered by solid fundamentals. Local debt, meanwhile, was the fastest growing segment of the year, benefiting from a surge in local currency issuance by EM corporates. In terms of market capitalization, local debt has grown to more than three times the size of the sovereign market (see Exhibits 4, 5A and 5B). Looking ahead, we expect this growth trend to continue, even though 2009 and 2010 external sovereign issuance will likely increase as compared to recent years (net external issuance was negative up until last year).
Several emerging countries have made notable progress in developing their domestic bond markets in recent years (Exhibit 6). Diversification and growth of the corporate bond market, in particular, has been crucial in meeting the funding requirements of the corporate sector, which had its access to international financial markets curtailed during the recent financial crisis.

According to IMF 2009 estimates, the refinancing needs of emerging market corporations and banks for their foreign-currency-denominated bonds and syndicated loans totals around $400 billion over the next two years. The development of the domestic corporate bond market has, therefore, been important to reducing future possible rollover risks in foreign currency bonds.

Emerging economies face several hurdles that advanced countries generally do not when developing corporate bond markets: small issue size, lack of a market-based yield curve, inadequate disclosure of accounting information, and weakness in corporate governance. Those obstacles aside, Malaysia, Thailand, Chile, South Africa, and China have been relatively successful to date in building deep corporate bond markets in terms of percentage of GDP.

Interestingly, Asia has up until now been the dominant regional player in the development of both local currency and corporate markets, showing deeper and more developed capital markets relative to other regions. The Middle East, through petrodollar recycling, ample liquidity, and fast domestic economic growth, has also experienced rapid expansion in the corporate market space, as has Europe. Latin America, meanwhile, has been the laggard (in terms of growth), particularly in corporates. Going forward, we expect this trend to reverse with Eastern Europe and the Middle East likely to go through a prolonged de-leveraging process over the medium term. That said, commodity prices should benefit both the Middle East and Latin America over the longer term.

### Domestic Investors Supporting Local Markets

To date, domestic institutional investors (pension funds, insurance companies, and mutual funds) have been the largest participants in local currency bond markets. In fact, high-quality government bonds have become the investment of choice for these investors, following volatility in emerging equity markets after 1997. Retail investors have also been attracted to the local currency bond markets as they seek relatively safe instruments with higher yields than bank deposits.

Domestic institutional investors play a key role in bond market development. These investors have a stable investment horizon and buy-and-hold behavior that can contribute to the financial stability of domestic financial markets. Moreover, they can maintain their asset allocations during market downturns, providing a buffer against volatile capital flows. The existence of a domestic institutional investor base also attracts foreign investors to domestic markets as these locals can provide foreigners with a put option if they wish to exit the market.

Assets managed by institutional investors in emerging markets have grown in recent years as the result of several factors: the excess of national savings over national investment (particularly...
in several East Asian countries), pension reforms (in Brazil, Chile, Mexico, and Thailand, for example), rapid growth of the insurance industry (in China and Thailand, for example), and expansion of collective investment schemes in most major emerging markets. Exhibit 7 shows that the size of pension fund assets as a percentage of GDP is significant in many countries. Substantial pension asset growth potential can also be found in China, India, Russia, and Thailand. As pension funds in these countries expand due to favorable working-class demographics, so should the demand for local currency and corporate bonds.

Exhibit 7: Pension assets as % of GDP

Source: OECD.

Foreign Investment Set to Increase

Going forward, we expect foreign pension funds to be a significant player in local markets and EM corporates. While foreign penetration to date has been small, it represents a major river of funds for the future.1

According to OECD data, autonomous pension funds globally have assets under management of US$16.9 trillion. This represents a 70% increase from 2002, or a US$6.8 trillion increase in absolute terms. Despite the size of this market, the actual holdings of pension funds in emerging markets fixed income and equities remains at negligible levels. According to the annual Pensions & Investments plan sponsor survey, the total allocation to emerging market instruments by the top 200 defined benefit pension funds in the United States stood at US$96.8 billion (as of 2008). When compared with total assets under management (US$4.4 trillion), the allocation to emerging markets stands at just 2.2% of the total. Of those defined benefit funds that have any allocation to emerging markets, the average investment in EM equities is 3.1% and EM debt is just 0.4%.

EM as a Source of Return

Strikingly, EM sovereign debt appears to have been one of the best risk-adjusted asset classes in the fixed income space over the 2002–2009 time period (see Exhibit 8). Going forward, we expect local markets and perhaps more likely EM corporate debt to gain this position on the efficient frontier (based on a 5-year to 7-year time horizon).

Since 2002, emerging markets have generated significant returns. While past performance does not necessarily reflect future behavior, over the past eight years emerging markets have performed strongly in comparison to the S&P 500, high yield, Treasuries and investment grade corporate debt (see Exhibit 9).

1 A significant portion of such foreign inflows to local markets includes petrodollar recycling, Japanese savings, Asian FX reserves, and to a lesser extent U.S. pension funds.

Note: Index data used to reflect asset class returns and volatility. The J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) is representative of the sovereign debt market. The J.P. Morgan Government Bond Index—Emerging Markets (GBI-EM) is representative of the local currency market. The J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) is representative of the corporate debt market. The J.P. Morgan Emerging Local Markets Index Plus (ELMI+) is representative of local-currency-denominated instruments. The J. P. Morgan Global Government Bond Index (GBI Global) is representative of developed government bond markets. The J.P. Morgan High Yield Index is representative of the high yield market. The S&P 500 is representative of the large-cap equity market. The MSCI Emerging Markets Free Index (EM Free) is representative of the emerging equity market. The J.P. Morgan US Liquid Index (JULI) is representative of the investment grade corporate bond market.
EXHIBIT 9: ANNUALIZED RETURNS AND VOLATILITY FOR VARIOUS ASSET CLASSES, 2002-2009

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<td>0.50</td>
<td>-0.12</td>
<td>0.52</td>
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Source: J.P. Morgan Asset Management.

Note: 2009 data as of September 30, 2009. See Exhibit 8 for index descriptions.

Projections for the Future

Emerging markets have experienced significant (and long lasting) improvements in fundamentals and policymaking over the past decade. The fact that roughly 50% of the investment universe is now rated investment grade is positive recognition of the progress made.

In the years ahead, growth in these economies is expected to outpace the developed world. Our conservative estimates put market capitalization at over $12 billion by 2020, or 30% of GDP (see Exhibit 10a and 10b). The actual level will most likely be higher, however, as these projections do not take into consideration currency appreciation and are far below developed market ratios.

EXHIBIT 10A: MARKET CAPITALIZATION PROJECTIONS (US$ MILLION)

Source: J.P. Morgan Asset Management.

Note: 2009 data as of September 30, 2009. Data for 2014 and 2020 are forecasts. Forecasts are based on current market conditions and are subject to change without notice. The J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) is representative of the local currency market. The J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) is representative of the sovereign debt market. The J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) is representative of the corporate debt market.

EXHIBIT 10B: MARKET CAPITALIZATION PROJECTIONS (% OF EM GDP)

Source: J.P. Morgan Asset Management.
To date, sovereign debt has been the main market segment to benefit from improved market conditions. Going forward, we expect emerging markets to continue consolidating as an asset class, and see investors moving toward local and EM corporate markets as sovereign markets mature. While global deleveraging may have dented the pace of development in the emerging economies, we believe the opportunities in this asset class remain substantial.

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