Outlook on **Emerging Markets**

OCT
2015

Summary

- The third quarter was challenging for emerging markets assets primarily due to concerns about Chinese growth, weaker commodity prices, and uncertainty over a US Federal Reserve rate decision.
- Valuations in emerging markets equity and debt remain compelling, but catalysts are needed to change the market's narrative.
- Sentiment can abruptly reverse, as seen over the past nine months in Russian and Indonesian stocks, rendering fundamental analysis and prudent security selection crucial.
- Adjustments in China's currency and local stock exchanges, and its pivot from fixed-asset investment to a consumption-led model have created uncertainty. Our emerging markets equity teams have no exposure to the onshore A-share market.
- We believe companies with structural advantages such as low dollar-denominated debt and stronger balance sheets are likely to outperform their peers in current conditions.
- Given the low probability of near-term catalysts, our equity and debt teams are focused on bottom-up analysis, as we also expect significant dispersion between individual countries and companies.

Lazard's emerging markets platform consists of experienced investment teams with differentiated philosophies and portfolio management processes. Each team has independent views that are enriched through discussions with colleagues throughout the platform and the firm. Thus, opinions across the platform may vary.

The third quarter was one to forget for both equity and fixed income markets. The pain was felt regardless of capital structure or region, with some of the worst quarterly returns for major indices since late 2011 (Exhibit 1). The primary drivers for the quarter's market correction were (a) worsening Chinese data, (b) lower commodity prices, (c) a rout in Brazilian financial markets, and (d) the US Federal Reserve's insistence on a year-end rate hike.

Exhibit 1
Universal Pain in 3Q 2015

Asset Class	3Q Return (%)
US Treasuries	1.76
US Fixed Income	1.23
Global Fixed Income (unhedged)	0.85
EM Sovereign Debt	**-1.71**
EM Corporate Debt	**-2.76**
US High Yield	-4.86
US Equities	-6.44
EM Local Debt	**-10.54**
German Equities	-11.74
Commodities	-14.47
EM Equities	**-17.79**
Chinese Equities	-27.90

Returns as measured by: US Treasuries–Barclays US Treasury Index; US Fixed Income–Barclays US Aggregate Index; Global Fixed Income (unhedged)–Barclays Global Aggregate Index (unhedged); EM Sovereign Debt–J.P. Morgan EMBI Global Diversified Index; EM Corporate Debt–J.P. Morgan CEMBI Broad Diversified Index; US High Yield– Barclays US High Yield Index; US Equities–S&P 500 Index; EM Local Debt–J.P. Morgan GBI-EM Global Diversified Index; German Equities–Deutsche Borse AG German Stock Index DAX; Commodities–Bloomberg Commodities Index; EM Equities–MSCI Emerging Markets Index; Chinese Equities–Shanghai Stock Exchange Composite Index.

The indices listed above are unmanaged and have no fees. It is not possible to invest directly in an index.

The performance quoted represents past performance. Past performance does not guarantee future results.

Emerging Markets Equity

Beyond the First Rate Hike

Although the Fed did not raise the short-term lending rate at its September meeting, it has two opportunities to announce such a move before year-end (27–28 October; 15–16 December). Fed Chair Janet Yellen commented in late September that this is likely to occur provided US data remain stable; however, subsequent September jobs data were weak. Although the Fed has primarily focused its remarks on the domestic economy,

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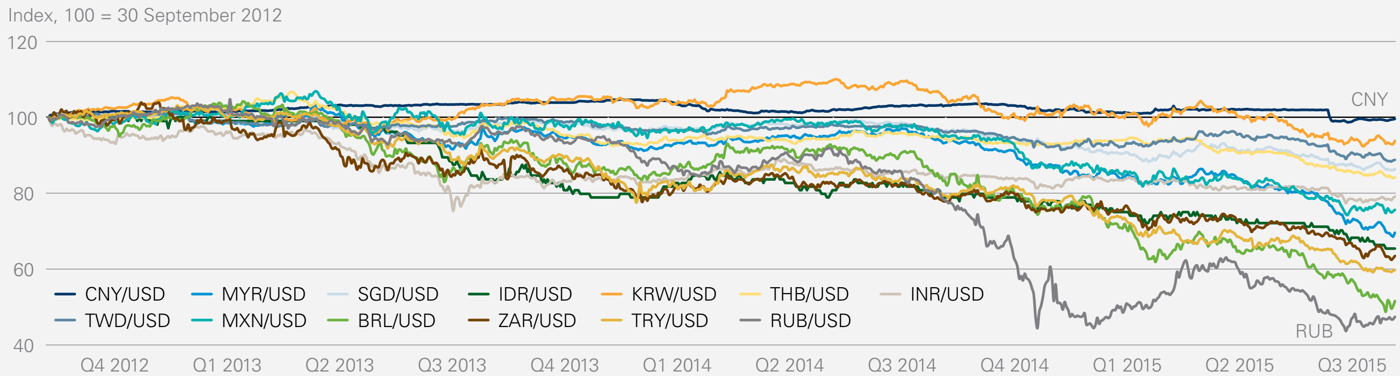
Exhibit 2
US Policy Risk Reflected in Emerging Markets Currencies



As of 30 September 2015
The performance quoted represents past performance. Past performance is not a reliable indicator of future results.
Source: FactSet

global conditions may also play a part in its decision as Chinese A-share turmoil and the renminbi's unexpected devaluation coincided with the Fed's decision to put rates on hold in September.

Views on the rate hike's timing are polarized, with officials from Peru, Mexico, India, and Indonesia citing the uncertainty as damaging to emerging markets psychology, while the International Monetary Fund has cautioned against premature Fed action, as it could create a new credit crunch in emerging markets.

Regardless of its timing, it is important for emerging markets to successfully clear the first rate-tightening step. Based on the Fed's communications, subsequent moves will be data dependent, implying that each rate decision will be independent of the next.

We believe US policy normalization has been largely already priced in since the start of the "taper tantrum" in May 2013, but emerging markets equities may nonetheless react strongly before settling down. The federal funds target is expected to increase by 25 basis points (bps) to 0.25%–0.50%, and the downstream effects on most developing companies and economies may be more manageable than feared. Growth in interest expense will be felt primarily by issuers of US dollar–denominated emerging markets sovereign and corporate debt. Notably, emerging markets corporate debt has grown faster than every other class of fixed income, including US Treasuries, over the last 10 years.

International currency markets have been quick to factor in the policy risk to emerging markets currencies, which have depreciated since 2012, relative to the US dollar. Tighter US policy has put the most pressure on the embattled economies of Brazil, Russia, South Africa, and Turkey, which have been weakened by high debt, high inflation, and significant currency depreciation. In 2015 the Brazilian real, South African rand, and Turkish lira reached record lows against the US dollar (Exhibit 2). The Russian ruble has also weakened significantly. It traded in the 30s versus the US dollar in late 2013, sharply depreciating to the 60–70 range by December 2014 amid the Ukraine crisis and sanctions, holding those levels until around March 2015, when it briefly strengthened before trading back above 60 rubles per dollar after July.

Significant depreciation in emerging markets currencies over the past three years and low equity valuations suggest that US tightetning and local concerns could be largely already absorbed by the market, hinting at upcoming stabilization, which could provide the basis for a recovery.

Investing through Macro Uncertainty

Currency weakness has increased the macroeconomic and political risk in these four countries, especially Russia and Brazil. While we are discounting these factors in our valuation analysis, market sentiment appears to be excessively negative in some instances, with several large-cap Russian and Brazilian companies trading at discounts to book value. These valuations are typically associated with distressed companies thought to be at the brink of failure, which is not consistent with the companies we are seeing. These firms are well capitalized, positioned to benefit from underpenetration in certain areas of the economy, and are taking market share from foreign competitors that may be exiting those countries.

The economic outlook for Brazil has certainly deteriorated. High unemployment, even higher inflation, and a worsening fiscal stance have added to asset price volatility. We believe the recovery in Brazil will occur at a very gradual pace and can only be helped or accelerated through internal restructuring and by addressing fiscal concerns.

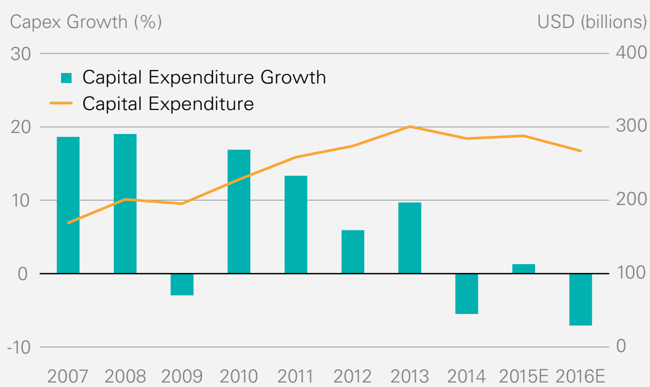
In our experience, sentiment can be extremely volatile and can change abruptly, which we believe reinforces the importance of fundamental analysis and staying a steady course. A comparison of the top and bottom five countries in the MSCI Emerging Markets Index shows that three of the worst

Exhibit 3
Leaders and Laggards Have Traded Places in Just Nine Months

2014 (%)		YTD through 30 Sep 2015 (%)	
Top 5			
Egypt	29.33	Hungary	22.34
Indonesia	26.59	Russia	8.70
Philippines	25.58	India	-5.26
India	23.98	United Arab Emirates	-6.09
Turkey	18.71	Philippines	-6.35
Bottom 5			
Colombia	-19.79	Turkey	-31.69
United Arab Emirates	-26.87	Indonesia	-33.35
Hungary	-27.44	Colombia	-35.76
Greece	-39.64	Brazil	-39.38
Russia	-46.27	Greece	-52.27

As of 30 September 2015
As measured by the MSCI Emerging Markets Index.
This information is not representative of any product or strategy managed by Lazard.
The performance quoted represents past performance. Past performance is not a reliable indicator of future results.
Source: FactSet

Exhibit 4
Emerging Markets Capital Discipline Is Improving



As of 18 September 2015
Calendarized to a December year end.
Source: Company data, UBS estimates

laggards in 2014—Russia, Hungary, and the United Arab Emirates—have vaulted ahead to claim three of the top five positions year to date through September, while Indonesia, a top-performing market in 2014, is now lagging badly year to date (Exhibit 3). Notably, dispersion of returns among the top performers has increased.

In this environment emerging markets companies with structural advantages like low dollar-denominated debt and strong currency hedging are likely to perform better than their peers. These are qualities we typically favor, but that are especially relevant today. Across style disciplines we are finding companies without currency mismatches, or with currency hedges naturally built into their business models. Our teams also manage macroeconomic risk during the portfolio construction phase, sizing positions in accordance with their risk payoffs.

Capex Trends Bring Mixed News

Capital spending by emerging markets companies is expected to be virtually flat in 2015 and should contract in 2016 (Exhibit 4). We are encouraged by this sign of better capital discipline and will look for companies to make better use of excess capacity that was created during the boom years. We are also watching for signs of resurgence in developed markets capital investment, which should renew demand for emerging markets goods.

Spending cuts in the oil and gas industry, attributed to weaker oil prices, may create job losses and reduce economic activity. However, one of the benefits of lower oil prices that has yet to more broadly filter through is the savings to net importers of oil—which are the majority of emerging markets (exceptions are oil-exporting economies such as Russia and Malaysia). One such beneficiary may be India, a net importer of oil that has forecast growth of about 8%. India also recently implemented an interest rate cut of 50 bps to stimulate more growth.

China's Economic Diversification Is Under Way

China bears do not lack for evidence: In September, a private survey of manufacturing activity, the Caixin China purchasing managers' index (PMI), fell to 47.3—its lowest reading in six-and-a-half years. Official PMI rose slightly to 49.8, up from August's three-year low of 49.7; however, it remains below 50, a level that indicates manufacturing expansion. Factory production in August grew 6.1% year over year (YoY), which was weaker than expected. Fixed asset investment increased at a 10.9% pace YoY for the period January–August, also shy of forecasts.

Importantly, however, China's consumer sector is growing, which is easily overlooked when viewing economic progress through the traditional lens of manufacturing activity.

Chinese retail sales have exceeded expectations, increasing 10.8% in August from a year before. Certain monthly consumer metrics also paint a more positive picture of the economy, with movie box office sales, airline passenger counts, and 4G mobile subscriptions all showing YoY growth. According to some analysts Chinese consumption data may also be understated due to quirks in calculation methodology. Official retail sales data do not include the sale of services, except those rendered to the government and investment services. It also excludes sales from e-commerce companies, which despite their small size have attracted a large portion of sales away from their brick-and-mortar competitors. In addition, our analysts have observed that property markets in Tier 1 and Tier 2 cities (ranked by population size) are now stable or rising, following a period of slumping sales. We find this quite encouraging as property has a more direct impact on wealth and consumption than does industrial activity.

The Long Shadow of A-Share Turmoil

We believe that authorities will focus on stabilizing the Chinese economy and financial markets before pressing for deeper reform. China's recently announced reform of its state-owned enterprises (SOEs) is disappointing. While its proposal to blend in private capital should expose SOEs to market forces and help alleviate capital misallocation, consolidation among SOEs may reduce competition.

It is critical for investors to keep in mind that the highly publicized Chinese stock turmoil relates to the mainland-traded A-share market, a separate and distinct pool of stocks from the H-share market. H-shares are stocks (commonly thought of as "blue chip") that are listed on the Hong Kong Stock Exchange. These often represent different companies than are listed on the mainland and some are constituents of MSCI's indices. Meanwhile, A-shares, or China's onshore market, are not represented in MSCI's indices and only have about 2% foreign investor participation. Importantly, Lazard's emerging markets equities strategies do not have exposure to A-shares.

The majority of the Chinese onshore market does not trade freely, with the government and company founders owning the majority of shares. Thirty-nine percent of the Chinese stock market (based on the Shanghai and Shenzhen stock exchanges) is freely floated compared to nearly 94% for the US stock market (based on the New York Stock Exchange). Partial market liberalization as seen in the recent Hong Kong–Shanghai Stock Connect program resulted in extreme volatility in the A-share market this year. Government intervention to stabilize stock prices has been antithetical to a free-market framework and has prevented the market from discovering its equilibrium level. However, we believe that at this point in China's evolution, the preservation of political and financial stability outweighs free-market ideals.

By some estimates, only about 7% to 10% of the Chinese population has any exposure to the equity market, however, the negative impact on investor sentiment has been significant.

We believe China will meet its 2015 growth target of 7% but we continue to expect growth to decelerate to more sustainable levels, and for that growth composition to evolve. The Chinese market is vast and our teams are finding opportunities at different levels. Keeping in mind that none of our strategies hold A-share companies (we invest in Chinese companies listed in Hong Kong or overseas), our relative growth and our all-cap, style unconstrained core equity teams hold companies across a wide swath of sectors for broad, balanced, and diversified China exposure. Both teams have more exposure to China than the index. Our relative value team, in line with their strict value discipline, maintains a lower-than-index weight to China, preferring opportunities elsewhere in the developing world. During the third quarter they selectively added Chinese exposure, taking advantage of opportunities presented in the recent sell-off.

Our fundamental approach and portfolio construction processes are consistent across all market environments; however, they are designed with the flexibility to price in different investment considerations. Today's environment presents a new set of considerations than were present during the boom years and requires patience and a capacity for dispassionate, disciplined analysis—but we believe these challenges have not eliminated the opportunity in emerging markets. Indeed, we think the valuation opportunity is exceptional in some securities, but this calls for prudent stock selection and a willingness to take a longer-term perspective.

Emerging markets valuations are low relative to their own history and compared to developed markets, posing an attractive entry point.[1] Emerging markets equities as an asset class have struggled with severe negative sentiment and slowing earnings growth. Improvements in global trade and deep-reaching local reforms will be the keys to unlock multiple expansion across the asset class, primarily by improving earnings growth. In the meantime, we believe it is possible to position for success in emerging markets by balancing risk and return through careful security selection and risk-aware portfolio construction.

Emerging Markets Debt

Attractive Valuations are Not Enough for the Market to Rally; the Market Needs a Change in Narrative

In China, economic data underperformed already-low investor expectations in a plethora of measures from PMI to fixed asset investment. Upon each monthly announcement of these indicators, both commodities and EM equities took large legs downward, followed by capitulation in developed markets stock indices. The unwinding of a multi-year commodity price bubble (which is causally related to China's managed growth slowdown) has been surprisingly damaging for even those countries that would have otherwise benefited from lower input prices. For example, the United States should benefit from the steep fall in oil prices; yet a dramatic shift by consumers to save versus spend has resulted in very little positive pass-through effects from this shift to lower commodity prices. In emerging markets, a country like Turkey should have been a huge beneficiary of lower oil prices, as oil imports represent roughly 60% of that country's trade deficit. Yet, the toxic combination of policy missteps, geopolitical worries, and executive branch hubris overwhelmed Turkey's sovereign balance sheet improvement. Market concerns then moved east to Brazil, where the real slid 21% during the quarter due to an all-encompassing corruption scandal and continued dithering on reforms by the President. The final nail in the coffin for third-quarter returns was Ms. Yellen's post-Fed-meeting press conference on 17 September where she insisted that the Fed intends to tighten monetary policy by year-end. This forced the capitulation of US investors, who sold down the S&P 500 Index by 5% from the moment Ms. Yellen began to speak that fateful day to month-end, just ten trading days later.

Valuations in emerging markets debt remain compelling, as they were even before the most recent quarterly rout. In calling a turn in the market, we are relying less on traditional valuation metrics like real effect exchange rate models and risk-adjusted expected returns. Rather, we are searching for triggers that would "change the narrative" of global markets. Potential positive catalysts through year-end are:

- Definitive change in Fed-speak that focuses on continued easy monetary policy (probability: very low). While this would be the easiest fix for global markets, it is also among the least probable. The Fed has hinted to markets for months that it is focused on labor market indicators showing tighter conditions; as such, shorter-term economic activity measures are less important. Thus, the market tends to sell both bad news and good news because a rate hike is seen as virtually a done deal within the next six months.

- Commodity price reprieve (probability: low to medium). Forecasting commodity prices is a certain widow-maker for Wall Street analysts and, as such, most just extrapolate current prices to predict the future. Nonetheless, with the backdrop of a generally slowing Chinese economy, the odds are stacked against a demand-side-induced price recovery. Conversely, supply-side shocks can certainly boost prices in the short term, whether as a result of conflict, cartel policy change, or production curtailment in the free market.
- Better growth prospects in emerging markets (probability: medium to high). The question is not **if** emerging markets growth is going to pick up, but rather **when**. The abysmal growth numbers from the first half of 2015 will make for a much more favorable base for comparison for 2016 growth. In countries like Brazil and Russia, a simple positive 2016 GDP growth number will be a huge improvement over the -2% to -3% growth contractions of 2015. The growth slowdown in the emerging world has been the single-largest contributor to currency underperformance, so a turn in that trend will likely be the driver for a changed narrative. Unfortunately, that turn may only materialize in the New Year.

In a market that is characterized by attractive valuations but bereft of near-term positive triggers, it is essential to limit large top-down macro positions and collect as much carry as possible. As such, we have moved the Blend strategy back to a neutral position of 50% external debt and 50% local debt. Similarly, in the Total Return strategy, we have reduced high volatility local-currency-denominated positions in favor of lower volatility (but high yielding) external sovereign paper. From a risk budgeting perspective, we have shifted to larger bottom-up security exposures in order to capitalize on the high degree of dispersion between individual countries. As has been the case for the better part of the last seven years, global markets can turn on macro and micro disruptions. As such, it is critical to stay liquid, limit counterparty risk, and adhere to concentration risk controls so as to enable portfolios to adjust quickly.

Notes

1 Based on price to earnings.