

Lazard Insights

Conference Call Series

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Emerging Markets: Risk or Opportunities?

Featured Speaker: **Ardra Belitz**, Managing Director, Portfolio Manager/Analyst

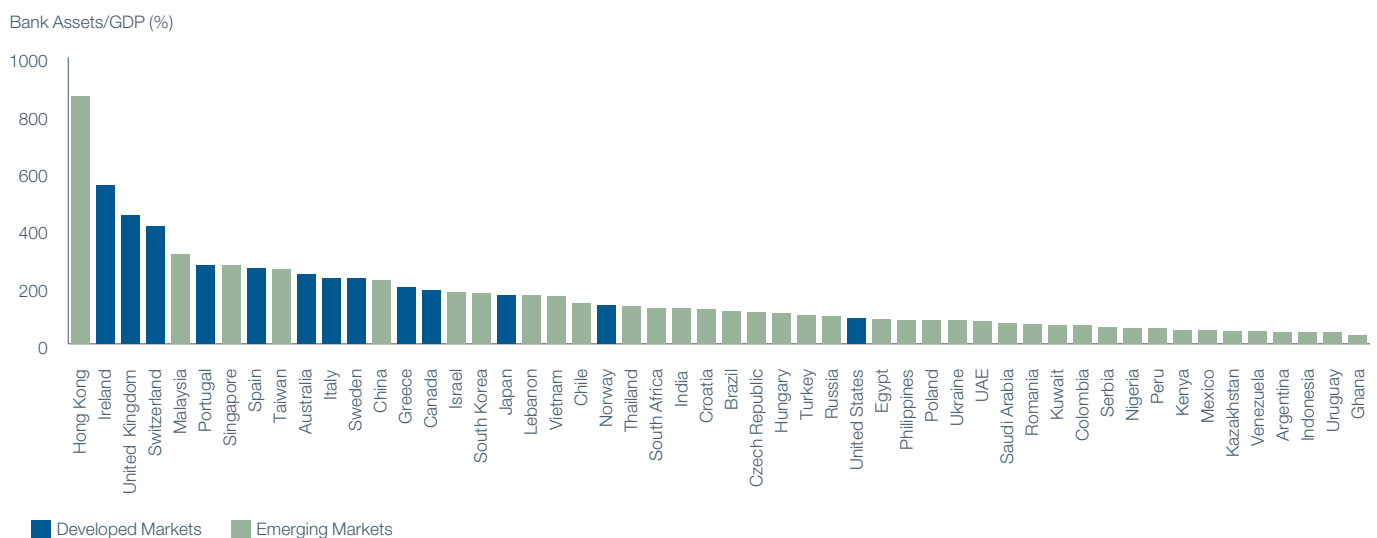
Many emerging market currencies have experienced a dramatic sell-off in recent weeks driven by developed market sovereign debt crises as well as fears of a global economic slowdown. Given this global macro backdrop of market fear and uncertainty, is it time to reassess the fundamental outlook for emerging markets? We will discuss the global backdrop, what emerging market fundamentals tell us in terms of ability and scope to rebalance, trends for emerging market fundamentals and policy responses, recent market developments in asset re-pricing, and the outlook for interest rates and currencies.

Global Backdrop

How did we get to this point? We know that U.S. monetary policy has been remarkably loose. The U.S. Federal Reserve

(the Fed) has injected massive amounts of liquidity, in the form of two rounds of quantitative easing, to support financial markets. However, according to data releases in the second and third quarters of 2011, these injections appear to have had little effect on the economy. U.S. corporations are hoarding cash, although there are indications that corporate investment is currently directed toward emerging markets. Additionally, government sponsored and foreign institutional entity deposits at the Fed have risen sharply. Cyclical policy tools appear to have had limited impact due to structural constraints in the economy and banking systems, not only in the United States, but across the developed world. There appears to be a global search for yield in light of near-zero interest rates, and emerging countries have been among the greatest beneficiaries of the global capital shift in recent years.

Exhibit 1
Emerging Markets Banks Have the Ability to Lend



As of 30 June 2011
Source: ING Estimates

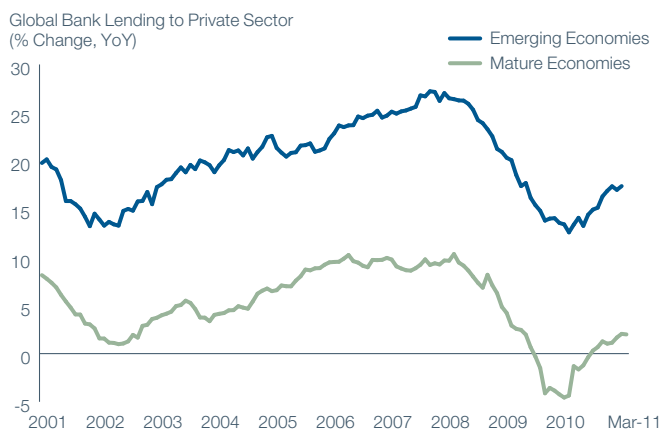
Emerging Market Fundamentals

Given the level of developed market uncertainty, emerging markets' economic outperformance has been impressive, in our view. Not only have emerging market countries continued to grow strongly, but their relative growth resilience has risen relative to developed markets. Why are emerging market countries able to post sustained rates of economic expansion? There are multiple factors that underpin the structural health of the domestic economies within the emerging markets; these include the ability and the willingness of the banking systems to lend. Emerging market exports have also continued to rise steadily despite soft demand from the developed world economies. This is explained in part by penetration gains in the developed markets, and equally, if not more importantly, by incremental demand from China.

Over the last two decades many emerging market countries experienced banking crises, and many of them were able to deleverage their balance sheets. This has contributed to the health of their banking systems. In Exhibit 1, we show the ratio of bank assets as a percentage of GDP around the world. The left side of the chart illustrates that most of the developed world economies are highly levered relative to the emerging market economies' banking systems.

This tells us two things: First, emerging market banking systems have the scope to lend. Second, private sector credit is growing within emerging markets, and it is posting healthy rates of expansion relative to the rates of credit growth in the developed world, which are essentially flat, as seen in Exhibit 2.

Exhibit 2 Emerging Markets Banks Have the Willingness to Lend

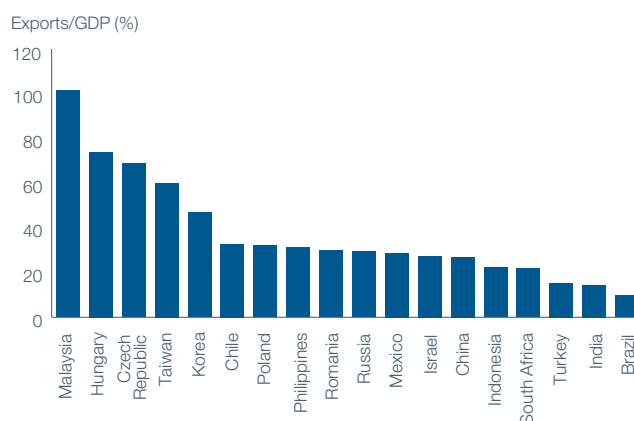


As of 31 March 2011
Source: RBC

The extent to which a country is reliant upon exports as a percentage of GDP is also a differentiating metric when we examine fundamentals across the asset class. For investors that approach emerging market investment with one broad stroke, we believe this is a shortcoming because it does not take into account that some emerging market countries are heavily exposed to global cyclical trade and demand conditions.

There are also a host of emerging market countries, some of which are bellwether countries, which have been heavily represented in indices, such as Brazil, India, Turkey, South Africa, and Indonesia, where export to GDP ratios are quite small, as seen in Exhibit 3. In our view, this is also a significant reason why GDP growth rates in emerging markets exhibit remarkable stability and resilience. There is differentiation between the extent to which each country's growth is reliant upon external trade.

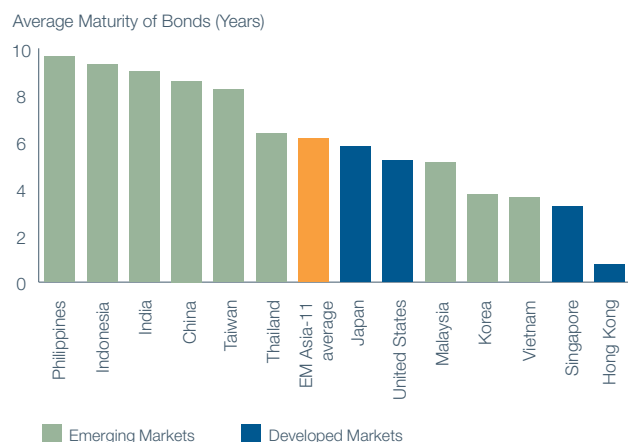
Exhibit 3 Wide Range of Reliance on Exports



As of 31 December 2010
Source: IMF, Haver Analytics, UBS estimates

We also highlight additional aspects of emerging market fundamentals and how we differentiate investment implications among these various metrics. Current account surpluses in emerging markets have been seen across many countries. By definition, this is an abundance of domestic savings rather than investment. The surplus indicates that a country is not reliant on attracting foreign capital to grow or for investment purposes. Additionally, we consider the basic balance of payments, which is the current account plus net foreign direct investment, as a measure of stability. A larger number of emerging market countries exhibit a surplus relative to developed market countries in this metric as well. Another very important differentiating metric is not just the size of debt stock, but the composition of the currency in which it is denominated. Some of the emerging market countries have fairly sizeable debt burdens at more than 80% to 100% of GDP.¹

Exhibit 4 No Obvious Need to Roll Over Short-term Liabilities



As of 30 September 2011

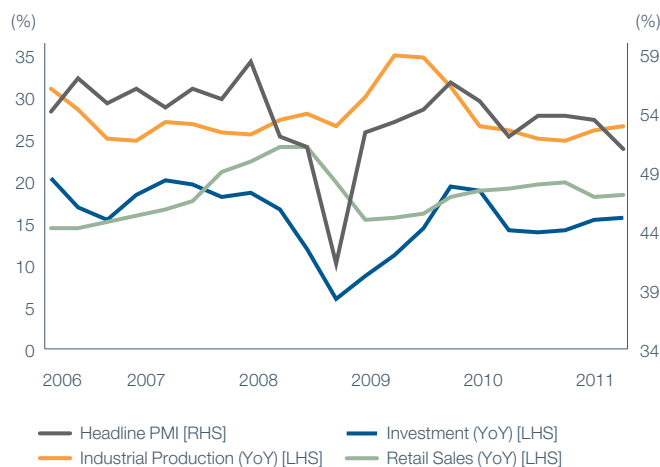
Source: CEIC, Credit Agricole

However, if a country finances itself in its own currency it does not have foreign exchange disparity at a sovereign level. Therefore, it could choose to monetize the debt, which is ultimately currency risk, not necessarily credit risk. India, for example, has a debt-to-GDP ratio that is approximately one-half to one-third the size of developed market countries.² Not only does emerging market debt stock appear to be much smaller than developed market debt stock, but their term structure and resulting duration is also more favorable, as shown in the Exhibit 4.

Finally, headline inflation in emerging markets has risen steadily over the last 18 months, driven by food and energy prices as a component of emerging market CPI baskets. However, over the last six to twelve months core inflation numbers have risen as well, which has prompted monetary tightening cycles in many emerging market countries over the last 12 to 18 months. It appears that inflation is leveling off, which we believe adds flexibility for policymakers to respond to a potential protracted period of soft developed market demand.

While these fundamentals seem generally supportive of emerging markets, much of the dislocation in global markets in the last two to three months was driven not only by concerns over a global slowdown, but also by the fear of a Chinese hard landing. More recently, the increased financing strains in the European banking system and the seeming inability of policymakers in the region to come up with a preemptive and comprehensive solution to solvency stresses has also negatively affected investor sentiment. In our opinion, we do not currently see a reason to worry about the risk of a hard landing in China based on the data. It warrants close attention, but secular trends do appear to be intact. They show

Exhibit 5 Chinese Economic Activity Indicators



As of 30 September 2011

Source: Bloomberg, RBC

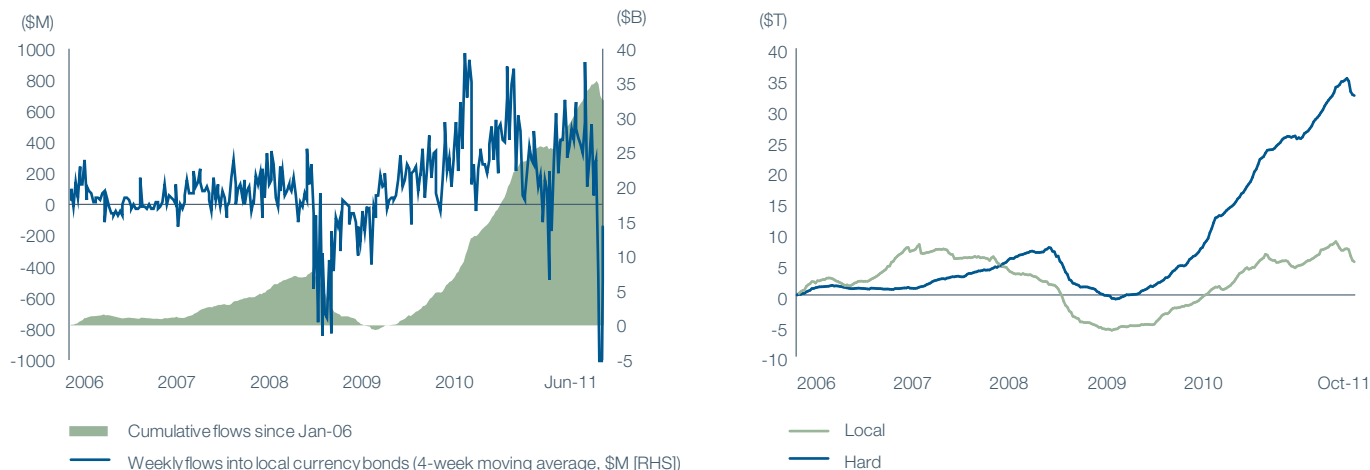
strong rates of GDP expansion, so it appears that China is engineering a policy-induced softening.

Chinese policy is aimed at slowing the rate of fixed-asset accumulation, as shown in Exhibit 5. There is a rebalance of focus occurring from reliance upon fixed-asset accumulation toward a desire to stimulate the domestic economy. This is exemplified by the August import figure, which was a record-high \$155 billion, suggesting that the consumption and domestic demand dynamic in China is faring well. However, we are watching closely for signs of softening. The September trade data does indicate some softening of the external backdrop, but we believe domestic demand conditions remain strong. Overall, the economy grew 9.5% in the second quarter, which followed the approximately 10% growth during the first quarter. This does indicate a soft landing relative to the pace of Chinese growth, and we expect levels of approximately 9% by year end.³

Trends in Emerging Market Currencies

We believe a long-term asset allocation shift toward emerging market investments is underway. Part of this is driven by the increasing recognition that emerging market fundamentals are stronger than those in the developed markets, and their representation in global portfolios is lower than it should otherwise be. However, an increased allocation to the emerging markets will increase the risk of tactical shifts from periodic positioning changes. In our view, this is what the market experienced in September when there was a massive outflow of portfolio capital from emerging market countries, which caused a sharp dislocation in some countries' currency valuation. We see this as more of an opportunity than a risk.

Exhibit 6 Inflows into EM-dedicated Local Currency and Debt Funds



As of 12 October 2011

Source: IMF, UBS estimates

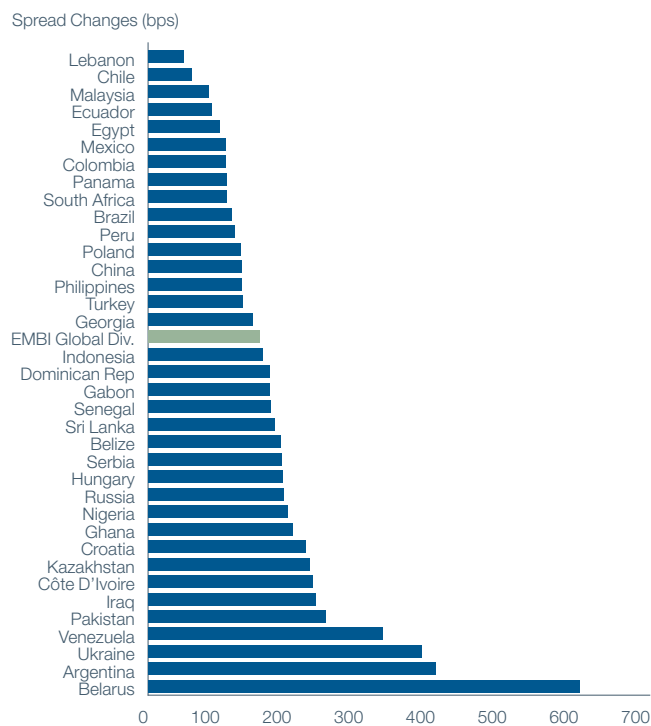
Capital inflows are running at historic highs of about 3% of GDP on average.⁴ Certain countries, which have typically been represented in market indices, have been big beneficiaries of that flow of funds. Therefore, it should not be surprising that when money leaves the emerging markets it does so at the same time, and tends to be from the countries that were among those large beneficiaries. Although the size of the asset class is relatively small compared to developed markets, the flow of funds into emerging markets is potentially enormous. The International Monetary Fund (IMF) estimates that every 1% shift in global pension allocations into emerging markets translates to a \$500 billion flow of funds. In our view, this is not a flow that emerging markets policymakers will readily be able to fight, and as such bodes well structurally for valuations in the asset class, as well as for currencies to rebound following this recent period of dislocation.

This secular shift is underway—although it will be volatile. If you look at the trends and the flows in Exhibit 6, money has gone into emerging markets equity as well as local debt and currency mandates. The increase in local mandates is a significant and notable shift relative to history, as the local currency debt asset class gains increased recognition in terms of its returns potential and, perhaps more importantly, its diversification potential. Relative to GDP, these flows are fairly small, so there is scope for them to grow.

Recent Market Developments

Markets experienced extreme declines from the end of July through September. The activity over this period for various market metrics is shown in Exhibits 7A and 7B.

Exhibit 7A Market Metrics since 31 July 2011

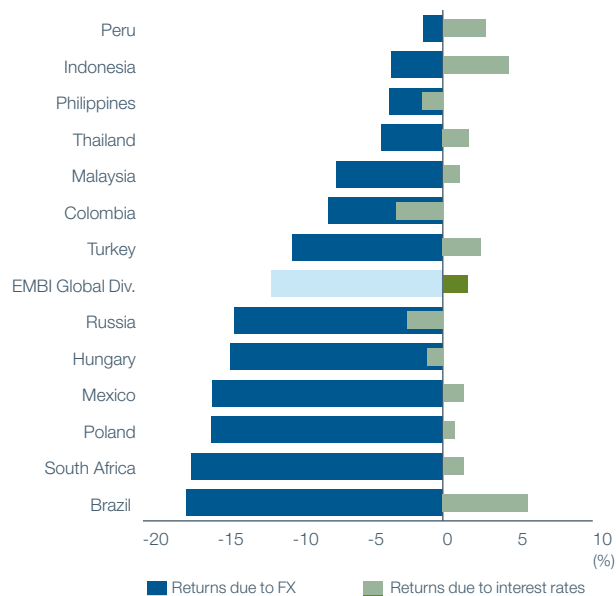


As of 30 September 2011

Source: Lazard, J.P. Morgan

Most strikingly, many emerging market currencies have depreciated by 5% to 20% over this very short time period. The only other time in history when we have seen this magnitude of adjustment

Exhibit 7B Market Metrics since 31 July 2011



As of 30 September 2011
Source: Lazard, J.P. Morgan

over such a short period of time occurred during the October 2008 peak of the interbank credit crisis. In this environment we might see sharp demand for U.S. dollar liquidity. Generally we view this as buying opportunity, however, one must take into account idiosyncratic country fundamentals. For example, Brazil, in terms of its currency loss, was among the largest across all emerging markets. However, its bond market was the strongest performer in total return. This was due in part to the re-pricing of the Brazilian monetary policy when authorities cut interest rates contrary to market expectation. We view this as a partial shift in tone across emerging markets, where policy is increasingly biased toward supporting growth in light of global uncertainties and potentially away from the monetary inflation-targeting agenda that we have lived through over the last ten years. We see value in selectively accumulating inflationary bonds in emerging markets, but there is a palpable shift in the tone of emerging market central banks that we believe investors ought to appreciate.

To the central question: Is this the time to panic? Is it the time to flee the asset class, or is it the time to step back and re-assess? There are many sources of stress, as there have been enormous foreign exchange and local rate movement dispersions, which we see as differentiation. Again, based on fundamental metrics, emerging markets is not one broad trade. There are reasons for caution, but the bearish positioning at the end of September was, in hindsight, quite extreme in our opinion. Positioning indicators illustrate this not just in emerging markets, but also in the shorts in

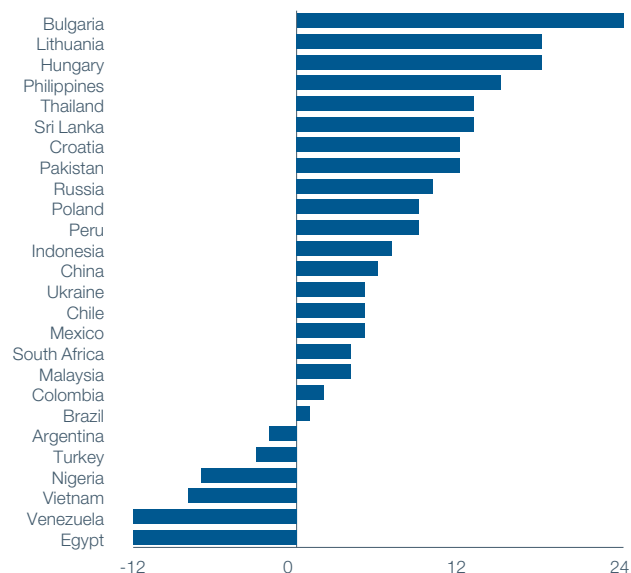
the S&P futures market, which reached extremes last seen during the 2007 and 2008 crisis. We also saw this positioning adjustment in the TOPIX futures market, as well as the Brazilian and Mexican IMF positioning on the Chicago exchange.

Is this time any different from 2008? If we look at the magnitude of currency dislocation experienced of late, most countries have not fallen as far as they did in 2008. However, the dislocation has, understandably, made investors somewhat reluctant to invest in this period of weakness. In addition, there are policy tools available that different countries can selectively deploy. Some of the metrics to consider when analyzing policy flexibility are outlined in Exhibit 8.

Exhibit 8A shows the increase in reserve coverage that is evidenced across a number of countries this year compared to 2008. This illustrates the ability of emerging market central banks to intervene in the event that their currency movement becomes disorderly. Exhibit 8B shows the extent to which Asian current account surpluses have grown during this period, and the extent to which emerging European current account deficits have shrunk, as well as the aggregate surplus, which is probably the most important shift that has occurred in the last three years. Foreign reserves have increased as a percentage of GDP, as illustrated in Exhibit 8C, and have risen markedly across a number of countries. Some

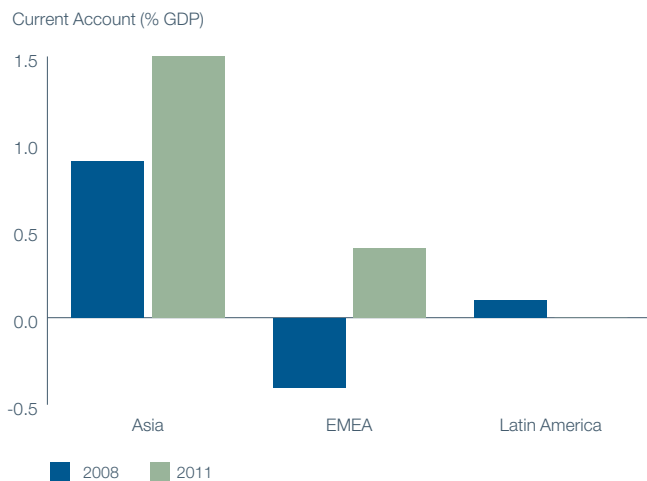
Exhibit 8A Emerging Market Policy Flexibility has Expanded

FX Reserves plus Current Accounts
Balance minus Short-term External Debt
(% GDP) — difference between 2011 and 2008



As of September 2011
Source: Lazard, Haver Analytics, Bloomberg

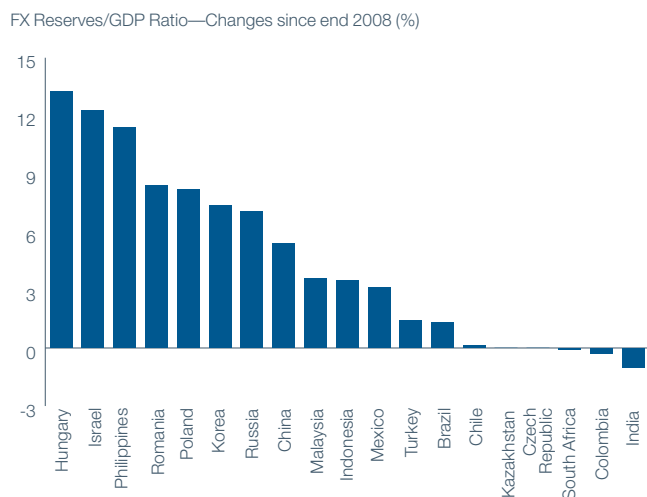
Exhibit 8B Emerging Market Policy Flexibility has Expanded



As of September 2011

Source: Lazard, Haver Analytics, Bloomberg

Exhibit 8C Emerging Market Policy Flexibility has Expanded



As of 31 December 2010

Source: Haver Analytics, UBS

of this movement is explained by formal IMF lending agreements, while some is explained by a basic balance of payment surplus that is positively affecting fundamental appreciation, much of which has been absorbed in central bank reserve coffers and, in doing so, has limited the scope for currency gains during those periods.

Outlook for Interest Rates and Currency

Given this context, what is our outlook for emerging market interest rates? We addressed the underlying growth trends and banking system health, partly explaining the resiliency therein. In addition, output gaps in emerging market countries have largely closed following the 2008 dislocation, so we acknowledge that underlying inflation risks exist, and are not going to disappear. We may be entering a period where headline inflation becomes softer largely because oil prices have declined 30% since April. However, underlying growth, inflation, and the stickiness of core inflation indicators are likely to limit the ability of emerging market central banks to cut interest rates in the period ahead. We believe that a need to re-inflate will likely be addressed by fiscal stimulus, and that the use of blunt monetary tools is highly unlikely in most countries. We appear to be entering a period where interest rate policy is on hold in emerging market countries, as opposed to what had previously been a tightening bias.

To the extent that conditions can normalize in global economic data and European policymakers can contain the contagion risks there and in the broader periphery, we believe emerging market interest rates need to move higher over the course of the next year. Short interest rates are negative, and are at the most negative real interest rate levels relative to recent years. This is contrary to the underlying growth and inflation drivers noted. So, while in nominal terms emerging markets bond yields may appear attractive, note that this attractiveness is relative to core market yields, particularly compared to U.S. Treasury yields, which are currently anchored artificially low by Fed policy. We believe negative real interest rates should be a warning to investors, and buying into a long-duration emerging markets trade at this juncture without considering the risk of capital loss on future interest rate hikes would be, in our opinion, a bit early. In terms of currency dislocation, given the magnitude of adjustment in the space, we believe better opportunity exists.

In terms of currency opportunity, we believe current account surplus nations are well-positioned to weather the storm. They have strong surplus savings over investment, and they do not need to attract capital from abroad for financing purposes. That is not to say that current account surplus currencies cannot come under strong depreciation pressure. For example, the Russian ruble depreciated by 13.5% in the August to September periods.⁵ However, in countries that are structurally in surplus and that have reserve coverage similar to Russia (as evidenced by Russian central bank balance sheets), we would be inclined to buy into that weakness for fundamentally sound countries.

In terms of low external indebtedness, the extent to which a country has borrowed in a currency that is not its own creates vulnerability due to foreign exchange mismatch. There is monetary union across Europe, but no fiscal integration, and the countries, such as Greece, cannot print euros to service liabilities. What may have begun as liquidity stress ultimately became a solvency crisis. Emerging market countries do not indicate such vulnerability for the most part, but there are exceptions. For example, in Hungary external debt is greater than 100% of GDP, and the stock of index reserves is relatively small compared to near-term funding requirements.⁶ We would not invest in the Hungarian forint weakness, in contrast to the prior Russian example outlined.

We look for flexible, transparent policy in emerging markets. If a country is reporting above target inflation, we do not want to see an aggressive willingness to cut interest rates because we believe that indicates a willingness to jeopardize their long-term inflation-targeting credibility. We will be watching the space closely in the period ahead. Most countries indicate fairly healthy foreign exchange risk reserve coverage, whether one measures it in months of imports (the IMF standard is three to four months or higher), or

the ability to cover short-term foreign debt obligations if we assume there is not access to foreign capital markets. Lastly, in respect to the banking systems, countries that have underleveraged debt banking systems have the scope to lend. This is a key differentiating metric compared to the developed markets, in our opinion.

Conclusion

In summary, we do not expect sustained weakness in emerging market currencies, although there will be potential for near-term volatility. We believe the source of that volatility is emanating from non-emerging market sources, which at times overwhelms sound emerging market fundamentals, and correlations rise on the downside. Historically, action has been taken to shrink the balance sheet, and that is what we saw in September—investment shrinking balance sheet risk. Over the medium and long term, we believe fundamentals will ultimately prevail, and this recent dislocation, particularly in emerging market currencies relative to developed market currencies, will prove to be a compelling buying opportunity. However, one needs to be selective in terms of differentiating between countries with sound fundamentals and those where the weakness is fundamentally warranted.

Notes

- 1 As of September 2011. Source: International Monetary Fund
- 2 As of 4 November 2011. Source: Merrill Lynch
- 3 As of October 2011. Lazard estimates. Estimated data is not a promise or guarantee of future results and is subject to change.
- 4 As of 30 June 2011. Source: IIF, RBC
- 5 For the period 31 July 2011–30 September 2011. Source: Bloomberg.
- 6 As of 4 November 2011. Source: Merrill Lynch.

Important Information

Published on 28 November 2011.

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