Outlook on Emerging Markets

Summary

• Emerging markets equities fell significantly in 2018 as macroeconomic and geopolitical developments weighed on market sentiment.

• Many emerging markets still have solid fundamentals and are well positioned to grow faster than the global growth average.

• Market volatility will likely continue in 2019 due to questions about the pace of global economic growth, the direction of the US dollar, and trade tensions.

• Emerging markets debt was down in 2018, largely due to performance in the second quarter, which was the largest quarterly decline in the history of the asset class.

• Emerging markets debt yields are near post-financial crisis highs, potentially offering investors income, a cushion against volatility, and the possibility of capital appreciation.

Equity

Emerging markets equities fell significantly in 2018 as macroeconomic and geopolitical developments weighed on market sentiment. Investors faced a number of unsettling trends last year, including a divergence in global economic growth, a strengthening US dollar, trade disputes, sanctions, and the specter of populism. The MSCI EM Index declined 14.6% in 2018 and 7.5% in the fourth quarter. In August, the index entered a bear market, dropping from high and sustained levels early in the year.¹

Some of this performance reflected the fact that emerging markets generated extraordinary returns in 2017 and that the asset class is relatively volatile. However, the downturn was also due to a significant shift in investor sentiment from the beginning of the year, when confidence was high as the major global economies appeared to be growing together and investors expected healthy earnings returns. Within a few months, however, US economic growth, boosted by tax cuts and fiscal stimulus, began to diverge from the rest of the world. Stronger US growth supported further Federal Reserve rate hikes, which in turn boosted the US dollar.

The rising dollar put pressure on emerging markets in general, but investors focused on countries with high current account deficits and/or significant holdings of US dollar–denominated debt. Argentina’s equity markets plunged almost 51% in 2018, with the value of the peso dropping by almost half. In Turkey, uncertainty related to the country’s trade deficit was exacerbated by US sanctions and a diplomatic dispute with the United States over a detained American pastor who had been accused of spying and aiding terrorists.² The Turkish lira slid more than 28% while equities fell 41%.

Another weight on emerging markets sentiment last year was trade. President Donald Trump in 2018 took action against trade deficits, implementing or threatening tariffs on nearly a quarter of US imports. Uncertainty about trade lowered Chinese confidence just as policymakers were trying to restrict credit growth, reduce systemic risk, and deleverage the economy. This is part of a deliberate, long-term effort to make the Chinese economy more balanced and growth more sustainable going forward. Chinese equities sold off, and decelerating Chinese growth (Exhibit 1) rippled through the global economy.

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¹ As of 30 September 2018
² Source: China National Bureau of Statistics
Sanctions have also worried investors. Russia, which was already being penalized for cybercrimes and use of force in Ukraine, faced additional US sanctions after Russian agents in March purportedly attempted to assassinate a Russian spy living in the United Kingdom. By the end of 2018, another round of sanctions appeared likely after a Senate report detailed new evidence about Russian involvement in the 2016 US election.

Meanwhile, much of the developed and emerging world faced populist challenges. In Europe, an impasse in Brexit negotiations threatened Prime Minister Theresa May’s hold on power, while violent street protests in Paris dealt a setback to French President Emmanuel Macron’s reform agenda. In Italy, the populist government negotiated a compromise with the European Commission over its proposed budget, which included increases to its deficit spending. In Brazil, markets fell significantly after truckers, enraged by higher fuel prices, blocked highways and brought shipping within the country to a standstill. Argentina was hit by strikes due to inflation and the government’s negotiations with the IMF, which evoked the IMF’s unpopular bailout of the country in 2001. In Mexico, newly elected President Andrés Manuel López Obrador’s actions seem to point to a bigger government role in the economy. He used a referendum vote to cancel a $13 billion airport construction project, protested higher bank fees, and has threatened the role of private companies in the development of the country’s oil industry. All of this helped undermine investor confidence in Mexico’s capital markets.

After a Difficult Year, Positive Trends in Emerging Markets

Given these challenges, it can be easy to overlook the many positive trends in emerging markets today. Emerging markets fundamentals remain relatively sound—country balance sheets have been stronger than expected, and fiscal deficits generally remain in good shape. Real interest rates are relatively high compared to developed markets, and we note that interest rates were last at these levels in 2016, just before a two-year rally in emerging markets assets.

The rising US dollar, while a challenge for individual countries, did not result in contagion, and most emerging markets have relatively low debt levels and so are well positioned as global liquidity tightens. At the same time, economic growth prospects for emerging markets are decent. The growth premium between the emerging markets and developed markets narrowed in 2018 as the US economy outperformed, but we believe this premium will start to widen again in 2019 (Exhibit 2). Looking forward, we expect US earnings growth will moderate and decline in 2019, potentially to a level below emerging markets (Exhibit 3). In addition, many of the adjustments forced on individual emerging markets in 2018 have driven necessary changes, while others are benefiting from positive trends.

• In Argentina, investor confidence rose after the IMF loaned the government $57.1 billion, which stipulated an ambitious austerity plan (including a “zero deficit” budget). Argentina’s currency rose 10% per cent in October and bonds yields declined. In addition, Argentina is scheduled to be incorporated into the MSCI Emerging Markets Index in mid-2019, which could provide a source of ongoing support for Argentinian equities.

• In Turkey, equities rose in the fourth quarter. The country’s GDP slowed from above 6.0% in the first half of 2018 to 1.6% in the third quarter, which drove the current account into positive territory. The lira, in the meantime, rebounded (Exhibit 4).

• In Brazil, investors were heartened by the presidential election of Jair Bolsonaro, a far-right political figure seen as pro business. Bolsonaro has promised a number of reforms, including an all-important overhaul to the nation’s pension system. Brazil’s economy in the third quarter re-accelerated while inflation declined. Brazilian equities, which fell 18% year-to-date in US dollar terms as of 31 August, rallied more than 25% between September and October.
• India and Indonesia, both of whom must import most of their oil, struggled with inflationary pressures and lower growth expectations when oil prices rose sharply in 2017 and 2018. With the drop in oil prices in October and November, however, both economies have benefited significantly. The Indonesian rupiah and the Indian rupee each rose more than 6% in November.

• Some US sanctions on Russia were lifted at the end of 2018. The Russian energy company, EN+ Group, and two subsidiaries—including aluminum giant Rusal—have been removed from the US sanctions list after Oleg Deripaska, an ally of Russian President Vladimir Putin, divested his majority stake in the company. The act signals that US policymakers may focus more on punishing individuals than companies—a development that is probably less unfavorable for investors. Rusal shares rose sharply after the news, though Russian equities overall remained flat. We believe Russian economic fundamentals have been strong and that Russian equities are at lower valuations due to uncertainty around sanctions. (The MSCI Russia Index was 5.2x P/E as of 31 December compared to the MSCI EM Index, which was at 11.8x.)

Above all, we have been encouraged that investors have differentiated among emerging markets. Those countries with the highest exposure to a stronger US dollar (i.e., those with the largest current account deficits) were disciplined by investors. Countries that were better positioned mostly outperformed. However, the vulnerable countries showed a slight improvement in the last quarter of 2018 (Exhibit 5).

Market Questions for 2019

While we see many reasons to have confidence in emerging markets assets, we also believe that market uncertainty and volatility will remain elevated in the coming year. Investors face a number of important questions that could, depending on their outcomes, drive performance in 2019. These questions include:

Will the US Dollar Rise Further, or Has It Peaked?
The direction of the US dollar is important to emerging markets—its rise in 2018 put extraordinary pressure on the asset class.

In 2019, we believe the US dollar will be supported in two extreme scenarios: 1) if the US economy strongly outperforms; or 2) if the global economy significantly contracts. Outperformance will likely compel the Fed to raise interest rates at a quicker pace or higher than expected, thus attracting investors in search of higher yields. An economic contraction, on the other hand, will drive investors to seek safety—typically in US assets.

If, however, other regions narrow the growth gap with the United States, or if global growth overall is sluggish but sustainable, then the US dollar will likely face downward pressure. Investors in this scenario may consider evidence that the dollar is overvalued. Much of the dollar’s recent outperformance was driven by the divergence in US versus global growth, which may be already largely priced into markets and is likely unsustainable because the tax cuts and fiscal stimulus were one-off measures. In addition, the US trade deficit recently hit a 10-year high, which may cause global savers to reconsider US assets. Finally, consensus on the US dollar is bullish—a contrarian indicator—and the US yield curve has inverted (between 3- and 5-year maturities), which historically has occurred before US dollar weakness.

What Is the Direction of the Global Economy?
Along with the US dollar, emerging markets have historically been tied to the fortunes of the global economy. The latest data, however, show a deceleration. In Europe, leading indicators have declined off elevated levels, and the euro zone’s 0.2% quarterly rise in GDP was the lowest since 2014. Germany posted negative growth figures (-0.2%) in the third quarter (though some investors believe this was mostly due to a one-off imple-
mentation of auto emissions standards). Japanese economic growth also declined, -0.3%, in the third quarter. In China, where the economy has slowed and trade tariffs weigh on sentiment, the government has implemented stimulus, including liquidity injections, tax cuts, and regulatory easing. In December, the People’s Bank of China (PBoC) lowered the costs for banks to make loans to small private businesses. This bolsters state support for the non-SOE sector and recognizes that restrictions in shadow bank lending needs to be eased.

If US growth continues to be strong but Europe and China falter (i.e., further divergence), then investors face the potential for slower growth in emerging markets and a rising US dollar. A sharply contracting US economy, on the other hand, would also likely put pressure on emerging markets given the importance of the United States to global growth. However, if US growth decelerates and the world avoids a recession, then emerging markets assets would most likely be supported.

Trade Disputes: Negotiating Ploy or New Reality?
One of the greatest uncertainties facing investors in 2019 is trade. It has long been conventional wisdom and official US policy that free trade is a “win-win” proposition for virtually all stakeholders in the global economy—producers, consumers, and investors. Thus, Trump’s 2018 tariffs have been a shock to investors, though they are consistent with Trump’s public positions. As he has often stated, Trump considers trade more like a zero-sum game, with surplus countries benefiting at the expense of deficit countries.

Investors are asking: are Trump’s tariffs a negotiating tactic for favorable trade deals, or a long-term effort to remake the global status quo? The uncertainty related to this issue has been a major drag on emerging markets stocks in 2018. Trump and Chinese President Xi Jinping have agreed to a trade truce at the G20 Summit, which delayed further US tariffs for 90 days (until 1 March). As US and Chinese representatives negotiate, we believe this truce could be extended. Even the partial resolution—or stabilization—of the issue in 2019 could be a strong support for emerging markets equity performance going forward. However, should trade continue to be a major issue, as it easily could, long-term pressures are likely to be placed on markets.

The Long-Term Emerging Markets Story Continues to Play Out
In 2018, fear came back to emerging markets investors. In 2019, we believe the uncertainty and volatility will persist, but we also expect clarity on a number of issues. In our view, if these issues resolve favorably—e.g., a stable or declining US dollar, a workable trade scenario, accelerating growth outside the United States—then emerging markets will likely benefit.

At the same time, it is important to note that equity declines in 2018 have significantly lowered valuations. At the end of the year, the MSCI EM Index was down to 11.8x trailing earnings, from 15.0x times, a discount of about 35% compared to US equities. This discount is wider than the average, which has historically hovered around 20% (Exhibit 6).

In addition, this discount exposes potential to greater growth opportunities—8.0% EPS growth vs. 7.6% for the United States in 2019—as well as relatively attractive free cash flow yields (6.5% versus 4.8% in developed markets and 4.3% in the United States). Emerging markets equities also offer opportunities to pick up dividends for yield-hungry investors—the emerging markets dividend yield is about 2.9% compared to 2.1% for the S&P 500 Index.

Investors can hold emerging markets for tactical reasons, but we believe the emerging markets “story”—characterized by higher growth potential, stabilizing institutions, a rising middle class of consumers—remains valid, regardless of higher volatility and relatively short-term changes in investor confidence. We believe that emerging markets companies with strong prospects, effective management, and relatively attractive prices remain one of the best ways to access this long-term investment opportunity.

Exhibit 6
The EM Discount Has Widened beyond the 20-Year Average

<table>
<thead>
<tr>
<th>Year</th>
<th>EM Discount</th>
<th>Avg (EM Discount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>-60</td>
<td>0</td>
</tr>
<tr>
<td>2000</td>
<td>-50</td>
<td>0</td>
</tr>
<tr>
<td>2002</td>
<td>-40</td>
<td>0</td>
</tr>
<tr>
<td>2004</td>
<td>-30</td>
<td>0</td>
</tr>
<tr>
<td>2006</td>
<td>-20</td>
<td>0</td>
</tr>
<tr>
<td>2008</td>
<td>-10</td>
<td>0</td>
</tr>
<tr>
<td>2010</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2012</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>2014</td>
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<td>2016</td>
<td>30</td>
<td>0</td>
</tr>
<tr>
<td>2018</td>
<td>40</td>
<td>0</td>
</tr>
</tbody>
</table>

As of 31 December 2018

a P/E (Last Twelve Months) provided by companies. EM = MSCI EM Index; US Equities = S&P 500 Index
Source: MSCI
Debt
Emerging markets debt was down in 2018, mostly due to its performance during the second quarter, which was the worst quarter on record for the asset class. The blended hard currency and local currency index each declined 7%. Returns have been roughly flat since then, but this conceals significant volatility as monthly returns have swung from -4% to +2%. Both hard currency and local currency markets suffered losses, unlike in other weak years, such as 2014 and 2015, when the brunt of the underperformance was driven by local currency markets. Last year’s performance was also different from other weak years because it was mainly driven by external factors, while emerging markets fundamentals have largely remained solid with a few well-publicized exceptions.

Sentiment Deteriorated, but Fundamentals Remained More Stable
As previously discussed, investors at the start of the year were optimistic about synchronized global growth before inflationary concerns drove Treasury yields higher in the first quarter. The yield on the 10-year US Treasury approached 3% in February, a nearly 100 bps rise from its lows in September 2017. The speed and magnitude of the increase in Treasury yields dragged down returns on external emerging markets debt nearly 2% in the first quarter while local currency debt continued to rally, earning more than 4%. Local outperformance soon reversed, however, as US leading economic indicators remained strong while those in Europe and China declined. Europe in particular, which significantly outperformed expectations in 2017, fell sharply and ignited a rally in the US dollar. The combination of higher interest rates and US dollar strength led to tighter financial conditions, which exposed some of the more vulnerable emerging markets. Argentina and Turkey, which run large current account deficits that are dependent on portfolio flows due to a lack of foreign direct investment, each experienced a currency crisis and significant drop in asset prices. These factors led to a decline in sentiment towards emerging markets broadly and drove outflows from retail investors.

Some market participants began to draw parallels to the “taper tantrum” in 2013 and speculate which countries would be next in line to be pressured by investors. However, it was clear that emerging markets fundamentals were much more stable than in 2013. Thus, only a small number of countries with significant twin deficits were highly exposed to tightening global liquidity (Exhibit 7). The taper tantrum was driven by the combination of monetary tightening in the United States and weak emerging markets fundamentals. In contrast, the sell-off of 2018 was driven by the confluence of several interrelated factors, including: the decoupling in growth between the United States and the rest of the world, higher interest rates, US dollar strength, trade tensions, and a few negative idiosyncratic headlines in emerging markets, despite continued solid bottom-up fundamentals.

Exhibit 7
A Limited Group of Countries Is Exposed to Tightening Global Liquidity

As of 30 June 2018
Source: Haver Analytics
Keeping Perspective

As we have written before, we believe the most important guiding principles during bouts of volatility are to avoid panic, to keep perspective, and to focus on the fundamental outlook and determine whether valuations are justified. In doing so, investors should realize that many of the factors that drove emerging markets debt returns lower earlier in the year have stabilized, reversed course, or are largely priced into current valuations.

Treasury yields have declined over the past several weeks and the US dollar has stabilized (Exhibit 8). The Fed has taken on a more dovish tone, causing market participants to recalibrate the expected terminal rate for the current tightening cycle. Both the Fed and the market appear comfortable with a terminal rate of 3.00%–3.25% for the Fed Funds Target Rate. Thus, the Fed appears to be in the final stages of this cycle, which indicates that long-term Treasury yields have already peaked, as yields tend to reach highs near the terminal rate. Emerging markets should benefit from a decline in Treasury yields, as well as a potential decline in interest rate volatility as the Fed guides the market to the terminal rate. This should also contribute to a more stable, if not weaker, environment for the US dollar, which would also provide a boost to emerging markets.

As we noted, a number of countries that experienced significant declines earlier in the year have made credible policy changes, which has mitigated some of the idiosyncratic risk in emerging markets as we move into 2019. We believe Argentina is implementing the right policies to address its imbalances. In addition to the credibility gained by the IMF loan, the new monetary program commits to zero growth in money supply, which should help stabilize the currency (Exhibit 9). Turkey has also taken important steps on the road to recovery, resulting in a stabilization in the lira (Exhibit 9) and a halt to deposit flight. The central bank has shown some signs of independence with a larger-than-expected rate hike. Inflation, which peaked at more than 25% in October and was a top concern of market participants, has declined sharply. In Brazil, as we explained, we believe the election of Bolsonaro has increased the probability of much-needed fiscal reform.
Brighter Days Ahead, though Risks Remain

In short, we believe the stabilization in many of the factors that contributed to the decline in emerging markets has helped reduce negative sentiment and has helped stop outflows (Exhibit 10). We believe that each asset class in emerging markets has reached a bottom at different times over the past three months (Exhibit 11). Local currencies bottomed in early September as the US dollar stabilized. Equities staged a recovery beginning in late October as valuations reached extreme levels and flows returned to the asset class. Lastly, hard currency emerging markets debt began to recover in late November, benefiting from the drop in Treasury yields as the Fed appears closer to the end of its tightening cycle.

Despite recent improvements, a number of key risks persist, including a potential slowdown in global growth, ongoing uncertainty in trade tensions, and potential for policy errors in key emerging markets. US leading economic indicators have continued to outperform the rest of world, although leading indicators across the globe have continued their downward trajectory. Although not our base case, disappointing global growth could weigh on emerging markets debt. The trade war between the United States and China could continue to weigh on global growth although the recent détente between the two countries could signal more willingness to reach a resolution. From a bottom-up perspective, full implementation of corrective policy actions in key markets—such as Argentina, Turkey, Brazil, South Africa, and Mexico—is important.

While many of the risks external to emerging markets have been largely priced into emerging markets assets for months, other risky asset classes, such as US high yield and equities, have only recently begun to account for these risks. Yields in emerging markets debt are near post-global financial crisis highs. This potentially provides investors with an attractive level of income and the possibility of additional upside should emerging markets outperform the market’s relatively low expectations. Accordingly, we have a constructive view on the asset class in 2019 as we head into what we believe will be a more benign environment for emerging markets.
Outlook on Emerging Markets

Notes
1 Defined as a decline of more than 20% from its 52-week high.
2 The American pastor, Andrew Brunson, was released in October and returned to the United States.

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