Market Overview

Equity

Continued concerns over a slowdown in the global economy coupled with further protectionist trade rhetoric and tariff increases slowed returns in emerging markets in the second quarter of 2019. The MSCI Emerging Markets Index rose by 0.6%, as measured in US dollar terms, over the quarter as Asian markets considerably underperformed stocks in Latin America and Eastern Europe. Year to date, the index has gained 10.6%.

Returns in China, Korea, and Taiwan were all negatively impacted by US President Trump’s new onslaught of protectionist comments and tariff increases against China. Performance in Indonesia and Thailand continued to be strong, aided by robust economic growth. Indian equity prices were helped by Prime Minister Modi’s re-election.

Performance across Latin America was also mixed. Mexican share prices were hit by US President Trump’s threat to apply tariffs if greater efforts were not made by Mexican authorities to discourage Central American immigrants from reaching the United States through Mexico. Ultimately, an agreement was made which seemingly solved this issue. Brazilian stocks performed well amid positive trends for pension reform. Elsewhere, volatile commodity prices caused weaker markets in Chile, Colombia, and Peru.

Most markets in Eastern Europe, the Middle East, and Africa finished higher over the quarter. Hungarian equities fell, partially due to its rejection of the European Union’s attempt to harmonise tax rules. The election of Cyril Ramaphosa as South African President was viewed positively, although the possibility of a sovereign debt downgrade remains. The initial results and then re-run of the Istanbul mayoral election, won with an increased majority by the opposition CHP party, was perceived as a victory for Turkish democracy. Egyptian stocks continued to rally on declines in interest rates.

From a sector perspective, health care and communication services performed poorly, while financials and consumer staples stocks were the best performers.

Debt

Like emerging markets equities, emerging markets debt has delivered outsized year-to-date returns (almost 10%), but the current environment is challenging global investors with divergent crosscurrents. On the one hand, many financial markets are trading near record highs, but on the other, leading economic indicators of growth are at or near historically contractionary levels. Capital spending and business confidence is falling rapidly, but global consumers (especially in the United States) have shown remarkable strength and endurance. We have a slightly different outlook than our equity teams, and we see three possible pathways for the global economy going forward. We detail each one below, along with our best estimates on probabilities and theories on how various parts of emerging markets debt perform in each outcome.

Path 1: Global growth slowdown that is met with extraordinary measures from central banks (Base Case: 60% probability)

Since the end of the financial crisis, the US economy has experienced three multi-quarter growth slowdowns (2011, 2012, 2015–2016). In each of these periods, quarterly growth fell from an approximately 3% level to approximately 1% over the span of 3–4 quarters. At the same time, US Treasury yields were the proverbial canary in the coal mine, falling 100 to 200 basis points (bps) in anticipation of significant monetary easing. In addition, risk market valuations compressed, with equity market corrections and emerging markets currency depreciation alongside US dollar strength. In each case, the selling abated when the Federal Reserve delivered an extraordinary response in the form of Operation Twist (2011), Extension of Operation Twist (2012), and a 12-month rate hike pause (2015–2016).

Similar to those times, our base case is that the United States will experience a significant quarterly growth decline from 3.1% in the first quarter of 2019 to less than 2.0% in the second quarter, and likely a growth rate of 1.0%–1.9% in the second half of the year due to prolonged worries regarding global trade. While capital spending has already declined, it will be important to track the resilience of US consumer spending into the second half of the year to determine how extended and deep an impending slowdown will be. In this type of scenario, we expect marginal US dollar strength, high yield spread widening, emerging markets currency weakness, and equity markets to correct. Based on prior corrections, a typical mark-to-market move would be roughly mid-single digit losses for the blended emerging markets debt index.

Because this is our base case, we have moved over the last two months to significantly reduce beta risk across our portfolios and reallocate to investment grade US Treasury–sensitive securities. We plan to maintain this position until two developments occur:
First, markets correct enough that we believe investors are, once again, adequately compensated to take risk in emerging markets debt. Thus, should the market move back to early 2019 valuation levels, we would look to re-risk our portfolios.

Second, global central banks implement appropriate policy responses. The market is already pushing the Fed and European Central Bank (ECB) in that direction, as we discussed above, with rate cuts having been priced into forward curves. However, we believe it is more important to markets that monetary easing is not simply “precautionary” or a “one-off event” but that both the Fed and ECB are willing to telegraph more permanent easing of liquidity conditions. Thus, to the extent that the Fed moves to a forceful dovish outlook and reveals a cycle of rate cuts at one of its fourth quarter meetings, that could be a credible enough response to move markets back to positive territory. Note that there are four Fed meetings remaining in 2019 and six in 2020 before the US presidential election, which should be more than enough opportunity for the Fed to get ahead of a potential growth slowdown.

Path 2: Out-of-consensus reversal of global trade tensions through a legitimate US–China deal (15% probability)

Over the last three years, we have learned the unpredictability of polls, the failure of economies to hit growth escape velocity, and policy changes that are announced via tweet. As such, while it does not make logical sense for the United States and China to reach a meaningful and sustainable trade deal ahead of the US elections, goalposts can certainly be moved by either side and markets can react to headlines instead of substance. Further, the market may be underestimating the resilience of the US consumer and its ability to power through reversions to the mean in growth. In this scenario, global central banks will have overreacted by cutting rates, thus providing a jolt of stimulus into late-cycle economies. Equity and emerging markets currency markets would likely significantly rally, while safe-haven securities such as US Treasuries would re-steepen to more normalised levels. This would also be an environment where non-investment grade spreads could tighten considerably through fair value levels to post-financial-crisis tights. It should be noted that our portfolios are not positioned for this scenario, as we have very limited exposure to FX and high yield and much more exposure to US dollar investment grade bonds.

Path 3: Global slowdown that uneartths other tail risk vulnerabilities and morphs into a recession (25% probability)

The final scenario is one in which the longest-running economic expansion in US history comes to an end. If that were to happen, history books would likely deem the two causes to have been unnecessary rate hikes by the Fed in 2018 and a trade war, started by President Trump, in an integrated global economy. Essentially, this would be the scenario where Trump’s tariffs backfire and harm the US economy. As has been well researched and documented by economists, investors should focus on the bond market to help predict if this scenario is about to occur. Currently, the bond market is flashing severe caution with parts of the US yield curve already inverted. It should be noted, however, that the traditional measure of curve inversion (2y to 10y) is still positively sloped, albeit barely. Other warning signs for investors are flagging energy demand (March and April oil demand were the lowest in years) and high yield spread movement (still trading close to yearly tights).

Recessions are normal events in even the best-run global economies, as cycles wax and wane. They tend to revert valuations to generation-marking lows, opening up significant opportunities to realise outsized gains. While no investor looks forward to these events, we are highly confident that an event like this would begin a multi-year cycle of emerging markets outperformance. For, unlike previous global economic downturns, emerging markets would enter the next one already in a valuation recession. Emerging markets currencies have been in a bear market since 2011 and emerging markets equities trade at significant discounts to their developed markets peers. In short, emerging markets are cheap and emerging markets would enter the next recession already in a valuation recession. Emerging markets currencies have been in a bear market since 2011 and emerging markets equities trade at significant discounts to their developed markets peers. In short, emerging markets are cheap and emerging markets debt entry points by year end. As such, we have positioned portfolios to lock in the first half of 2019’s high absolute and relative performance so that we can increase firepower to be able to deploy again.

Lazard Emerging Markets Equity

The Lazard Emerging Markets Equity team follows a bottom-up, fundamental approach to investing which focuses on identifying financially productive companies, defined as those companies with high and stable returns on equity, trading at relatively attractive valuations.

After posting significant gains in the first half of 2019, emerging markets continue to trade at discounts of about 23% compared to developed markets (as represented by the MSCI World Index), near their historic averages. However, in our view, valuations still reflect a high level of investor uncertainty, and we believe positive data, a favourable trend, or a resolution to trade negotiations could buoy sentiment and further lift indices.

We believe this relatively wide discount offers long-term investors a particularly attractive entry point to gain exposure to industry-leading companies with potentially a greater economic growth premium over the slowing developed world. Emerging markets equities also offer attractive free-cash-flow yields (5.5% versus 4.7% in developed markets and 4.6% in the United States) and opportunities to pick up dividends—the MSCI Emerging Markets Index dividend yield is about 2.7% compared to 1.8% for the S&P 500 Index. If we experience an increase in developed markets capital expenditure, after very little in the last decade, emerging markets companies should be significant beneficiaries.

Over the period, we purchased BPCL, an Indian oil refining and marketing company, China Merchants Bank, a Chinese bank, and UPL, an Indian manufacturer of agrochemicals.
Lazard Developing Markets Equity

The Lazard Developing Markets Equity team seeks companies that are able to grow earnings on a sustainable basis, whether due to favourable competitive positions, strong management, or other reasons—and particularly during times when competitors are struggling.

Despite the decline in the International Monetary Fund’s global economic forecast, it is critical to note that the developing world increasingly drives the majority of global growth and that the economic growth premium over developed markets is projected to re-widen in emerging markets’ favour this year. Emerging markets EPS growth is expected to be in line with US EPS growth in 2019 and exceed it in 2020.

Recent gains in emerging markets equities have left many investors wondering what will drive returns going forward. Investors continue to face a number of uncertainties, but we believe the potential negative effects from these uncertainties are mostly priced into markets. The positive effects that would come from their resolution, on the other hand, are mostly not.

Emerging markets equity valuations continue to be attractive compared to developed markets equities, and that should attract investors seeking higher relative growth prospects. The developing world increasingly drives the majority of global growth and the economic growth premium over developed markets is projected to re-widen in emerging markets’ favour this year. Emerging markets EPS growth is expected to be in line with US EPS growth in 2019 and exceed it in 2020.

Finally, we believe the long-term emerging markets “story” remains valid. We continue to believe that, regardless of higher volatility and relatively short-term changes in investor confidence, the overall trends in emerging markets—higher growth potential, stabilising institutions, a rising middle class of consumers—are positive. In fact, the gap between emerging and US economic growth is expected to widen again after shrinking for two years. This is likely as stimulus efforts drive growth in China, which has become an engine of the global economy. More important for equities, we believe emerging markets are poised to deliver stronger earnings than in the United States.

During the quarter, we initiated new positions in Focused Photonics, a Chinese provider of environmental protection equipment; Sunway Communication, a Chinese electronic components manufacturer; Wonik IPS, a Korean semiconductor equipment manufacturer; Zhongsheng, a Chinese auto dealership; SJM, a Macau casino operation; Stone, a Brazilian online payment platform; Rumo, a Brazilian railroad operator; Semir Garment, a Chinese apparel maker; and CTRIP, a Chinese online travel service operator.

We sold our positions in CVC, a Brazilian travel service operator; Hikvision, a Chinese surveillance company; Hiwin, a Taiwanese manufacturer of linear motion control products; BR Distribuidora, a fuel distribution operator in Brazil; Sunway Communication, a Chinese electronic components manufacturer; and Baidu, a Chinese internet search company.

Lazard Emerging Markets Debt

The Lazard Emerging Markets Debt team seeks to capture the full emerging markets fixed income opportunity set through hard currency local debt investments, with an emphasis on liquid assets to maintain high flexibility.

The 50% J.P. Morgan EMBI Global Diversified/50% J.P. Morgan GBI-EM Global Diversified returned more than 6.0% (as measured in AUD terms) in the second quarter, bringing the index’s year-to-date return to more than 10%. Hard currency debt returned 5.4% in the second quarter, driven mainly by the rally in US Treasury yields, which fell to multi-year lows across the curve on weaker-than-expected growth data, a re-escalation of global trade tensions, and comments from the Fed that hinted towards rate cuts in the second half of the year.

The yield on the 10-year US Treasury rallied 40 bps in the second quarter and was around 2% in early July—the lowest level since November 2016 and about 125 bps lower than the recent high in November 2018. Meanwhile, local debt registered a gain of 6.9%, also reaping the benefits of the Fed’s dovish tilt. Local yields rallied nearly 50 bps to end the quarter at 5.69%, the lowest level since mid-2013, while emerging markets currencies gained 1.5% versus the US dollar during the quarter as the dollar weakened against most currencies due to concerns about slowing global growth. Despite outperforming hard currency debt by more than 150 bps during the second quarter, local debt trails hard currency debt by more than 250 bps on a year-to-date basis. That said, both have performed exceptionally well since the market bottomed in October 2018, with returns of more than 13% and 14% for hard and local currency debt, respectively.
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The Lazard Emerging Markets Debt strategy invests primarily in emerging markets debt positions. The strategy will generally invest in debt investments denominated in either US dollars or local emerging markets currencies. As such, an investment in the strategy is subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging markets investments, including currency fluctuation, devaluation, and confiscatory taxation. The strategy may use derivative instruments that are subject to counterparty risk. Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation, and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss. The strategy will invest in securities of non-US companies, which trade on non-US exchanges. These investments may be denominated or traded in both hard and local currencies. Investments denominated in currencies other than US dollars involve certain considerations not typically associated with investments in US issuers or securities denominated or traded in US dollars. There may be less publicly available information about issuers in non-US countries that may not be subject to uniform accounting, auditing, and financial reporting standards and other disclosure requirements comparable to those applicable to US issuers.

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