Outlook on Emerging Markets

Equity

The MSCI Emerging Markets (EM) Index finished the second quarter up under 1.0%, bringing returns to just under 5.0% year to date. There has been renewed outperformance of tech-related themes globally, particularly as growth expectations for generative artificial intelligence (AI) gained steam. For emerging markets, information technology (IT), the second-largest sector in the index, was the strongest performer for the half year. While direct AI-related exposure is small, many Asia AI-exposed companies across Taiwan and South Korea re-rated. Energy and communication services were the other two top-performing sectors this year, while real estate, utilities, and healthcare lagged (Exhibit 1).

Summary

- Emerging markets equities continued to make gains for the quarter and the year. We see the asset class as attractively valued with growth expected to be higher than for developed markets in 2024, serving as a source of ever-changing investment opportunities.
- Buoyed by information technology, the second-largest sector in the MSCI Emerging Markets Index, emerging markets equities moved higher on tech-related gains as growth expectations for generative AI grew.
- Emerging markets debt added to its year-to-date gains with positive returns seen across all segments of the asset class despite significant volatility in US Treasury yields; local debt continued to shine.
- Central banks across emerging economies reacted quickly to inflationary risks, initiating a remarkable series of rate hikes in 2021 that continued until early 2023, allowing them to reap the benefits of falling core inflation sooner than the developed world did.

By region, Latin America (Exhibit 2) was the clear winner over the second quarter and half-year period, led by Mexico and Brazil. Mexico and the Mexican peso have benefited from nearshoring, while Brazil has been helped by a stronger currency and the increased likelihood of policy rate cuts as inflation continues to moderate. In Asia, strong performance across Taiwan, South Korea, and India outweighed the decline in China as concerns over a sluggish post-COVID economic...
recovery weighed on the country. Within Europe, the Middle East & Africa (EMEA), Eastern European countries fared much better than those in the Middle East or Africa. Following elections in May, Greece has been the best-performing market this year, not just in EMEA but across the MSCI EM Index. South Africa lagged on fears of sanctions following alleged arms sales to Russia and on expectations of extreme load shedding by Eskom, the country’s primary electricity provider.

China’s Post-Pandemic Road to Recovery

While China’s reopening at the end of last year provided a boost to economic activity, the country continues to struggle to sustain that growth as evidenced by the drop in PMI figures since March (Exhibit 3). A contraction in both exports and imports in May pointed to more subdued global and domestic demand and is fueling calls for more central bank stimulus. Additionally, youth unemployment reached 20.8%, the property sector continues to struggle, and private fixed asset investment turned negative, the first time since the start of the COVID-19 pandemic, reflecting a lack of investment by businesses.

While weaker economic data may prompt Chinese policy leaders to introduce stimulus measures in the short term, they are likely to lean on existing measures rather than unveil much larger stimulus packages as they did in 2020 and 2022. In fact, the People’s Bank of China announced a series of policy rate cuts recently, while the National Development and Reform Commission also introduced 22 measures to lower costs for firms, including tax breaks. Yet the impact of these easing measures on credit conditions will likely be marginal given that lending rates are already near record lows.

Further, more than 18 months following the default of China’s Evergrande, one of the world’s most indebted developers, Beijing has not yet stabilized the real estate market, which accounts for approximately one-third of China’s GDP. It is contemplating additional measures, such as further loosening administrative restrictions on purchases, supporting policies that lower the cost of home purchases (like down payment requirements and transaction fees), and deploying more financial assistance to speed up construction of unfinished homes. However, these measures would be temporary solutions. Policy leaders would need to introduce confidence-building measures to begin to meaningfully tackle the debt crisis for over-levered property developers.

On the diplomatic front, US Secretary of State Antony Blinken visited Beijing recently for meetings with high-level officials including President Xi Jinping. This visit comes after several meetings between lower-level officials, appearing to signal that the United States and China were ready to reengage in direct dialogue on multiple issues (trade, commerce, national security, global multilateral relations). The resumption of high-level talks increases the possibility of a meeting between US President Joseph Biden and President Xi later this year. At last year’s G20 summit, Presidents Biden and Xi agreed to try to set a “floor” under their relationship, an effort that was soon derailed by the Chinese spy balloon episode.

Both countries are struggling to revive military-to-military communications channels, however, which is critical following two near-collisions between US and Chinese warships and aircraft. Despite signs of increased communications and engagement in the near term, other long-term trends are pointing to increased confrontation: China plans to build a multi-billion-dollar surveillance station in Cuba while the United States is set to sell nuclear submarines to Australia—and to expand defense cooperation with Taiwan.

Why Have Emerging Markets Underperformed the US?

Emerging markets have lagged the United States significantly this year, constrained by concerns surrounding US inflation and monetary policy, the trajectory of the US dollar, geopolitical risks, and global macroeconomic conditions.

However, when comparing emerging markets and the United States by sector, information technology has been the clear winner in both markets (Exhibit 4), led by enthusiasm surrounding the growth potential of generative AI. Multiple expansion have been the main driver of returns year to date, with one notable observation being the lack of market breadth in the outperformance, illustrated by the large gap between the performance of the median stock and the total return of the corresponding index, particularly for the United States. For the
S&P 500 Index, for example, IT drove approximately two-thirds of performance, led by the 179% return for NVIDIA, 134% return for Meta Platforms, and 109% return for Tesla.

Other stocks have not fared as well this year, with the median US security showing just a 4.0% gain compared with over 15% for the S&P 500 Index as a whole, or a more than 11% performance gap. In emerging markets, while the median security’s return of -1.8% lagged the MSCI EM Index’s nearly 5% total return, the performance gap was much narrower than that of the S&P 500.

In the developing world there are far fewer AI beneficiaries, particularly outside Asia. While information technology in emerging markets may have outperformed the MSCI EM Index overall, it has significantly underperformed its US counterpart, up only 21% versus 43%, respectively (Exhibit 5).

Emerging Markets Remain Attractive
Over the past 20 years, emerging markets equities have evolved, serving as a source of ever-changing 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.

Emerging markets economies enjoy an economic growth premium over those of developed markets. After a sharp decline following the global financial crisis, there are reasons to expect an even higher economic growth premium through at least the end of 2024 (Exhibit 6). For example, with its demographic dividend and nearly 80% of its population younger than 50, India is projected to grow well into the 2060s. Indonesia’s growth prospects are also improving as it is climbing up the metals value chain, from ores to processed metals to electric vehicles (EV) as it is home to many of the key metals (e.g., nickel, copper, bauxite) for EV production. 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. Barring a major global recession, we believe 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 remain under-owned despite being attractively valued, with high and improving financial productivity, such as return on equity, free cash flow yield, and dividend yield. Compared to the developed world, earnings growth is expected to be higher in emerging markets in 2024, driven by emerging Asia and information technology companies (Exhibit 7).

### Exhibit 6
**Growth Premium Expected to Shine for Emerging Markets**

<table>
<thead>
<tr>
<th>Economic Growth Premium (EM-DM Real GDP, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EM-DM</td>
</tr>
<tr>
<td>8.3</td>
</tr>
</tbody>
</table>

As of 11 April 2023

Source: Haver Analytics, International Monetary Fund

### Exhibit 7
**Earnings Growth Expected to Be Higher in Emerging Markets**

<table>
<thead>
<tr>
<th>Region</th>
<th>Earnings Growth 2024 (%)</th>
<th>ROE (%)</th>
<th>Dividend Yield (%)</th>
<th>Free Cash Flow Yield (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets</td>
<td>19</td>
<td>12</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Developed Markets</td>
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<td>2</td>
<td>4</td>
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<td>Japan</td>
<td>5</td>
<td>9</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

As of 21 June 2023

Source: Bloomberg, JPMorgan, MSCI
We believe that emerging markets may be one of the most mispriced asset classes, with valuations reaching some of their most attractive levels ever. Overall, we think 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 8), currently hovering at a 26% discount to the MSCI World Index and an almost 35% discount to the S&P 500 Index. Currently, the MSCI EM Index is trading just under 12x on a price/earnings basis over the next twelve months (Exhibit 9), or just above its long-term average of 11.3x.

Debt

Emerging markets debt added to its year-to-date gains during the second quarter, with positive returns across all segments of the asset class despite significant volatility in US Treasury yields as markets reassessed the Federal Reserve’s policy trajectory amid incoming economic data. The yield on the 10-year US Treasury bond rose around 40 basis points (bps) during the quarter, while the yield curve inversion deepened with the difference between the yield on the 2- and 10-year bonds increasing to more than -100 bps. In sovereign and corporate credit, the impact of higher Treasury yields was offset by credit spread compression, while emerging markets local debt continued to outperform core fixed income markets almost entirely driven by lower yields. Emerging markets currencies were roughly flat against the US dollar, consistent with the US Dollar Index.

Rate Hike Cycles Play Their Part

The global inflation surge in 2021–2022 caught the attention of central banks worldwide. However, emerging markets central banks were quicker to respond to this inflationary shock, initiating a remarkable series of rate hikes in the first quarter of 2021 that continued until late 2022/early 2023. This swift action allowed emerging markets countries to witness falling core inflation over the last five months, unlike the developed world, which continues to grapple with entrenched core inflation (Exhibit 10).

By the middle of 2023, we expect all but two major emerging markets central banks—Thailand and South Africa—to have completed their rate hike cycles. We believe that emerging markets central banks are on the brink of a rate cut cycle likely to start in the third quarter of 2023, continuing well into 2024. China has already begun implementing rate cuts, and we anticipate countries across Latin America and Eastern Europe to follow suit.

Historically, periods of excessive gains from duration have occurred from the end of rate hike cycles through the entirety of rate cut cycles. We expect the current situation to follow this pattern. Consequently, we believe the most lucrative opportunity in emerging markets debt investing is currently in local rates, where investors can benefit from high nominal yields, high real yields, and impending rate cuts (Exhibit 11).
Currency Complexities

Our outlook for emerging market currencies (EMFX) is more complex. While EMFX typically performs well during periods of widening growth differentials between the emerging and developed world, the current growth deceleration in the developed world is due to negative factors. If the developed world experiences a recession, EMFX becomes vulnerable, as developed market currencies tend to absorb capital flows during flight-to-safety events. Therefore, our EMFX investing strategy focuses on being beta neutral (with regards to the dollar) and isolating currency pairs that have diverged on a relative value basis.

The Strategy Behind External Debt

In terms of external debt, we find current spread levels tight, with investment grade spreads trading near multi-decade levels and BB spreads near fair value. High yield and distressed debt may appear cheap, but weaker credits are also the most susceptible to a global growth slowdown. As a result, we have concentrated our active overweights in the BB sector while remaining lightly positioned in the lower credit sector for both sovereigns and corporates. Due to tight spreads in A and BBB credits, we remain underweight sovereign spread duration while being overweight US Treasury duration (Exhibit 12).

Exhibit 11
Emerging Markets Local Real Yield
GBI EM GD Countries ex. Turkey 5Y Ex-Ante Real Yields
(5-year Local Bond Yield – CPI)

EM Local Real Yield (%)

As of 31 May 2023
Source: Lazard, Bloomberg

Exhibit 12
Emerging Markets Sovereign Credit Spreads by Quality
EMBI Global Diversified (bps)

As of 31 May 2023
Source: Lazard, Bloomberg, JPMorgan

In corporate credit, we prefer shorter duration instruments to capitalize on their pull to par, amortizing features, or call options. We consider these securities to be less exposed to global macroeconomic risks and can be considered purely idiosyncratic investments. We favor utilities and pipelines within industries, as they usually provide transparent, long-dated cash flow streams.

We predict that the second half of 2023 will be challenging for investors, with consensus estimates forecasting negative growth in the United States, continued stagnation 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 bottom-up sovereign events or global macroeconomic shocks. We maintain a conservative stance in terms of overall risk and are in a highly liquid position, ready to capitalize on emerging markets opportunities that we believe will materialize at more attractive valuations in the near future.
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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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