From Chaos to Clarity

Unearthing Opportunities During Periods of Change

Evan L. Russo
Chief Executive Officer, Lazard Asset Management

Change is the only constant. Unpredictable market shocks—a pandemic, a war, social unrest—inevitably trigger changes in investor sentiment when they arise, and the start of 2023 has served as testament to this. Right now, changes in both developed and developing markets are prompting three recurring questions in our conversations with investors around the globe:

1. What does dislocation in the world's largest banking system mean for our portfolios?
2. Is now the time to return to emerging markets?
3. And is Japan—under-appreciated and under-researched for decades—one of the best places to be?

There are no one-size-fits-all answers; the ideal course of action will vary depending on investors' needs. But research and experience have shown us that the best approach to identifying opportunities amidst change is this: Focus on the fundamentals of individual companies, and understand the external forces that stand to impact their strength over the long term.

Regional Banking: Too Small to Thrive?

The regional bank failures of early 2023 laid bare two structural problems in the US financial system: insufficient regulation and flaws in our country's deposit insurance framework. Initial fears of financial contagion have been alleviated somewhat in recent months, as these events are now widely viewed as idiosyncratic rather than systemic in nature. Yet while the causes may have been unique to individual banks, we cannot say the same for the effects. Increased regulation will likely create profitability headwinds as more banks are subjected to the same regulatory oversight that previously only applied to the systemically important financial institutions. At the same time, decreased depositor confidence in smaller, less regulated banks might lead to ongoing funding challenges that limit their competitiveness.

Just as the crisis of 2008 led to a flurry of discounted asset sales, these pressures will inevitably create buying opportunities. But not all banks are created equal, which is why investors will need to pay close attention to two things: the sustainability of individual banks' business models, and how their returns on equity—a key measure of financial productivity—will be affected by the costs of tighter regulation.

Emerging Markets: Why Now?

As uncertainty lingers in developing markets, the tide is slowly shifting back in emerging markets' favor. A bird's eye view of the region shows several improving conditions coming together at once: the winding-down of rate hiking cycles, a stable or possibly weaker US dollar, and strong economic growth prospects compared to developed markets on top of inexpensive valuations. China's reopening has been a focal point this past year, and importantly, should help to counterbalance a softening in the US economy. Other developing countries, namely India and Indonesia, continue to experience the most rapid economic growth in the world.

Despite this positive momentum, there continues to be uncertainty. How will business operations be impacted if tension between China and the West continues to escalate? Will government crackdowns on large companies put their competitive advantages in jeopardy? Risks that are unique to individual countries and companies remain prominent for investors.

Japan: The Land of Rising Returns?

Conversations about Japan are changing too. The asset bubble of the '80s sparked long-lasting fears of inflated valuations and persistent deflation, while the equity market's sustained underperformance led a generation to consider Japan practically uninvestable. These attitudes are changing as investors see the benefits of years of structural reforms designed to increase corporate accountability. The shift began under Prime Minister Shinzo Abe with a Stewardship Code and a Corporate Governance Code. Initially, these Codes did not appear particularly impactful, but they laid the groundwork for more recent changes that are materially improving the outlook for corporate returns on capital. Most recently, the Tokyo Stock Exchange tightened standards to require companies that trade below book value for too long to show improvement or risk de-listing.

Active Management: The Path Forward

Changes in regional views appear to be driven by one common thread: valuations that do not reflect the outlook for returns. Deep fundamental analysis that leads to differentiated perspectives on the future profitability of companies is critical in order to take advantage of the opportunities presented by these trends. Looking ahead, bottom-up research and consistent engagement—the hallmarks of active management—will be critical in identifying the best opportunities for investors during yet another period of change.

Whether investors are seeking refuge from volatility or trying to capitalize on the opportunities emerging from it, our goal is to help simplify complexity and optimize decision-making to best meet investment objectives. This has always been our role as active managers, but it is one that takes on greater significance as turbulence and mixed signals become the norm.

Information and opinions presented have been obtained or derived from sources believed by Lazard Asset Management LLC or its affiliates ("Lazard") to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions expressed herein are as of the published date and are subject to change.

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

No risk management technique or process can guarantee return or eliminate risk in any market environment.

This material is for informational purposes only. It is not intended to, and does not constitute financial advice, fund management services, an offer of financial products or to enter into any contract or investment agreement in respect of any product offered by Lazard Asset Management and shall not be considered as an offer or solicitation with respect to any product, security, or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited.

Certain information contained herein constitutes "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "intent," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events may differ materially from those reflected or contemplated in such forward-looking statements.

Published on 15 June 2023 HBX626366