Emerging markets equities performance in the third quarter was overwhelmed by macroeconomic factors, including weakening growth data, sporadic trade negotiations, and considerable geopolitical uncertainty. Most of the quarter’s losses were posted in August, when equities sold off and bond yields fell to historic lows as investors feared a global recession was imminent. While markets recovered somewhat in September, the MSCI Emerging Markets Index ended the quarter down 4.3% in US dollar terms.

The quarter’s negative performance reflected a broader trend that has emerged in 2019: Investors appear to be losing confidence that globalization—the engine of emerging markets development over the past several decades—is sustainable. Global consensus on the benefits of trade has collapsed, and populist parties have become political forces around the world. Emerging markets equities, compared to developed markets equities, have lagged year to date (Exhibit 1). In addition, investors were unsettled by specific events, which we detail below, especially in Argentina and Saudi Arabia.

We believe, however, that investors appeared to disregard factors in the quarter that could support the economy and sentiment going forward. These include synchronized easing from central banks in both developed and emerging markets, growing potential for a US-China trade deal, and reform in parts of the global economy. The MSCI Emerging Markets Index—even after recent underperformance—remained 5.9% higher year to date. We also see positive signs in a number of specific emerging markets, such as Brazil, where reforms could help unshackle growth potential.
Global Weakness Draws Central Bank Response

Investor fears about globalization have been driven mostly by signs of a global economic deceleration and trade uncertainty. Equities slumped in the third quarter and bond yields around the world declined to levels normally associated with a recession. The yield on the US 10-year Treasury fell more than 50 basis points (bps) from the end of July through August. An inversion of the US yield curve—considered by many to be a harbinger of an economic slowdown—occurred between 2- and 10-year Treasuries for the first time since mid-2007. Yields for the entire German government bond curve entered negative territory, and the market value of negative-yielding fixed income globally reached $15 trillion in nominal terms.

Global growth has declined 1.2 percentage points since President Donald Trump first ordered tariffs on steel and aluminum in the first quarter of 2018. Regions with high exposure to global trade—including virtually all emerging markets—have showed signs of strain. The International Monetary Fund (IMF) revised down its emerging markets GDP growth estimate to 4.1% in 2019. Developed markets also came under pressure. Germany, an export powerhouse, reported zero real GDP growth, negative inflation expectations, and deteriorating manufacturing indices.

China—the world’s second largest economy and source of almost 20% of global growth—also appeared to struggle. Total Chinese exports dropped unexpectedly in August, factory output fell to its lowest level in 17 years, and unemployment in Chinese cities hit a relative high. Chinese GDP growth was reported at 6.2% in the second quarter—a 27-year low. Inward direct investment in China has dropped 35% in the first half of 2019 year over year (Exhibit 2). Chinese Premier Li Keqiang publicly stated that exceeding 6.0% GDP growth in the current macroeconomic environment was unrealistic.2

The Chinese government, however, has not been inactive. State-owned enterprises and investment vehicles of local governments have been actively involved in many private businesses—partially to prevent a sharp rise in unemployment—that are in weaker financial positions with limited access to bank loans or other types of financing. As the latest US tariffs on Chinese imports—such as clothing and shoes—went into effect on 1 September, the Chinese government took further measures to stimulate the economy by increasing liquidity. The People’s Bank of China cut bank reserve requirements by 50 bps, which will increase the amount banks can lend. This is the second cut enacted by the central bank in 2019 and follows 250 bps of cuts in reserve requirements in 2018 and 300 bps over 2015 and 2016.

China’s easing of monetary policy is part of a global trend. On 12 September, the European Central Bank (ECB) announced a new stimulus package. The ECB’s key interest rate was cut by 10 bps to -0.50%, a record low and the first time the bank has lowered rates since March 2016. The ECB intends to buy €20 billion of euro zone debt per month in November, restarting a quantitative easing program that was wound down in December. The ECB also initiated its third targeted longer-term refinancing operation to help lenders lower funding costs. Finally, the bank strongly guided that interest rates may stay lower for longer than previously expected.

Just a few days later, the Federal Reserve lowered its benchmark rate 25 bps to between 1.75% and 2.00%—the second cut since the end of July. The Fed’s action was in line with market expectations, though the Fed’s guidance was more conservative. Fed officials expressed a positive economic outlook for the United States, and Fed Chair Jerome Powell said further rate cuts would be considered “meeting by meeting.”3

The Fed’s easing has reduced upward pressure on the US dollar, which has historically benefited emerging markets equities (Exhibit 3). It has also allowed some emerging markets central banks to loosen their monetary policies. Starting in February, more emerging markets central banks have cut rates over the past seven months than have raised them. In August, that differential reached 14—up from 8 in July. Central banks lowering rates in the third quarter included Turkey (7.50%), Brazil (1.00%), Indonesia (0.75%), and Mexico, Russia, and the Philippines (0.50% each). This loosening follows a nine-month period in which more emerging markets central banks raised rates than cut them.

Global economic weakness was not the only threat investors faced in the third quarter. Events in Argentina and Saudi Arabia were strong reminders of the governance and security challenges faced by emerging markets.
Argentina: Back to the Brink

Argentina’s markets and currency sold off following President Mauricio Macri’s surprisingly large defeat in a primary election in August. Macri’s more left-wing Peronist opponents, Alberto Fernandez and his running mate, former President Cristina Fernandez de Kirchner, are now strongly favored in the October elections. The last time the Peronists held power, the government nationalized companies, expanded deficits, and defaulted on its debt.

Argentines, having already experienced financial crises and runaway inflation, moved quickly to convert their assets into US dollars. With the peso falling about 25% since the primary results and the country’s foreign-exchange reserves dissipating, Argentina imposed capital controls. The country’s central bank forced exporters to repatriate earnings within five days. In addition, Argentinean residents were limited to $10,000 in foreign-exchange purchases per month, while non-residents were limited to $1,000. Among the implications for investors, for example, would be the inability to convert coupons or dividends from Argentinean securities into another currency.

These controls could lead to the removal of Argentina from the MSCI Emerging Markets Index, where it accounts for just 0.18% (or about $1.1 billion), and could expedite a potential reclassification of the country’s equities back to frontier or even stand-alone status. MSCI will consult with market participants until mid-December and will announce results by year-end. More important, and less tangible, is the impact Argentina’s situation could have on its neighbors and on investor sentiment in general. We are watching this closely—especially in countries with large current account and/or balance of payment deficits.

Saudi Arabia Attacked

The other significant macroeconomic event in the third quarter was a cruise missile and drone strike on two key Saudi oil facilities on 14 September, which knocked out 50% of Saudi oil production and caused a spike in oil prices. Iranian-backed Houthi rebels in Yemen took credit for the attack, though Saudi Arabia and the United States blamed Iran. US Secretary of State Mike Pompeo called it “an act of war.” Iran has denied all charges.

Tension between the United States and Iran has risen steadily since the United States withdrew from the nuclear pact in 2018. It has imposed heavy sanctions on Iran, including on the Supreme Leader Ali Khamenei, and has designated the Revolutionary Guard a terrorist organization. Iran’s oil sales have declined to about 230,000 barrels per day from 2.5 million in May 2018. Iran, feeling the pressure of sanctions, appears to have turned to force. In addition to the strikes on Saudi oil facilities, the United States accuses Iran of crippling two oil tankers in the strategically vital Strait of Hormuz and shooting down a US drone. After the mid-September attacks, the United States imposed even more sanctions, this time targeting Iran’s central bank and a development fund. The United States also placed sanctions on several Chinese companies for allegedly shipping Iranian oil.

The attacks took out approximately 5.7 million barrels per day of production, which is significant and cannot immediately be replaced by oil suppliers such as OPEC, Russia, Norway, Brazil, or the United States. Saudi Arabia has been able to meet orders by tapping its oil reserves of 188 million barrels. Output, however, has rebounded faster than anticipated to nearly 10 million barrels per day. Oil prices ended September only marginally higher for the month (and well below 2019 highs reached in April), underscoring excess supply concerns amid a weaker global growth outlook.

Saudi Arabia was added to the MSCI Emerging Markets Index in May 2019, and foreign ownership of Saudi equities has since risen to 5.4% versus 1.2% at end-2018. Saudi Arabia has also tentatively scheduled a massive IPO for the state-owned oil company Saudi Aramco later in 2019, which they have announced will go forward. According to EPFR, 79% of global emerging markets active funds held no Saudi equities at the end of July. On a forward price to earnings (P/E) basis, Saudi valuations look more expensive than those of global emerging markets (by about 25%–30%). They are currently at the high end of the valuation range since oil prices collapsed in the second half of 2014.

Geopolitically, the Iran-United States relationship has become another major source of uncertainty. Miscalculations on any side in the current environment could lead to a general conflagration. In addition, Iran has demonstrated its ability to disrupt global oil supply.

Made in Emerging Markets: Reform

Given the pessimism and uncertainty in the global economy in the third quarter, it was easy to overlook the positive trends in many individual emerging markets:

• In mid-September, India slashed corporate taxes from a range of 30%–40% to 22%–25%. The cuts, worth about $20 billion, were a response to disappointing economic growth, which had declined for five consecutive quarters to six-year lows. Newly re-elected President Narendra Modi sought to deliver economic reforms and bring India’s tax policy more in line with those of other Asian countries. Modi’s government also looked to exploit the trade war with China, offering new manufacturing companies a tax cut from 25% to 15%. Indian equity investors responded favorably to the mostly surprising news, posting significant single-day gains.

• Indonesia’s re-elected President Joko Widodo has vowed a similar program to boost the economy’s growth prospects. Widodo has sought lower corporate taxes, looser labor laws, and higher foreign ownership of local companies. The government has also announced a five-year plan to spend a significant portion of its GDP on infrastructure. Indonesia appears to be following a playbook set by China and other Asian emerging markets such as Thailand and Vietnam.

• Brazil, though somewhat exposed to turmoil in Argentina, has continued to make progress on pension reform. If the legislation continues on its current path, the issue could be resolved in the fourth quarter. Brazilian equities already appear to be reacting positively—the MSCI Brazil Index is up nearly 11% in 2019 through 30 September in US dollar terms—and we expect many benefits to both markets and the economy. Another potential upside for Brazilian markets could come from proposals to privatize state-controlled companies.
Another potential support for emerging markets assets is a US-China trade deal. The divisions between the United States and China are significant. At the end of the quarter, President Trump announced a plan to restrict capital flows into China and to limit Chinese companies from trading on US exchanges. Given this negative outlook, it is easy to miss the fact that both sides could benefit enormously from a deal—even one of limited scope. The decline in foreign direct investment (FDI) into China has been noteworthy. China has already taken some important measures to close this gap—it has removed quotas for foreign investors to invest in public markets, and it has fulfilled requirements to enter the MSCI GBI-EM Index and other mainstream bond indices. Thus, even though the headlines may imply China is closing itself off from foreign investment, the opposite is occurring. China is opening up further, offering more opportunities to investors.

Restoring Confidence

Investors face considerable uncertainty at the beginning of the fourth quarter of 2019—economic as well as geopolitical. In our view, investors are focusing on negative factors and are underestimating the fundamental strength in the economy as well as significant, synchronized efforts by central banks and some governments to stimulate demand. We believe that looser monetary policy will benefit emerging markets in several ways. By taking some upward pressure off the US dollar, it should provide room to emerging markets central banks to support their economies and allows countries with twin deficits (current and fiscal account) or significant debt in US dollars to adjust. It should stimulate global growth, which increases demand for emerging markets products, and it supports risk appetite for assets such as emerging markets equities. However, the potential for easing could change quickly if the US dollar appreciates, which would force central banks to raise rates to defend their currencies.

We see other reasons to believe emerging markets may draw investor support. As we have stated in past Outlooks, the emerging markets growth premium compared to developed markets appears ready to widen in 2020. Earnings growth for emerging markets companies, while negative to flat in 2019, is expected to reach low double digits for 2020 (Exhibit 4). In addition, emerging markets valuations continue to trade at significant levels below developed markets (Exhibit 5: the MSCI Emerging Markets Index P/E is about 25% below developed markets. The P/E of 12x is just above the index’s 15-year average of 11x). The US-China trade war is a deep source of uncertainty for global investors, but it will likely produce winners as well as losers. Global manufacturers are trying to diversify their supply chains to countries that are not subject to tariffs—e.g., Vietnam and Taiwan. US imports from China are down about 5% year-on-year in the 12 months through July 2019, while imports from Vietnam over the same period are up about 23% and from Taiwan are up more than 15%. The increase in FDI to Vietnam as well as the growth of exports has offset the impact of lower global growth. Some risks for Vietnam include the apparent rise of Chinese shipping through Vietnam to avoid the “Made in China” label and tariffs. This could result in tighter control of, and ultimately tariffs on, Vietnamese exports.
India, as described above, has modified its tax code to attract manufacturing. We are encouraged by India’s reforms, but tax cuts alone are unlikely to revive the country’s capex cycle. We believe India will have to implement further reforms, particularly around land, labor, and FDI, to help spur capital spending.

In addition, the major engines of global activity—the United States, Europe, China, and other emerging markets—appear to be in somewhat different stages of the economic cycle. The United States is still growing from tax cuts and fiscal stimulus, though this momentum is dissipating. Emerging markets, especially China, and Europe appear to be at or near cyclical lows. Other emerging markets have also shown resilience. This divergence in regional performance can have a benefit because it diversifies growth. If the United States slows, other parts of the economy appear more likely to outperform from stimulus and monetary easing. Thus, while the global economy is unlikely to exceed trend performance over the near term, in our view, it is also less likely to fall into recession.

Ultimately, though macroeconomic and political issues will continue to influence the asset class, we believe that emerging markets economic growth will continue despite the recent decline in global growth expectations, and we will witness renewed confidence in some of the more economy-sensitive stocks. However, given the trouble spots as well as areas of great potential in the current markets, skilled stock selection is essential.

**Debt**

While economic growth in both developed and emerging markets remained lackluster in the third quarter, the strong liquidity measures by central banks globally helped support emerging markets debt. After two consecutive quarters of nearly 5.0% gains, the blended asset class eked out a positive gain of about 0.5% in the third quarter, bringing year-to-date returns further into double-digit territory. While the quarter was more volatile for equity markets and other risk assets, the resilience of emerging markets debt points to the global, rather than emerging markets-specific, nature of investor returns.

Economic growth has continued to decelerate across the developed world, with Europe now barely in positive territory and the United States also growing below trend. Leading indicators of growth, such as purchasing manager indices (PMIs), have been on downward trajectories for more than a year (Exhibit 6). Moreover, late cycle growth dynamics have been exacerbated by uncertainty from the US-China trade dispute. While developments and headlines surrounding trade tensions have caused market participants to oscillate between complacency and anxiety, we believe trade tensions are likely to play out over a protracted period. One-and-a-half years into the trade dispute, elevated uncertainty has weighed heavily on business sentiment, investment, and international trade, as can be seen in the ailing manufacturing sector (Exhibit 7). Given the current macroeconomic and geopolitical environment, a significant rebound manufacturing and trade seem unlikely. While recent policy easing efforts by the Fed and ECB may help, China has been reluctant to provide the type of credit-fueled stimulus that it did in 2015–2016.
On the other hand, the bright spot for growth has been the US consumer, which accounts for about 70% of US GDP. Consumer spending has remained strong on the back of record low unemployment, low inflation, and interest rate cuts. However, consumer sentiment in August sustained its largest monthly decline since 2012 (Exhibit 8). Sentiment rebounded in September, making it unclear whether sentiment is entering a sustained downturn and to what extent it may impact spending. Thus, one of the key risks going forward is whether weakness in trade and manufacturing could spill over into the labor market, which would inevitably hurt consumer spending.

Against this backdrop, the global growth outlook remains lackluster and emerging markets growth is likely to be restrained. Emerging markets are currently growing well below potential at around 3%. Leading indicators of emerging markets growth have rebounded recently and have shown signs of stabilization, but it is unclear whether the improvements represent the green shoots of a sustainable recovery (Exhibit 9). Many large economies in emerging markets—such as Brazil, Mexico, Russia, Turkey, and South Africa—stand to benefit from favorable base effects for forward-looking growth, but emerging markets are unlikely to decouple from developed markets, in general.

Nevertheless, benign inflation and strong liquidity measures from developed markets central banks have created a supportive environment for fixed income assets and the higher quality parts of the emerging markets debt universe, especially those correlated with core rates. In contrast to 2018, emerging markets central banks have more flexibility to ease policy. As a result, we have a constructive medium-term outlook for emerging markets credit and local rates markets, but we see potential for continued headwinds in emerging markets currencies.

Within credit, we favor higher quality sovereigns, which should remain well-supported in a low yield environment. Broadly speaking, we do not find valuations in high yield sovereigns attractive at current levels, but we expect heightened dispersion to create opportunities to generate meaningful alpha through active management. The recent attacks on Saudi Arabian oil facilities led to a jump in oil prices which, if sustained, could impact oil-importing and oil-exporting countries differently. Additionally, country-specific factors are likely to play an important role independent of global factors. For example, distressed asset prices in Argentina reflect the market’s highly pessimistic outlook. While Argentina faces significant challenges over the medium term, we believe near-term developments could prove more favorable than market expectations, as we believe the next government and the IMF both have high incentives to work together and negotiate a new deal. We also see select opportunities in emerging markets corporates. Although the risks to global growth have increased, emerging markets corporate balance sheets are, on the whole, in good shape, with lower leverage and more cash liquidity than their developed market peers. As such, we do not see material risk to a deterioration in credit metrics in the current environment. Consequently, returns in the near term are likely to come from carry and idiosyncratic country- and company-specific stories. With regard to emerging markets currencies, although valuations remain cheap, growth differentials between emerging markets and developed markets are likely to remain challenged, thus capital flows into local markets are unlikely to support sustained currency appreciation.

Exhibit 9
Leading Indicators Suggest Stable Conditions in EM

As of 30 September 2019
Source: Markit
Outlook on Emerging Markets

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Notes
1. Based on monthly total exports of goods in USD, not seasonally adjusted, year-over-year % change
2. John Ruwitch and Jing, Wang, “‘Very difficult’ for China’s economy to grow 6% or faster: Premier Li,” Reuters, 15 September 2019.

Important Information
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