Outlook on
Emerging Markets

Emerging markets (EM), as measured by the MSCI Emerging Markets Index, finished the third quarter down 2.9%, bringing this year’s return to approximately 1.8% (Exhibit 1). Top-performing sectors and markets over the quarter included energy, consumer discretionary, and real estate, as well as Turkey, Egypt, and the United Arab Emirates. Bottom performers included industrials, communication services, and information technology as well as Poland, Chile, and Greece. By comparison, developed markets (DM), as measured by the MSCI World Index, finished the quarter down 3.5%, having gained 11% this year. However, emerging markets small cap securities (MSCI EM Small Cap Index) have outperformed large cap developed markets both over the quarter, up 2.9%, and the year, up 13.7%, led by information technology, materials, and industrials, particularly across India, Taiwan, and South Korea.

Summary

- Emerging markets equities finished the third quarter down 2.9%, bringing this year’s return to near 1.8%. The asset class has stumbled, in large part due to China’s performance, which was down nearly a quarter from its January highs, and weaker earnings growth overall.

- We believe emerging markets equities are in line to benefit from improving economic growth more than developed markets are, driven primarily by emerging Asia and information technology companies.

- Strong economic indicators, particularly in the United States, sparked concerns that interest rates would remain higher for longer, contributing to a surge in US Treasury yields—and a shock to emerging markets debt.

- We believe investment grade corporate and sovereign yields offer attractive opportunities where credit risk is limited and thus insulated from spread widening and high US Treasury yields allow investors to harvest near-record levels of carry.

Equity

Emerging markets (EM), as measured by the MSCI Emerging Markets Index, finished the third quarter down 2.9%, bringing this year’s return to approximately 1.8% (Exhibit 1). Top-performing sectors and markets over the quarter included energy, consumer discretionary, and real estate, as well as Turkey, Egypt, and the United Arab Emirates. Bottom performers included industrials, communication services, and information technology as well as Poland, Chile, and Greece. By comparison, developed markets (DM), as measured by the MSCI World Index, finished the quarter down 3.5%, having gained 11% this year. However, emerging markets small cap securities (MSCI EM Small Cap Index) have outperformed large cap developed markets both over the quarter, up 2.9%, and the year, up 13.7%, led by information technology, materials, and industrials, particularly across India, Taiwan, and South Korea.

China’s Weakness Bears Weight

Emerging markets have stumbled, in large part due to China’s performance (the second-largest economy globally and the largest emerging markets economy) which is down more than 25% from its January highs following the ending of its zero-COVID policy and the reopening of its economy. Even if exclude from calculations China
(MSCI EM ex-China Index), one of the worst-performing emerging countries, and the United States (MSCI World ex-US Index), one of the top-performing developed countries, emerging markets would continue to trail developed markets. The US stock market, which accounts for about two-thirds of the MSCI World Index, has moved higher due to the resilience of the US economy and the growing enthusiasm for artificial intelligence.

However, in recent weeks, there has been an uptick in investor interest in China, notably on the back of policy support announcements from the central government. For the country’s troubled real estate sector, downpayment requirements for mortgages have been reduced, while banks have been encouraged to lower interest rates on existing mortgages. Coupled with further rate cuts from the People’s Bank of China, investors are wondering whether China’s growth trajectory could stabilize without the need for a massive stimulus package.

**Earnings Outlook Portends a Brighter Future**

The relative earnings growth differential between emerging and developed markets equities is usually considered a determinant of their relative performance momentum. Notwithstanding the share price decline from China, emerging markets have lagged developed markets this year partly because of weaker earnings growth (Exhibit 2). However, in our view, the outlook for earnings growth in emerging markets is more optimistic over the coming years, tracing a profile similar to that which occurred from 2016 to 2018, when emerging markets outperformed developed markets by approximately 25% (Exhibit 3). Importantly, an end to dollar strength, or even dollar weakness (which occurred during 2016–2018), could further support the outlook for emerging markets earnings growth as a number of emerging central banks are poised to ease ahead of the Federal Reserve.

Following a sharp decline throughout 2021 and 2022, earnings growth expectations over the next twelve months has moved higher for emerging markets compared to developed markets, including the United States (Exhibit 4).

For 2024, current earnings growth forecasts show a positive 9% spread in favor of emerging markets (19%) over developed markets (10%), with a 7% positive earnings growth spread for emerging over the United States—a key indicator for emerging outperformance over US equities (Exhibit 5).

The largest expected increase in earnings growth in emerging markets is being driven by South Korea where consensus expectations are near 70%. Consensus earnings growth increases of near 20% are anticipated in Taiwan, Turkey, Egypt, and India (Exhibit 6A). Within China, there has been some divergence between equity returns and earnings delivery. Disappointing performance in Chinese equities stands in contrast to the resilient earnings growth that Chinese corporates have been delivering. Over the next two years, earnings growth in China is expected to average 15%, driven by the healthcare, materials, consumer staples, and consumer discretionary sectors. And after sharp declines this year, South Korea’s and Taiwan’s robust earnings growth projections are being driven primarily by a recovery in the information technology sector.

From a sector perspective across emerging markets more broadly, information technology leads all sectors followed by utilities and healthcare (Exhibit 6B).
Emerging Markets: Stay Invested

We believe emerging markets remain one of the most mispriced asset classes globally. While absolute valuation levels have moved higher since they bottomed in the fourth quarter last year (Exhibit 7), relative to developed markets equities, valuations remain inexpensive. Valuation discounts relative to developed markets and US equities are hovering near 30% and 35%, respectively, both wider than their long-term averages (Exhibit 8). Currently, the price-to-earnings ratio for the MSCI EM Index is trading a little more than 12x over the next twelve months, or slightly above its long-term average of 11.3x.

Over time we would expect this valuation discount to narrow, driven by a combination of stronger earnings growth, the potential increase in emerging markets profitability, where the return on equity gap of emerging versus developed markets narrows, and the economic growth premium. Emerging markets economies enjoy an economic growth premium over those of developed markets. Not since the 2000s during the commodity super cycle has the economic growth premium been moving in emerging markets’ favor.

Following the global financial crisis (GFC), the economic growth premium narrowed before bottoming in 2022. Leading up to the GFC, economic growth across regions and countries was generally moving in a synchronized fashion, which prolonged the global recession and recovery. Today, economic growth across regions is moving in a nonsynchronous fashion, which, we believe, should result in a more balanced global growth outlook.

Emerging markets economic growth is now starting to move higher as developed markets growth slows, and emerging markets are being
Driven by more than just China, India is expected to benefit from a demographic dividend with nearly 80% of its population younger than 50, while Indonesia’s growth prospects are also improving as it is climbing up the metals value chain. Beyond Asia, growth prospects in Latin America, namely Brazil and Mexico, have greatly improved on the back of nearshoring trends and an increase in foreign direct investment as companies adjust their global supply chain strategies.

While weakness in China’s economy remains a top concern there have been incremental policy measures to support growth. The upcoming Third Plenum and National Financial Work Conference may define the extent to which policymakers are willing to act against headwinds facing the Chinese economy.

Even though we believe domestic inflation developments are likely to guide near-term easing across emerging markets, the median headline inflation for emerging economies has fallen to 4.7% from a peak of nearly 8% in July last year; the spread for emerging markets versus developed markets is just 1% relative to a historical spread of nearly 2% since 2000. This could pave the way for emerging markets central banks to lead developed central banks in shifting from tighter monetary policy to looser. The result may lower the cost of equity and is likely to be supportive for valuations, particularly in markets with high real interest rates, such as Brazil where the central bank has already started cutting rates. With the resilience of the US economy, however, the Federal Reserve’s policy actions will likely be increasing more data dependent, which, we think, could translate into an extended higher-for-longer interest rate environment.

Much capital has left emerging markets in recent years, and many parts of the asset class remain markedly under-owned despite being attractively valued, with high and improving economic growth and financial productivity, such as return on equity, free cash flow yield, and dividend yield. As mentioned above, compared to the developed world, earnings growth is expected to be higher in emerging markets in 2024, driven to great extent by emerging Asia and information technology companies.

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) gave back a portion of its year-to-date gains in the third quarter, breaking a streak of positive returns over the prior three quarters. Strong economic indicators, particularly in the United States, sparked concerns that interest rates would remain higher for longer, contributing to an increase in US Treasury yields and an environment of broad US dollar strength. The yield on the 10-year US Treasury bond rose nearly 75 basis points (bps) during the quarter and the curve steepened but remained inverted with the spread between the yield and the 2- and 10-year Treasury bonds narrowing to just under -50 bps from over -100 bps at the end of June. Emerging markets local debt yields increased just under 45 bps for the quarter along with the rise in core rates, while emerging markets currencies declined 2.6% in aggregate, less than the decline across major currencies including the euro (-3.1%), the Japanese yen (-3.4%), and the British pound (-4.0%).

Surge in Treasury Yields Creates Fallout

The significant increase in US Treasury yields during the third quarter served as an exogenous shock to emerging markets debt. This development had a negative affect across the EMD capital structure, including investment grade sovereign credit, high yield sovereign credit, emerging markets local rates, and emerging markets currencies. While investment grade sovereign credit is, we believe, less exposed to credit risk, the duration impact due to its high correlation to US Treasury yields led to mark-to-market losses (Exhibit 9). For high yield issuers in emerging markets, the increase in Treasury yields has pushed more countries out of primary capital market access, leading to a rise in credit risk for approximately 15% of the issuers in our investment universe. While emerging markets local rates typically have a lower correlation to US Treasury yields, strong and rapid upward movements in yields tend to contribute to higher correlations, similar to the experience during the taper tantrum of 2013. Finally, emerging markets currencies have experienced a correction primarily due to the strengthening US dollar.

In external debt, we believe that credit spreads are too tight and expect widening in the near term such that investors are adequately compensated for credit risk. We expect a 25-to-50 bps widening in investment grade spreads to a widening of more than 100 bps in high yield spreads before this happens. At these levels, we would expect to shift from underweight emerging markets sovereign credit spreads to a more neutral stance.

Carry Levels Ease Challenges

Currently, we believe investment grade corporate and sovereign yields offer attractive opportunities (Exhibit 10). In both cases, credit risk is limited and thus insulated from spread widening, and high US Treasury yields allow investors to harvest near-record levels of carry.

Regarding local debt, we have pared risk in both local rates and currencies. Local debt is the segment of the EMD capital structure most levered to potential negative tail risk from rising US Treasury yields, which could alter central bank reaction functions across emerging markets and further constrain capital flows. As a result, we are focusing primarily on a handful of idiosyncratic opportunities in local debt.
Looking ahead to the fourth quarter of 2023, we anticipate that the market environment will remain challenging for investors. Consensus estimates predict slowing growth in the United States, recessionary conditions in Europe, and deceleration in China. The combination of declining growth and tightening monetary conditions in the United States and Europe leaves little room for error from idiosyncratic sovereign events or global macroeconomic shocks. Consequently, we have maintained a conservative stance in terms of overall risk and expect to capitalize on EMD opportunities at more attractive valuations in the near future.

Exhibit 10
EM Investment Grade Yields

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Sovereign: JPM EMBI Global Diversified IG; Corporate: JPM CEMBI Broad Diversified IG
Source: Lazard, JP Morgan
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Notes
1 Source: HSBC Global Research: GEMs Equity Strategy. “Will the ‘early cutters’ outperform?” 11 September 2023

Important Information
Published on 11 October 2023.

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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