Outlook on **Emerging Markets**

OCT
2018

Summary

- While 2018 has brought extreme volatility and declines in emerging markets debt and equity, progress in key areas point to a recovery that could be within sight. Global election uncertainty and policy direction, however, are key risks.
- Broad US dollar appreciation reversed in the third quarter as long dollar positioning stabilized at recent high levels. The dollar appears overbought and could provide a catalyst for emerging markets currency gains.
- Earnings growth has moderated along with capex cuts, but it is expected to outpace US earnings growth in 2019.
- Emerging markets equities have the lowest valuations of any major asset class and free cash flow yields estimated at 5%–7% over the next 12–15 months. Their discount to developed markets has deepened to the 30% range.
- Emerging markets debt yields are near post-global financial crisis highs, offering adequate compensation to investors who remain invested, in our view

Equity

Emerging markets equities recorded a volatile third quarter, with gains in July offset by weakness in August. After entering bear territory in September, the MSCI Emerging Markets Index rallied and ended the quarter down about 1.0%, as measured in US dollars.

The quarter brought hints of improvement in a challenging capital markets backdrop, helped by supportive fundamental emerging markets trends. Although the US dollar has broadly strengthened since the second quarter, it retreated to its June level at the end of September. US dollar performance is important to the emerging markets asset class. On average over the past 20 years, the index rose 22.0% when the dollar weakened 5.8% and fell 14% when the dollar strengthened 6.8%.[1] We believe the dollar appears overbought as long dollar positioning is near a historical turning point. Stimulus from US tax reform and capital repatriation may also be wearing off. In the third quarter, hard hit emerging markets currencies advanced against the dollar. The Turkish lira gained 8% and Turkish equities rose more than 20% in September after the central bank raised interest rates by 625 basis points (bps). The South African rand was up just under 4% for the month, while the Russian ruble rose 3%.

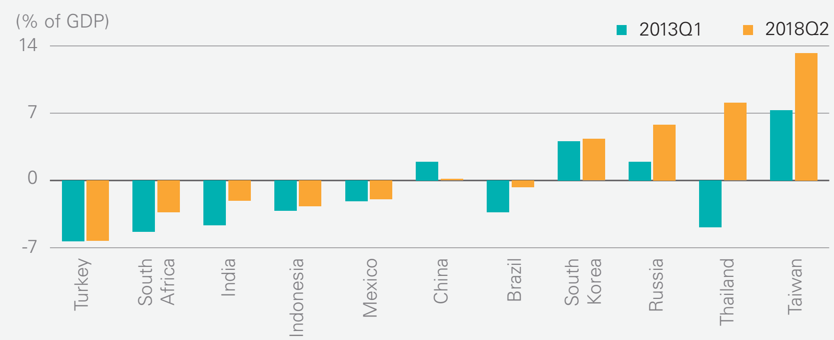
Fundamental Differentiation

Several weeks after Argentina and Turkey's very public economic fallout, we see few signs of contagion. While these events hurt asset class sentiment, the size of these economies and their limited global linkages have helped contain the damage. We firmly believe the asset class is not experiencing a systemic crisis.

The emerging markets complex today shows a roughly even division of nations with current account surpluses and those with deficits. Russia, China, Taiwan, Thailand, and South Korea are in the former group, and Brazil, India, Indonesia, Mexico, and the Philippines belong in the latter group. No countries except for Argentina and Turkey have deficits in the range of 5% or more, as seen in 2013 (the year of the "Fragile Five"). In the past five years, emerging markets countries have overall delivered dramatic improvements in their economic health, primarily Brazil, Russia, Thailand, and Taiwan (Exhibit 1).

Exhibit 1
EM Economic Health Has Dramatically Improved

Current Account Balance



As of 30 September 2018
Source: MSCI

LAZARD ASSET MANAGEMENT

Markets seem to have discounted this fundamental dispersion. Countries with surpluses have had stable or appreciating currencies this year and those with deficits have had currencies in decline (Exhibit 2). It appears that negative sentiment may even have overshot as emerging markets currencies have sold off by more than debt and equity outflows would generally imply. Notably, in the last week of September, emerging markets bond inflows rose to their highest level ($2 billion) since February ($483 million). Emerging markets equities have recorded outflows in nine of the past 10 weeks, but the pace is decelerating.

Trade protectionism remains a real risk, but we believe the global GDP impact is relatively contained for the moment, although company managements appear to be delaying big, long-term spending decisions pending more clarity. During the quarter, markets were unruffled by news of another $200 billion round of US–China tariffs and barely reacted to news that Mexico and the United States reached a preliminary trade deal in late August, as well as an announcement just before the September 30 deadline that the US-Mexico-Canada Agreement (USMCA) would replace NAFTA. Following this trilateral agreement, it is possible that the United States will focus on finalizing a bilateral trade deal with China ahead of the November midterm elections. Some analysts have observed that the longer the trade war persists, the higher the political consequences as increased import tariffs will act as a retail tax on Americans. This theory is consistent with the White House's decision to exclude smartphones, as well as other consumer electronics, from the latest tariff announcement.

Exhibit 2
A Tale of Two Emerging Markets

Current Account Surplus		Current Account Deficit	
Singapore	Russia	Turkey	Peru
Taiwan	China	Argentina	Mexico
Thailand	Poland	South Africa	Chile
South Korea	Czech Republic	Colombia	Philippines
Hong Kong		Indonesia	Brazil
Malaysia		India	
Hungary			

Data through 28 August 2018
Source: FactSet

A New Phase of Capex Cuts

The earnings drivers that drove 2017's rally have moderated but appear to be intact. In particular, capex cuts, initiated during emerging markets' rebalancing from 2011–2015, have driven earnings higher in the materials, energy, and industrials sectors and should continue to do so for the remainder of 2018 and 2019, albeit at a slower pace as companies enter the later stages of cutbacks. In China, capacity rationalization has taken even greater prominence following President Xi Jinping's "Beautiful China" speech last October. Policing of new industrial capacity is now tied to pollution limits, eliminating loopholes that existed when using capacity growth targets. In China's quest for cleaner air, licenses to build new industrial facilities have been reduced if not eliminated outright, and not just in heavy industries dominated by state-owned enterprises.

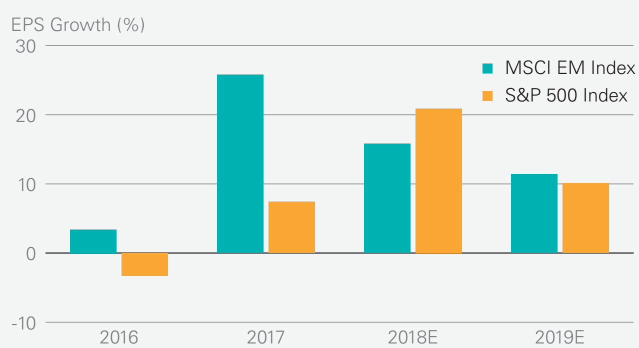
Of note, Chinese credit growth, which was declining, recently ticked higher as China redeployed investment spending as stimulus to offset the impact on growth from tariffs. We believe short term deviations of this kind are to be expected as China walks a thin line between restructuring its economy and dampening credit-driven growth and maintaining the growth that is essential to its social and political stability.

Earnings Downgraded, but Still Impressive

Emerging markets earnings growth in 2018 is expected to be in the high single digits to low double digits despite downgrades reflecting macro stresses. Looking ahead to 2019, we see emerging markets taking the lead from the United States, where earnings are expected to decelerate as the stimulus effects of US tax reform moderate (Exhibit 3).

In 2018, earnings growth is expected to improve in smaller sectors such as health care, real estate, consumer discretionary, and utilities. It is expected to slow in consumer staples and industrials, among other sectors (Exhibit 4). Downgrades have been sharpest in technol-

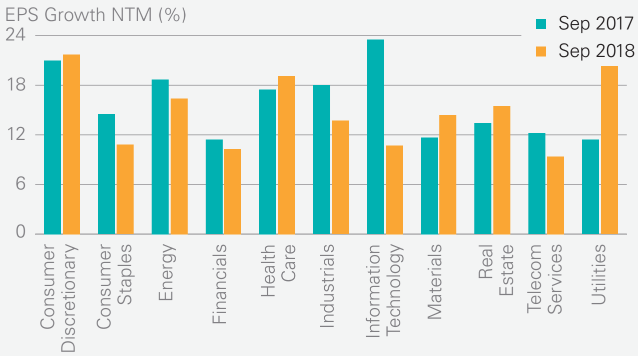
Exhibit 3
Earnings Growth is Expected to Favor EM in 2019



Calendar year earnings per share estimates for 2018–2019 calculated on 30 September 2018
Source: FactSet Market Aggregates

Exhibit 4
The Changing Face of EM Earnings Growth

Earnings Growth by Sector



As of 30 September 2018
Based on the MSCI Emerging Markets Index.
Source: FactSet Market Aggregates

ogy (primarily due to the high base set in the past two years). From a growth perspective, however, we believe tech continues to offer exciting opportunities. In the Chinese internet sector alone there is a race to capture market share, which has created a new generation of entrepreneurship. Chinese founders are breaking moulds, creating and in some cases integrating e-tailing, social media, and payment platforms using different models than exist in the West. Some of the independent tech giants that have been created have quickly become profitable and now have plans to be publicly listed. These IPOs are opportunities for investors with the means to research them. China is also contributing to earnings upgrades in the health care sector. Its "Made in China 2025" industry plan encourages domestic pharmaceutical R&D to address the needs of its aging population.

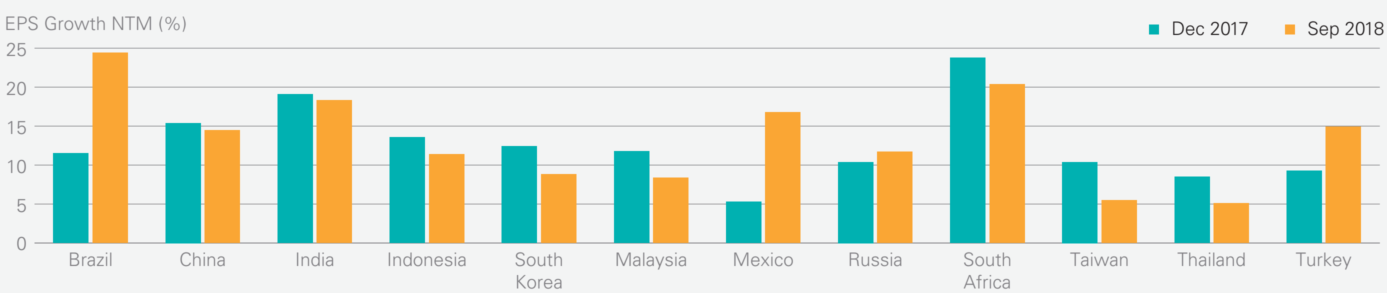
In a reminder that macro and political fundamentals do not necessarily dictate the earnings outlook, earnings growth is still expected to improve in Brazil, Mexico, Turkey, and Russia, countries associated with economic and political difficulties (Exhibit 5). Downgrades have been posted for South Africa, with deceleration also expected in South Korea, Malaysia, and Indonesia.

We expect volatility ahead as tightening financial conditions put pressure on economically vulnerable countries, and US policy announcements could continue to challenge the status quo. Key global elections are also approaching. The outcomes are too close to call and will be closely watched, as the victors' policies will affect emerging markets. These include November midterms in the United States, a presidential election in Brazil on 7 October, and presidential elections in India and Indonesia (expected to be called in early 2019).

Uncertainty has become the norm over the past decade, and so we must examine the facts more closely than ever. Emerging markets equities have the lowest valuations of any major asset class, and this year's underperformance has pushed the valuation discount to developed markets back to the 30% range. The asset class offers the highest real growth globally. Free cash flow yields are estimated at 5.0% in 2018 and 6.6% in 2019.[2] These are high by any standard and competitive with, if not firmly above, developed markets levels.

Emerging markets companies exist not just to survive but thrive. Macro and political clouds have cast a shadow over fertile terrain, and our research suggests this has disguised good investment opportunities. We believe that with style discipline, bottom-up insights, and patience, an emerging markets investor can chart a thoughtful course through a market that could be preparing to turn.

Exhibit 5
Earnings Trends ≠ Macro Trends

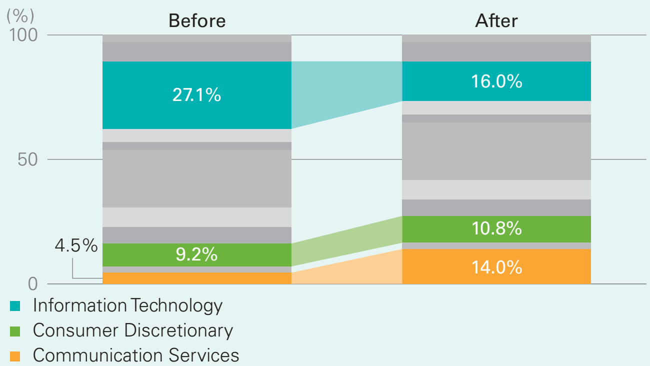


As of 30 September 2018
Based on the MSCI Emerging Markets Index.
Source: FactSet Market Aggregates

Changes to EM Sector Composition

In November, the sector classifications of the MSCI and S&P equity indices will change as part of a GICS Semi-Annual Index Review.

MSCI Emerging Markets Index



As of 30 September 2018
Source: Bloomberg, Data One Strategy, JP Morgan Derivatives, MSCI, S&P

- 35 emerging markets companies will migrate to different GICS sectors. The impact will be biggest among Chinese and Korean index holdings.
- Telecom Services will be renamed Communications Services.
  - Most Chinese internet stocks and some Chinese consumer discretionary companies will also migrate to this sector.
  - Media companies will be included (previously Consumer Discretionary), notably Naspers in South Africa.
  - Certain technology companies (Tencent, Baidu, Naver, 58.com, Momo) will be included under the Interactive Media & Services sub-industry.
  - The Interactive Home Entertainment sub-industry will include NCsoft and NetEase.
- The Internet Software & Services industry classification will be eliminated and replaced with Internet Services and Infrastructure.

Exhibit 6
Progress on Five Key Market Concerns

Concern	Q2 View	Q3 View
US growth vs. rest of the world	Favoring United States vs EM	Turning in favor of EM vs. United States
Trade wars	Significant uncertainty	Market assuaged but significant risks remain
Chinese imbalances	Trending negative	China policy change is credible
Policy error in EM	High with non-credible response	Significant improvement in EM
US dollar positioning	Starting to correct	Growth in USD positioning halts

Source: Lazard

Debt

Emerging markets debt stabilized in the third quarter, as the blended external debt/local debt index gained slightly. US dollar–denominated debt led the way, surging 2.3% while local debt declined about 2.0%. The relatively flat return of the blended asset class understates the significant volatility on both sides of the capital structure in the third quarter.

During the quarter, external debt had four instances of movements in excess of 1 standard deviation[3] (3 positive versus 1 negative). Similarly, the local debt market twice recorded gains exceeding 1 standard deviation and once posted losses within 2 standard deviations, all within the same quarter. As is often the case when a bottom is set, volatility becomes extreme as markets search for a clearing level and this time was no different. We believe the most important guiding principle during times of high uncertainty and volatility is not to panic, not to overtrade, and to continue to evaluate whether the economic conditions in the developing world are as bad as the market might suggest. As a reminder, the 7.0% plunge in emerging markets debt in the second quarter was the single worst episode on record for the asset class since the formalization of the blended benchmark in 2003.

In June, we identified five market concerns that we believed would have to be assuaged before emerging markets debt could bottom. We share our update on their progress (Exhibit 6).

Concern 1: US Growth vs. Rest of the World

The United States recorded stunning 4.2% GDP growth in the second quarter, which was the highest quarterly showing in nearly four years. Not only did the US economy show remarkable strength in that period, but it occurred at the same time that euro zone growth slowed to just 2.2%. Market participants were surprised by this gap and began to parade a narrative in which the United States was growing at the expense of the rest of the world.

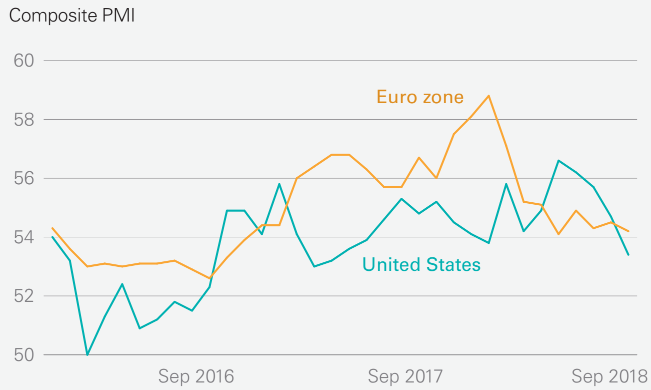
Since that time, two conditions have changed. First, market expectations for third and fourth quarter growth differentials between these two regions have narrowed. In the United States, growth is expected to slow considerably to 2.9% in the second half because of base effects and less overall stimulus. In Europe, growth is expected to slow marginally to 1.9% over the same period. The net effect of these changes is that the nearly 200 bps of US outperformance relative to Europe in the second quarter is expected to halve in the second half of the year. Second, when trying to project beyond the next two quarters, we tend to rely on the strong predictive capability of the global PMI composite surveys. Traditionally, those surveys lead quarterly GDP growth trends by two to three quarters. In the most recent September reading (Exhibit 7), US composite PMI fell below that of Europe.

More importantly, the growth trajectory in the United States has been negative for four consecutive months, while it has been stable in Europe. The narrowing short- and medium-term growth differentials between the United States and Europe are likely to drive significant positive change in sentiment about non-dollar assets. To the extent that growth does begin to slow at a controlled rate in the United States, we would expect recent dollar strength to dissipate, to the benefit of emerging markets performance.

Concern 2: Trade Wars and Determining the Loser

Perhaps the most surprising development of the third quarter was the market's reaction to the early September announcement of $200 billion of additional US tariffs on Chinese imports. Instead of selling off, equity and currency markets rallied. We attribute this to two things. First, additional tariffs had been strongly telegraphed by the US administration throughout the summer and, as such, much of the second quarter dollar strength/emerging markets weakness reflected this negative news. Second, the market seems convinced that these tariffs are temporary. It appears the market views the US strategy as a negotiating tactic, where after a short period, a deal is reached and tariffs are rescinded. That market view was supported in August when the United States announced a bilateral deal with Mexico after more than a year of negotiations. The risk is that the longer tariffs are in place, the greater the chance that the trade war has a pernicious effect on global GDP growth and, as a result, a negative effect on markets. We remain concerned about the tail risk of mutually assured destruction between two superpowers who have (thus far) shown very little willingness to negotiate in good faith.

Exhibit 7
US Leading Economic Indicator Weakens



As of 30 September 2018
Source: Bloomberg, Markit

Concern 3: Chinese Imbalances and Reaction to US Policy

In August, Chinese central bank (PBOC) authorities altered their currency fixing mechanism to include a stabilization factor to take into account US dollar strength. In addition, the PBOC increased reserve requirements on foreign exchange forward contracts to 20% in order to increase the cost of shorting the currency. Those two policy changes have seemingly worked, with the Chinese renminbi stabilizing at roughly CNY6.9/USD (Exhibit 8).

Exhibit 8
Policy Intervention Stabilized the Yuan

As of 30 September 2018
Source: Bloomberg

In addition to these monetary policy changes, China also significantly boosted fiscal stimulus over the past quarter through additional fiscal and infrastructure spending, looser regulations, higher targeted loan growth, and housing policy adjustments. These stimulus and protection measures are very similar to the ones used by Chinese authorities in the second half of 2015, when the renminbi also came under speculative pressure. The eventual result of those policies was a positive reversal of growth trajectory and outsized gains in non-dollar assets over the next two years. While history is unlikely to repeat in order of magnitude, we expect Chinese growth conditions to improve by more than expected in the year ahead, which should provide support to emerging markets assets.

Concern 4: Policy Error in Emerging Markets and Countries' Reaction to Market Pressure

As emerging markets fixed income specialists, we assess emerging markets policy and determine whether it is credible for each country within our universe. Every country is at a different stage of development, has unique vulnerabilities, and reacts to policy choices in different ways. In the first half of this year, many emerging markets countries came under pressure as a result of poor policy choices made in previous quarters and years. While markets can be very forgiving for long periods of time, US dollar strength is almost always the trigger for pressure on emerging markets assets. This year was no different, with market ire focused on Turkey and Argentina for overly loose monetary policy and, in the case of Argentina, a bloated fiscal account.

Turkey and Argentina attempted to improve policy in the second quarter, but these attempts were widely panned by markets as not credible. Only after the pain of significant currency depreciation and spread widening did both countries act forcefully. Turkey hiked interest rates by a higher-than-expected 625 bps in early September. A week later, this was followed with a credible fiscal and growth plan focused on allowing GDP growth to slow while maintaining overall fiscal discipline. Thus far, we have seen very little deposit flight in the Turkish banking system and roll-overs of syndicated loans have proceeded on schedule. None of this means that Turkey is out of the woods in its current difficult period, but market participants are slowly coming to the realization that the negative tail risk in Turkey is sharply diminished.

Similarly, Argentine assets were pressured throughout the third quarter after officials failed to deliver a credible fiscal austerity package in June. This forced the authorities to release a new fiscal plan that called for a balanced primary account in 2019, which was supplemented by $7 billion of extra funding and $19 billion worth of front-loaded near-term support from the International Monetary Fund. Additionally, Argentina committed to 0% growth in its monetary base in 2019 in order to forcefully attack inflation. We view these extreme policy adjustments as tough enough to stabilize Argentine asset prices over the next year. These policies will, no doubt, cause tremendous financial pain for the local populace, which could influence President Mauricio Macri's chances of re-election next October. That being said, with former President Cristina Kirchner having been indicted on corruption charges in September, the risk of an extreme populist taking office is now diminished.

Other emerging markets countries benefited from positive global macroeconomic news. A large number of emerging markets oil exporting countries have revised their growth estimates higher and narrowed their fiscal and current account deficits as Brent oil prices have risen nearly 24% year to date. Non-economic factors were also supportive in the third quarter, with the timeline of additional US sanctions on Russia being pushed back to end-2018, from October/November.

In our view, the most important emerging markets event, however, is in Brazil. First and final round presidential elections will take place on 7 October and 28 October, respectively. The winner will determine whether Brazil will embark on the deep fiscal reform necessary to stabilize its debt ratios. The market believes that a victory by far-right candidate Jair Bolsonaro would result in a high probability of pension reform, while there is considerable uncertainty over what a administration led by leftist candidate Fernando Haddad would look like. Volatility in Brazilian assets should peak in between the two election rounds, we believe, as both politicians try to win over undecided and undeclared voters. Furthermore, the market is anxiously awaiting details of Haddad's fiscal reform plans. In our view, a Bolsonaro win would likely supercharge Brazil's economic stabilization and the incipient recovery for emerging markets debt in the fourth quarter, given Brazil's large weight in fixed income indices. If Haddad triumphs, the market's reaction would depend on his policy rhetoric.

Concern 5: US Dollar Positioning

In late June, we observed that the market had swung from a significant short dollar position to an equally large long dollar position in a very short period of time. In the third quarter, we were encouraged by the stabilization of that long positioning as market participants ceased to add to their long dollar positions (Exhibit 9). We believe this large, stable long dollar positioning provides unused ammunition for an eventual emerging markets rally/US dollar sell-off, which can only occur when growth differentials between the United States and the rest of the world begin to converge. Current US dollar long positioning could also weaken depending on the outcome of the US midterm election in early November. Currently, the market expects the Democratic Party to retake the majority in the House of Representatives, but not the Senate. Should they manage to win both chambers, the chances for policy stagnation and presidential impeachment rise markedly, which would likely support bonds and weaken the US dollar.

Exhibit 9
Dollar Long Positioning Is High

Futures Contracts

As of 30 September 2018
Source: Bloomberg, Chicago Board of Trade

While 2018 has been a period of tremendous volatility and negative returns for emerging markets debt, most economic signs and investor positioning point to an imminent recovery. Current sentiment is particularly poor and valuations have moved to the extreme levels seen after the global financial crisis. While the exact timing of a rally remains difficult to predict, the high overall yield of the asset class provides adequate compensation to investors who wait it out, in our view. Our confidence in the asset class is buttressed by policy reaction in the largest emerging markets countries. While many emerging markets countries missed opportunities to proactively prepare for global pressure, most reacted (albeit belatedly) when that pressure peaked in the third quarter. We expect the market to reward those efforts and for emerging markets credit spreads and currencies to rally in the coming months.

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 Source: Bloomberg, J.P. Morgan, MSCI

2 As of 5 September 2018. Source: Goldman Sachs

3 As measured by rolling 30-day returns since 2010.

Important Information

Published on 5 October 2018.