

Outlook on Emerging Markets

JAN 2024



Summary

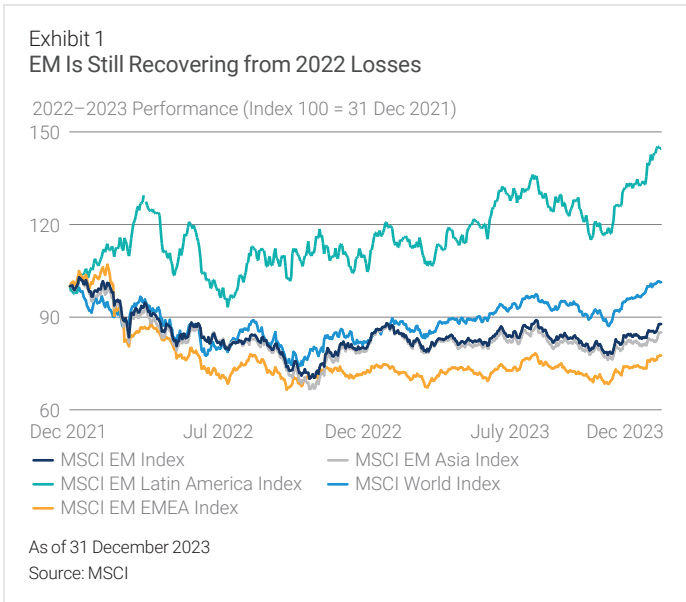
- We believe emerging markets (EM) equities are becoming ever more attractive as it remains one of the most mispriced asset classes globally with valuation discounts relative to developed markets and US equities hovering near 30% and 40%, respectively.
- While many parts of EM equity remain markedly under-owned despite their low cost, we expect earnings growth to be higher in EM in 2024 compared to the developed world, driven to great extent by emerging Asia and information technology companies.
- Because fixed income markets historically tend to generate equity-like returns during the period between the end of central bank rate hikes and the completion of rate cuts, we remain constructive on EM debt amid a backdrop of ongoing monetary cycle easing.
- Considering the dispersion in monetary and fiscal policies, we believe ample opportunities for alpha generation in EM debt fill this election-heavy year.

Equity

Following broad market declines in 2022, 2023 started with low and declining expectations for global growth and elevated fears of the onset of a recession. However, China's reopening after the pandemic, large fiscal stimulus packages in the United States and Europe, and the resilience of US consumers stabilized global economic growth. In the United States investors ignored concerns over the sustainability of the fiscal outlook and the US debt downgrade last summer. For much of 2023, nearly all the S&P 500 Index's gains came from a small number of mega-cap companies ("Magnificent Seven") that capitalized on technology growth trends including artificial intelligence, cloud computing, and cutting-edge hardware and software. The rest of the stock market was largely in a "holding pattern," unsure of prospects for the economy.

All of this occurred despite the largest increase of interest rates in decades, wars in Ukraine and the Middle East, high energy prices, a regional banking crisis, and a recession in parts of the euro zone. While the second half of the year began with a "higher-for-longer" mentality, the focus in the fourth quarter began to shift to the timing of the first rate cuts, as many central banks approached the end of their tightening cycles, reassured by the downward trajectory of inflation in developed markets (DM). In emerging markets (EM), some central banks began their easing cycles in 2023, including Hungary in May and Brazil in August.

Over the fourth quarter, falling inflation and declining rates supporting a relatively soft landing generated an 11% rally in global equities. The fall in the US 10-year Treasury yield from 5% to 4% was a key catalyst for significant gains in the last two months of the year. Global equities (MSCI All Country World Index) were up 11% in the fourth quarter and more than 22% in 2023, while developed market equities (MSCI World Index) posted comparable returns, 11% and 24%, respectively. This meant that by the end of 2023, for developed market equities, many regional indices had recovered most of the ground lost in 2022. However, in emerging markets (MSCI EM Index) the story was different: Despite ending up nearly 8% in the fourth quarter and nearly 10% in 2023, much of 2022's losses are yet to be recovered. EM Asia and EM EMEA remained subdued, while Latin America performed better (Exhibit 1).



Elections across the Globe: What to Watch in 2024

2024 is shaping up to be one of the busiest electoral calendars in recent years, not just within emerging markets but also developed markets, with votes taking place in countries accounting for over a third of EM GDP. The upcoming votes will have important implications for geopolitics and potentially global supply chains as well as long-term economic reform prospects and fiscal trajectories in certain markets.

While global economic fracturing between US- and China-led blocs appears to be the new normal, elections in Taiwan at the start of the year and in the United States toward the end of 2024 could potentially contribute to widening this rift. Taiwan's outgoing president of the Democratic Progressive Party Tsai Ing-wen is most likely to be replaced by another member of the same party, Lai Ching-te, which could mean a more volatile relationship with China. However, Lai's lead in the polls has narrowed recently, with an opposition victory potentially leading to a near-term easing of tensions with—and a lifting of sanctions from—China, especially if the Kuomintang (KMT) party were to take office. We believe, however, that the threat of invasion would still linger.

In the United States, it is still too early to declare a victor and it is a very uncertain situation. Republican frontrunner and former President Donald Trump has been indicted on 91 separate felony criminal charges, and if convicted might not be able to vote for himself, though he could still be elected. For President Joseph Biden, concerns have developed regarding his age, and any serious medical issue could negatively impact his campaign. The return of Trump as president is likely to lead to a more isolationist approach that strains relations with many US allies. It could also spell the end of US support for Ukraine with strategic consequences in Europe and Asia. Relations with China are likely to remain tense under either candidate, but the approach might be unilateral under Trump and more multi-lateral under Biden. Under the Biden administration, tensions with China have broadened to include areas such as technology transfers, financial flows, and semiconductors. A Trump victory could see a return to a narrower form of fracturing, perhaps focused primarily on trade.

For Indonesia and India, upcoming elections may influence the direction of long-term structural reforms. In Indonesia, outgoing President Joko Widodo has sought to make his country, home to the world's fourth-largest population and a key supplier of metals such as nickel, copper, and bauxite for batteries and electric vehicle production, a more integral part of the international supply chain. This year's election points to policy continuity as both candidates have pledged to continue pursuing the business-friendly reforms under Widodo.

India's Prime Minister Narendra Modi is seeking his third term in office and over the past decade has overseen the roll-out of infrastructure upgrades, a national digital identity system, and digital payments. If successful, his Bharatiya Janata Party could become the first party since 1971 to win a third-consecutive majority. This would likely set the stage for continued gradual reforms to sustain the country's strong economic growth trajectory. The coming years may be crucial in determining whether India can capitalize on the opportunities presented by friend-shoring or China Plus One supply chain strategies to develop a large, productivity-boosting export manufacturing base.

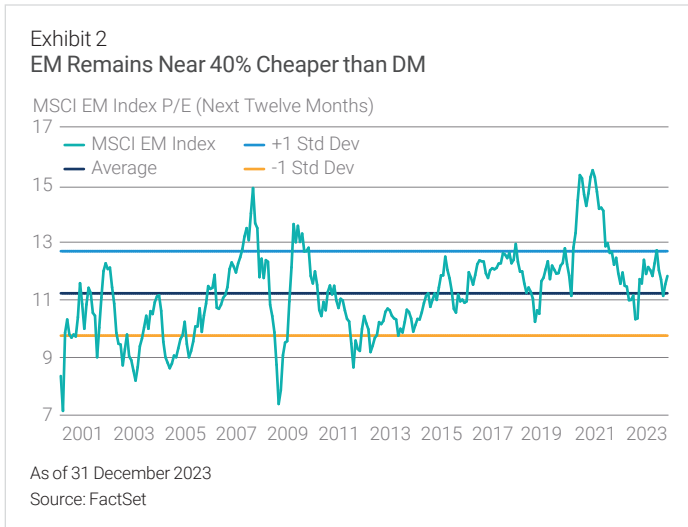
In a handful of countries, elections may mean a shift away from fiscal responsibility, which would raise public debt risks. The most high-profile of these is South Africa. While President Cyril Ramaphosa is expected to be re-elected, there is a risk that the African National Congress party will fail to clinch a majority for the first time since the end of apartheid in 1994 and be forced to enter a coalition with the left-wing Economic Freedom Fighters, worsening the country's already fragile public finances.

Argentina, under new President Javier Milei, is actively taking steps to contain its economic crisis and control inflation, which is expected to exceed 200%, by devaluing the peso by about half, cutting public spending, and reducing subsidies for energy and transport.

Emerging Markets: Ever More Attractive

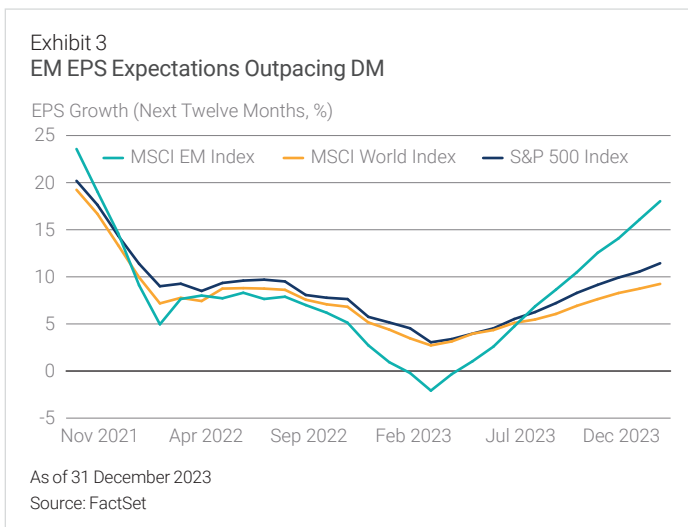
We believe emerging markets remain one of the most mispriced asset classes globally. While absolute valuation levels have moved higher since they bottomed in the fourth quarter of 2022, relative to DM equities, valuations remain generally inexpensive. Valuation discounts relative to developed markets and US equities are hovering near 30% and 40%, respectively, both wider than their long-term averages. The sharp rise in the EM discount relative to DM is driven to a significant extent by China's low valuations. Ex-China, however, EM discounts are inline with the 10-year average. Currently, the price-to-earnings (P/E) ratio for the MSCI EM Index is trading at approximately 12x over the next twelve months, or slightly above its long-term average of 11.3x (Exhibit 2).

Over time and barring any adverse geopolitical or economic events, we would expect this valuation discount to narrow, driven by a combination of stronger earnings growth, the potential increase in EM profitability, where the return on equity gap of emerging versus developed markets narrows, and the possible widening of the economic growth premium. EM economies enjoy an economic growth premium over those of DM. Not since the 2000s during the commodity super cycle has the economic growth premium been moving in emerging markets' favor. Boosted primarily by energy companies in Latin America, dividend yields for the MSCI EM Index



remain an attractive characteristic for the asset class, sitting at just under 3%, a near 20% premium relative to history and double that of the S&P 500 Index.

Following a sharp decline throughout 2021 and 2022, earnings growth expectations have moved higher for emerging markets compared to developed markets, including the United States (Exhibit 3). Within the standard MSCI EM Index, Asia leads all regions, followed by Europe, Middle East & Africa and Latin America. Within Asia, China internet platform companies, of which the biggest stocks are in media and entertainment and retailing sectors, are also among the bigger contributors to earnings growth. The sector has seen earnings upgrades and an improvement in profitability on the back of lower subsidies, cost cutting, and more cautious capital allocations.



From a sector perspective, IT leads all sectors, and the memory cycle could find support with demand recovery broadening across several segments. Some supply discipline is also likely to continue with inventory digestion well underway. IT is followed by utilities, materials, and healthcare.

Today, economic growth across regions is moving in a non-synchronous fashion, which, we believe, should result in a more balanced global growth outlook. EM economic growth, driven by more than just China, is now starting to move higher as DM growth slows. India is expected to benefit from a demographic dividend with nearly 80% of its population younger than 50, while Indonesia's growth prospects are also improving as it is climbing up the metals value chain. Beyond Asia, growth prospects in Latin America, namely Brazil and Mexico, have greatly improved on the back of nearshoring trends and an increase in foreign direct investment as companies adjust their global supply chain strategies. European growth has been relatively weak underlying the synchronized and relatively imbalanced nature of global growth.

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

The preceding outlook reflects the views and analysis of Lazard's emerging markets equity team. The following outlook reflects the views and analysis of Lazard's emerging markets debt team.

Debt

Emerging markets debt (EMD) ended the year on a high note, posting its largest quarterly gain since 2020, bringing the gain for 2023 into double digits across both sovereign credit and local debt. Lower global inflation eased concerns around the policy trajectory of major global central banks during the fourth quarter, contributing to a sharp decline in global yields. After briefly rising over 5% for the first time in more than 15 years in October, the yield on the 10-year US Treasury bond fell over 100 basis points (bps) from its peak and ended the year roughly unchanged at 3.88%. Emerging markets local debt yields fell roughly 60 bps in the fourth quarter, benefiting from the decline in core rates, while emerging markets currencies appreciated over 3% in aggregate as the dollar spot index (DXY) declined over 4.5%.

As we enter 2024, we maintain a constructive outlook on EMD amid a backdrop of ongoing monetary cycle easing. Fixed income markets historically tend to generate equity-like returns during the period between the end of central bank rate hikes and the completion of rate cuts. We expect this trend to continue as major global central banks have concluded their rate hike cycles, with inflation remaining better than expected and labor markets loosening.

Key macroeconomic trends shaping our base-case scenario for 2024 include:

- The European Central Bank (ECB) and the Federal Reserve initiating a traditional cycle of rate cuts in mid-2024, extending into mid-2025.
- Developed markets growth stagnating at near 0% in the first half of 2024, with only tepid improvement in the second half of the year.
- Emerging markets growth picking up in the second half of 2024 as a result of significant policy easing enacted in 2023 and 2024, with leading EM economic indicators bottoming out around mid-2024.

Ample Opportunities Fill a Year of Elections

Considering the dispersion in monetary and fiscal policies and the heavy election year in 2024, we believe there are ample opportunities for alpha generation. In sovereign credit, countries we currently favor include Colombia, Oman, Indonesia, Azerbaijan, Paraguay, and Serbia, while we continue to avoid AA and A countries, where credit spreads remain near multi-decade tights.

In local debt, we see opportunities in high yielders where real yields remain substantially above potential growth rates (Exhibit 4), while we are generally avoiding duration exposure in Asian low yielders, most notably China and Thailand. We believe 2024 will also be rife with idiosyncratic opportunities, with elections scheduled for major emerging markets including El Salvador, Pakistan, Indonesia, Senegal, Turkey, India, South Africa, Panama, Dominican Republic, Mexico, Sri Lanka, Uruguay, Venezuela, and Ghana.

Sturdy Flows Help Carry the Day

In terms of asset class inflows, we believe 2024 will be a strong year for EMD, which should support technicals. Asset class inflows tend to be highly correlated with 12-month trailing index performance (Exhibit 5), and with double-digit returns as of the end of 2023, we expect inflows to return.

Against this backdrop, however, we have identified two potential tail risks to watch for EMD in 2024:

- **Hard Landing:** In this scenario,—in which we anticipate slow growth, but not a financial crisis—we see potential for significant spread widening and EMFX depreciation. However, we believe the asset class should be insulated against a large drawdown given the high carry in EMD combined with lower US Treasury yields we expect in such an environment.
- **Inflation Reaccelerates:** In this scenario, global inflation inflects higher, prompting developed markets central banks to restart rate hikes and EM central banks to end rate cuts early. We would expect US Treasury yields to rise to new cycle highs, EM credit spreads to widen, and credit events (i.e., defaults) to spike as EM countries face challenges accessing capital markets, resulting in losses for the asset class.

However, we maintain a constructive outlook for EMD in the coming year, driven by favorable macroeconomic trends and opportunities

Exhibit 4

Local Debt High Yielders Show Potential

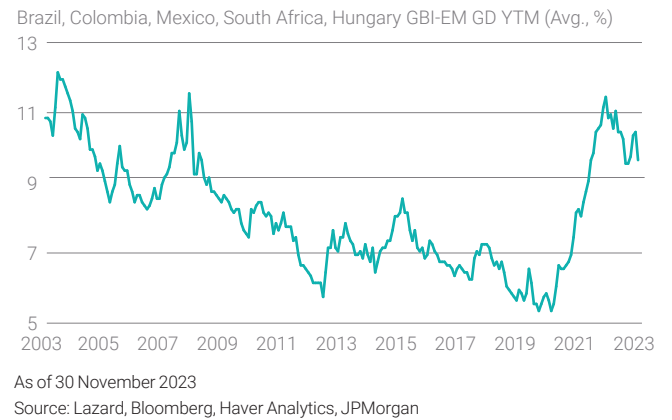
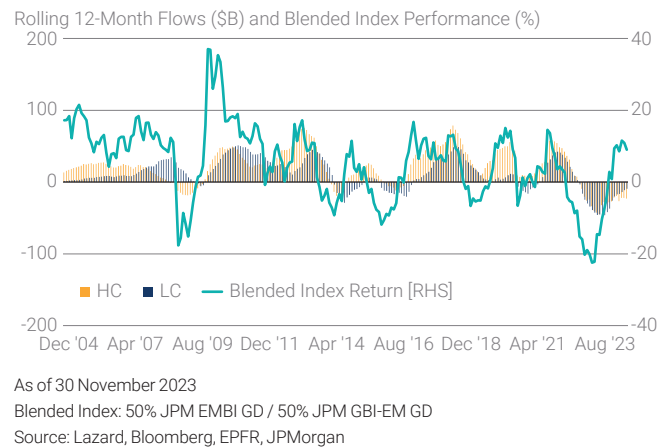


Exhibit 5

EMD Flows Typically Follow Performance



for alpha generation. We will continue to monitor potential risks and global developments to help ensure we are well-positioned to capitalize on upcoming opportunities.

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The MSCI All Country World Index (ACWI) is a free-float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The index is unmanaged and has no fees. One cannot invest directly in an index.

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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