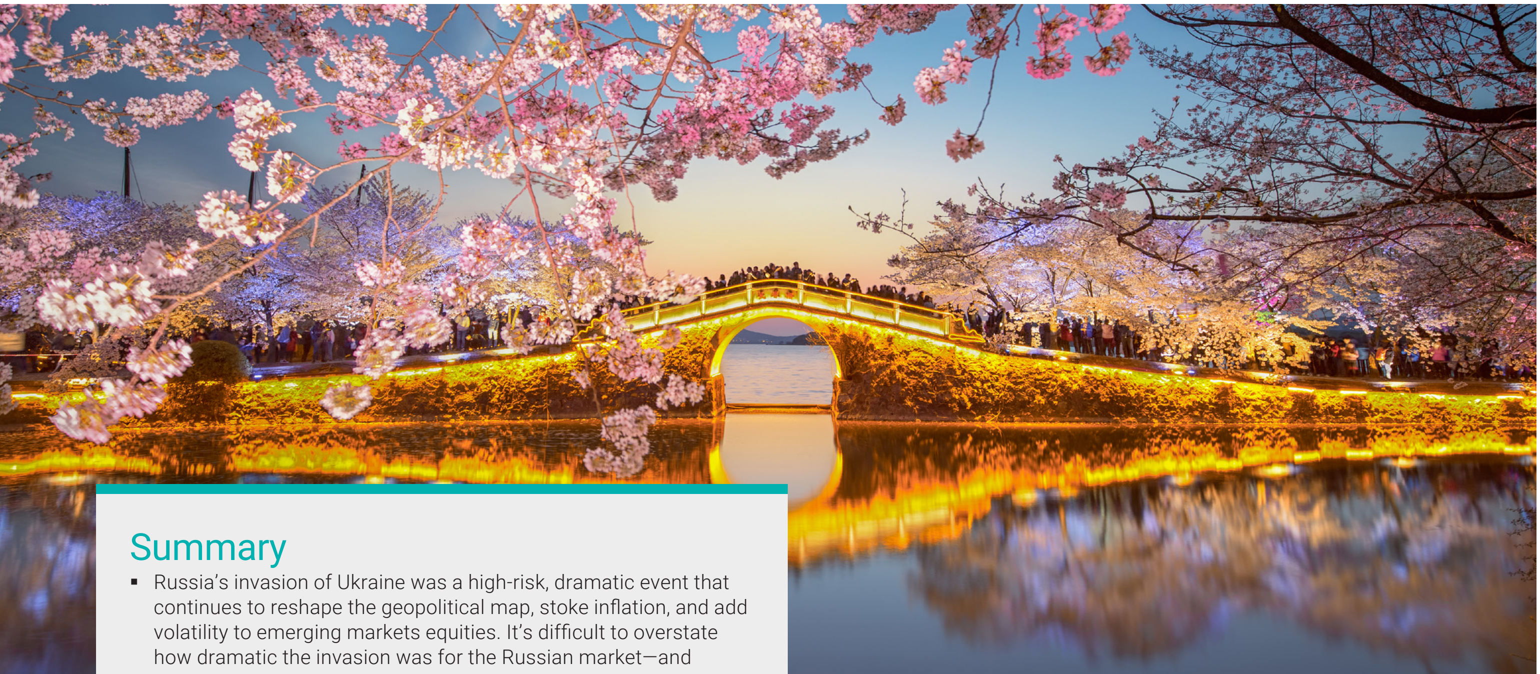
Outlook on

Emerging Markets

APR 2022



Summary

- Russia's invasion of Ukraine was a high-risk, dramatic event that continues to reshape the geopolitical map, stoke inflation, and add volatility to emerging markets equities. It's difficult to overstate how dramatic the invasion was for the Russian market—and commodity prices.
- In other emerging markets countries, however, the overall decline has been relatively modest. Latin American markets like Brazil have benefited from higher commodity prices; Beyond Latin America, Saudi Arabia and South Africa have also recorded strong performance.
- Russia's invasion put emerging markets debt in the crosshairs of a crisis, causing the asset class to suffer one of its worst drawdowns in recent history and underperform nearly all other fixed income markets.
- In our view, the key risk for emerging markets debt as an asset class is the degree to which the conflict slows global growth, ratchets up inflation, and tightens global financial conditions. We continue to expect inflation to moderate in the second half of the year as supply chain shocks wear off and the effects of monetary tightening begin to take hold.

Equity

Invasion Changes Almost Everything

Emerging markets experienced a challenging and dramatic series of events in the first quarter of 2022 with signs of global monetary tightening and Russia's invasion of Ukraine. The MSCI Emerging Markets Index fell by 7% over the period, underperforming the developed markets MSCI World Index by approximately 1.8%. The top three performing markets included Brazil, Peru, and Colombia and the bottom three markets were Russia, Egypt, and Hungary. The top three performing sectors included financials, materials, and utilities and the worst-performing sectors were energy, consumer discretionary, and healthcare.

However, since the start of the Russia-Ukraine war in February, the impact has been disparate across emerging markets (Exhibit 1). The emerging European (Hungary, Poland, Czech Republic, Greece, Turkey) and Egyptian equity markets have been some of the worst performers given their dependence on Russian energy, grains, and tourism. On the other hand, with Russia no longer part of the MSCI Emerging Markets Index, Latin American markets have benefited from higher commodity prices. Beyond Latin America, Saudi Arabia and South Africa have also recorded strong performance as they have the next-largest market exposures to commodities. In contrast, the market exposure to commodity sectors is considerably smaller in Asia, at only 10%, which is one reason the region has lagged.

A Closer Look at Trade in a World of Sanctions

The fallout from Russia's invasion of Ukraine on 24 February was swift, as Russian stocks first plunged and then froze, and Western nations announced plans for waves of heavy and unprecedented sanctions. More broadly, the global political and economic landscape that had been gradually established since the fall of the Berlin Wall—one that supported a trade environment unprecedented in its openness and boosted competition across the world—was suddenly upended.

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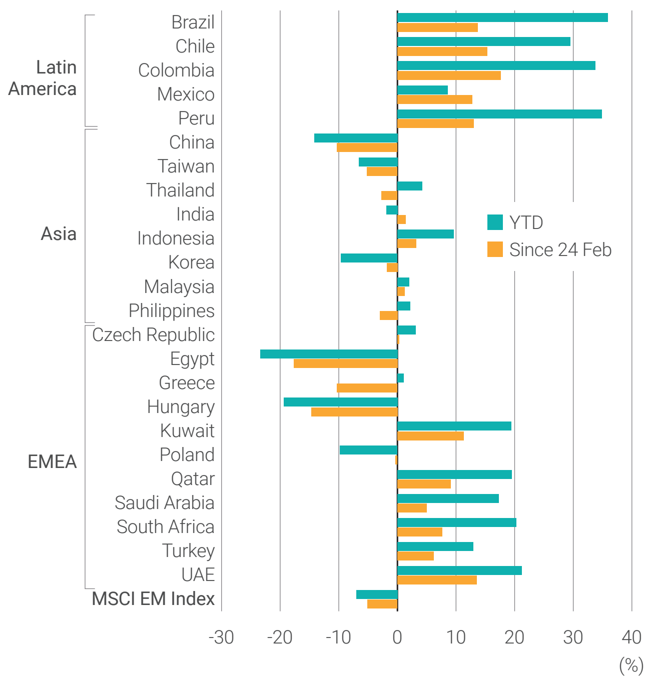
Exhibit 1
Emerging Markets Equities: Country Performance Since Russia Invasion



As of 31 March 2022
Source: MSCI

The globalized trade system that formed gradually after 1989 included a Russian economy supported by plentiful amounts of crude oil, gas, minerals, and agricultural commodities. By 2014, however, Western countries implemented the first round of sanctions against Russia over military action in Ukraine, specifically Crimea, and added to them in the wake of other Russian acts of aggression. Russian President Vladimir Putin's most recent move, though, has caused a much more severe response and is likely to significantly change overall economic circumstances for Russia and the world.

Russia and Ukraine: Small Index Positions Pack Economic Punch

While Russia produces a relatively small percentage of global goods and services, making up just under 4% of the MSCI Emerging Markets Index at the start of 2022 (falling from 10% of the index in 2008), it is an important producer of some very critical resources.[1] Approximately 10% of petroleum, 20% of natural gas, and 17% of wheat are produced in Russia. Russian producers also produce enough steel, palladium, platinum, and other materials to directly affect global markets (Exhibit 2).

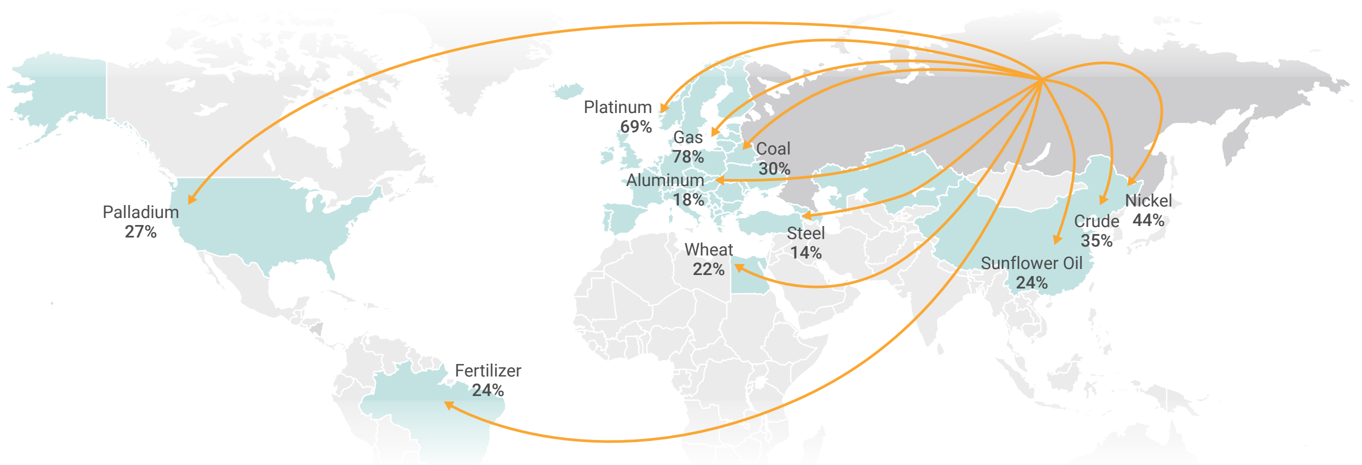
For emerging markets, this creates a paradox. They have relatively small direct linkages to Russia, exporting just 1.4% of goods to the country and importing 2.2% of goods from it, on average. Being a major exporter of commodities, however, Russia's share in emerging markets' commodity imports is higher, especially fuel, and particularly for economies in Central and Eastern Europe and Africa (Exhibit 3).

Global Food Security Set to Be Altered

As a significant producer of corn, wheat, and other agricultural products and commodities, Ukraine is also a key global resource provider for many emerging markets economies (Exhibit 4). It is also worth noting that the countries that are most dependent on Ukraine's wheat are by and large poor countries that will likely be hard-hit by rising prices, as discussed in greater detail below.

In fact, looking at the combined contribution Russia and Ukraine make to the world's food supply is a startling reminder of the risks the current conflict poses to global food security (Exhibit 5).

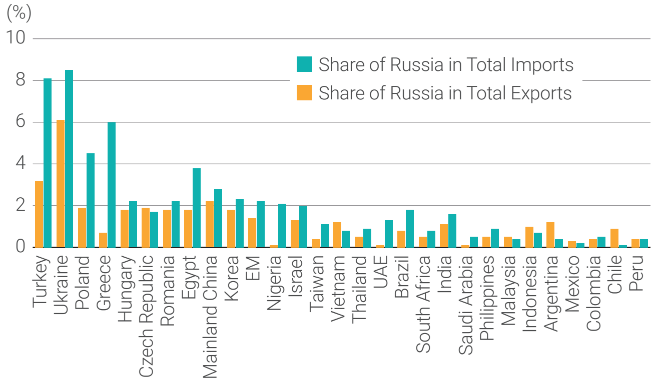
Exhibit 2
Russia's Commodities Reach: Share of Exports That Go to Each Destination



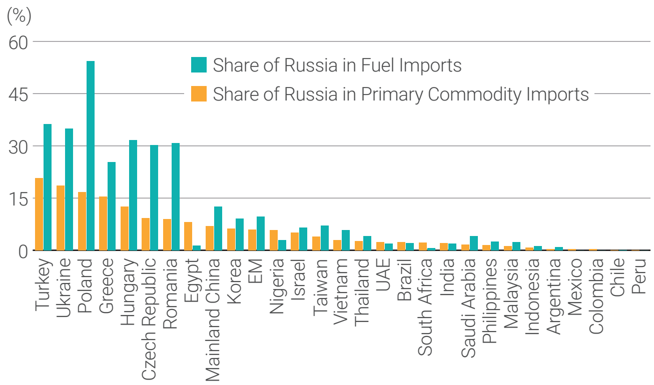
As of 18 March 2022
Note: Coal figures combine thermal and metallurgical; liquefied natural gas and pipeline gas are also combined.
Source: UN Comtrade Database (metals); International EnergyAgency (coal); UN's Food and Agriculture Organization (wheat; sunflower oil); Joint Organizations Data Initiative; Bloomberg; Eurostat; BP (crude); TradeData Monitor; Green Markets, a Bloomberg company (fertilizer); BP (gas).

Exhibit 3
EM Exposure to Russia Is Small Overall, but Commodity Imports Have a Larger Impact

Share of Russia in Total Exports & Imports by Country

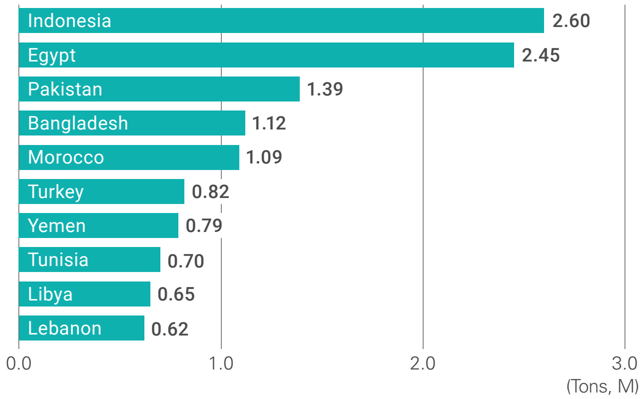


Share of Russia in Primary Commodity & Fuel Imports by Country



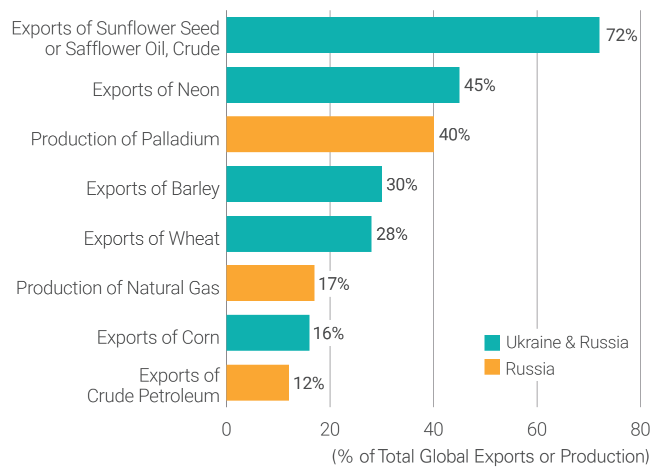
As of 31 December 2020
Source: HSBC, International Monetary Fund, World Bank

Exhibit 4
Top 10 Importers of Ukrainian Wheat (2020–2021)



As of 31 December 2020
Source: Financial Times, Observatory of Economic Complexity, US Department of Agriculture

Exhibit 5
War in Ukraine Upends Commodity and Agricultural Production



As of 31 December 2020
Source: HSBC, International Monetary Fund, World Bank

Europe's Breadbasket Puts Pressure on Egypt

Egypt provides an example of a country for which the conflict poses a significant and poignant risk. Russia and Ukraine account for 80%–90% of Egyptian wheat imports, or about half the nation's total consumption. The country also imports significant amounts of oil from Russia. As a net commodity importer, Egypt's finances will likely come under pressure as food and oil prices reach new highs.

Egypt's 2021–2022 budget allocated EGP18.4 billion ($1.17 billion) for hydrocarbon subsidies, based on an average of $65 per barrel. With current oil prices already double the average level and expected to remain high, Egypt's leaders will have limited flexibility to cover costs for the approximately 120 million barrels of oil it purchases each year. At the same time, 50% of Egypt's wheat imports are sourced from Russia and 30% from Ukraine. By some estimates, the country's budget gap could near $1 billion.

How Supply Pressures Could Play Out

Commodity prices have already risen globally and are likely to continue rising as war and sanctions continue to take Ukrainian and Russian goods offline. However, the impact on countries around the world will likely be uneven.

Since the start of the conflict, the emerging European (Hungary, Poland, Czech Republic, Greece, Turkey) and Egyptian equity markets have been some of the worst performers given their dependence on Russian products. While we believe Russian energy dependence will likely tamp growth for these economies, higher food prices may also jeopardize inflation and current account positions, particularly in Egypt and Turkey. Half of Egypt's wheat imports are sourced from Russia and 30% from Ukraine, while Turkey sources 70% of its wheat from Russia and 15% from Ukraine.[2] Tourism revenue may be at risk for these countries, too—20% of Turkey's tourists come from Russia, for example—potentially negatively impacting growth and external balances.

Dependence on Russian Energy Comes at a Price

The degree to which countries depend on Russian energy will also play a role in their fate. Some areas, including both developed markets such as the European Union and Japan and emerging markets such as Turkey and many Asian countries, for example, are very far from meeting 100% of their domestic fuel needs—making them highly dependent on petroleum imports and potentially more vulnerable to price rises. Latin American countries, by contrast, produce close to or above 100% of their domestic fuel needs and should benefit from price increases for both energy and other commodities, including precious and industrial metals.

Russian Markets Suffer Invasion Fallout, Other EM Countries Fare Better

It's difficult to overstate how dramatic the invasion was for Russian markets. Shares of Russian companies collapsed, local capital markets shut down, and major providers removed Russian equities from their emerging markets, global, and international indices. The Russian exchange reopened under heavily restricted trading at the end of March, with foreign asset owners unable to sell shares and short-selling banned.

In other emerging markets countries, however, the overall decline has been relatively modest. With Russia no longer part of the MSCI Emerging Markets Index, Latin American markets have benefited from higher commodity prices. The two natural resource-heavy sectors, energy and materials, constitute a substantial portion (20%-45%) of these countries' market capitalizations.

Russia's Ripple Effects: A Better Environment for Brazil?

The history of the Brazilian economy has been one of ups and downs. Most recently, though, it's been up: GDP grew 4.6% in 2021, the largest expansion in 11 years, offsetting a 3.9% contraction in 2020 that was due in large part to the pandemic.

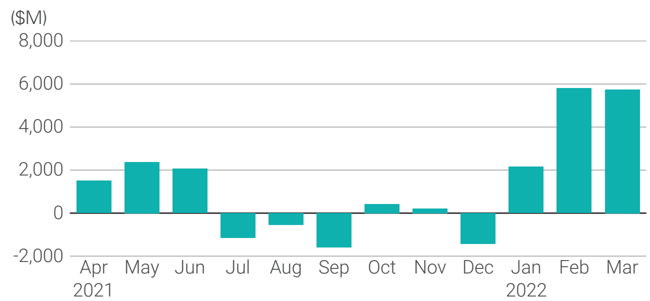
In the fourth quarter, GDP in Brazil grew 0.5%, reversing its 0.3% and 0.1% contractions from the previous two quarters, lifting the South American country out of recession. The rebound was driven by growth in the services and agricultural sectors. The services sector expanded 0.5% quarter over quarter and 3.3% year over year, while the agricultural sector gained 5.8% on the quarter, though it contracted 0.2% for the year after the country's worst drought in nearly a century.

While a full recovery is nowhere near complete, improving economic sentiment has translated into strong equity market returns. After falling 19% in 2021, the MSCI Brazil Index gained 36% through the first three months of 2022 with the Brazilian real appreciating 15% versus the US dollar. The strength in global commodity prices as a result of Russia's invasion of Ukraine has been a benefit to the commodity-exporting country and its markets, and companies like iron-ore giant Vale and oil producer Petróleo Brasileiro, which combined make up nearly a third of the MSCI Brazil Index.

Foreign Interest Boosts Equity Inflows

Brazilian equities have also seen record foreign inflows. Throughout the first quarter, for example, foreign investors piled into Brazil's equity market at a record clip. Nonresidents added approximately $14 billion over the period, followed by 30.1 billion reais in February, the largest net inflows since 2008 (Exhibit 6). The rebound helped fuel a strong start to 2022 for the MSCI Brazil Index, which gained more than 35% in US dollar terms for the quarter.

Exhibit 6
Brazil Portfolio Equity Flows



As of 5 April 2022
Source: Institute of International Finance

It's worth noting that the strong inflows come at the beginning of a controversial election year. In fact, some believe the recent strong flows are related not only to commodities prices and attractive valuations after a difficult year, but also to foreign investors predicting that former President Luiz Inacio Lula da Silva will win the presidency in October, which they view as a potentially positive development. The exit of former judge Sergio Moro from the presidential race and speculation that the governor of Sao Paulo state João Doria may also pull out seems to reinforce the view that it will be difficult for a credible "third way" centrist candidate to challenge the incumbent Jair Bolsonaro and the former president.

China: Still Top of Mind for EM Investors

Though the Russia-Ukraine conflict received most of the attention over the past quarter, investors looking to the next quarter must still keep a close eye on developments in China. By the end of the quarter, the US Securities and Exchange Commission (SEC) had identified six Chinese companies that trade in the United States as American depository receipts as failing to adhere to the 2020 Holding Foreign Companies Accountable Act (HFCAA), which permits the SEC to ban companies from trading and order them delisted from US exchanges if they are found to be in violation of foreign ownership laws or audit requirements. The SEC's list is expected to grow, although the potential delistings would not occur until 2023 at the earliest. The companies named as noncompliant included BeiGene, Yum China, Zai Lab, ACM Research, HUTCHMED, and, most recently, Weibo.

There is a chance that Chinese and American regulators will come to terms and avoid delistings. In March it was reported that in a continued push for transparency Chinese regulators had asked some of the country's US-listed firms, including Alibaba, Baidu, and JD.com, to prepare for more audit disclosures to comply with the HFCAA. At a special meeting of the Financial Stability and Development Committee (FSDC) in March, China's top economic advisor, Liu He, also mentioned the FSDC's progress in solving issues with the SEC over audit requirements for Chinese companies and pledged to maintain stability in US-listed Chinese stocks. Though the China Securities Regulatory Commission withdrew a requirement that only Chinese regulators could conduct audit inspections of Chinese businesses listed overseas, paving the way for a potential resolution, a deal to avert a forced delisting of US-listed Chinese companies is in our view premature. We continue to watch developments in this area closely.

Chinese stocks have also had to contend with market volatility due to COVID-19 outbreaks and investor concerns over potential ripple effects of the Russian war, both in terms of global growth and the potential for sanctions if China is perceived to be supportive of Russia. China is set to relax its zero-COVID policy in an effort to jump-start the economy, but close to half of the country's exports are produced in areas that are now experiencing COVID outbreaks.

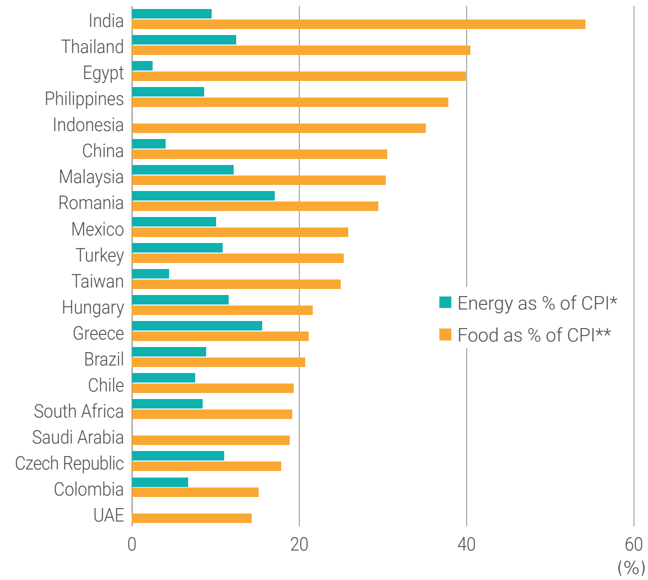
Responding to these challenges, Liu also signaled at the FSDC meeting that policy easing was on the way. He stated that the government would take measures to "boost the economy in the first quarter" and introduce "policies that are favorable to the market." He urged regulatory agencies to enact rules that would be beneficial to the economy rather than policies that detract from growth.

Emerging Markets Equities: Opportunities against a Precarious Backdrop

Our base case scenario for the Ukraine conflict is that Russia will gain a degree of control over Ukraine and sanctions will continue. In that event, commodities prices would likely remain relatively high and we believe worldwide economic growth could fall from our previous expectations of 4%–5% to 3%–4%. Global inflation is likely to rise at a faster rate, possibly as high as 4%, over the next five years. Emerging markets sectors that tend to move higher with higher inflation expectations include materials, automotive, consumer durables, and energy. On the other hand, sectors that move inversely to inflation expectations belong to the more defensive categories of household products, commercial and professional services, pharmaceuticals and biotech, telecommunications, healthcare equipment, and services, food staples, food beverage, and utilities.[3] Emerging markets, particularly the more vulnerable economies where external financing needs are significant, may be pressured by a stronger US dollar as the Federal Reserve increases interest rates to tame inflation. Many emerging markets countries are running current account surpluses or, if they have deficits, these are generally small.

Many countries have raised short-term interest rates already, and higher inflation can be a relative advantage for some developing countries, especially those that are significant commodity producers. That said, unlike in developed markets, half of the inflation basket in emerging markets consists of food and energy, which means that emerging markets central banks cannot ignore the headline consumer price index (CPI) (Exhibit 7). Central and Eastern European countries have the largest share of energy in their CPI basket, while for food it is primarily the Asian countries, such as India (45.9%) and the Philippines (34.8%) that appear the most exposed. Should commodity prices remain at current levels, the pressure to continue hiking in this growth downturn could present significant headwinds to any sustained growth recovery.

Exhibit 7
Emerging Markets: Main CPI Components



As of 31 December 2020

* Refers to electricity, gas and other fuels for housing, as well as fuel & lubricants for personal transport equipment.

** Refers to food & non-alcoholic beverages.

Source: FactSet, FTSE, HSBC, Russell

Conclusion

Over the short term, it is likely that market volatility will persist given the increased geopolitical uncertainty, weaker global growth, and earnings risks from oil shocks and higher inflation. Encouragingly, since the end of 2020, lower-valued shares with higher dividend yields and free cash flow yields in emerging markets equities have become more sought after. These improving characteristics, along with the lower valuation multiples versus its own history and compared to developed markets, could present investors with an attractive entry point into the asset class.

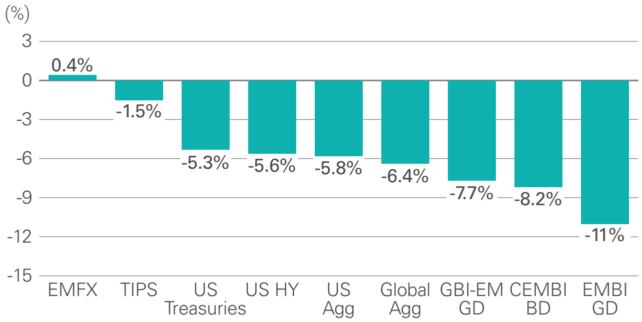
Debt

With Crisis Comes Opportunity

Even before Russia invaded Ukraine in late February, emerging markets debt was under significant stress. Persistent and elevated inflation around the world placed pressure on central bankers, including the Fed, to brace markets for an accelerated pace of monetary tightening and caused a significant sell-off across fixed income markets (Exhibit 8). Russia's invasion put emerging markets debt in the crosshairs of a crisis, causing the asset class to suffer one of its worst drawdowns in recent history and underperform nearly all other fixed income markets.

Investors began to pull money from emerging markets debt in late 2021, and the pace of outflows has accelerated in 2022. Over the past six months, investors have withdrawn around $21 billion from the asset class, including over $14 billion since the start of the year. Nearly all of the outflows since the start of the year have been from hard currency debt which has suffered the steepest losses. The nearly

Exhibit 8
Bond Markets Suffered Losses in Q1 2022

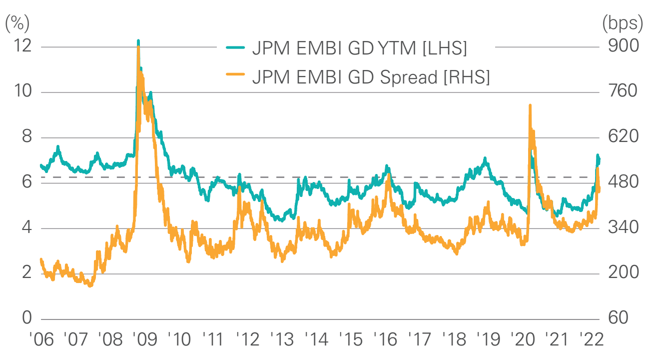


As of 23 March 2022
Source: Bloomberg, JPMorgan

$13 billion in hard currency redemptions in the first quarter is the second-worst quarterly outflow in absolute terms, trailing only the COVID-19 crisis in the first quarter of 2020. However, as a percentage of the overall asset class, the recent outflows are less than half of what they were during the Taper Tantrum and COVID-19 at around 4%.

After months of selling, valuations have reached historically attractive levels. As of this writing, the index-level spread was around 465 basis points (bps) while the yield exceeded 7%. In the modern history of the asset class, which we define as the period since 2005 when emerging markets debt first reached investment grade status, there have been only two previous occasions when the spread breached 450 bps and the yield breached 7% concurrently—the global financial crisis and the height of the COVID-19 crisis in March 2020 (Exhibit 9).

Exhibit 9
Valuations Reach Levels Rarely Seen



As of 23 March 2022
Source: Bloomberg, JPMorgan

In both of these instances, the macroeconomic outlook was far worse and more uncertain than it is currently. During the global financial crisis, the future of the world's entire financial system was called into question, yet valuations returned to more normal levels within a year. Meanwhile, during COVID-19 the world faced its first global pandemic in a century and was confronted with economic shutdowns on a scale never seen before. Many people initially feared another Great Depression, sparking a rapid sell-off, but the return to more normal valuations occurred almost as quickly. In each of these instances, investors were rewarded with strong returns as conditions normalized.

By comparison, the current situation seems less concerning from a macroeconomic perspective. While the conflict in Europe has exacted a tragic and devastating human toll and is a major military shock, the effect on the global economy will likely be more limited, barring a severe escalation. We acknowledge that the Russia-Ukraine war has a global impact and has caused many investors to reassess their allocations to emerging markets. However, stepping back from the conflict, a key question for investors is whether this could mark the beginning of more challenging times ahead—perhaps either a severe global recession or stagflationary environment—or whether it is a rare opportunity to capitalize on a significant market dislocation.

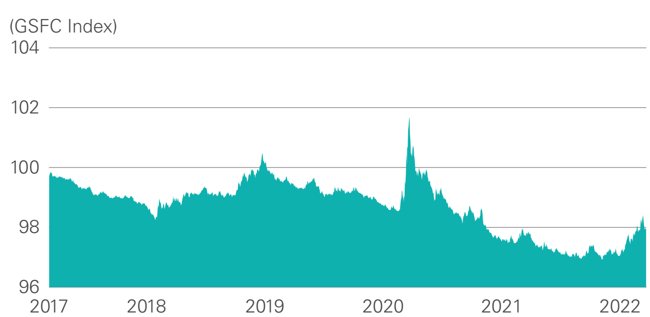
We are very much of the view that the latter is true and have high conviction that emerging markets debt is poised to deliver strong investment returns over the medium term. However, there are likely to be clear winners and losers in this market. Navigating the risks and opportunities will require a flexible approach.

The Macro Effects of War

As a direct consequence of the Russia-Ukraine conflict, global growth expectations have been revised down. Prior to the invasion, most data suggested that the global economy was primed to accelerate in the second quarter as the impact of the Omicron variant faded. While a raft of new Russian sanctions and higher commodity prices have reduced growth expectations, our base case is that the global economy will not be dragged into recession, barring a significant escalation in the conflict. Meanwhile, inflationary pressures have grown. The conflict created a massive negative supply shock in commodities, affecting not only oil and gas, but also many metals, fertilizers, and grains—especially wheat, where Russia and Ukraine play a crucial role in global supply.

Financial conditions have also tightened, but they are not what we would call "tight." In fact, we would characterize them as closer to neutral (Exhibit 10), roughly in line with late 2020, when the economy was still in the early stages of recovering from the height of the pandemic. They are not near a level that would either alarm us or cause us to reduce risk.

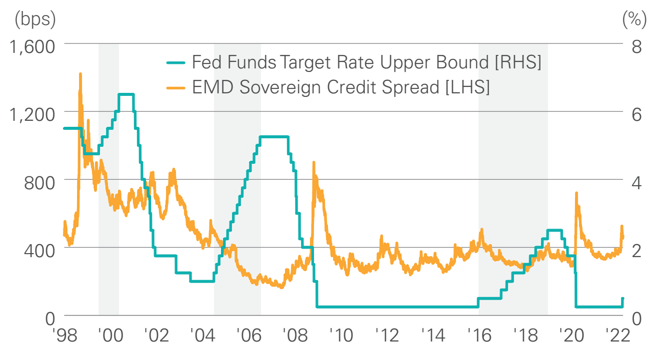
Exhibit 10
Financial Conditions Tighter, but Not "Tight"



As of 23 March 2022
Source: Bloomberg, Goldman Sachs

Meanwhile, investors have been grappling with the idea of Fed rate hikes since before Russia invaded Ukraine, and concern about rising rates remains acute after the central bank raised rates in March for the first time since late 2018. As common as it is, the idea that emerging markets bonds underperform during rate hike cycles is a misperception. The logic behind the belief is that as yields become more attractive in developed markets, investors flee emerging markets, causing spreads to widen and emerging markets bonds to underperform. What has actually happened during the past three Fed rate hike cycles, however, is that spreads have tightened on dollar-denominated emerging markets sovereign bonds (Exhibit 11).

Exhibit 11
Spreads Have Tightened in Past Rate Hike Cycles



As of 23 March 2022
Source: Bloomberg, JPMorgan

Why is this the case? First, investors begin to price in rate hikes well ahead of actual moves, so a lot of negative news may already be baked into the cake by the time rate hiking begins. For example, ahead of the Fed's recent lift-off, markets were already pricing in about seven rate hikes for 2022. Second, if the Fed is hiking for the "right" reasons (i.e., stronger growth), it stands to reason that credit spreads—which are mostly compensation for default risk—should tighten amid a strong global growth backdrop. To be fair, inflation is more of a concern in this rate hike cycle than it has been in the recent past. However, it is also worth noting that emerging markets central banks have been more proactive in confronting inflation than they have been in past cycles. Emerging markets central banks began raising rates in early 2021 and are well ahead of the Fed in their tightening cycles. We believe this, coupled with light investor positioning in emerging markets, could limit the outflow of capital from emerging markets.

Not All Emerging Markets Will Bear the Same Burden

While the current macroeconomic environment has its fair share of challenges, we believe the impact is likely to be differentiated across countries and asset classes. The Central and Eastern European countries that are subject to the spillover effects from the war in Ukraine are likely to remain so given their geographic proximity to the conflict, along with historically higher economic and financial linkages. Growth in the region is likely to be revised down significantly while high energy prices are set to exert upward pressure on inflation forecasts.

Energy and commodity-importing countries will be hurt by higher prices and the impact will likely be most acute in countries that were already in a vulnerable position prior to the war. However, we believe contagion to the rest of emerging markets should be limited and that investors will probably begin to differentiate between countries in due course. For example, commodity-exporting countries in Latin America, the Middle East, and Africa are geographically isolated from the conflict in Europe and stand to benefit from the increases in the price of oil, metals, and other commodities. Countries such as Angola and Ecuador have been among the best performers over the past few months. Currency performance has also been highly differentiated and is likely to remain so. The outperformers are likely to be commodity exporters, high yielders, and countries distant from the conflict, such as the Brazilian real.

In our view, the key risk for emerging markets debt as an asset class is the degree to which the conflict slows global growth, ratchets up inflation, and tightens global financial conditions. The ability of developed markets central banks to navigate higher inflation while engineering a soft landing will be critical. Core central banks, including the Fed and the European Central Bank, have recently taken a decisively more hawkish stance. Markets are currently pricing in around 175 bps of additional Fed rate hikes in 2022, including the possibility of a 50 bp hike in May. Additionally, balance sheet run-off is expected to commence around the middle of the year. Still, the risks may be tilted toward further tightening. Some of the more hawkish members of the Federal Open Market Committee have publicly stated a desire for the fed funds rate to reach 3% by the end of the year. As a result, US Treasury yields have risen and the curve has flattened sharply in recent weeks. However, we continue to expect inflation to moderate in the second half of the year as the initial supply shocks wear off and the effects of monetary tightening begin to take hold. We are closely watching the shape of the yield curve, but are mindful that while an inverted yield curve is a good predictor of recession, it tells us nothing about the timing of a recession and risk markets typically rally in the months following inversion.

In conclusion, we believe now is an opportune time to selectively add risk in emerging markets debt, especially in hard currency sovereign debt. The high carry on the asset class provides more than adequate compensation in our view for investors to ride out any near-term volatility and await potential spread tightening. However, differentiation between the winners and losers is likely to be elevated in this market. We are focused mainly on fundamentally strong BB- and B-rated credits, including commodity exporters that stand to benefit from the recent rise in commodity prices and have little direct exposure to the conflict in Ukraine.

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 Zangari, P. MSCI, 3 March 2022. From Crisis to Crisis: Russia's Diminished Role in Emerging Markets

2 Argus Media, 1 February 2022. Turkey's Wheat Imports from Ukraine Hit Record

3 BofA Global Research

Important Information

Published on 11 April 2022.

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 index is unmanaged and has no fees. One cannot invest directly in an index.

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 index is unmanaged and has no fees. One cannot invest directly in an inde. The MSCI Brazil Index is designed to measure the performance of the large and mid-cap segments of the Brazilian market. With 49 constituents, the index covers about 85% of the Brazilian equity universe.

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