Outlook on Emerging Markets

Pack Leader

Emerging markets equities began the New Year fresh from 2017’s successes. During the year, the asset class rose 37% in US dollar terms and outpaced developed ex-US equities and US equities, its closest rivals, with gains of 25% and 22%, respectively. The emerging markets rally continues to enjoy strong fundamental support and we believe the earnings outlook remains compelling in 2018. However, it is unlikely investors will see a repeat of last year’s performance, which was extraordinary not just for its vigor but also its concentration of returns. About 60% of the rally was driven by gains in technology and financials companies alone. Rising earnings have resulted in fuller valuations—emerging markets are trading about one standard deviation above their 15-year average—and themes are relatively more crowded, an example being internet-related technology companies. As such, opportunities going forward could be more idiosyncratic and therefore less readily obvious.

Emerging markets equity fundamentals are currently at their best in over a decade. Inflation is low, growth modest but steady, and profitability continues to improve as global demand recovers and businesses tighten fiscal discipline. Earnings are projected to increase 13% in 2018, a moderation from the previous year’s mid-20% earnings growth, but nevertheless strong compared to the poor showing between 2012 and 2016 and reflecting growth from a higher base. In our view, higher earnings growth in 2018 and beyond should support emerging markets valuations and a continuing recovery in emerging markets currencies should also help.

Some of the equity trends that characterized 2017 faded somewhat at year-end. In the fourth quarter, the market’s strong focus on technology and financials broadened to consumer discretionary, materials, and energy companies. In December, style leadership rotated to emerging markets stocks with the lowest price to earnings, interrupting the year-long dominance of stocks with strong price momentum, earnings growth, and return on equity.

US Protectionism

Emerging markets risk appears to be tilted to the first half of 2018, largely due to US tax reform and ongoing NAFTA negotiations. During the fourth quarter, demand for US assets rose and the dollar strengthened slightly as investors anticipated tax cuts. A resurgent dollar poses a risk to emerging markets assets, but it remains to be seen whether a new tax regime will significantly change how global capital is deployed and how this might affect the dollar over the long term. It is estimated that US corporations currently hold $2.5 trillion of their foreign earnings offshore, with nearly three-quarters of the total already in US dollars. The potential conversion into dollars of the remainder is likely to be moderate. Using the 2005–2006 US tax holiday as an example, improving economic growth was the primary driver of dollar strength, not repatriation. Additionally, any meaningful effects of repatriation are likely to be more isolated and could be more evident in certain sectors, including technology, healthcare, financials, and consumer staples.

In the interim, any funds directed to US infrastructure projects and productivity-enhancing programs are likely to benefit emerging markets. US investment is at multi-decade lows and a ramp-up will likely be positive for suppliers in the developing world. It is also possible that repatriated funds are redistributed to some extent in the form of US share buybacks and dividend payouts. We note that emerging markets dividend yields are

Summary

- In 2017, emerging markets equity and debt advanced strongly. We expect this to continue into 2018; however, opportunities are likely to be more idiosyncratic going forward.
- We believe emerging markets equities offer a rewarding but possibly bumpier 2018 as growth accelerates against a backdrop of higher valuations and the possibility of a resurgent US dollar.
- Emerging markets equities trade at a large but now-narrower discount to developed markets amid more favorable growth differentials, strong earnings growth, and significant reform progress in major economies.
- We expect dollar-denominated and local currency emerging markets debt to earn returns that amply compensate for their respective risks, driven by improvements in bottom-up fundamentals, a supportive global economic backdrop, and favorable technicals.
- Risks to our overall outlook are primarily exogenous to emerging markets. These include an increase in developed markets inflation that causes monetary tightening to accelerate, an unexpected global growth slowdown, a central bank policy error, and sustained dollar strength.
competitive with those in the developed world, and they have been on a rising trend alongside emerging markets free cash flow and return on equity (Exhibit 1).

Ultimately, the longer term impact of the new US tax structure on global capital deployment and the implications for the US national debt remains to be seen, and we believe it is this potential for deeper, more lasting change that is most relevant for long-term emerging markets investors.

**Premium on Precision**

In 2017, valuation dispersion within sectors increased quite significantly, although this was masked at the headline level (Exhibit 2). In the seven years since 2011, consumer discretionary companies traded up from 12x to 16x earnings. This concealed large increases in the media, retail, and consumer service subsectors, particularly in 2016 and 2017. During this time, valuations of media companies doubled to 36x, retail jumped from 15x to 25x, and consumer services from 15x to 24x. Similarly, in technology, internet software and services companies surged to 30x earnings in September 2017. Tech hardware and semiconductor companies were fairly unchanged at 9x and 12x, respectively, which dampened the overarching technology sector valuation, which stayed in a 12x–15x range.

As valuation spreads widen in pockets of the universe, investors must be careful to avoid overpaying for growth or falling for value traps as this could undermine gains in the rest of their portfolio. An index-based basket of stocks that did well in the early-stage rally could perform quite differently as the rally evolves. When valuations become less forgiving, that same mix of companies—some fundamentally sound and others now overpriced or fundamentally deteriorating—becomes a less reliable source of returns compared to a few well-chosen, attractively valued holdings.

Moreover, what constitutes “fair value” is highly contextual. Low valuations in themselves may not indicate a good opportunity, just as higher valuations do not necessarily rule out investment. Whether or not a company is considered overpriced, fairly priced, or attractively priced depends on assumptions that are informed by investment horizon, risk tolerance, and investment goals. A skilled active investor forms an independent conclusion guided by their mandate, and this compels them to pursue or avoid opportunities for reasons that may not be immediately obvious to the market.

In 2017, emerging markets equities attracted about $80 billion in flows from both retail and institutional investors. Retail participation rose dramatically in 2016 and 2017, while institutions invested incrementally more, in line with their steady accumulation over a long time period. Active management remains popular in emerging markets—much more so than in other major asset classes, although passive approaches have gained share alongside retail interest. Flows to the four BRIC countries were positive in 2017, with India attracting the lion’s share at about $25 billion. Actively managed funds received over one-half of these Indian flows.
As of December month-end, emerging markets equities were valued at 12.5x forward 12-month earnings, slightly higher than one standard deviation above their 15-year average. We believe this earnings multiple is fundamentally supported by earnings growth. The asset class opportunity continues to look compelling relative to developing markets, which traded at 17.0x earnings at the end of the year. Emerging markets companies are valued at about a 25% discount to developed markets at a point when growth differentials are widening in favor of the developing world, company fundamentals are recovering, and reform momentum is unlocking the economic potential of large countries such as China, India, and Brazil.

**EM Currencies Are Back**

Emerging markets currencies performed well in 2017, with returns that were quite possibly understated due to reserve accumulation by countries seeking to replenish policy arsenals and manage currency strength. The US dollar correction during the year helped, but currencies also had fundamental and tactical backing, the latter including accelerating emerging markets equity inflows and a rotation into emerging markets local debt. The emerging markets export cycle is in an upswing, providing substantial fundamental support. The basic balance of payments not covered by foreign direct investment is also positive for emerging markets as a whole, which should help dampen risks posed by any capital outflows during the year. We expect the currency dispersion that began in 2016 to continue into 2018, providing opportunities for carry trades in high-yielding emerging markets countries with undervalued currencies.

**Brightening Economy, Darkening Geopolitics**

Interestingly, the global economy has come back to life as geopolitical risks have risen. Investors have focused on economic growth with a buoyancy that appears to have offset most reservations they may have about the nuclear threat from North Korea, growing unrest in the Middle East, populist politics, and Brexit. On the last point, emerging markets have been relatively unaffected by Brexit’s difficult negotiations. This is perhaps understandable as continental Europe and the euro zone are enjoying their strongest and most coordinated economic recovery in a decade. However, it also invites the question as to whether emerging markets investors have sufficiently priced in Brexit risk, along with other types of geopolitical uncertainty.

China, with its economic clout, remains a key piece of the emerging markets puzzle. The country’s 2018 growth target has not yet been announced, but could be shy of last year’s 6.5%, keeping in mind the state’s goal to transition the Chinese economy from “high speed growth” to “high quality development.” China’s supply-side and financial reforms have yielded some convincing results. Chinese credit growth moderated in 2017 as authorities tightened financial regulation and raised interest rates to discourage lending and cool the housing market. Capacity has been slashed by 12% and 22% in China’s coal and steel industries, respectively (Exhibit 3). Capacity utilization in steel has increased since 2015 and is projected to reach nearly 90% in 2018. Meanwhile, capacity reduction has been low among aluminum and cement producers, with the former sector only recently included in the supply-side reform agenda.

### Exhibit 3
**Leaner, Fitter Chinese Industries**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Cumulative reduction in capacity since 2015a (mnt)</th>
<th>Reduction in 2014 capacityb (%)</th>
<th>Capacity utilization in 2015 (%)</th>
<th>Capacity utilization in 2017E (%)</th>
<th>Capacity utilization in 2018E (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steel</td>
<td>275</td>
<td>22</td>
<td>73</td>
<td>83</td>
<td>87</td>
</tr>
<tr>
<td>Coal</td>
<td>538</td>
<td>12</td>
<td>88</td>
<td>87</td>
<td>88</td>
</tr>
<tr>
<td>Aluminum</td>
<td>2</td>
<td>5</td>
<td>85</td>
<td>81</td>
<td>90</td>
</tr>
<tr>
<td>Cement</td>
<td>6</td>
<td>0.3</td>
<td>72</td>
<td>75</td>
<td>78</td>
</tr>
</tbody>
</table>

As of November 2017

- a Since 2016 for aluminum
- b Reduction in 2015 capacity for aluminum

Source: Morgan Stanley Research, Ministry of Industry and Information Technology, National Development and Reform Commission
We expect longer-term forces of innovation and recovery to continue to drive growth in emerging markets. Valuations are higher, but they are supported by earnings growth. And while US tax and trade policies could have ramifications for emerging markets through dollar strength and potential capital rotation, speculation continues to outweight facts. These policies and their theoretical stimulus effects remain controversial and untested. What is more, growth and investment in the United States and other parts of the world have generally been beneficial for emerging markets, which participate in the global supply chain.

We believe emerging markets equities offer a rewarding but possibly more modest 2018 as growth continues to accelerate against a backdrop of more crowded popular themes and the possibility of a resurgent US dollar. In a buoyant market, we believe valuation discipline will be increasingly important to achieve capital preservation and capital appreciation for emerging markets investors.

Debt

Emerging markets debt returned nearly 13% in 2017, with local debt outperforming US dollar-denominated debt by a healthy 500 basis points (bps). Return drivers were broad-based, with external spreads falling 57 bps, local yields compressing 65 bps, and emerging markets currencies appreciating by 5.8% against the US dollar. These positive returns, never mind their magnitude, surprised many investors as they occurred during a period of significant political uncertainty in both the developed and emerging worlds. The positive performance also occurred against a backdrop that most feel is negative for the asset class, namely the first half of a US rate hike cycle that is typically accompanied by significantly higher short-term yields. Nonetheless, emerging markets debt overcame these hurdles and outperformed almost every other fixed income asset class in 2017.

This is not the first time that emerging markets have rallied during a resurgence in global growth or a rising rate environment. Looking back at previous economic environments bearing these two features, we see that emerging markets have typically outperformed other risk markets. However, at the start of a new year, it is considerably more important what history tells us about the second half of rate hike cycles.

Unlike previous rate hike cycles, investors have considerably more clarity around the development of monetary policy in both the United States and Europe. Investors have the advantage of forward guidance from the Fed and the European Central Bank (ECB). The importance of forward guidance is often lost on market pundits, but its significance should not be understated. Instead of market volatility around each central bank meeting, speech, and data release, there has been calm. In fact, at year-end 2017, the CBOE Volatility Index (VIX), a popular indicator of market volatility, fell to an all-time low. As a general rule, the lower the volatility, the more conducive the environment for risk assets. Furthermore, forward guidance (especially on the terminal rate) helps investors gauge what stage of the rate cycle they are in and extrapolate what to expect as the cycle ages. Finally, the Fed’s credibility on forward guidance dramatically improved in the eyes of investors in 2017 as its predicted three rate hikes and the beginning of balance sheet reduction came to fruition.

With that in mind, the Fed has maintained, for a while now, that it is likely to hike rates three times in 2018 to 2.00%–2.25% and could wrap up the rate hike cycle toward the end of 2019 at a roughly 2.75% terminal rate. Meanwhile, the ECB has guided that its balance sheet tapering will continue until September 2018, at which point it anticipates an imminent first rate hike. Depending on which forecast is emphasized, the market is of the view that the initial ECB rate hike will occur in early to mid-2019 and overnight rates (currently -0.4%) will not breach positive territory until the end of 2019. Unlike this time last year, when markets did not put much stock in rate predictions by the Fed or the ECB (futures markets predicted just one US rate hike for 2017), this time they are much more synchronized with central bank guidance (futures markets suggest 2.5 hikes in 2018). Furthermore, positioning by investors is currently heavily short both US and euro zone bonds, indicating that investors are already preparing for a significant negative reaction in Treasuries. Due to more reasonable forward expectations and current short positioning in US Treasury bonds, we are not anticipating a significant rise in mid- to long-dated Treasury yields this year.

If these rate hike forecasts are realized, then the first quarter will represent the mid-point of the Fed rate hike cycle, with overnight rates reaching 1.25%–1.50%, versus an expected terminal rate of 2.75%. The first half of the rate hike cycle was characterized by improving developed markets growth, which spilled over to emerging markets through the export channel. Improved growth conditions ended up being a stronger force for emerging markets currency strength than the negative force of higher short-term US rates last year.

Country Highlight: South Africa

South Africa poses an intriguing proposition for investors. Representing about 7.1% of the MSCI Emerging Markets Index at year-end (about equivalent to Brazil’s index weight at 6.8%), South Africa has strong rule of law, with an independent judiciary and law enforcement. Politically and economically, conditions are challenging. The country is in a stagflation bind and corruption and cronyism are rampant. South Africa’s credit rating was downgraded to junk last year.

In December, billionaire investor and South Africa’s Deputy President Cyril Ramaphosa won a closely-fought election for leadership of the ruling African National Congress (ANC). Ramaphosa is expected to run for president in 2019, replacing Jacob Zuma, who has held the office since 2009 and is currently the target of corruption and fraud charges. Ramaphosa is viewed as more business-friendly and better positioned to repair the government’s relationship with the mining industry, the country’s most important source of wealth.

South Africa trades at a premium to the emerging markets index, but when excluding Naspers, a South African internet and media company, it trades approximately in line with the index. Changes in the entrenched power dynamic could be the economic catalyst that investors hope for. But with elections more than a year away, we believe it is premature to draw any conclusions. From a currency perspective, the rand might be considered undervalued if the current political and economic scenario is in line with expectations.
In 2018, we expect US and European growth rates to further accelerate to the mid-2% range, which is highly likely to result in a significant upward revision in emerging markets growth rates over the same period. With higher growth in the developed world comes a likely surge in commodity and goods demand, which has historically been satiated by emerging market exporting countries (Exhibit 4). We believe this time will be no different from 2004–2006 and anticipate that emerging markets currencies and debt spreads will react positively to this development. As such, we maintain our bullishness on emerging market debt, a view that we were admittedly late to adopt, but one that we have held since the second quarter of 2017.

In the context of a bullish macroeconomic backdrop, higher GDP growth rates ought to be a panacea for many of the ills that face emerging markets countries. Higher growth rates immediately improve fiscal accounts (as we are currently witnessing in Asian countries like Indonesia and Philippines). Better growth conditions also result in peaking debt ratios and can potentially lead to a deleveraging cycle (as is currently happening in African countries such as Ghana and Zambia). Furthermore, improved growth conditions makes difficult structural changes more palatable to local populations (as illustrated by pension reform negotiations in Argentina and Brazil). It should be noted that we expect South Africa to join the list of “reforming” emerging market countries as the populace expects Ramaphosa to assume the presidency.

With very few exceptions, every emerging markets region is rife with countries that have improving bottom-up credit, leverage, and fiscal conditions and a real chance at structural reforms that can last through future administrations.

Our bullish call on emerging markets debt is not without risks. One major potential macro risk is a dramatic change in central bank guidance toward significant monetary policy tightening because of rapidly increasing inflation. If this were to occur, investors would immediately start questioning the sustainability of economic growth and revise those expectations lower. Another large risk is growth. To the extent that there is an unforeseen global event that causes the coordinated economic growth resurgence to falter for a sustained period of time, either through a reduction of confidence or a large geopolitical shock, that would be damaging to emerging markets asset prices.

At an idiosyncratic level, emerging markets countries are no longer enjoying the benefit of doubt from investors, unlike before the global financial crisis. While economic conditions are supportive of higher asset valuations, policy error can still sink countries. Last year, Turkey learned this the hard way as the only country to post negative local returns. Continued interference by the executive branch diminished investors’ confidence in central bank autonomy at the same time that inflation spiked due to strong credit growth and higher headline commodity prices. The result was a significant devaluation of the Turkish lira, making it one of the worst-performing currencies in an otherwise strong year for the asset class. In an extreme example, Venezuela has been making policy mistakes for well over a decade. The once-prosperous country that boasts massive oil reserves and a strategic location close to its major export market has defaulted on its debt. It is difficult to imagine an oil-exporting nation defaulting at an idiosyncratic level, emerging markets countries are no longer enjoying the benefit of doubt from investors, unlike before the global financial crisis. While economic conditions are supportive of higher asset valuations, policy error can still sink countries. Last year, Turkey learned this the hard way as the only country to post negative local returns. Continued interference by the executive branch diminished investors’ confidence in central bank autonomy at the same time that inflation spiked due to strong credit growth and higher headline commodity prices. The result was a significant devaluation of the Turkish lira, making it one of the worst-performing currencies in an otherwise strong year for the asset class. In an extreme example, Venezuela has been making policy mistakes for well over a decade. The once-prosperous country that boasts massive oil reserves and a strategic location close to its major export market has defaulted on its debt. It is difficult to imagine an oil-exporting nation defaulting at a time when oil prices have risen to the mid-60s per barrel, but policy cuts both ways. We fully expect Venezuela’s macroeconomic position to worsen in the months ahead and bond prices to fall further; that being said, it is highly likely that worst-case scenarios will be fully priced in later this year, potentially resulting in a very compelling entry point into large investments in that country.

Overall, in 2018 we expect strong gains in both dollar-denominated and local currency debt, in line with their respective volatilities. We believe external spreads will re-test their tight post-financial-crisis levels as economic conditions brighten across the asset class. We also expect investor flows to pick up further as investors chase the high absolute returns and very compelling relative returns that the asset class has to offer relative to other types of fixed income investments. This will likely result in 2017 and 2018 going on record as having the largest two-year inflows in the history of the asset class. We expect local debt to finally gain the respect it deserves and attract more flows than dollar debt. That should force valuations higher for emerging markets currencies and rates.

In conclusion, we expect this year to be the sweet spot in a multi-year rally for emerging markets debt. We believe there ought to be less global macroeconomic uncertainty, strong bottom-up economic performance, more widespread positive regime changes, and higher commodity/asset prices. This combination should drive returns. We urge investors to maintain their structural overweight to the asset class, as the expected returns are likely to compensate for the risks.
Outlook on Emerging Markets

Notes
1 Emerging markets equities as measured by the MSCI Emerging Markets Index; developed ex-US equities by the MSCI EAFE Index; US equities by the S&P 500 Index. Expressed in US dollar terms.
2 UBS Global Macro Strategy. 21 December 2017.

Important Information
Published on 8 January 2018.
This document reflects the views of Lazard Asset Management LLC or its affiliates (“Lazard”) based upon information believed to be reliable as of the publication date. There is no guarantee that any forecast or opinion will be realized. This document is provided by Lazard Asset Management LLC or its affiliates (“Lazard”) for informational purposes only. Nothing herein constitutes investment advice or a recommendation relating to any security, commodity, derivative, investment management service or investment product. Investments in securities, derivatives and commodities involve risk, will fluctuate in price, and may result in losses. Certain assets held in Lazard’s investment portfolios, in particular alternative investment portfolios, can involve high degrees of risk and volatility when compared to other assets. Similarly, certain assets held in Lazard’s investment portfolios may trade in less liquid or efficient markets, which can affect investment performance. Past performance does not guarantee future results. The views expressed herein are subject to change, and may differ from the views of other Lazard investment professionals.

This document is intended only for persons residing in jurisdictions where its distribution or availability is consistent with local laws and Lazard’s local regulatory authorizations. Please visit www.lazardassetmanagement.com/globaldisclosure for the specific Lazard entities that have issued this document and the scope of their authorized activities.

Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one’s home market. The values of these securities may be affected by changes in currency rates, application of a country’s specific tax laws, changes in government administration, and economic and monetary policy. Emerging markets securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in these countries.

The strategies invest primarily in emerging markets debt positions. The strategies will generally invest in debt investments denominated in either US dollars or local emerging markets currencies. As such, an investment in the strategies is subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging markets investments, including currency fluctuation, devaluation, and confiscatory taxation. The strategies use derivative instruments that are subject to counterparty risk.

Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation, and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss.

The strategies will invest in securities of non-US companies, which trade on non-US exchanges. These investments may be denominated or traded in both hard and local currencies. Investments in currencies other than US dollars involve certain considerations not typically associated with investments in US issuers or securities denominated or traded in US dollars. There may be less publicly available information about issuers in non-US countries that may not be subject to uniform accounting, auditing, and financial reporting standards and other disclosure requirements comparable to those applicable to US issuers.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.