Outlook on
Emerging Markets

Summary

• Emerging markets equities started the year strong, building on encouraging economic trends of 2022. While the asset class experienced significant profit-taking in February, falling by 6.5%, it was relatively unscathed by March’s banking stresses.

• Emerging markets economies enjoy an economic growth premium over those of developed markets—which is expected to move even higher. While capital has recently left the asset class, many parts are under-owned and attractively valued, with high financial productivity.

• While mostly resilient against recent banking turmoil, emerging markets debt also began 2023 amid one of its strongest rallies in recent years, but then gave back most of its January gains over the course of the next month.

• With peak inflation likely behind us, monetary tightening cycles are reaching late stages for some emerging economies, especially those that have already been exceedingly aggressive with rate hikes. We estimate that they will likely begin rate cuts as early as the middle of 2023.

Equity

The first quarter of 2023 was off to a strong start and continued to build on the recovery that began in the fourth quarter last year (Exhibit 1). While encouraging economic trends, such as a deceleration in global inflation and the ongoing reopening of the Chinese economy, helped the MSCI Emerging Markets (EM) Index rise 7.9% in January, the asset class experienced significant profit-taking in February, falling by 6.5% with generally weaker commodity prices and currencies versus the US dollar. After declining in the first half of March due to concerns over tighter financial conditions and the solvency of US regional banks, a reversal took hold in the latter half as fear of contagion from the banking sector began to dissipate and as China provided increased support for the internet and gaming sectors. Emerging markets equities climbed 3.0% for the month, bringing first-quarter returns to 4.0%.

Since March 2022, the Federal Reserve in the United States has raised rates at the fastest pace since the 1980s. Even as markets declined last year, the global financial system stayed relatively stable. Now, global equities appear to be facing significant uncertainty in the face of sticky inflation coinciding with continued rate tightening in the United States that has led to the collapse of some regional banks and concerns over insolvency across the banking sector.

Stresses in the Global Banking Sector

The collapses of US regional banks Silicon Valley Bank (SVB) and Signature Bank on 10 March represent the biggest US bank failures since the 2008 global financial crisis. Price action was fairly orderly with negligible impact on emerging markets banks but mainly focused on US banks (Exhibit 2). Emerging markets do not appear to have suffered large capital outflows or strains in their banking sectors.

With experience and lessons learned from past crises, emerging markets banks have, thus far, proven resilient given the progress in regulatory oversight in conjunction with their relatively healthy balance sheet construction. With the exception of Taiwan, all emerging markets bank sectors have Tier 1 capital ratios superior to that of the United States bank sector. At the same time, apart from Brazil, the investment (e.g., US Treasury securities) to assets ratio for banks across emerging markets countries is lower than that of the United States. A key point to stress is that the global banking system, as a whole, remains well capitalized. Additionally, with lessons learned from 2008 and 2020 and with new tools put in place since then, central banks
have indicated that they are likely to step in earlier to provide liquidity to financial institutions and minimize the rise of contagion and panic.

Although emerging markets appear to be relatively unscathed since the stresses began, we are monitoring the below items:

- **Direct exposure to SVB & Credit Suisse**: The links appear small as SVB provided financing to relatively few companies in emerging markets, and the direct links between emerging markets and Credit Suisse are generally small.

- **Emerging markets exports**: To the extent that financial conditions in the United States were to severely tighten going forward and should US import demand weaken, we believe emerging markets exports would also decline. Countries that are particularly dependent on trade with the United States, such as Mexico, would probably be most affected.

- **Capital flows**: Higher risk aversion could weaken capital flows to emerging markets countries; however, there is not much evidence of this occurring at this stage, at least based on developments we see in foreign exchange markets. Many emerging markets currencies have actually strengthened relative to the US dollar since SVB began its route to failure.

- **Banking flows**: Emerging markets banks primarily rely on local deposits with a dependence on foreign wholesale funding relatively low. During the global financial crisis, many European banks were hit particularly hard as parent banks restricted funding to their subsidiaries, resulting in a sharp credit crunch. Loan-to-deposit ratios in major emerging markets are generally close to or below 100%, again emphasizing that lending is primarily financed by domestic deposits rather than wholesale funding.

- **Domestic monetary policy**: Emerging markets central banks that have yet to finish their tightening cycles may bring their rate hikes to an end sooner, as the path for continued rate increases in the United States is now looking like it may be lower than previously anticipated. Should the stress in the US financial sector continue to worsen, certain emerging markets central banks could be forced to hike rates to support their currencies. However, this is primarily a risk for those countries that are heavily dependent on foreign capital flows.

- **Emerging markets financial conditions**: Conditions remain looser than they were in the middle of 2022 though they have tightened a little since the collapse of SVB and Signature Bank and the forced takeover of Credit Suisse by UBS.

Emerging markets banks were already relatively inexpensive and attractively priced and are now trading at deep discounts relative to their histories. Likewise, the median emerging markets bank is trading with higher return on equity, or profitability levels, than the median developed market bank is (Exhibit 3). From a longer-term perspective, there is potentially greater scope for consumer and corporate credit growth in emerging markets than in developed markets.

**Could the Situation Get Worse?**

While we could see more institutions follow SVB in struggling with unrealized losses, the key question is whether these institutions have hedged interest rate risk. And, if not, whether they may be forced to divest assets and thus realize those losses. The most likely trigger for this would be a loss of confidence and an outflow of deposits.

Even though we believe the problems at SVB, Signature Bank, and Credit Suisse can largely be described as an unusual feature, or idiosyncratic, the banks have revealed that problems are lurking in the financial system in a higher interest rate environment. A potentially more serious crisis could develop if credit risks started to emerge, where loan default rates would rise as banks’ asset quality deteriorates. Encouragingly, the global banking system is much better capitalized than in the past. But with banks likely to tighten lending conditions in response to the events of the past few weeks, it is possible that a vicious cycle begins to form in which credit tightens, the real economy deteriorates, and default rates start to rise.

**Hike Aggressively, Cut Moderately**

The Fed increased rates by 0.25% in March, bringing the upper limit of its federal funds target range to 5.0%. Regarding the impact of monetary policy in the United States on emerging markets, generally, more balanced emerging markets current accounts, a higher level of reserves, lower currency mismatch risk from US dollar debt, and more resilient policy frameworks have reduced the risks for the asset class today.

Notwithstanding February’s economic data that showed how resilient inflation has been, we believe we are closer to the end of the rate
hiking cycle. Because emerging markets central banks began to raise rates aggressively before the developed world has (Exhibit 4), we think they could also be first to gradually lower rates later this year.

Though emerging markets equities have underperformed developed markets since the start of the Fed’s hiking cycle in 2022, they have not significantly underperformed (Exhibit 5).

Emerging Markets Remain Attractive

For investors, the steep drop in equity markets overall in 2022 and renewed market jitters in 2023 may raise the question of where to find attractive long-term opportunities. We believe that emerging markets may be one of the most mispriced asset classes, with valuations reaching some of their most attractive levels ever.

Over the past 20 years, emerging markets equities have evolved, serving as a source of interesting investment opportunities. Liquidity has deepened and investor interest has increased. Demographic trends and urbanization are supportive of long-term tailwinds that may be able to accelerate growth for the asset class; with a growing middle class comes a consumer that is younger, increasingly more educated, and a faster adopter of new technology, with constantly changing consumption patterns and preferences.

Although economic growth forecasts globally declined over 2022 due to the effects of the pandemic, the war in Ukraine, and tighter financial conditions to combat inflation, emerging markets economies enjoy an economic growth premium over those of developed markets. There are reasons to expect even higher economic growth premiums going forward: Barring a major global recession, emerging markets are likely to enter a period of economic recovery beginning in the latter half of 2023.

Much capital has left emerging markets in recent years, and many parts of the asset class are under-owned and attractively valued, with high financial productivity (or return on equity, free cash flow yield, and dividend yield). Earnings growth is expected to be higher in emerging markets this and next year, driven by emerging Asia (Exhibit 6). Overall, we believe the potential increase in emerging markets profitability, where the return on equity gap of emerging markets versus developed markets narrows, could also warrant a narrowing of the valuation discount to developed markets (Exhibit 7).
A diverse opportunity set, numerous fundamental drivers, and persistent market inefficiencies make the asset class ripe for attractive returns through active management.

Debt

Emerging markets debt rebounded sharply in late 2022, beginning 2023 amid one of its strongest rallies in recent years. Similar to nearly all fixed income markets, emerging markets debt gave back most of its January gains over the course of the next month. However, the asset class has been resilient since concerns surrounding global bank sectors began to spread in early March, with positive returns across all segments of the asset class since 8 March 2023 (Exhibit 8). Following the recent turmoil, global yields rapidly repriced to reflect a lower probability of rate hikes in the months ahead. The yield on the 10-year US Treasury bond declined 60 basis points (bps) from its high in early March, while the yield curve steepened significantly (but remained inverted) with the difference between the yield on the 2- and 10-year bonds narrowing to just over 55 bps from nearly 100 bps. While US Treasury moves of this magnitude typically reflect a “flight to quality” that results in US dollar strength, the greenback has actually weakened in recent weeks. Partly as a result of this, emerging markets currencies have appreciated by more than 3% the past several weeks.

Growth Differentials Are Shifting in Favor of EM

Economic cycles over the last two years have been characterized by “FIFO” (first in, first out). Emerging markets was the first part of the world to get hit by the COVID-19 pandemic, followed by the developed world. Monetary policy reacted much faster in emerging markets, with central banks beginning rate hike cycles nearly a year before developed markets and hiking at a much faster pace. Recessionary growth conditions—largely due to tightening monetary policy, higher input prices, and capital outflows—also weighed on emerging markets in 2022, with similar conditions only now reaching the shores of Europe and the United States. And even as the developed world currently reaches the latter stages of the monetary cycle, emerging markets central banks have already largely finished hiking rates. Put another way, the epicenter of financial market distress was in emerging markets countries in 2022 as growth slowed, currencies depreciated, credit spreads widened, and policies tightened. This type of distress—including recent financial sector turmoil—has now shifted to the developed world as growth is expected to slow significantly in the United States and Europe in 2023.

The growth differential between emerging and developed markets is expected to widen in favor of developing nations for the first time in nearly a decade, with the International Monetary Fund expecting growth in advanced economies to slow from 2.7% in 2022 to 1.2% and 1.4% in 2023 and 2024, respectively. Meanwhile, growth in emerging markets is expected to increase from 3.9% in 2022 to 4.0% in 2023 and 4.3% in 2024 (Exhibit 9). Improving conditions for emerging markets were originally attributed to peaking inflation and the end of monetary tightening. More recently, however, the end of China’s zero-COVID policy has bolstered emerging markets’ overall growth prospects given that the country is the largest incremental buyer of commodities and the single-largest trading partner of most other emerging markets countries.

Peak Inflation Is in the Past

After rising steadily from late 2021 to mid-2022, we believe inflation finally peaked in the summer of 2022 for both developed and emerging...
economies. Since then, we have seen a marked reduction in both headline and core measures of price appreciation. Furthermore, inflation expectations have leveled off to more normalized levels. Because food and energy are larger components of the inflation story for emerging economies than developed, we expect even faster disinflation over the coming quarters for emerging markets (Exhibit 10).

**Emerging Markets Central Banks Are Set to Ease**

With the peak of inflation behind us, monetary tightening cycles are reaching late stages. For some emerging markets countries, which have already been exceedingly aggressive with rate hikes, we estimate that they will likely begin rate cuts as early as the middle of 2023. Historically, outsized fixed income returns occur at this point in the monetary policy cycle. The transition period from extreme hawkishness to “approach to terminal” typically experiences meaningful declines in bond yields. We believe that this time, however, is a bit different for emerging markets because their starting point is even more extreme, with weighted-average policy rates of around 8% (Exhibit 11). Countries like Brazil, Mexico, Chile, Uruguay, Colombia, and Hungary will likely all begin to cut rates from double-digit starting points, which may result in large-magnitude rate cuts (with potential scope of 100 bps or more) when easing cycles commence.

**Staying Selective in the Near Term**

We are closely monitoring the potential impact of the banking sector turmoil and potential contagion on global markets through a lens of tighter financial conditions and growth. Consistent with this view, we are currently deploying around half of our risk budget across portfolios. Over the medium term, we believe broader trends supporting emerging markets—increasing growth differentials, peaking inflation, and monetary easing—remain intact. Bottom-up fundamental trajectories are varied, creating a high degree of differentiation and select opportunities across emerging markets. Most issuers rated BB and above benefit from solid fundamentals (i.e., improving deficits, low debt levels, comfortable reserves) and the balance sheet strength to withstand a mild external shock.

From a positioning standpoint, we are focusing primarily on quality credits (i.e., those rated BB and higher) and local rates positions in markets where we see scope for easing. Specifically, we see value in certain BB rated credits that offer an attractive mix of high carry and balance sheet strength, such as Serbia, the Dominican Republic, and Côte d’Ivoire. In local rates, we see a number of attractive idiosyncratic opportunities, primarily in the high yielding areas including South Africa, Mexico, and Brazil. In currencies, we are taking a highly selective approach with an emphasis on areas that offer attractive carry: We expect to benefit from the improving growth trajectory in emerging markets, especially in Asia.
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Notes
1 Source: CLSA: Global Equity Strategy. 15 March 2023

Important Information
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The MSCI Emerging Markets Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consists of emerging markets country indices including: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

The MSCI World Index is a free-float-adjusted market capitalization index that is designed to measure global developed market equity performance comprised of developed market country indices.

The MSCI Brazil Index is designed to measure the performance of the large and mid-cap segments of the Brazilian market. With 49 constituents, the index covers about 85% of the Brazilian equity universe.

The JP Morgan Emerging Markets Bond Index (EMBI Global Diversified) is a uniquely weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global. The JP Morgan Government Bond Index-Emerging Markets Global Diversified Index is a uniquely weighted version of the GBI-EM Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries’ eligible current face amounts of debt outstanding. The countries covered in the GBI-EM Global Diversified are identical to those covered by the GBI-EM Global Index.

The indices are unmanaged and have no fees. One cannot invest directly in an index.

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