Outlook on

Emerging Markets

JUL 2024

Summary

- Emerging markets equities gained 5% in an eventful quarter, with surprise election results, AI optimism, and a resilient US dollar.
- Our outlook is bright for the asset class: Accelerating growth, higher corporate earnings expectations, global monetary easing, and valuation discounts all bode well, in our view.
- Our outlook for emerging markets debt is constructive, after mixed results in the second quarter.
- Monetary policy, economic growth, fiscal policy, and valuations all favor emerging over developed markets debt, in our view.

Equity

Gains in emerging markets equities improved in the second quarter: The MSCI EM Index finished ahead by 5.0%, bringing year-to-date returns to 7.5%.

From a sector perspective, information technology, communication services, utilities, and consumer discretionary led the way over the quarter, while healthcare, consumer staples, and materials lagged the index and finished in negative territory (Exhibit 1).

While Asia led all regions, from a country perspective, Turkey outperformed all markets, as its central bank has followed more orthodox monetary policy to combat inflation since mid-2023, followed by Taiwan, South Africa, India, Hungary, and China. Taiwan's equity market was driven by artificial intelligence (AI) optimism and a strong increase in technology orders, while South Africa rallied sharply after the African National Congress (ANC) party announced it would form a "Government of National Unity" with the Democratic Alliance and a host of others. India also demonstrated significant post-election strength despite Prime Minister Narendra Modi's weaker electoral performance.

Latin America was the worst-performing region over the quarter, driven by Mexico and Brazil. Mexico's sell-off was primarily related to election results, with Claudia Sheinbaum and the Morena party's near-supermajority in Congress raising concerns about power concentration and a potential weakening of judicial independence. While emerging markets, in general, have lagged as investors tempered their expectations for US interest rate cuts this year, Brazil has been hit by growing concerns over plans for increased spending and corporate interference from President Luiz Inácio Lula da Silva's government. The worst-performing emerging markets currencies so far this year have included the Mexican peso and the Brazilian real, along with the Egyptian pound and Turkish lira.

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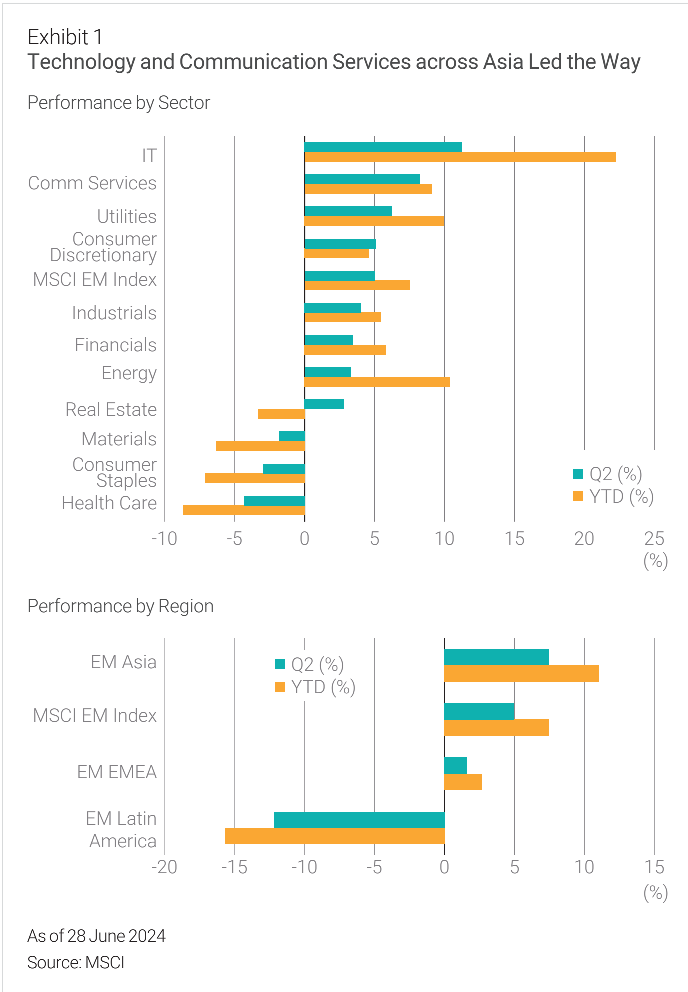
Exhibit 1
Technology and Communication Services across Asia Led the Way

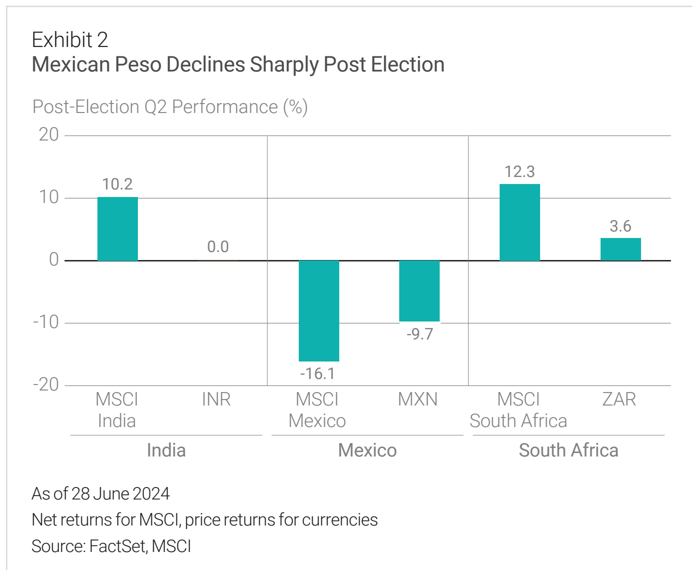


As of 28 June 2024
Source: MSCI

Election Outcomes Can Move Markets

Three important emerging markets elections—in India, Mexico, and South Africa—have shown how surprising election outcomes can have major market impacts (Exhibit 2).

Exhibit 2
Mexican Peso Declines Sharply Post Election



As of 28 June 2024
Net returns for MSCI, price returns for currencies
Source: FactSet, MSCI

India: Modi 3.0

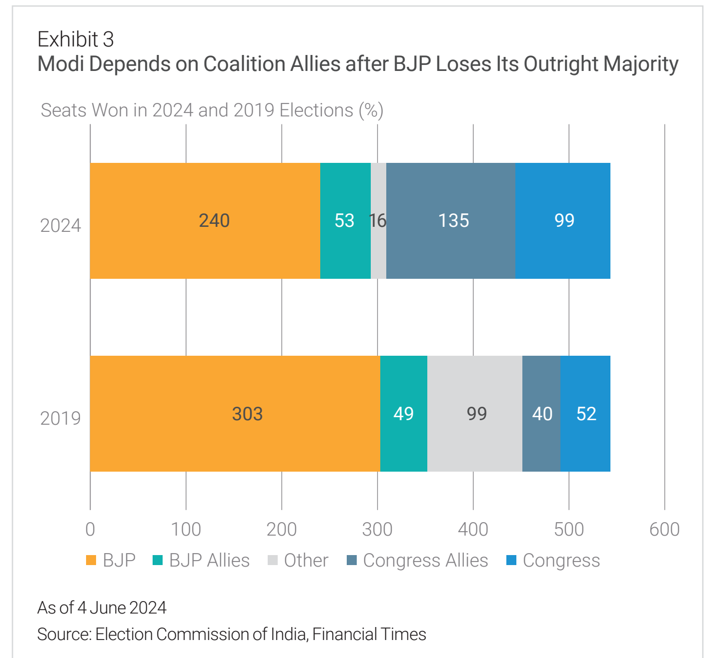
Following a six-week election, Narendra Modi has been sworn in for a historic third term as India's Prime Minister, but with a weaker electoral performance that leaves him dependent on coalition allies. Modi's Bharatiya Janata Party (BJP) lost 63 seats in the lower house, leaving it reliant on 14 regional parties in the National Democratic Alliance. This marks the biggest setback to Modi during his decade in power and may force him to rule more through consensus (Exhibit 3).

During his first two terms, Modi's governments have stabilized India's macroeconomy, integrated millions of people into the digital economy, and implemented tax and other reforms. However, we note that India still faces significant challenges in education and agriculture; in 2021, mass protests forced Modi to abandon planned farming reforms. Before the election outcome, officials claimed that a larger majority would enable them to advance reforms for a manufacturing economy, including a flexible labor code and easier land acquisition. The return to multi-party negotiations, however, has raised investors' concerns over fiscal slippage and pressures on the government to provide financial support for political interests.

Moody's has warned that coalition politics could "impede progress on fiscal consolidation" and slow economic reforms as India seeks to build a globally competitive manufacturing industry. Modi's pledge to turn India into a developed country by 2047 will remain a key component of his third term, but we expect compromises and an increased allocation to welfare schemes in the July budget.

India remains the region's fastest-growing major economy and is actively taking steps to become a global manufacturing center. With a young and growing labor force—nearly 80% of its population is under the age of 50—and a rising middle class with real wage growth, India has a demographic dividend tailwind, in our view, and the country is projected to grow quickly until the 2060s.

Exhibit 3
Modi Depends on Coalition Allies after BJP Loses Its Outright Majority



As of 4 June 2024
Source: Election Commission of India, Financial Times

Mexico: Sheinbaum and the Morena Agenda

In Mexico, Claudia Sheinbaum of the Morena party was elected with a constitutional majority in both houses of Congress. With the help of party allies, it should allow her to make constitutional reforms. Although she shares outgoing President Andrés Manuel López Obrador's (AMLO) fiscally conservative views, which may give some comfort to investors, she also appears to share his ambition to overhaul the judiciary, which could potentially weaken or eliminate the country's checks and balances. An independent judiciary has served as a helpful line of defense against many of AMLO's most controversial policies, in our view, and investor and business confidence may weaken should Sheinbaum pursue significant change.

In an effort to reassure investors after her electoral victory, President-elect Sheinbaum has appointed Marcelo Ebrard, a business-friendly former foreign minister, to head the economy ministry. Ebrard will be responsible for promoting industry, trade, and attracting foreign investment in a challenging global economic environment. Sheinbaum also confirmed that Rogelio Ramírez de la O will continue in his role as finance minister. Political analysts expect Sheinbaum to grant more control to her team than AMLO did during his administration. This approach, combined with the appointment of experienced cabinet members, may help to address investor concerns about the potential impact of AMLO's proposed reforms on Mexico's economy and political stability.

Mexico should continue to be a big beneficiary of nearshoring trends. As US companies increasingly look to their southern neighbor to bolster their supply and value chains, it is likely to boost Mexico's GDP growth as investment surges, providing new opportunities for companies and investors alike. As an environmental scientist, Sheinbaum does want to increase renewable power generation and attract more nearshoring investments, which we expect will lead to more opportunities for private firms in the energy sector. Mexico offers a large, low-cost labor force and has free-trade agreements with the United States and Europe.

Other potentially disruptive bills, in our view, include revamping the electoral system and revising the pension system, which could add as much as 0.9% of GDP in spending. Some of these changes may be postponed or abandoned, however, due to their fiscal cost and possible negative effects on investor confidence.

Sheinbaum will have to balance pressures from her party and from AMLO to push forward legislation while containing damage to investor sentiment. So far, we think she appears sensitive to negative market reactions and will likely aim to tweak significant legislative changes to avoid threatening economic stability. However, with pressure from AMLO and Morena, Sheinbaum may still need to approve most of the proposed changes.

South Africa: Ramaphosa and Coalition Governing

Cyril Ramaphosa has been re-elected as South Africa's president. While Ramaphosa defeated Julius Malema, the leader of the Economic Freedom Fighters, and former president Jacob Zuma and his newly created M.K. party, the ANC failed to secure a majority in the country's seventh democratic election, the first time this has occurred since the end of apartheid. The ANC, which has governed since the end of apartheid in 1994, won less than a majority of votes at 40.2%, prompting a power-sharing agreement with the opposition Democratic Alliance and the Zulu-dominated Inkatha Freedom Party.

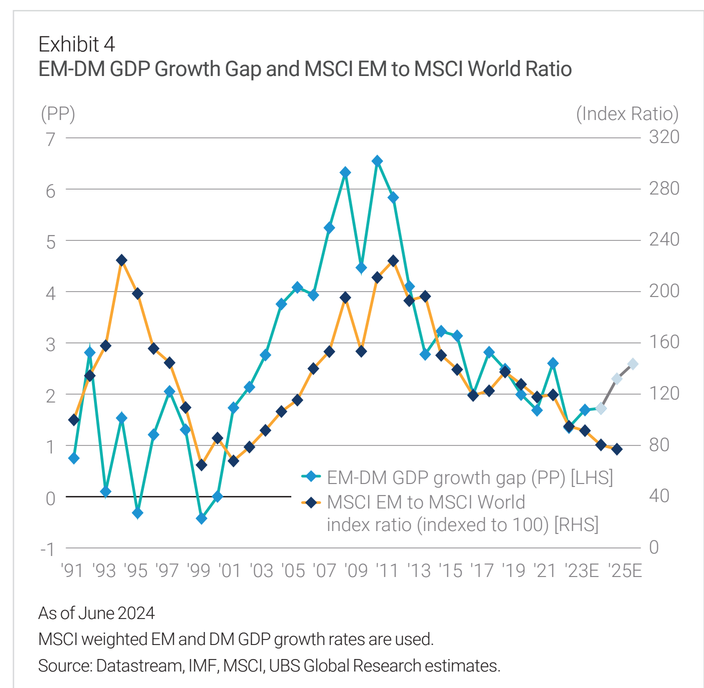
The coalition deal focuses on economic reforms, with nine high-level priorities for fixing South Africa's struggling economy. These range from "rapid, inclusive, and sustainable economic growth" to "stabilizing local government." The agreement has been viewed as a chance for South Africa to create a stable democracy and an inclusive economy.

Prior to the election results, South Africa's domestic growth outlook was expected to improve as long as loadshedding, the widespread electricity blackouts that have troubled the economy, was reduced. Thus far, power utility Eskom has managed three consecutive months with no power cuts. Additionally, with cost-of-living pressures easing due to moderating inflation, the potential for rate cuts over the next 12 months has increased. Although we are encouraged by the coalition government so far, we will monitor potential areas of friction among the parties in the months ahead.

Outlook: Optimistic

While global investors' willingness to add to EM equities has remained tepid through the first half, our outlook is encouraging for the asset class for many reasons:

Exhibit 4
EM-DM GDP Growth Gap and MSCI EM to MSCI World Ratio



As of June 2024
MSCI weighted EM and DM GDP growth rates are used.
Source: Datastream, IMF, MSCI, UBS Global Research estimates.

- **EM-DM relative GDP growth acceleration:** 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 to 4.2% in 2024 as DM growth slows to 1.5%.
- **Earnings growth reacceleration:** Following a sharp decline throughout 2021 and 2022, earnings growth expectations have moved higher for EM compared to DM, including the United States, over 2024 and 2025. Consensus earnings growth[1] for EM in 2024 and 2025 is nearly 17% and 15%, respectively, compared to less than 11% and 14% in the United States.

- **Attractive valuations:** In our view, EM equity is one of the most mispriced asset classes globally, with valuations remaining very inexpensive compared to DM equity. On a forward price-to-earnings multiple, EM is trading at 12.6x, compared to 18.7x for DM and 21.7x for the United States.[2] Over time, this more than 30% valuation discount, compared to a 24% historical average discount, may narrow due to stronger EM earnings growth, recovering EM profitability, attractive free cash flow yield and dividend yield, and a widening economic growth premium in EM's favor.
- **Global monetary easing:** Key EM central banks have already begun to ease monetary policy this year. Monetary policy in developed markets is still in restrictive territory, with the policy easing substantially slower than anticipated at the beginning of the year, reflecting relatively resilient growth and continued inflationary pressures. The Federal Reserve is expected to begin cutting interest rates later this year, which would provide a more supportive environment for EM equities with potential easing in US dollar strength.
- **Diversification from US equities:** Global investors seeking to diversify their portfolio allocations and guard against a risk of valuation derating in US equities may want to add EM equities to their portfolios.
- **Low investor positioning:** EM remains an under-owned asset class. Global investors are 5.3%[3] allocated to EM equities. A reversion to a 20-year average allocation of 8.4% would represent inflows of $910 billion, or about 58% of current EM assets under management.

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) performance was mixed during the second quarter. US economic "exceptionalism" helped keep the US dollar strong, while global yields were volatile amid mixed economic data and diverging central bank policies. The yield on the 10-year US Treasury bond ended the second quarter roughly 20 basis points (bps) higher at 4.40%; although rates had risen sharply early in the quarter, they subsequently retraced much of their movement on lower-than-expected US inflation.

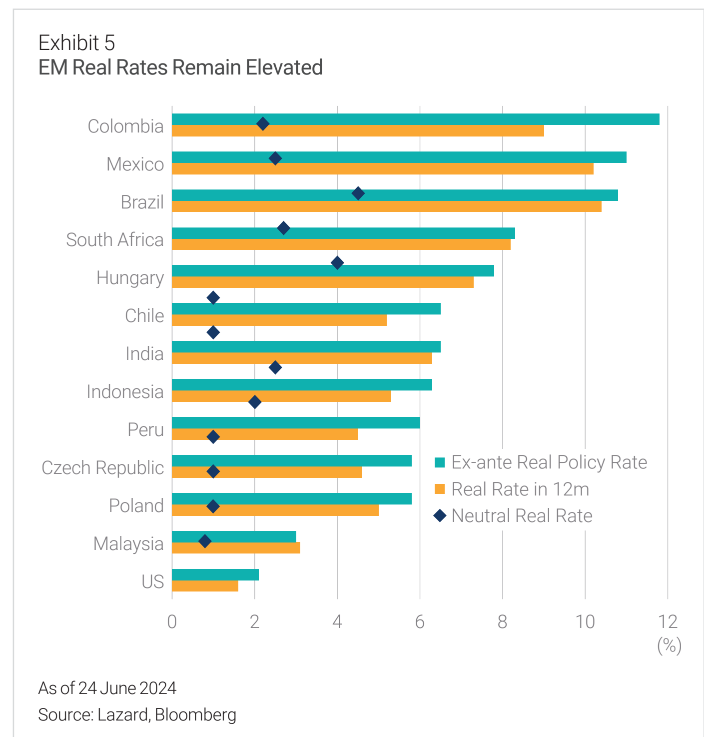
Emerging markets local debt yields moved higher due to the underperformance of high-yielding countries and increased just over 30 bps during the quarter, while emerging markets currencies fell 2.5% in aggregate as the dollar spot index (DXY) increased more than 1%. Meanwhile, emerging markets sovereign credit spreads widened by roughly 50 bps, primarily attributable to the reintroduction of Venezuela into the JP Morgan Emerging Markets Bond Index (EMBI) Global Diversified.

In the next few months, we expect performance to be driven by a combination of emerging markets (EM) "pull" factors and developed markets (DM) "push" factors across three main dimensions: monetary policy and economic growth, fiscal policy, and valuations.

Monetary Policy and Growth

From a monetary policy standpoint, EM countries are generally one-third of the way through monetary policy easing, by our estimate, while DM countries have only just begun. The European Central Bank, for example, made its first rate cut of this cycle in June, and markets have reduced their expectations for rate cuts from the Federal Reserve to just one or two before the end of the year. As a result, we expect DM rate cuts to extend through 2025, which should contribute to making EM policy rates more attractive. Overnight real policy rates in EM, even after adjusting for expected rate cuts implied by the markets, are well above neutral real rates (Exhibit 5).

Exhibit 5
EM Real Rates Remain Elevated



As of 24 June 2024
Source: Lazard, Bloomberg

From a growth standpoint, GDP growth has already bottomed across most EM countries and is showing signs of inflecting higher, while US exceptionalism appears to be entering its final stages, based on consensus economic forecasts.

Fiscal Policy Improvements

Fiscal policy has significantly improved across EM due to orthodox policy choices, IMF engagement, and strong legislative pushback to spending requests. By contrast, we view US fiscal policy as reckless and expect fiscal deficits of 6% or more in 2025–2028, regardless of the outcome in US elections in November, resulting in nearly a full decade of very large deficits.

EM countries have received extraordinary support from multilateral institutions, including the IMF, since the onset of the COVID-19 pandemic. This has led to lower default rates than normal over the past couple of years, and capital markets have now reopened to new issuance from lower quality countries.

Attractive Valuations

Given this backdrop, EM credit spreads have compressed, but the move has lagged that in DM credit since 2022. Recently, DM credit spreads have been trading near their post-Global Financial Crisis lows, showing unusual strength at this late stage of the economic cycle. In light of this, we believe EM sovereign and corporate credit spreads look more attractive than those for similar quality peers in DM (Exhibit 6).

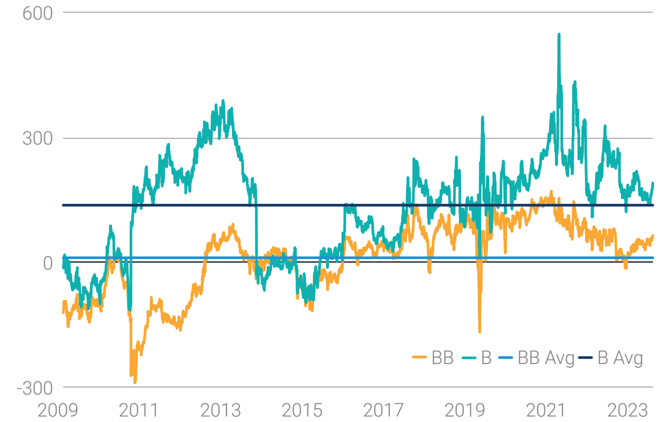
What to Watch

Key risks that we are monitoring closely include China's slower growth trajectory—despite the additional fiscal and monetary measures the government has recently undertaken—and the implications of the November US presidential election. Specifically, if former President Donald Trump returns to office, we would expect a hawkish tilt to global trade policy, which would have negative implications for Europe and China as well as global growth.

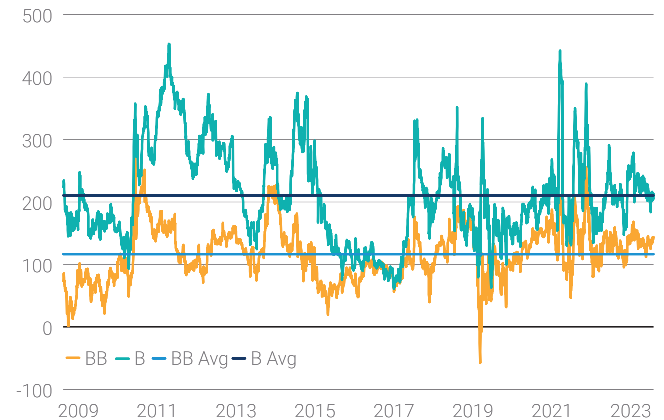
Overall, we maintain a constructive outlook for EMD as we believe a combination of EM pull factors and DM push factors will create opportunities for alpha generation. We will monitor global developments and risks to ensure we are positioned to capitalize on opportunities over the coming year.

Exhibit 6
Sovereign and Corporate Spreads: EM vs. US

Sovereigns



Corporates



As of 24 June 2024
Source: Lazard, Bloomberg

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Notes

1. J.P. Morgan Global Research, "Emerging Markets Equity Strategy Steering Board" (19 June 2024)
2. Ibid
3. J.P. Morgan Global Research, "EM Lighthouse: US Easing Cycles Are Not Always Easy for EM" (5 June 2024)

Important Information

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The MSCI All Country Asia ex-Japan Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in Asia, excluding Japan. This index includes both developed and emerging markets.

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: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

The MSCI Emerging Markets EMEA Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the emerging markets countries of Europe, the Middle East, and Africa.

MSCI Emerging Markets Latin America Index - The MSCI Emerging Markets Latin America Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the emerging markets countries of Latin America.

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 US Dollar Index (DXY) is the global benchmark for the value of the US dollar measured against a basket of foreign currencies.

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 indices are unmanaged and have no fees. One cannot invest directly in an index.

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