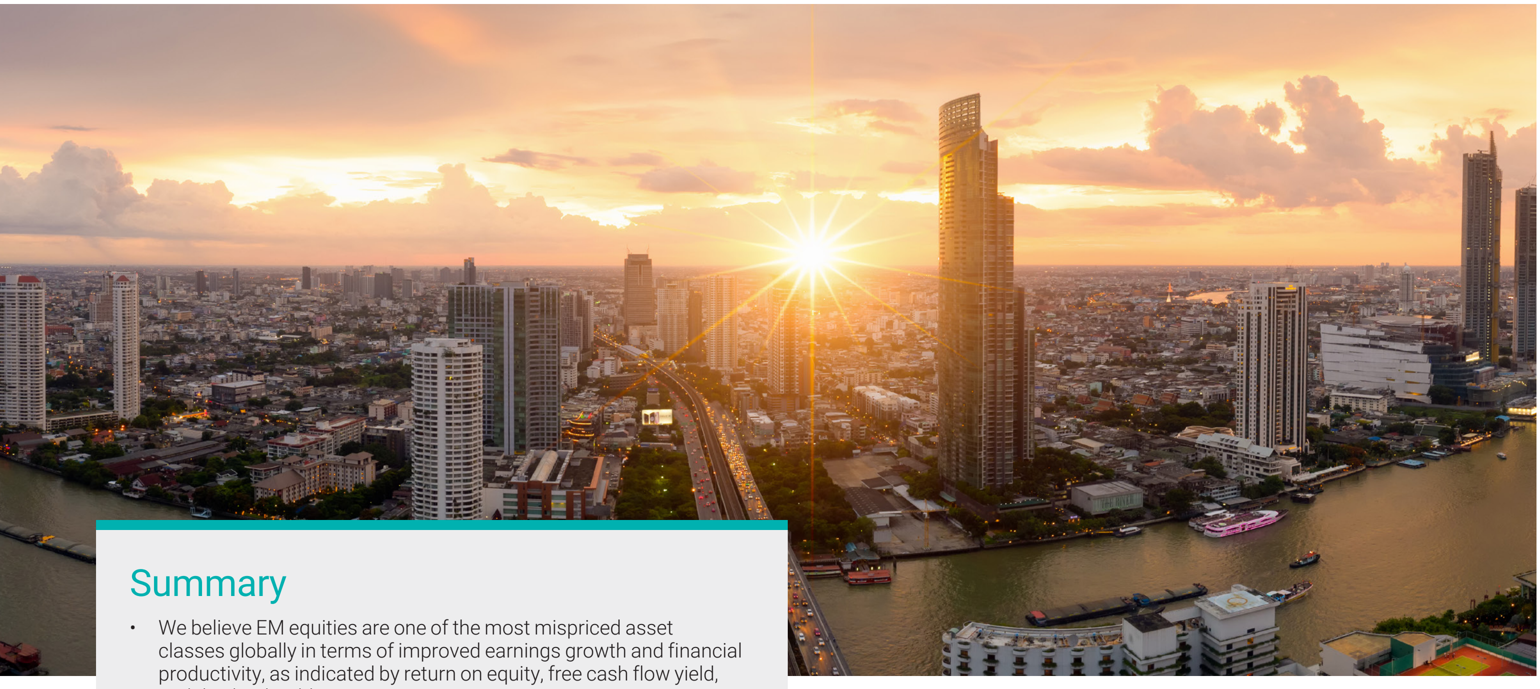
Outlook on Emerging Markets

APR 2024



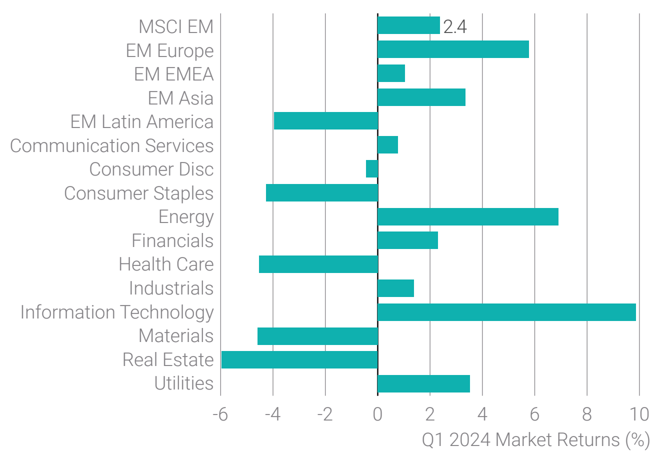
Summary

- We believe EM equities are one of the most mispriced asset classes globally in terms of improved earnings growth and financial productivity, as indicated by return on equity, free cash flow yield, and dividend yield.[1]
- Driven by more than just China, EM economic growth—and optimism—have moved higher as developed markets' growth has slowed.[2]
- We maintain a constructive outlook for emerging markets debt (EMD) driven by favorable policy trends, contributing to expectations of meaningful spread compression and opportunities for alpha generation.
- As EM countries continue to improve policy, we believe a return of investors—and inflows—should build in 2024, attracting at least half of the money that left the asset class over the last couple of years.

Equity

Equity markets in the developing world, as measured by the MSCI Emerging Markets Index, fell 4.7% to start 2024, the largest underperformance for the month of January since 1998. Market sentiment weakened, as investors perceived the strength in the US economy as a sign that the Federal Reserve would keep interest rates higher for longer. Performance improved in February and March to end the first quarter 2.4% higher (Exhibit 1). Though AI-related optimism lifted technology-heavy markets such as Taiwan and South Korea, the boost to developed markets was stronger, with the S&P 500 Index finishing nearly 11% higher and the MSCI World Index nearly 9%.

Exhibit 1
EM Returns Led by Europe, Asia, Energy & Technology



As of 29 March 2024
Source: MSCI

LAZARD ASSET MANAGEMENT

Key Risks (and Some Rewards) for EM Equities

We believe emerging markets remain one of the most mispriced asset classes globally with high and improving earnings growth and financial productivity, such as return on equity, free cash flow yield, and dividend yield. Emerging economies enjoy an economic growth premium over those of developed markets—EM economic growth, driven by more than just China, is now starting to move higher as developed markets' growth slows. However, the downside risks for EM are present, particularly with the upcoming US elections, persistent headwinds in China, and rising tensions in the Middle East.

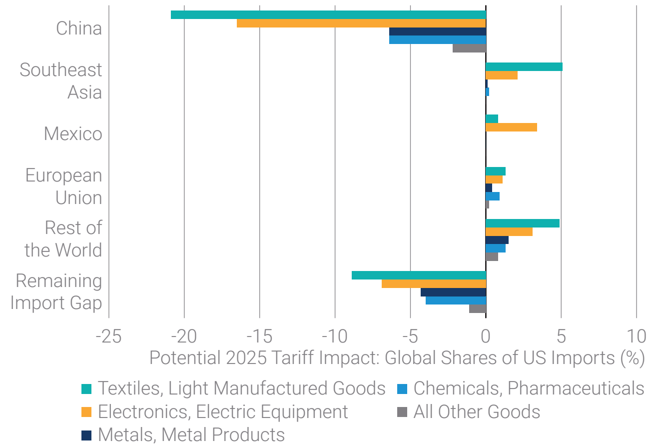
Risk #1: US Elections

Approximately 76 nations have either conducted or plan to hold elections this year, including the United States, where it appears that former President Donald Trump will compete against President Joseph Biden. In our view, a Biden victory would likely continue the status quo, while a Trump victory could introduce significant change, particularly more trade confrontation, which could weaken transatlantic ties, and a more aggressive posture toward China. Although specifics are uncertain and sparse, Trump has suggested a 60% import tariff on Chinese products and a universal 10% import tariff if reelected. Notably, the implementation of extra tariffs could likely lead to a stronger US dollar. While Trump's stated policy is to increase tariffs and restrictions on Chinese technology, medium-term normalization or reduction in tariffs is possible if Trump gains key concessions (e.g., better market access for US products).

Such trade restrictions might have significant consequences for EM equities. During Trump's initial presidency, tariffs increased fourfold from 3% to 12%[3] on average, causing a considerable shift in supply chain strategies and the geographical sourcing of US imports. Total US imports from Mainland China decreased from a high of 21% in mid-2018 to 14% by the end of 2023, with the euro zone, the rest of EM Asia, Mexico, and Canada gaining from China's reduced market share. The euro zone and Mexico are now the two biggest suppliers of goods into the United States, accounting for 17% and 15% market share, respectively. The proposed 60% tariff on all Chinese imports next year could further these supply chain shifts, especially in the textiles and electronics sectors. Bloomberg Economics predicts that China's market share could drop to nearly zero, exerting greater pressure on Chinese equities (Exhibit 2).

Trump's additional proposed 10% import tariff could also cause disruption beyond China and affect a broader range of developing countries. Crucially, this type of tariff could be implemented without congressional approval. Emerging economies that may be most negatively affected include those highly dependent on the United States as an export market and those where exported goods could be sourced within the United States. Asia, particularly Malaysia, South Korea, and Thailand, as well as Mexico, have high exposure to the United States with more substitutable products. However, Mexico might be exempt from the 10% import tariff due to its inclusion in the US-Mexico-Canada trade agreement. Countries with high exposure to the United States but with less replaceable products, such as commodities, including Chile, South Africa, and Indonesia, may also be spared.

Exhibit 2
China's Share of US Imports Could Decline under New Tariffs



As of 11 February 2024
Note: Projections assume Trump's proposed tariff starts in 2025.
Source: Bloomberg Economics

Aside from trade policy, a second Trump term could result in a more isolationist approach to global relations that strains partnerships with numerous US allies. Trump has expressed intentions to fundamentally reevaluate NATO's purpose and mission, potentially ending US support for Ukraine. This could cause strategic consequences in Europe—the European Union and its members would be left as the dominant providers of assistance to Ukraine. Weaker US ties with Europe could also result in a more moderated European posture toward China on economic security and supply chain issues, reinforcing unilateral US-China policy.

While we expect relations with China to remain cool under either candidate, the approach might be unilateral under Trump and more multilateral under Biden. During the Biden administration, tensions with China have expanded to include topics such as technology transfers, financial flows, and semiconductors.[4] Under Trump, a new trade war with China could be followed by a worsening decline in diplomatic relations between the United States and China, according to some political commentators.

Risk #2: China's Challenges

Investor perception of China in recent years has been negative for reasons including increased regulatory oversight, its weak economic recovery in this post COVID-19 environment, concerns over a potential reunification with Taiwan by force, and ongoing tensions and competition with the United States, particularly access to critical technologies in the semiconductor industry. US-China tensions have continued to linger. The US-China Science & Technology Agreement was extended for another six months, but future renewals will likely require new congressional oversight. Additionally, four bipartisan bills were introduced that may reduce US investments in China and the recent passage of H.R.7521 (TikTok divestment bill) in the House is also a strong signal about Chinese companies in the United States. However, likely further weakening confidence in the prospects of the Chinese economy has been its real estate downturn and the country's robust debt levels. As a result, China's equity market has roughly halved since the start of 2021 (Exhibit 3), and absolute and relative valuations for Chinese equities are close to record lows.

While the Chinese equity market has shown signs of recovery this year, there remain strong headwinds, particularly within the property sector and fully embracing the transition to consumption as the primary economic driver. President Xi has also indicated that Beijing will continue to weigh national security concerns—including concerns about societal and political stability—as seriously as economic growth objectives. The attempt to straddle both perspectives continues to present a policy coordination challenge within China's increasingly centralized bureaucracy under Xi—leading to more mixed signals coming from Beijing toward the private sector and dampening investor confidence.

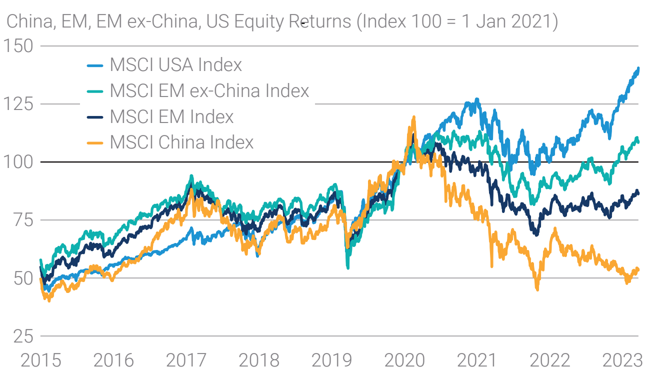
Property

The sentiment appears to have shifted from real estate being perceived as one of the most attractive to among the least reliable of investments in China. More concrete measures may stabilize and restore confidence to the property market. Policymakers could choose to relax the hukou household registration system to encourage additional first-time buyer demand. Additionally, greater price transparency may remove valuation uncertainties, placing limits on home price reduction risks and severely prolonging the real estate crisis as a consequence.

For decades, property has been the primary store of wealth for Chinese households. Down from almost two-thirds in 2010, property still accounts for more than half of household net wealth, compared to a little over one-third for US households. China has more than 30 months' worth of unsold housing starts at the rate of sales recorded in 2023, or around 28 million units.[5] At the same time, between 12% to 15% of sold housing units, or between 65 and 80 million units, lie vacant in China, which would likely take seven years to clear.

With more than half of Chinese household net wealth comprised of real estate, it is no surprise that consumer confidence is weak with negative spillover effects on big-ticket purchases. If the housing downturn persists, consumers could further curtail spending, leading to a deflationary environment. Historically, the economy emerged out of deflation in the past four cycles (late 1990s, 2008–2009, 2014–2016, and 2020) with a revival in property demand on the back of population growth, urbanization, and investment, as well as a rebound in exports.

Exhibit 3
Chinese Equity Market Halves since 2021



As of 20 March 2024
Source: MSCI

Consumption

Though an investment-driven growth model fueled much of China's growth historically, policymakers may need to embrace a shift to consumption as the main driver of economic growth. China's 53% consumption share of GDP is significantly lower than that of many leading global economies (e.g., India, Germany, Japan, and the United States), which hover between 69% and 82%.[5]

Meanwhile, China's national savings rate remains near 45%, and Chinese households have been reluctant to deploy their excess savings in the current environment. No fiscal stimulus was announced during the recent Two Sessions meetings in March nor are there any clear signals that Beijing is shifting full-throttle toward fostering a consumer-driven economy. What was notable was Premier Li's announcement of the issuance of one trillion yuan in special national bonds, which is a mechanism for the central government to increase its leverage while decreasing the debt burden of regional governments.

Overall, Beijing's decision to double down on advanced industrial innovation without structural reforms targeted at boosting domestic consumption would continue a trend of leaving China overly reliant on export-driven growth. In a global environment with governments increasingly wary of growing Chinese overcapacity, this policy approach could face growing backlash. Indeed, China's push into high-end manufacturing and the export of the "new three" growth drivers (i.e., electric vehicles, batteries, and solar panels), distinct from the "old three" pillars of Chinese manufacturing (i.e., household appliances, furniture, and clothing) is drawing the scrutiny of the United States and the European Union, both of which are likely to enact anti-subsidy probes and tariffs.

Stimulus measures taken by the government to date have not lifted consumption to the extent necessary for it to be a greater driving force for the economy.

However, during the recently concluded 40-day Spring Festival, the country's annual period of travel rush, the total number of cross-regional passenger movements reached a record high. While the strength in mobility data bodes well for ongoing services consumption demand, more policy support is likely on the way to boost durable goods consumption across automobiles, home appliances, and home furnishings.

Risk #3: Middle East Tensions and Global Transit

Nearly six months after Hamas' attack on Israel, the conflict in Gaza has driven an uptick in confrontations across the Middle East to include missile strikes between Iran and Pakistan, an attack on the US military base in Jordan, and US drone strikes in Iraq. In the Red Sea, which is densely populated with sea internet cables, Houthi rebels have attacked more than 40 commercial ships, and the recent attack on the Rubymar cargo ship likely damaged several undersea internet and global telecommunications cables.

Attacks in the Red Sea have resulted in a sharp increase in freight rates and travel time as hundreds of vessels have opted to sail an extra 4,000

miles around the Cape of Good Hope in South Africa, and a steep decline in passages through the Bab el-Mandeb Strait near Yemen's coast and the Suez Canal in Egypt (Exhibit 4). While container rates have not yet risen as much as they did during the coronavirus pandemic, this has the potential to put pressure on corporate margins as a result of higher input costs. The Red Sea crisis will likely persist in the short-to-medium term in spite of US-led strikes on Houthi assets in Yemen.

Aside from the Red Sea, drought-related disruptions through the Panama Canal have led to a surge in sea freight rates from China and other East Asian economies by as much as 275% since the beginning of December 2023. Other shipping routes have also experienced cost increases, though less extreme—shipping rates from China to the United States have risen by more than 175% since the beginning of December.[6]

The Red Sea and Suez Canal have become increasingly important over the past two years, not just for vessels transporting goods, but also oil and liquified natural gas cargos, as 1) Russia increased the amount of oil it ships to India via the Suez Canal and 2) Europe ramped up its natural gas purchases from the Middle East. Going forward, inflationary impacts could become stronger headwinds should maritime disruptions persist and negatively impact energy flows. While crude oil prices have remained relatively subdued thus far, a closure of the Strait of Hormuz, for instance—through which nearly 20% of global oil supplies flow—could cause oil prices to spike materially.

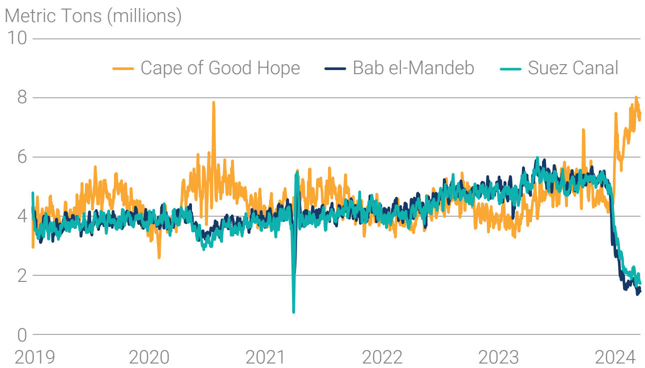
Reasons for Warming Optimism—and Changing Minds

While global investors' willingness to add to EM equities remains tepid, the outlook remains encouraging for the asset class for the following reasons:

- **EM-DM relative GDP growth acceleration**: Today, economic growth across regions is moving in a non-synchronous fashion, which, we believe, should result in a more balanced global growth outlook. EM economic growth, driven by more than just China, is now starting to move higher to 4.0% in 2024 as DM growth slows to 1.4%.

Exhibit 4
The Red Sea Poses a Choke Point for Global Trade

Trade Disruptions in the Red Sea



As of 19 March 2024
Source: IMF PortWatch

- **Earnings growth reacceleration**: Following a sharp decline throughout 2021 and 2022, earnings growth expectations have moved higher for EM compared to DM, including the United States, over 2024 and 2025. Consensus earnings growth[7] for EM in 2024 and 2025 is nearly 19% and 15%, respectively, compared to less than 11% and 13% in the United States.
- **Attractive valuations:** In our view, EM are one of the most mispriced asset classes globally, with valuations remaining very inexpensive compared to DM equities. On a forward price-to-earnings multiple, EM is trading at 12.0x, compared to 18.9x for DM and 21.7x for the United States. Over time, this more than 30% valuation discount may narrow due to stronger EM earnings growth, recovering EM profitability, attractive free cash flow yield and dividend yield, and a widening economic growth premium in EM's favor.
- **Global monetary easing**: Key EM central banks have already begun to ease monetary policy this year. The Fed is expected to begin to cut interest rates in the second half of this year, which would provide a more supportive environment for EM equities.
- **Diversification from US equities**: Global investors seeking to diversify their portfolio allocations and guard against a risk of valuation derating in US equities may want to add EM equities to their portfolios.
- **Low investor positioning**: EM remains an under-owned asset class. Global investors are 5.2%[8] allocated to EM equities. A reversion to a 20-year average allocation of 8.4% would represent inflows of $912 billion, or about 62% of current EM assets under management.

The preceding outlook reflects the views and analysis of Lazard's emerging markets equity team. The following outlook reflects the views and analysis of Lazard's emerging markets debt team.

Debt

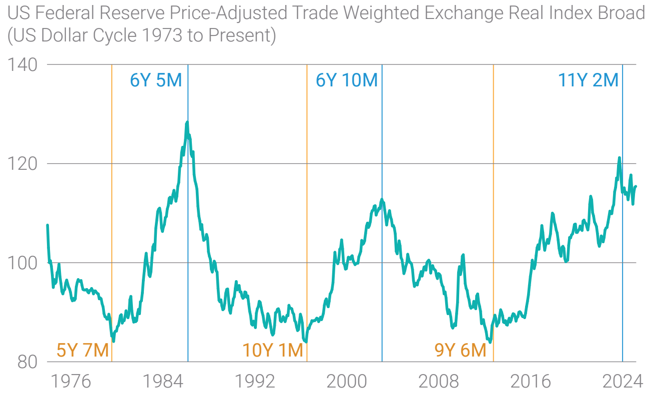
Emerging markets debt (EMD) performance was mixed to start 2024. US economic exceptionalism contributed to a backdrop of broad dollar strength and higher real yields, but strong risk sentiment drove credit spread compression. Following a sharp decline in the fourth quarter of 2023, the yield on the 10-year US Treasury bond rose over 30 basis points (bps) to end the first quarter of 2024 at 4.2% as markets repriced Fed rate cuts to reflect an extended timeline and reduced magnitude. EM local debt yields fared better than core rates did but still increased roughly 10 bps during the quarter, while EM currencies fell nearly 3% in aggregate as the dollar spot index (DXY) increased around 3%. Meanwhile, EM sovereign credit spreads compressed by over 40 bps, with spread compression especially pronounced among high yield issuers.

Policy Changes Take Pride of Place

Since the COVID-19 pandemic, macroeconomic factors have been driving market performance. However, 2024 marked a shift in this trend, with policy changes driving growth in a wide array of EM countries including Egypt, Argentina, Turkey, Serbia, Montenegro, Tunisia, Pakistan, and Sri Lanka, among others. For the first time since 2016, these nations are implementing proper policy changes, contributing to expectations of meaningful spread compression across these non-investment grade countries.

In local markets, EM central banks should continue to successfully combat inflation, providing room to cut interest rates and drive yields lower. We remain cautious on EM currencies in the near term as return expectations depend heavily on the performance of the US dollar. However, we believe EM local debt offers attractive opportunities over the medium term as the US dollar's long cycle appears to be overextended (Exhibit 5).

Exhibit 5
Is the Long US Dollar Cycle Strained?

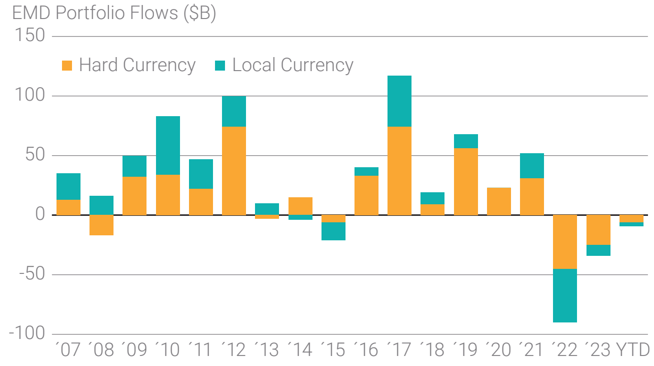


As of 31 March 2024
Source: Lazard, Deutsche Bank

Are Inflows the Next Big Thing?

We believe we are currently in the second year of "easier" returns in EMD, following a challenging 2022 across all fixed income asset classes. Last year, EMD returned 10% to 12%, and we expect similar results in 2024. By 2025, we anticipate returns to normalize closer to the yield of the asset class. EMD portfolio management has returned to traditional bottom-up country and corporate analysis, with a focus on positive policy shifts driving spreads tighter in EM countries.

Exhibit 6
Are Investors Ready to Return to EMD?



As of 20 March 2024
Source: JP Morgan

There Are Risks Involved

We continue to closely monitor the implications of China's slower growth trajectory on the emerging markets investment universe. Despite efforts by the country's fiscal and monetary authorities to inject liquidity into the system, risk appetite has remained low, resulting in persistent deflation. Fortunately for EM, the growth baton has been passed to India, with trade spillovers benefiting Mexico, Vietnam, and Indonesia.

Risk related to the November 2024 US presidential election also remains one of our key areas of focus. Former president Trump's possible return to office could reintroduce a hawkish tilt to global trade policy, negatively impacting Europe and China. This would not only suppress global growth but also contribute to inflationary pressures, in our view. While Trump's return to office could be generally negative for EM assets, there is a possibility that capital may flow into global markets if the world perceives American exceptionalism to be waning due to high fiscal deficits and tariffs.

The last positive trigger we expect for EMD is the return of investors. Over the past few years, EMD has seen outflows of around $135 billion (Exhibit 6) as investors reallocated in favor of private credit, levered loans, and other less liquid asset classes. Portfolio flows typically follow performance, so we expect the inflows to return to EMD in mid-2024. If EM countries continue to improve policy, we believe this story can build upon itself and attract at least half of the money that left over the last couple of years.

In conclusion, we maintain a constructive outlook for EMD driven by favorable policy trends, which we expect to create opportunities for alpha generation. We will continue to monitor potential risks and global developments to ensure we are well positioned to capitalize on opportunities over the coming year.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1. As of 31 December 2023; Source: Lazard, FactSet, MSCI
2 As of 31 December 2023; Source: FactSet, Haver Analytics, International Monetary Fund
3 Tax Foundation (as of 29 January 2024); HSBC Global Research: "Navigating the Risks" (6 March 2024)
4. Lazard Q1 2024 Outlook on Emerging Markets
5. CLSA Global Equity Strategy, "China: What Would Change Our View?" (5 March 2024)
6. Goldman Sachs Global Macro Research: Issue 126 (12 March 2024)
7. JP Morgan Global Research, "Emerging Markets Equity Strategy Steering Board" (28 March 2024)
8. JP Morgan Global Research, "EM Lighthouse – EM on the 110-Meter Hurdles Track" (22 March 2024)

Important Information

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The S&P 500 Index is a market capitalization-weighted index of 500 companies in leading industries of the US economy.

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 MSCI All Country World Index (ACWI) is a free-float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

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 USA Index is designed to measure the performance of the large and mid-cap segments of the US market. The index covers approximately 85% of the free float-adjusted market capitalization in the US.

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.

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