Outlook on **Emerging Markets**

JAN
2015

Summary

- Lower oil prices are economically favorable for many emerging markets as the savings to consumers and countries can boost growth and narrow current account deficits.
- Prolonged oil price weakness may force structural change to fiscal accounts and allow currencies to depreciate to pre-commodity-boom levels, enhancing competitiveness.
- Market overreactions to headline events remain a classic source of equity opportunity as idiosyncratic stock strengths are often overlooked in broad-based market declines.
- We believe that the debt market has entered a new period of lower-beta returns, with much greater opportunities for alpha creation.

Lazard's emerging markets platform consists of experienced investment teams with individual philosophies and portfolio management processes. Each team maintains independent viewpoints that have been enriched by dialogue with colleagues on the platform and within the broader firm. As a result, opinions across the platform may differ.

Emerging markets equities were volatile amid macro stresses in 2014, but rose 2.5% for the year through November. Sharp oil price declines in December tipped the scales and, as investor confidence wavered, the MSCI Emerging Markets Index went from year-to-date gains at November-end to a 2.2% loss for the full year in US dollar terms. Emerging markets small-cap stocks rose for the year and outperformed their large-cap counterparts, helped by the MSCI Emerging Markets Small Cap Index's lower allocation to energy companies. Emerging markets debt returns were mixed for the year, as US dollar–denominated assets advanced in contrast to declines in local currency–denominated assets. Investment-grade debt significantly outperformed high yield debt.

Emerging Markets Equity

From the viewpoint of Lazard's emerging markets equity teams:

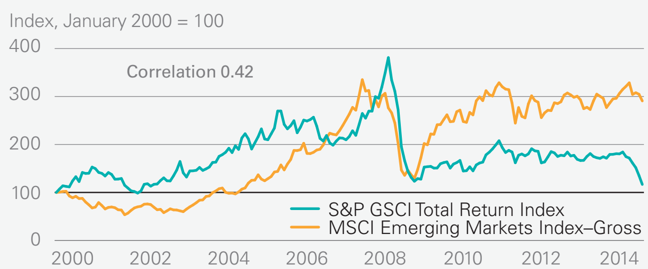
The conclusion of emerging markets elections in 2014 is only the first chapter for many developing countries as the true test will be the progress elected leaders can make toward their mandates. The reform-minded premiers of India and Indonesia appear to be off to an encouraging start, while it remains to be seen what polices re-elected leaders in South Africa, Turkey, and Brazil will adopt to manage structural issues. In *Life after the Elections*, we share our post-election analysis of these five countries.

The biggest risks we imagine for emerging markets in 2015 include a credit crisis in China, widespread recession, increased currency volatility (including a sharply rising US dollar), prolonged commodity price uncertainty, and further geopolitical destabilization in Ukraine, Russia, and the Middle East. On the other hand, we see opportunity in relatively low emerging markets valuations, economic growth that is still stronger than in the developed world, and secular consumer growth in many countries. Moreover, progress on reforms could result in a greater number of attractive investments in countries such as Brazil, India, Indonesia, and China. Market overreactions to headline events remain a classic source of opportunity as individual stocks are often indiscriminately punished in broad-based declines.

Double, Double, Oil and Trouble

The halving of oil prices since their June 2014 highs has triggered a sell-off in developing markets stocks. Are these declines warranted? The net economic effect should be positive as commodities exports are either nonexistent or represent a small share of GDP for the majority of emerging markets (e.g., China, South Korea, Taiwan, Turkey), while they are a major component of other emerging economies (e.g., South Africa, Chile, Brazil, Saudi Arabia). However, commodities price trends have a disproportionate effect on emerging markets investor psychology. Historically, there has been a positive correlation between global commodity performance and emerging markets equity returns, but the strength of that relationship has varied (Exhibit 1). Concerns about outcomes from extended oil price weakness have also weighed on sentiment.

Exhibit 1
Commodities and EM Equity Returns: Positively Correlated to Varying Degrees



From 31 January 2000 to 31 December 2014.

The indices listed above are unmanaged and have no fees. It is not possible to invest in an index. Past performance is not indicative of future results.

Source: MSCI, S&P Dow Jones

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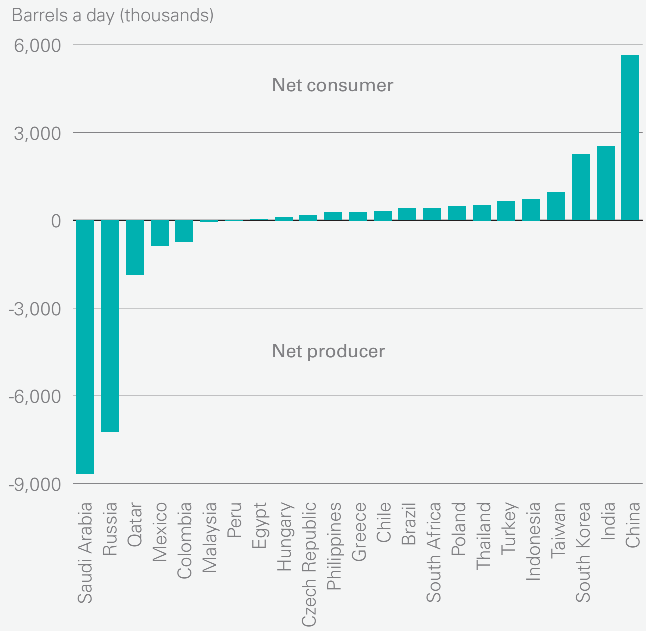
It should be noted that cheaper oil creates more economic winners than losers in the emerging markets and should help bolster developed markets growth, primarily in Japan and Europe. From a consumption perspective, sixteen of the twenty three countries represented in the MSCI Emerging Markets Index are net consumers of oil, led by China, India, and South Korea (Exhibit 2). While in some of these countries lower oil prices could drive spending, as consumers realize savings at the pump; in other countries, such as India and Indonesia, it will reduce and possibly even eliminate oil subsidies, helping narrow current account deficits. (Fuel prices were raised to drive inflation in Indonesia, but fuel subsidies have shrunk.) Oil-producing states such as Saudi Arabia, Russia, Argentina, Iraq, and Nigeria will take big hits to revenues from oil taxes, but some of the bad news appears to have been priced in and, in some cases, possibly overstated. In terms of market effect, some strategists have noted that energy companies in Russia have been trading at valuations that imply oil prices of $25 a barrel.

The current oil price level should not be permanent based on self-correcting price mechanisms, however its duration is unclear. Unlike during the 1986 price shock when there was a disastrous confluence of oversupply and crumbling demand, world consumption is currently growing (driven by the economic ascendance and oil appetite of countries now considered emerging markets), albeit at a slower pace than supply. At today's prices many oil projects are not profitable and capital expenditures will be cut, eroding future supply. On the demand side, rising wages in emerging markets should also support demand for oil which will help to offset declining oil consumption in Japan and Europe.

Exhibit 2
Cheaper Oil Creates More Economic Winners than Losers



As of 16 December 2014
Source: US Energy Information Administration

Some researchers believe persistent oil price weakness may pose a threat to US growth as high-cost US shale oil and gas projects become uneconomic, cutting off a major artery for new jobs in the US economy and, worse yet, causing job losses. The prospect of a widespread recession, with Europe and Japan already on economic tenterhooks, would become more severe with US growth in question. This is a risk for emerging markets equities, which we believe require steady global growth free of exogenous shocks in order to significantly outperform developed markets equities.

Currency Uncertainty, Stronger Economic Frameworks

Lower energy prices should have a positive effect on macroeconomic variables like growth, inflation, and the current account balance, which should in turn boost currencies and interest rates. Given these macro tailwinds, however, the currencies of some emerging markets beneficiaries have not appreciated. We believe the currency market will eventually respond, but with a lag, as other factors tend to interfere with otherwise straightforward macroeconomic relationships. In reality, currencies are simply more sensitive to global risk appetite and US Federal Reserve policy.

From a macroeconomic perspective, oil-importing countries such as Turkey (which had a net energy bill of $50 billion, or roughly 6% of GDP in 2013) benefit significantly from lower oil prices. The impact is quick—falling energy prices help improve the terms of trade and ease pressure on the current account deficit. This helps stabilize the exchange rate, which amplifies the disinflationary impact of falling energy prices and boosts demand. In the case of the Turkish lira, however, a sudden hawkish shift from the Fed would neutralize any benefit to the currency.

Weak emerging markets currencies and falling oil prices evoke memories of Asia's 1997 financial crisis and Russia's 1998 default. The Russian ruble has depreciated sharply, and investors have been broadly critical of the central bank's interventions to stabilize the currency, which have also been viewed as insufficient. If capital controls are imposed, we believe they will be applied with care not to further alienate foreign investors, with lessons taken from Malaysia's controversial 1997 defense of the ringgit from currency speculators. But there are critical differences that will help emerging markets weather the storm: (1) Most emerging markets countries have abandoned currency pegs for freely floated currencies, which grant all-important flexibility in a country's economic and financial frameworks. (2) Emerging markets fundamentals are strong, and sovereign indebtedness has declined dramatically. Russia has reasonable debt coverage, with $388 billion of foreign reserves relative to $110 billion of external debt repayments consisting of external debt maturities of bank and non-bank entities in 2015.

Our equity teams are being selective with their Russian exposures, and their portfolio positioning differs as an extension of their unique disciplines, investment objectives, and investment processes. In the financials sector, there are opportunities in systematically important banks that have large deposit bases and liquid balance sheets. Our teams also see opportunity in defensive Russian businesses offering competitively priced, staple goods. Across the board, our teams are looking for companies well positioned to navigate Russia's current challenges because of their strong balance sheets, good liability matching, and sound business models.

China's Long March

In China, rising wages have boosted incomes and willingness to spend. Consumption has risen since 2009, lending credence to the central government's stated goal of pivoting to consumption-driven growth. The economic benefits are spreading to the country's interior as tightening labor supply in the Pearl River Delta has prompted manufacturers to relocate inland. There are consequences, however. With an average worker earning between three to five times more her counterparts in Indonesia, Vietnam and the Philippines, Chinese labor is no longer cost competitive and China must ascend the value chain. It is already making headway. On a recent trip, we observed businesses setting up near universities in Chengdu to take advantage of a better educated labor supply. China has also established special economic zones with tax incentives to attract foreign investment. The property market, which has been the country's biggest source of growth, is declining, but lower prices have also helped to clear supply in an overheated market. In addition, authorities have loosened margin requirements and lifted restrictions on mortgages on second homes to stimulate buying.

China is in many respects following in the footsteps of the Industrial Revolution. Challenges such as environmental and labor management, social safety nets, and displacement of jobs through mechanization will take time to work through, but its centrally planned economy also grants authorities more control over outcomes. Its financial frameworks are evolving alongside attempts to introduce open-market elements, and the quality of credit growth in the country has come under close scrutiny. We would not be surprised to see more debt defaults, but we believe authorities will be careful to prevent a disorderly unraveling.

Opportunity in an Undervalued Asset Class

From the late 1980s through the 1990s, emerging markets stocks traded at a premium to developed markets stocks based on price to earnings. Between 1994 and 1995, the US dollar strengthened, the Fed doubled interest rates from 3% to 6%, and emerging markets equities underperformed their developed markets counterparts. Emerging markets equities have been trading at a discount ever since. As of December 2014, they were valued at 11 times forward earnings, 31% less than developed markets equities as measured by the MSCI World Index. We believe that this wide gap could help sustain emerging markets valuations in the event of US rate increases. Forward returns on equity in the emerging markets have declined since 2011, falling behind those of the developed world at 11.5% versus 12.1% at year-end, but are still strong.

In an emotionally charged environment, the merits of bottom-up stock selection in the emerging markets can be pronounced. Our equity teams are adhering closely to the equity disciplines and investment processes that have served as a reliable compass time and again, especially in periods of uncertainty and market stress.

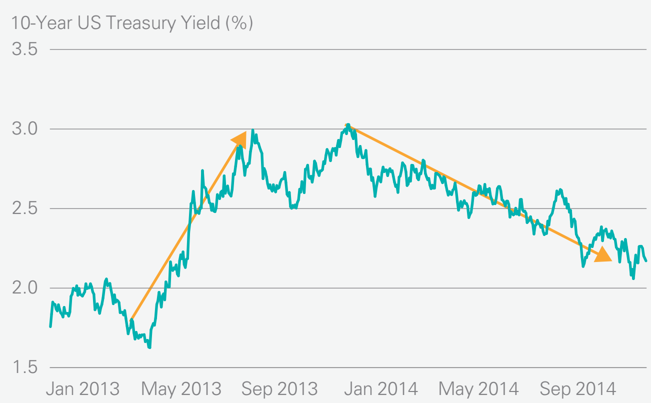
Emerging Markets Debt

From the viewpoint of Lazard's Emerging Markets Debt team:

2014—A Year of Surprises

The major themes in 2014 were ones that most market observers (us included) thought were highly unlikely at the beginning of that year. The first surprise was the near-100 basis point (bp) decline in US Treasury yields even as US GDP growth met expectations at 2.8%. The fall in yields essentially erased the "taper tantrum," which occurred in the second half of 2013 as the market readjusted to an extended period of dovish policy by the US Federal Reserve (Exhibit 3).

Exhibit 3
A Year of Unexpected Yield Movements



As of 31 December 2014
Past performance is not indicative of future results. The indices listed above are unmanaged and have no fees. It is not possible to invest directly in an index.
Source: Bloomberg

The second big surprise, and one that had a dramatic impact on emerging markets debt valuations, was the near-50% collapse in oil prices in the second half of the year. Oil prices had a delayed reaction to the global commodity price correction that has been occurring for the better part of three years because of the market's assumption that OPEC (more specifically, Saudi Arabia) would always act as the ultimate adjustment valve and cut production when needed to balance global oil supply and demand. Instead, in a dramatic show of strength to higher-cost US producers and offshore producers in Brazil and Africa, Saudi Arabia held firm to its production targets at the most recent November OPEC meeting, further stating that OPEC would not cut production even if oil prices traded in the range of $50 a barrel. Needless to say, that is exactly the level to which the market adjusted, resulting in a rout of all sovereigns and corporates that stand to benefit from high oil prices. The biggest casualty of falling oil prices was Russia, where external debt prices corrected 9.2% in 2014 and where the ruble collapsed versus the US dollar, falling more than 50%! Other oil-producing countries were also hurt, including Venezuela, where external debt valuations fell 29% and Ecuador, which corrected 8%. The third and final surprise was the underperformance of local debt versus US dollar debt for a second year in a row. External debt closed 2014 up roughly 7.4%, while local debt lost 5.7%. That 1,300-plus bp difference in returns is the largest dispersion of returns in the history of the asset class (Exhibit 4).

Exhibit 4
Record Divergence in Local and External Debt Returns in 2014

(%)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
External	22.2	11.6	10.3	9.9	6.2	-12.0	29.8	12.2	7.3	17.4	-5.3	7.4
Local	16.9	23.0	6.3	15.2	18.1	-5.2	22.0	15.7	-1.8	16.8	-9.0	-5.7
Difference (bps)	+530	-1,140	+400	-530	-1,210	-680	+780	-350	+910	+60	+370	+1,310

As of 31 December 2014
Source: J.P. Morgan

2015—More of the Same?

Let's begin by reviewing consensus views into the New Year. First, there is nearly unanimous support for the view that the US dollar has begun a trend of multi-year appreciation versus its global peers, primarily as a result of divergent monetary policy between the Fed and most other global central banks. A common belief is that the Fed will hike its policy rate in the third quarter of this year, leading to further US dollar appreciation. Meanwhile, the market also believes that European quantitative easing (to the tune of almost €1 trillion) will be announced in the first quarter, thereby resulting in sustained euro depreciation versus the US dollar. We fully agree with the market on the prospect, timing, and magnitude of QE in Europe and its near-term effect on the euro. As such, we have maintained the euro as the largest net short position in our total return strategy. In a similar vein, we remain underweight European currencies versus the benchmark in our long-only strategies as the negative drag from the euro ought to more than offset the concomitant fall in eastern European local bond yields. Our largest dollar-denominated bond positions are European credits that should also benefit from the collapse in spread differentials in the European periphery, including those in Portugal and Slovenia. However, investors should be reminded that the basic rationale for large-scale monetary stimulus is to "juice" economies to take additional risk. If (and that is a big if) QE is successful in Europe, the market should expect higher levels of risk-taking behavior, higher levels of forecast growth, and higher levels of expected inflation in the continent. All of those factors are indeed positive for emerging market assets as Europe is as significant a trading partner for the emerging markets universe as the United States. As such, European growth, trade, and inflation data will become critical in the quarter after QE is announced (likely on 22 January, 2015), with potential upside surprises in store. If European fundamental data improve, we would reverse many of our local market underweights and shorts to position for a near-term bounce in those same emerging markets debt assets.

Outside of European growth malaise, the other elephant in the room for emerging markets debt investors is the expected path of global oil prices. Unlike 2008, where oil prices bounced as quickly as they fell, markets are correctly bracing themselves for a more drawn out bottoming in crude prices. If we take the Saudis at their word and believe in their commitment to maintaining market share, then the market likely needs to wait until at least the second half of this year for oil prices to rise again. Already, we are seeing a slowing growth rate of US oil production, as oil prices fall below some of the higher-cost producers' breakeven points. However, most of these companies are relatively well capitalized and oil prices must hover at or below current levels for an extended period of time before they suffer credit events or production stoppages. Lower-for-longer oil prices may be the single most effective reason to force lackadaisical emerging markets policy makers to enact structural change to fiscal accounts and allow emerging markets currencies to depreciate to pre-commodity-boom levels to enhance competitiveness.

For the five-year period between 2009 and 2014, emerging markets debt was characterized by significantly positive and negative "beta" performance. The entire asset class rallied and corrected, with little regard for individual country differentiation. We believe that the market has now entered a new period of lower-beta returns, with much greater opportunities for alpha creation. As an example, within the oil complex, countries such as Russia, Angola, Nigeria, Ecuador, Ghana, and Venezuela will all face fiscal deficits in the high single digits and, in some cases, double digits. Each country will be challenged to make rapid painful adjustments in order to make it through what will likely be a low revenue environment in 2015. It is our view that a country like Venezuela will indeed make those adjustments, which will likely include a maxi currency devaluation, the end to certain energy subsidies (particularly the Petrocaribe program), and sweeping expenditure cuts at the government level. In other cases, such as Ghana's, we believe there is very little political will to reduce what were already double-digit fiscal and current account deficits before the collapse in oil prices. Instead, Ghanaian authorities will likely continue to rest their hopes on an IMF bailout; the likelihood of which is inversely proportional to the level of hubris shown by senior fiscal operatives in the country.

With regards to emerging markets debt expected returns for 2015, we anticipate mid-single digit returns, which will likely fall just short of the expected annualized volatility for the asset class. Similar to 2013 and 2014, external (US dollar–denominated) debt will likely outperform local currency debt. Tailwinds for external debt outperformance are certainly more prevalent in the first half of the year as monetary policy divergence between the United States and the rest of the world becomes more pronounced. We may very well see the reverse in the second half of the year, provided that stimulus efforts result in more stable developed markets growth conditions, which should then support emerging markets exports (and, hence, currencies and local markets).

As investors, we believe it is critical not to live in the past. Emerging debt markets in 2013 were all about the "Fragile Five" whose current account deficit problems resulted in significant currency depreciation in the second half of that year. Yet, those same countries in 2014 were some of the best performers as markets (in retrospect) had significantly overshot as investors shed exposure to these countries, and the countries themselves made significant positive adjustments. Similarly, 2014 was all about avoiding oil and commodity exposure and many investors offloaded exposure in the last month of the year. It is hard to explain how a country like Venezuela, with limited debt maturing in the next two years trades below 40 cents on the dollar. Yet, the reality of forced stop-loss selling, coupled with the typically less liquid markets at year-end, gives investors an opportunity for outsized gains in 2015. Yet again, we believe that some of the most beaten-up countries from 2014 will make much-needed adjustments in 2015 and rise to the top of the returns table in the twelve months ahead. Success in 2015 will rely on old fashioned bottom-up credit and currency analysis, with a focus on the ability and willingness of sovereign and corporate credits to adjust and stay current on debt payments. Active management of portfolios between dollar-denominated and local currency–denominated debt will also be critical to preserving gains in what is likely to be an action-packed year for investors.

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