Outlook on

Emerging Markets

OCT 2024

Summary

- Our outlook is constructive for emerging markets (EM) equities due to higher economic growth, improving corporate earnings, global monetary easing, and steep valuation discounts.
- As the US election nears, the possibility of higher import tariffs looms large: We see the potential for not only direct effects on individual EM countries but also ripple effects on global trade.
- Despite the complex global environment, we continue to have a positive outlook for emerging markets debt thanks to global monetary easing and a weakening US dollar.
- We see three developments likely to influence the debt markets in the coming months: falling global inflation, waning US growth relative to the rest of the world, and the US election.

Equity

EM equities outperformed developed markets (DM) equities in the past quarter, gaining 8.7% versus 6.4%. This marked two consecutive quarters of EM outperformance for the first time since 2020. The positive shift began as the Federal Reserve cut rates in mid-September, and outperformance accelerated in the final week of the quarter as China unleashed a series of stimulus measures.

Looking ahead, Fed easing and potentially more stimulus from China should be positive forces for EM equity markets, along with expectations for higher economic growth and corporate earnings growth in EM. The tight race for president in the United States, however, has raised uncertainty for EM around longer-term issues that could stem from higher US import tariffs if the Republican party wins.

China: Last-Minute Surprise

After the People's Bank of China and the Politburo announced a broad stimulus package with the promise of fiscal stimulus to come, China's equity markets rose sharply.

The MSCI China Index gained 24% in September alone, bringing its year-to-date return to nearly 30%, ahead of the MSCI United States, World, and Emerging Markets Indices (Exhibit 1) and on par with MSCI Taiwan and Malaysia returns.

Consumer discretionary, health care, communication services, and real estate sectors, which all have many Chinese constituents, were the leaders over the quarter. Consumer discretionary and communication services have now both eclipsed information technology year to date, with gains of 31%, 26%, and 19%, respectively (Exhibit 2). Thanks to China's gains, the Asia region posted the biggest return in EM for both the quarter and year to date (Exhibit 3).

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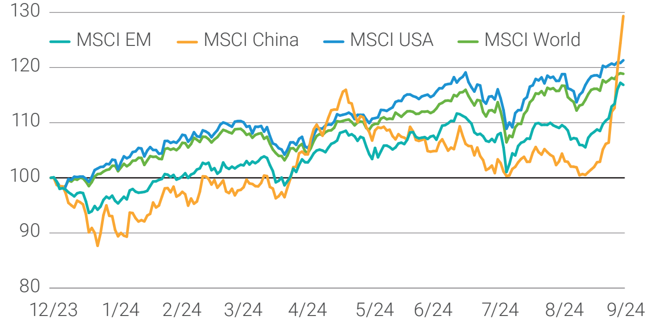
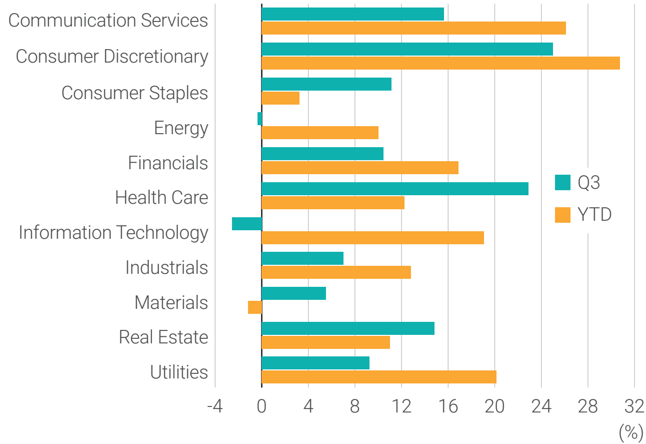
Exhibit 1
China Rallies 24% in September Following Stimulus Measures
YTD 2024 Performance



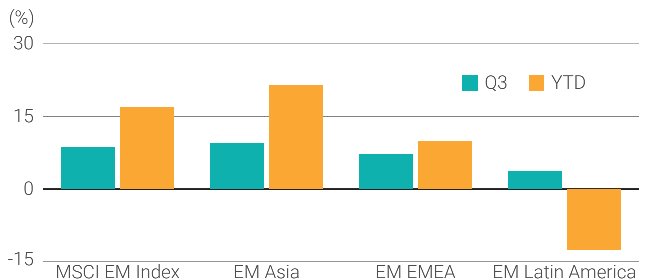
As of 30 September 2024
Source: MSCI

Exhibit 2
Consumer Discretionary, Health Care, and Communication Services Lead All Sectors in Q3
Performance by Sector



As of 30 September 2024
Source: MSCI

Exhibit 3
China's Rally Boosts EM Asia
Performance by Region



As of 30 September 2024
Source: MSCI

Elections: A Step Up in Tariffs?

In a year filled with elections across the globe, one of the last—the US presidential race—may be the most significant for EM investors; the outcome will have important implications for economic growth, inflation, monetary policy, and, specifically, US-China trade relations.

For EM, the biggest concerns stem largely from the proposals for new import tariffs from Republican candidate and former President Donald Trump. During the 2016–2020 Trump administration, the average tariff on US imports from China rose to 17% from 4%. If the current proposal for a 60% tariff on China were fully implemented, the incremental tariffs on imports from China could represent more than $230 billion annually (1.3% of China's GDP in 2023). In recent weeks, Trump has also hinted at 100% tariffs on imports from countries moving away from using the US dollar.

The proposed 10%–20% import tariffs on other countries could also cause disruption, especially among the markets most vulnerable to protectionist trade policies from the United States. These countries generally have high revenue exposure to and a high dependency on the United States as an export market; they are also deeply involved in the US supply chain and contribute a large share to US final demand. By these measures, Canada, Switzerland, and Mexico top the list currently (Exhibit 4), although it is possible that Mexico would be exempt from new import tariffs due to its inclusion in the US-Mexico-Canada trade agreement.

That said, the implementation of a universal 10% tariff would likely be used more as a negotiation tool with some trading partners to try to avoid Chinese circumvention of tariffs through third countries, reduce trade deficits, and gain leverage in other negotiations, such as immigration with Mexico.

Among other emerging economies, those with high exposure to the United States and products that can be easily substituted would likely be most negatively affected, including Malaysia, South Korea, and Thailand. Countries with high US exposure but less replaceable products, such as commodities, could be spared, including Chile, South Africa, and Indonesia.

In terms of sequencing of these tariffs, China would likely be the first target. Trump and his advisors have highlighted that competition with China is an important challenge for the United States, signaling this would be a primary area of focus.

China Effects

The impact of more US tariffs on China's economy would depend partly on how much China ends up shouldering the burden. While US consumers and companies would pay the tariffs, many of China's exporters would potentially lower their prices—and thus their margins—to maintain competitiveness in the United States. Adding to the uncertainty, the Biden administration has recently proposed changes to a de minimis loophole, currently used by companies like Temu, Shein, and AliExpress to ship their low-value Chinese goods to the United States without paying import duties and processing fees. With new tariffs, the overall economic environment could become more uncertain, hindering investment in innovation and further affecting China's long-term growth.

Exhibit 4
Countries' Exposure to US Trade Protectionism

	% of Equity Market Revenue from US	Exports to US as % of GDP	Value Added in US Final Demand as % of GDP
Canada	29	20	13
Switzerland	29	7	7
Mexico	13	25	15
Taiwan	24	7	7
Germany	21	4	3
Singapore	4	9	9
South Korea	10	6	5
Netherlands	25	3	3
Thailand	4	9	6
Denmark	23	2	4
Japan	16	3	3
United Kingdom	19	2	4
Chile	5	4	3
Sweden	21	3	3
Italy	14	3	3
India	6	2	4
Mainland China	3	3	3
France	14	2	2
Brazil	7	2	2
Norway	5	1	3
Spain	11	1	2
Indonesia	1	2	2
South Africa	4	3	2
Australia	8	1	2
Turkey	4	2	2
Poland	1	1	2

As of 2023
Source: Bloomberg, FactSet, IMF, OECD

The effects of the proposed tariffs on China would also depend on whether trade patterns would shift as a result. Approximately two-thirds of China's exports to the United States already face additional tariffs, and this appears to have accelerated the diversion of trade to other regions. China's exports to the United States as a percentage of its total exports fell from 21% in 2018 to 14% in 2023, while its exports to other regions like the Association of Southeast Asian Nations and the European Union have expanded. At the same time, US imports from other economies are increasing at the expense of China's exporters.

In the event that China chooses to respond with reciprocal tariffs, it would likely damage its own economy more than that of the United States. If both countries imposed reciprocal 60% tariffs, China would suffer a GDP loss of approximately $770 billion, while the United States would incur a loss of approximately $327 billion over the same period, based on estimates from the Peterson Institute.

China could also opt to employ nontraditional trade retaliation measures that would disproportionately impact the United States, such as currency depreciation, withholding supplies of critical minerals, reducing imports of politically sensitive US products, selling off US assets, extending tax rebates to local exporters, and cutting interest rates.

Looking ahead, China could also shift its import strategy away from the United States—last year, its largest US imports were soybeans, integrated circuits, and crude oil. Brazil, various countries in Asia, and Saudi Arabia are significant global suppliers of these commodities and could potentially expand their market share in mainland China (Exhibit 5).

Easing: Central Banks Ready to Lean In

The Fed's easing cycle, with the first cut on 18 September, should create a more supportive environment for EM assets through a moderation in US dollar strength. Historically, EM assets have enjoyed some of their strongest years of outperformance following a peak in the US federal funds rate and strong risk-adjusted returns after global rate-cut cycles commence.

Exhibit 5
Potential Beneficiaries if China Diversifies Away from the US
Three Main Products China Imports from the US

Largest Global Exporters of Products (% of Total Exports)

Soybeans (US$18bn)		Integrated Circuits (US$9.6bn)		Crude Petroleum (US$6.9bn)	
Brazil	53%	Taiwan	23.2%	Saudi Arabia	16.2%
USA	35%	Mainland China	22.1%	Russia	10.0%
Argentina	3.5%	South Korea	12.6%	Canada	8.5%
Canada	2.9%	Singapore	8.5%	USA	8.2%
Paraguay	1.2%	Malaysia	8.2%	Iraq	7.6%
Ukraine	0.9%	Japan	3.8%	UAE	7.2%
Uruguay	0.9%	Philippines	3.4%	Kuwait	4.3%
Russia	0.4%	Germany	2.0%	Norway	4.1%
Netherlands	0.4%	Vietnam	1.8	Nigeria	3.6%
Togo	0.3%	Ireland	1.6%	Kazakhstan	3.3%

As of 2023
Source: Bloomberg

Many EM central banks have already or are expected to begin easing in response to moderating inflation and external pressures. Most in Latin America and Eastern Europe have been ahead of their developed markets counterparts, both in raising policy rates in 2021–2022 and in lowering rates.

Each country has its own nuances, though, including these four key markets:

Brazil: A Hawkish Turn

Bucking the trend in emerging markets, Banco Central do Brasil raised the Selic rate by 25 basis points (bps) to 10.75% in late September. Although inflation has been near the central bank's target, recent currency weakness has created concerns about potential pass-through effects on inflation. Market pricing indicates that investors expect rates to reach 11.75%–12% before easing resumes. President Luiz Inácio Lula da Silva has eased his criticism of the central bank's hawkish stance, thus reducing political noise, which should somewhat help anchor inflation expectations.

Mexico: A More Cautious Approach

Banco de México (Banxico) cut its policy rate in March 2024 from the peak of 11.25% and cut again in August, prompted by a drop in inflation and weakening growth. With the policy rate now at 10.75%, Banxico is expected to ease further, either in the fourth quarter of this year or early 2025, likely moving at a gradual pace to avoid reigniting inflation, which has moderated but remains above target. President Claudia Sheinbaum underscored her respect for Banxico's independence during her inauguration speech on 1 October, which should allow the central bank to continue focusing on its single mandate of controlling inflation with limited political influence.

India: On Hold with Easing Signals

The Reserve Bank of India (RBI) has kept its benchmark repo rate steady at 6.5%, despite declining inflation and concerns over slowing economic activity. Overall inflation has cooled, but recent spikes in food prices have complicated matters. Once these price pressures subside, RBI could signal rate cuts in early 2025. It is expected to prioritize growth as India seeks to bolster its recovery in a challenging global economic environment.

Indonesia: Early Signs of Easing

Bank Indonesia surprised markets with a rate hike in April 2024, raising its benchmark rate to 6% from 5.75%. The unexpected tightening was driven by concerns over currency stability and global financial conditions. However, with inflation below the central bank's target and global headwinds dampening growth, pressure to cut is building. We believe gradual easing could begin as early as the fourth quarter and continue through 2025.

Earnings: Finding Their Wings?

Overall, EM earnings per share (EPS) grew 33% on an annualized basis in the second quarter, compared to 15% in the previous quarter. EPS growth was led by South Korea and Taiwan, while Indonesia and Brazil saw year-over-year declines.

In another significant development for EM equities, earnings momentum has turned positive over the last three months, with 2024 and 2025 EPS up 3% and 3.8%, respectively. Stocks accounting for more than 70% of the MSCI EM Index by weight had EPS upgrades over the third quarter, including broad-based upgrades across Asia, led by Taiwan, South Korea, and China. Notably, India and Hong Kong saw downgrades during the period, as did Brazil, Mexico, and Saudi Arabia.

An acceleration in EM earnings momentum along with US rate cuts (historically, EM has been more sensitive to rate moves than US equities) could be tailwinds for relative performance even when absolute valuations are not inexpensive. Geopolitical factors, such as escalation in the Middle East, the ongoing conflict in Russia and Ukraine, and tensions in the South China Sea could act as headwinds.

Reasons for Warming Optimism—and Changing Minds

While global investors' willingness to add to EM equities has remained tepid through the first three quarters of the year, our outlook for the asset class is constructive for many reasons:

- **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 all regions and not just China, is now starting to move higher towards 4.0% in 2024 as DM growth slows to 1.6%.[1]
- **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[2] for EM in 2024 and 2025 is over 15% and nearly 16%, respectively, compared to just 7% and 11% for DM and 11% and 14% for the United States.
- **Attractive valuations**: In our view, EM equity is one of the most mis-priced asset classes globally, with valuations remaining very inexpensive compared to DM equity. On a forward price-to-earnings multiple, EM is trading at 11.6x, compared to 18.6x for DM and 21.5x for the United States.[3] Over time, this nearly 40% valuation discount relative to DM, compared to a 25% 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 more mixed with certain DM central banks maintaining their policy rates while others begin to cut rates. The Fed's initial 50 bps cut could provide a more supportive environment for EM equities with the potential for continued softening in the US dollar.
- **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 portfolios are 5.3%[4] 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) performed well in the third quarter as the beginning of the Fed's rate-cut cycle contributed to a backdrop of lower global yields and broad US dollar weakness.

The yield on the 10-year US Treasury bond ended the quarter nearly 60 bps lower and EM local debt yields fell by about 50 bps, in line with similar duration global bonds. Meanwhile, EM currencies appreciated by almost 5% in aggregate as the dollar spot index (DXY) fell around 5%. EM sovereign credit spreads tightened by 30 bps, consistent with the prevailing strong risk sentiment.

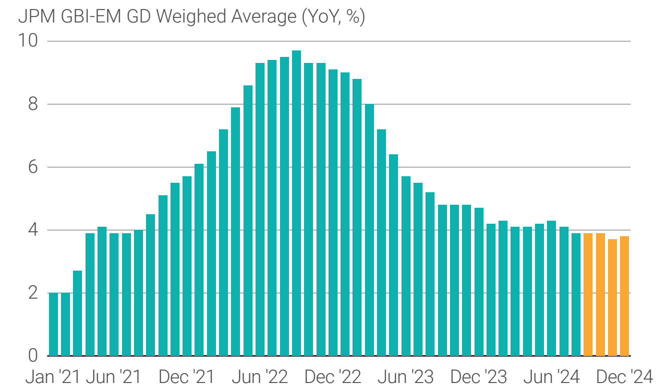
We maintain a constructive outlook on EMD despite the complex global environment. We see three pivotal trends that are poised to influence market movements significantly in the coming months.

1. **Falling global inflation**: The phenomenon of declining global inflation, which began as negative base effects in 2023 following pandemic pressures and stimulus measures in 2021–2022, has now evolved into a more pronounced decrease in inflationary pressures worldwide (Exhibit 6). Goods prices entered deflationary territory nearly two years ago, and more recently, services inflation has seen a significant reduction from its 2021–2022 highs. This trend is evident across both developed and emerging markets, with some countries, such as China, even approaching deflation.

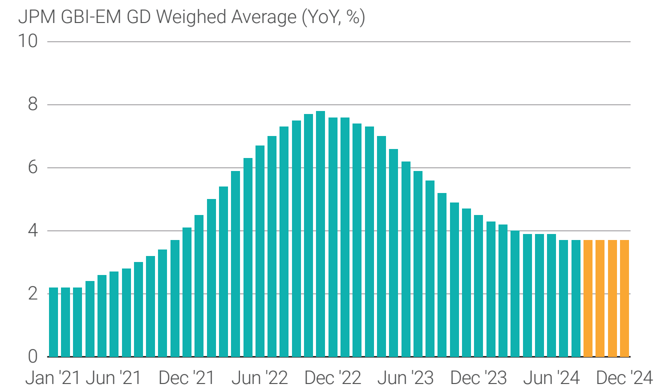
   In this environment, investors typically prefer to hold long positions in US dollar-denominated duration (positions that benefit from falling yields). When it comes to local duration, our positioning hinges on the efficacy of monetary policy in each country and the credibility of their central banks. For countries where central banks are deemed credible, such as Mexico and Indonesia, we favor long duration positions in the local market. Conversely, in countries where there are persistent concerns about adherence to inflation targets or rising long-term inflation expectations, such as Brazil, we are more cautious.

Exhibit 6
EM Inflation Has Moderated

EM Headline Inflation

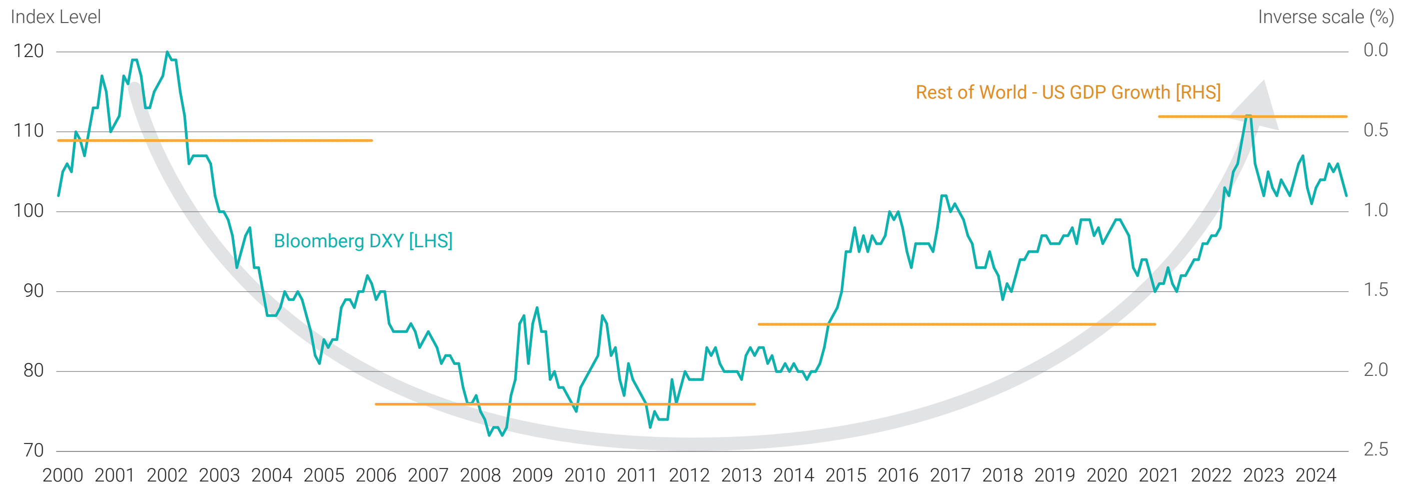


EM Core Inflation



As of 31 August 2024
Source: Lazard, BLS, Haver Analytics, JPMorgan

Exhibit 7
US Dollar Level Varies through Growth Regimes



As of 31 August 2024
Source: Lazard, Bloomberg, World Bank

2. **Waning US Growth vs. Rest of the World**: Relative growth remains the most significant determinant of foreign exchange valuations. Leading indicators suggest that US economic growth is likely to decelerate at a faster rate compared to many global peers, excluding China (Exhibit 7). This shift marks a departure from the past decade, and we anticipate capital flows to move outside the United States as investors seek opportunities. Consequently, we foresee a broad depreciation of the US dollar, driven by less favorable growth dynamics and a persistent rate-cutting cycle in the United States from September 2024 through December 2025.

   In this context, investors should consider short US dollar positions against most currencies, unless the growth outlook for the other country is worse than that of the United States.

3. **US Elections**: The upcoming US presidential election is shaping up to be a binary event with significant implications for EMD. If the Democratic candidate Vice President Kamala Harris wins, likely with a divided government, tariff risk would likely decline and we would expect lower growth and investment conditions in the United States, which could lead to sustained outperformance of EM assets.

   On the other hand, a victory for Republican Donald Trump could present two distinct scenarios. A clean Republican sweep would introduce substantial headline risk and the potential for high tariffs—60% against China and 10% or more against Europe. This could prompt those regions to depreciate their currencies to offset the tariff impact, making US dollar-denominated assets more attractive than those denominated in other currencies. Alternatively, if Trump wins with a divided government, where Democrats take the House of Representatives, we expect slight weakness in EM assets, primarily affecting currencies.

Overall, we maintain a constructive outlook for EMD. We will continue to monitor potential risks and global developments to ensure we are well positioned to capitalize on opportunities over the coming year.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 As of 26 September 2024. Source: J.P. Morgan Global Research, MSCI "Emerging Markets Equity Strategy Steering Board"

2 As of 26 September 2024. Source: J.P. Morgan Global Research, MSCI "Emerging Markets Equity Strategy Steering Board"

3 As of 26 September 2024. Source: J.P. Morgan Global Research, MSCI "Emerging Markets Equity Strategy Steering Board"

4 As of 5 June 2024. Source: J.P. Morgan Global Research, "EM Lighthouse: US Easing Cycles Are Not Always Easy for EM"

Important Information

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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 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 MSCI China Index is constructed based on the integrated China equity universe included in the MSCI Emerging Markets Index, providing a standardized definition of the China equity opportunity set. The index aims to represent the performance of large- and mid-cap segments with H shares, B shares, red chips, P chips and foreign listings (e.g., ADRs) of Chinese stocks.

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 USA Index is designed to measure the performance of the large and mid-cap segments of the US market. The index covers approximately 85% of the free float-adjusted market capitalization in the US.

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.

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