

## Summary

- Currency, interest rate, and policy turbulence weighed on developing markets in the second quarter, driving the largest quarterly decline on record for emerging markets debt and weakness in emerging markets equities and currencies.
- Where before emerging markets investors may have been somewhat exuberant, they now appear too bearish. The macro drag has been extreme, but we believe many of the drivers should be short lived.
- Equity fundamentals have held strong, with stable-to-higher earnings growth estimates for 2018 and 2019, and new areas of return have formed in established as well as newer industries.
- We believe the valuation opportunity has improved significantly across emerging markets debt. The key question going forward is whether the sell-off is in line with the deterioration in fundamentals, with some areas appearing oversold even at lower valuation targets.
- Despite the possibility of further consolidation in the near term, we believe emerging markets equity and debt valuations currently provide an attractive entry point and a good cushion against any further volatility, with emerging markets fundamentals intact in the medium term.

## Equity

Emerging markets equities gave up their 8.8% gain in January in a streak of weakness from February through June. The second quarter in particular visited currency turbulence upon the asset class and election cycles destabilized investor sentiment. Year to date, Turkey, the Philippines, Poland, Indonesia, Brazil, and South Africa were among the biggest laggards. The smaller markets of Colombia, Peru, Qatar, the Czech Republic, and Egypt recorded gains, as did Russia.

Dollar strength was emerging markets' single biggest challenge during the quarter. The second quarter's sell-off was relatively modest in local currency terms, with the MSCI Emerging Markets Index declining 3.5%. For US dollar-based investors, however, losses were amplified to declines of 8.0% due to currency translation. Year to date, the index sold off 2.8% in local currency terms and gave up 6.7% in US dollar terms.

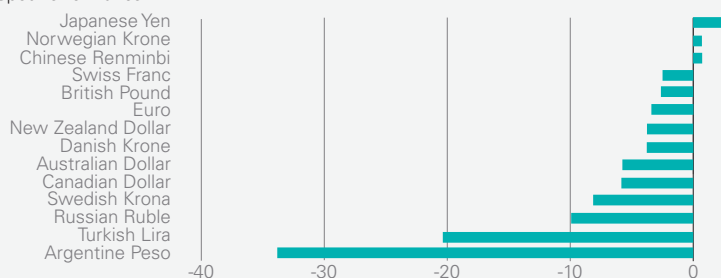
Across our emerging markets equity platform, we have focused on evaluating the drivers of change in emerging markets this year. In the process, we have been struck by the contrasts between the macro and fundamental trends. Since the beginning of the year, the US dollar has strengthened. Interest rates are rising slightly faster than anticipated, and global trade hostilities have intensified, fueling anxiety about the growth and profit outlook. On a political front, an election surprise recently occurred in Malaysia, which we believe is positive for the country's outlook. More elections are slated in the coming months, including in Brazil (October), Thailand (February 2019, as of the latest estimate), and India (April 2019). Meanwhile, the tone is much more upbeat from a fundamental perspective. Emerging markets earnings growth expectations for 2018 remain steady at 18% and estimates for 2019 were revised slightly higher to 11%. Dividend yields and free cash flow yields remain higher in emerging markets compared to developed markets, while developed markets return on equity has moved slightly higher than emerging markets, at 12.3% versus 12.2%. Emerging markets are also expected to grow more than twice as fast as developed markets in 2018 and 2019 at 5% versus 2.3%, respectively.<sup>1</sup>

## More Dollar Strength to Come?

The dollar's strength has taken many investors by surprise, raising concerns about how much further it can run (Exhibit 1). We attribute the dollar's sharp rise to fundamental and technical drivers, which we believe will be short lived. The two main drivers are pro-cyclical tax reform (following an already strong US economy) and US policy tightening in contrast to the accommodative stance of most other developed markets central banks.

Exhibit 1  
The US Dollar Has Appreciated against Most Global Currencies

2018 Spot Performance



As of 20 June 2018

Source: Bloomberg

Rising US interest rates have been a key reason for dollar appreciation, as investors have focused on developed markets rate differentials that are strongly in favor of the United States. We expect these differentials to narrow as the European Central Bank (ECB) and Bank of England focus on tightening monetary policy and rebuilding their monetary policy arsenal. US tax reform has been a key catalyst as tax breaks have encouraged capital repatriation, but this too is temporary.

More importantly, rate differentials between developed and emerging markets have widened over the past two years in favor of emerging markets. And, on the basis of real effective exchange rates, emerging markets currencies seem most undervalued against the dollar (Exhibit 2). Their external financing burdens have also eased as they have put their fiscal houses in order and their real interest rates—the compensation for investing in their markets—have risen. This should provide a strong base from which emerging markets can defend against a stronger dollar.

For a more in-depth dollar discussion, explore our [June Insights](#).<sup>2</sup>

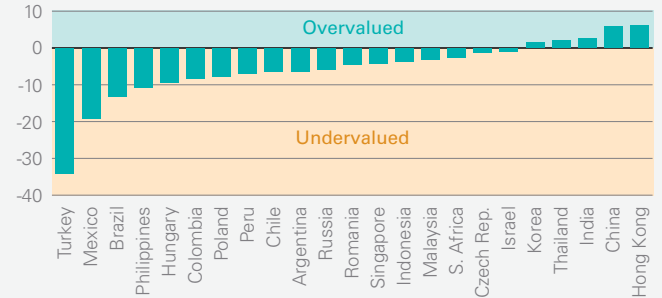
## Gaming, eSports, and Self-Help Models

Despite election uncertainty, trade tensions, and currency turbulence, emerging markets companies are finding ways to grow. Our relative growth team has identified gaming and eSports as areas of new opportunity. The businesses they are analyzing are concentrated in Asia and have revenue models and customer behaviors that are fundamentally different from those in the West. eSports, a subset of gaming, is expected to have nearly 300 million viewers by 2022<sup>3</sup> and an ecosystem is beginning to form around it, creating new pathways for growth. We expect new businesses and revenue lines to be created, from hardware and components to game design, streaming platforms, and advertising, as eSports moves into the mainstream. Gaming has generational appeal—multiplayer games tap into online behaviors, as gamers can meet virtually to form teams. They can also choose to watch others play.

Our core team is beginning to consider more value opportunities. Like our relative value team, they see improvements across the commodity complex and certain emerging markets banks. These companies de-rated in the past four years as the commodities supercycle ended, leaving overcapacity and bad loans in its wake. Fresh from the hard lessons of easy money, many commodities-based companies moved to a self-help model, adopting tighter fiscal discipline and reining in capital expenditures to restore their balance sheets. In emerging markets, growth in non-performing loans appears to have peaked and lending activity is picking up. Rising interest rates are providing banks with opportunities to earn better margins on their loans. Across our teams, we hold positions in attractively valued Chinese and Indian banks, to cite examples, with strong deposit bases that are positioned to benefit from rising interest rates and increasing penetration of modern credit and banking services.

### Exhibit 2 Emerging Markets Currencies Appear Undervalued

Valuation: REER/ToT<sup>a</sup> vs. 10-Year Average (%)



As of 1 June 2018

<sup>a</sup> Real effective exchange rate/terms of trade

Source: Lazard, Bloomberg

## Overnight Change in Malaysia

In May, Pakatan Harapan, a coalition party formed in 2015, toppled Barisan Nasional (BN) in the Malaysian general election, ending 61 years of BN rule. The shock defeat puts Mahathir Mohamed, a 92-year old former prime minister (1981–2003) back at the country's helm, this time as the leader of a reform-minded political party.

The country has been roiled by the misappropriation of \$4.5 billion of state funds, \$700 million of which was traced to former prime minister Najib Razak's personal accounts. Public discontent has mounted over rising food, housing, and transportation costs and eroding trust in national institutions. The coalition has pledged to restore the rule of law and the independence of institutions; however, there is concern they will reverse some economic policies viewed as pro-growth. Mahathir has either canceled or is seeking to renegotiate infrastructure projects where China-based investors are involved. There is also speculation the government may reinstate fuel subsidies, whose removal in 2014 was welcomed by investors as a way to narrow the budget deficit. The new administration removed the goods and services tax at the beginning of June, which previously stood at 6%. The sales and services tax will be reinstated at a rate that is yet to be announced.

Although the Malaysian ringgit weakened to a low of 3.9 to the dollar after the election result, it remains the best performing Asian currency year to date, partly due to rising oil prices and a current account surplus at 4.4% of GDP as of the first quarter. Since the election, Mahathir has assured investors that the administration's focus is on maintaining a stable ringgit and a healthy economy. The relative inexperience of Malaysia's new chiefs and the potential for disagreements between members of the ruling coalition is a source of concern, however. Although they have strong track records as senior civil servants, state administrators, and professionals, many lack national exposure. There is a strong possibility that given their backgrounds and under Mahathir's leadership (he is credited with transforming the country from an agricultural backwater to high income emerging markets economy), the new administration will take a pragmatic approach to governing.

## Shelter from the Storm

Year to date, the energy and health care sectors were the sole advancers in a declining market, gaining 2.4% and 1.6%, respectively. The technology sector weakened but outperformed the broad market, weathering currency turbulence relatively well despite dollar headwinds and trade war concerns, perhaps because the sector has been supported by strong earnings growth and investor enthusiasm. (A stronger dollar typically hurts emerging markets tech companies, as imports of tech components are priced in dollars.) Energy companies were helped by stronger oil prices during the quarter.

Recent threats and the introduction of US–China trade tariffs have elicited a strong negative reaction from the Chinese equity markets, primarily in mainland A-shares (Exhibit 3). The Chinese renminbi has also begun to devalue against the US dollar despite the central bank lowering the reserve requirement ratio and boosting liquidity. Declining Chinese equity and property markets were further strained by weakness in the renminbi, slowing domestic demand, and falling infrastructure spending. Encouragingly, corporate loan growth in China (while still high) has begun to stabilize, which helped allay concerns of a Chinese credit crisis. Recent closures of lossmaking state-owned enterprises (SOEs) and a directive to tighten oversight of overseas investments by SOEs have shored up investor sentiment. SOEs are a significant part of Chinese industry and improvements in their management could make them much more attractive investments. Korea and Taiwan were buoyed by their tech-heavy markets and were possibly helped at the margin by positive sentiment following the US–North Korea summit held in Singapore.

There have been areas of refuge in the sell-off year to date, but whether or not investors are willing to accept the associated valuations is a different matter. Market preferences remain pronounced and, so far, investors in general have been willing to pay higher multiples for companies with sought-after characteristics. We believe that caution is warranted to minimize the risk of paying a premium that is disproportionate to any longer-term upside a stock has to offer. In the second quarter, higher valuation (high price to earnings) stocks continued to perform strongly, while deep value (low price to book) stocks regained favor.

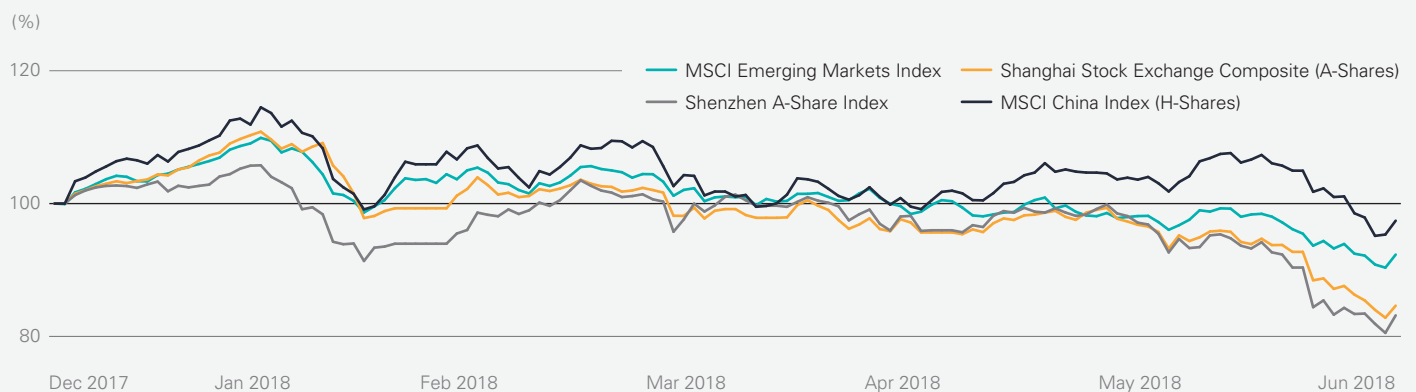
## Long-Term Growth Catalysts

Emerging markets have repeatedly proven their return potential and we do not expect any less going forward. We also expect the asset class to continue to be more volatile on average than developed markets equities, consistent with an investment area that is gaining in popularity but that is still relatively inefficient and little understood. The tremendous ability of emerging markets companies to evolve and innovate is clear when looking at how far they have come in the past 20 years. In 1995, technology was 2% of the emerging markets index. As of mid-2018, it was the largest sector at a nearly 30% weight. Materials, once the second-largest sector at 20% of the index, is less than 8%.

More exciting, we believe the metamorphosis is far from over. We have written in past Outlooks about the improvements we see among state-owned enterprises and industrial and materials companies where financial mismanagement is being tackled in meaningful ways. eSports and gaming have huge growth potential in our view, with much of that innovation stemming from emerging markets in East Asia. Health care, still a small component of the index, is showing promise, with Chinese companies driving cutting-edge medical technology—a concept that would have been virtually unthinkable twenty years ago, when China’s economy was still closed to foreign investment. Progress has been incremental over time. Viewed as a whole, it has been dramatic.

The economic potential of emerging markets countries and companies and their resourcefulness is the source of their long-term strength. Today, macro and fundamental trends are at odds, and emerging markets equities are consolidating gains after a period of exuberance. Many of the current drivers of volatility are likely temporary. In the interim, the correction is creating new entry points for active, bottom-up investors with a well-researched point of view and a longer-term outlook.

Exhibit 3  
China A-Shares Trailed H-Shares and the Broad Emerging Markets in the Quarter



As of 30 June 2018

Source: MSCI, Shanghai Stock Exchange, Shenzhen Stock Exchange

## Debt

Emerging markets debt, measured as a blend of US dollar and local currency sovereign debt, turned in its worst quarterly performance in its 15-year history (Exhibit 4).<sup>4</sup> Local currency markets drove the underperformance, as is normal in most emerging markets sell-offs, due to the higher risk and higher beta of emerging markets currencies versus the dollar. In fact, the second quarter's sell-off in local currency debt (-10.42% in US dollar terms) far exceeded its quarterly loss during the 2013 "Taper Tantrum" and was roughly in line with the loss in the third quarter of 2015 following China's surprise currency devaluation. From another perspective, the market's loss over the last three months was equivalent to nearly 70% of the downdraft in the second half of 2008, during the depths of the global financial crisis.

Naturally, the question on investors' minds is whether the current juncture represents an epic buying opportunity in an otherwise healthy asset class or whether it is a harbinger of the type of performance associated with a deep emerging markets recession. We aim to address the numerous causes of the second quarter sell-off and whether we believe these drivers have been mitigated and/or "priced in" as we enter the second half of the year. In doing so, we isolate five specific market concerns: (1) divergent US growth versus the rest of the world, (2) effect of trade wars, (3) China's imbalances, (4) policy errors in certain emerging markets, and (5) investor positioning.

### Concern 1: Divergent US Growth versus the Rest of the World

A large developed economy can grow in a divergent pattern from the rest of the world over a short time period. Due to a confluence of events, global economic data from the first half of this year exhibited that exact result (Exhibit 5). Leading US economic growth indicators accelerated, while both European and global growth indicators retreated to their three-year averages. US economic outperformance over this time was largely a result of the fiscal stimulus package from the fourth quarter of 2017 working its way through the economy. We expect realized US GDP growth in the first quarter of 2018 to be slightly higher than recent averages at 2.0%, while growth in the second quarter will likely double to nearly 4.0%. Full year 2018 growth is likely to average out just below 3%. Also aiding in the recent US economic resurgence has been significant deregulation, which has boosted business and consumer confidence and spending.

As of June, the Federal Reserve's GDP growth forecast for 2018 is 2.9% and 2.4% in 2019. The expected slowdown will likely be due to the higher base of comparison and tighter US monetary policy as the economy pushes past full employment. If the Fed's projections are accurate, that would translate into US composite PMI indicators of approximately 55.3–56.8, which would suggest a leveling off and eventual decline in US leading indicators from this point forward. Put another way, the close of the second quarter likely marks the high point of forward-looking US GDP indicators. Going forward, we expect these indicators to fall to more typical levels, which are more commensurate with potential US growth.

As leading growth indicators rocketed higher in the United States in the first half, the exact opposite was occurring in Europe. A key reason for the decline in European PMI was due to its elevated starting point. At end-2017, European composite PMIs had reached multi-decade highs, which translated into stunning forward growth of 3.5%. Many market participants (us included) realized that the data was abnormally high, but were expecting a reduction back to 2017 averages. Instead, European PMIs fell continuously in the first five months of the year, landing back at late 2016 levels, equivalent to GDP growth of approximately 2.0% (just below the ECB's forecast for 2018). These abnormal moves over the last six months have fed an incorrect market narrative that the United States is growing at the expense of the rest of the world. Going forward, we are likely to see both US and European leading indicators of growth normalize, which show that these two major engines of global growth remain very much in sync with one another.

Exhibit 4  
Worst Quarterly Drawdown in the History of Emerging Markets Debt

Quarter	Performance (%)	Theme
2Q'18	-7.02	Trade War/Growth Divergence
2Q'13	-6.33	Taper Tantrum
3Q'15	-6.19	China Devaluation
4Q'08	-6.06	Global Financial Crisis
3Q'11	-5.33	US Debt Downgrade
4Q'16	-5.05	US Election
3Q'08	-3.97	Global Financial Crisis

As of 30 June 2018

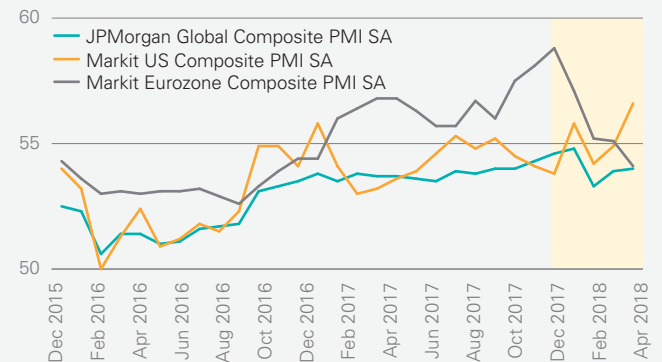
Based on a blended 50% J.P. Morgan EMBI Global Diversified/50% J.P. Morgan GBI-EM Global Diversified index.

As measured in US dollars.

Source: J.P. Morgan

Exhibit 5  
Divergent US Growth versus the Rest of the World

Composite PMI



As of 31 May 2018

Source: J.P. Morgan, Markit

## Concern 2: The Effect of Trade Wars

A second dominant market worry in the first half was the war of words and threat of tariffs between the United States and its major trading partners. The acrimonious verbiage has increased lately, leading markets to consider a scenario of calamity for both sides of a trade war. From recent comments by Fed officials and tangential evidence from corporate CEOs, the threat of trade wars appears to have had a meaningful impact on confidence (i.e., animal spirits) and, as a result, capital spending. Should these worries persist, we would expect lower potential growth around the globe. The market seems to have priced itself to an extreme scenario—in which global trade volume is on the precipice of collapse. Evidence of this is limited, with our forecasting models indicating that trade volume is likely to return to its recent strong (i.e., 5%) growth trajectory in the third quarter (Exhibit 6). Our proprietary trade volume model has historically served as a strong leading indicator of actual trade data over time.

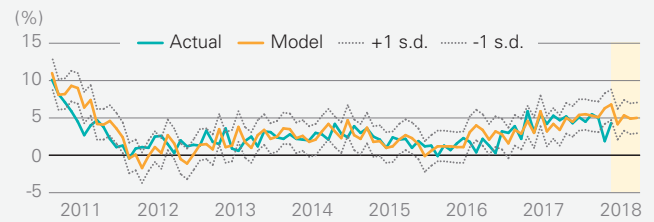
Because of the importance of world trade to emerging markets, we frequently cross-reference our data with sell-side street estimates. To cite one example, Morgan Stanley's proprietary trade model also forecasts a strong rebound in trade next quarter, commensurate with above-average US and European growth. As such, we expect worries about lower trade volumes to subside over the remainder of this year.

## Concern 3: China's Imbalances

We are relatively sanguine about the first two concerns, but we are more concerned about recent economic events in China. As the market learned in 2015, many of China's imbalances can be ignored for an extended period of time, with the exception of a strengthening dollar's impact on the Chinese economy. During the last bout of dollar strength, China was forced to devalue its currency at a time of significant capital outflows, plummeting foreign currency reserves (Exhibit 7), and worries about a Chinese hard landing. At that time, China responded with both fiscal and monetary stimulus, which planted the seeds for the emerging markets rally that began in early 2016. This time, however, the combination of dollar strength and trade pressures is happening against an improved backdrop with China reporting stable currency reserves over the last six quarters.

Not all is rosy, however, as the country's current account balance has been deteriorating (Exhibit 8) since 2015. Should the trade disagreement with the United States further escalate, China's vaunted current account position may well slip into a deficit. If this occurs, the immediate impact would likely be further renminbi weakness, which would drag down emerging markets assets over the short term. As such, a key component of emerging markets stability, and an eventual rally, is for the renminbi to stabilize at weaker levels, which requires a cooling down of US–China rhetoric on the subject of trade.

Exhibit 6  
Our Model Predicts World Trade Volumes Will Resume Growth

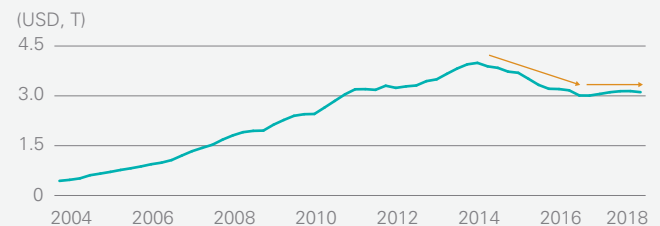


As of 30 June 2018

Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: Lazard

Exhibit 7  
China's Foreign Currency Reserves Have Stabilized and Are a Source of Strength

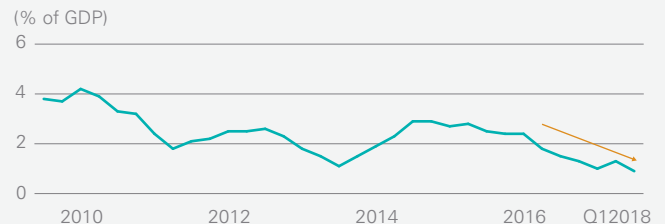


As of 31 May 2018

Source: Bloomberg, People's Bank of China

Exhibit 8  
China's Current Account Balance Could Be a Source of Weakness

China, Current Account Balance



As of 31 March 2018

Source: Bloomberg

## Concern 4: Policy Errors in Certain Emerging Markets

After several years of positive structural reforms and multiple market-friendly election results in 2015 and 2016, a number of emerging markets countries fell back on their laurels and made policy errors over the last twelve months. The market grew complacent and ignored these errors while the dollar was weakening, but began to attack these countries as the dollar recently began to strengthen. Among the hardest hit were Argentina, which favored growth over inflation targeting; Brazil, which failed to pass much-needed fiscal reform; Turkey, which further eroded the credibility of its central bank through executive branch meddling and too-loose monetary policy; and South Africa, which still has not passed positive structural reform nearly six months into its new administration. As a result of market pressure, all of these countries were forced to use various tools to defend their currencies.

Argentina, the worst offender, had to use its currency reserves, massively hike interest rates, and reach for an outside policy anchor in the form of the International Monetary Fund. The lesser offenders, such as Turkey and Indonesia, were able to defend through a combination of rate hikes and currency reserve deployment. Across the board, these measures were effective in different ways, including driving real yields higher for investors and bringing significant pressure for governments to pursue economic reform. It remains to be seen whether these countries follow through on reform promises; however, we believe those that do will be handsomely rewarded by market participants, while those that do not will be pushed to the brink of economic malaise.

Most countries are already on the path to policy improvement, although not without significant valuation scars. Tighter monetary policy has led us to cut our growth estimates for the second half for a number of large emerging markets countries; as such, we have also widened our fair value spread and yield targets. We revised our index-level yield target higher by about 40 basis points (bps) to approximately 5.80% (Exhibit 9). Note that even at the new revised target, the market appears to have overshot in its bearishness, leading to significantly positive forward-looking expected returns for the asset class.

## Concern 5: Investor Positioning

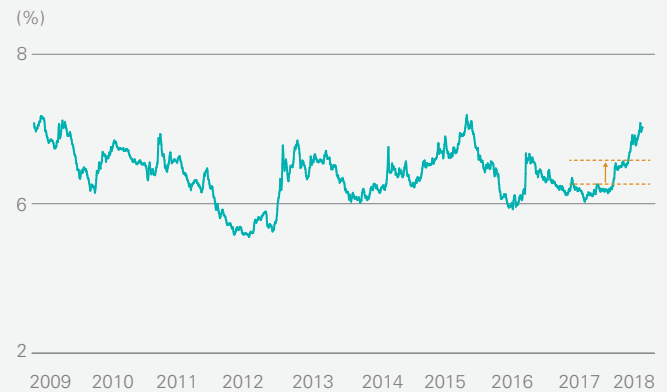
After two consecutive years of equity-like returns, emerging markets debt entered this year with a particularly bullish stance. At the start of the second quarter, dollar short positioning (a strong indicator of bullish sentiment on emerging markets) was approaching multi-year extremes. Since then, not only have these positions unwound, but the market is now net long dollars (Exhibit 10). The change in sentiment and positioning mirrors the market's reaction during the broad recovery that followed the taper tantrum. Additionally, investor positioning surveys show that during the second quarter sell-off many emerging markets debt managers trimmed their net long exposure to the asset class and built significant cash positions.

Overall, given attractive market valuations, the high likelihood of a reversal in the negative narrative on emerging markets, and more balanced investor positioning, we expect a healthy rebound in emerging market assets. As a result, we have maintained our bullish overall positioning in both our long-only and total return emerging markets debt strategies. On a bottom-up basis, we have rotated away from sovereigns that have exhibited significant policy error and added to countries where we believe valuations have overshot fundamentals.

As we enter the latter stage of the global economic cycle, we believe emerging markets debt is poised to outperform. Importantly, with valuations across different parts of the asset class approaching post-global financial crisis levels, we believe investors are more than adequately compensated for the risks.

Exhibit 9  
Hard Currency Sovereign Yields Are Attractive

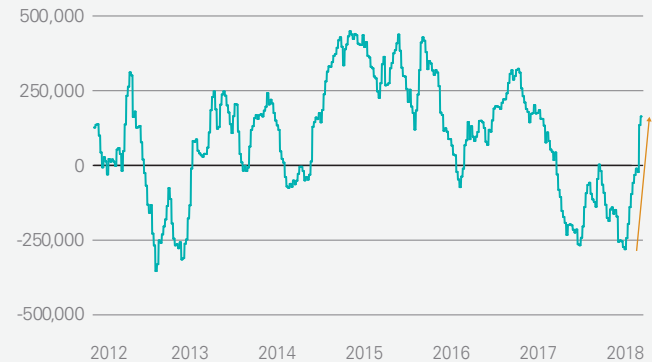
EM USD Sovereign Yields



As of 30 June 2018  
Source: J.P. Morgan

Exhibit 10  
Dollar Long Positioning Spiked during the Second Quarter

Futures Contracts



As of 30 June 2018  
Source: Bloomberg, Chicago Board of Trade

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 January 2018. Source: International Monetary Fund. World Economic Forecast.
- 2 <https://www.lazardassetmanagement.com/gl/research-insights/lazard-insights>
- 3 As of 26 June 2018. Source: Goldman Sachs.
- 4 Based on a blended 50% J.P. Morgan EMBI Global Diversified/50% J.P. Morgan GBI-EM Global Diversified index. As measured in US dollars.

## Important Information

Published on 6 July 2018.

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The strategies invest primarily in emerging markets debt positions. The strategies will generally invest in debt investments denominated in either US dollars or local emerging markets currencies. As such, an investment in the strategies is subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging markets investments, including currency fluctuation, devaluation, and confiscatory taxation. The strategies may use derivative instruments that are subject to counterparty risk.

Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation, and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss.

The strategies will invest in securities of non-US companies, which trade on non-US exchanges. These investments may be denominated or traded in both hard and local currencies. Investments denominated in currencies other than US dollars involve certain considerations not typically associated with investments in US issuers or securities denominated or traded in US dollars. There may be less publicly available information about issuers in non-US countries that may not be subject to uniform accounting, auditing, and financial reporting standards and other disclosure requirements comparable to those applicable to US issuers.

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