RBC Global Asset Management

# Emerging markets outlook

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**Emerging-market equities have ceded all of this year's outperformance relative to developed-market equities following a sharp decline in Chinese stocks in the MSCI Emerging Markets Index, a rally in the U.S. dollar and a worsening COVID-19 situation in many key emerging markets.**

China's drop has been driven primarily by regulatory uncertainty involving technology stocks and aggressive policy tightening. A breakdown of the MSCI China Index reveals that valuations for the most expensive quintile of stocks, which are largely technology-related, have undergone unprecedented declines relative to history and also relative to other segments of the market. While recent regulatory intervention has led to lower valuations for the most expensive segments of the stock market, we find that valuations in these areas are still above historical averages. The valuation premium that the most expensive stocks had built up in recent months could not be explained by an improvement in relative profitability. In fact, returns on equity for the most expensive decile of stocks in China have actually declined significantly in recent years, in both absolute and relative terms.

Beginning in November 2020, investors shifted the focus of their portfolios to value stocks from growth stocks on expectations for a faster economic recovery after successful trials for COVID-19 vaccines. Over this period, the difference in price-to-book valuations among companies with the highest and lowest returns on equity fell to the least since 2009. This move came from investors rewarding lower-quality cyclical companies with higher valuations, and high-growth, low-profitability companies continuing to perform well. This evolution suggests to us that "quality" as a style is out of favour and now appears to be trading at attractive valuation levels compared with growth and value. Returns on equity for higher-quality companies are now seven times those for lower-quality companies, the biggest gap since the global financial crisis in 2008-2009.

Over the past 12 months, the disparity in performance among emerging-market countries has been widening. Focusing on the past three months, two factors have been significant in determining country-level performance. The first is an increase in political risk in many Latin American countries, where the prospect of electoral shifts toward the hard-left and hard-right have weighed heavily on financial-market performance. Second, emerging markets have lagged developed markets in easing mobility restrictions and reopening their economies. Lately, however, the COVID-19 situation has been improving in key emerging markets such as Brazil and India, and turnarounds have corresponded to stronger financial-market market performance in recent months.

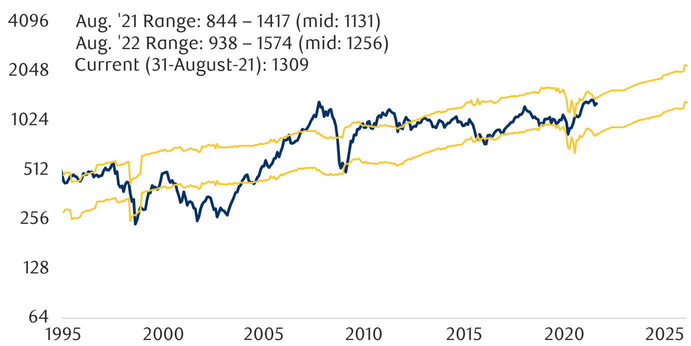
Emerging markets are lagging developed markets in terms of the pace of vaccinations, with a resulting delay in the reopening of their economies. The median level of full vaccination among emerging markets is currently 12%, compared with about 50% in the U.S. and the U.K. In our view, emerging markets will be able to fully recover once their vaccination rates start to catch up with those in developed markets.

Like developed markets, emerging markets have tried to contain the virus with lockdowns and social distancing. The difference has been that developed markets have spent much more liberally to stave off the worst effects of the pandemic and have added significantly more debt than emerging-market governments. In our view, the more limited emerging-market policy response means that emerging-market central banks may have an easier time navigating their way out of the pandemic. In fact, most emerging-market central banks are expected to hike policy rates in the next 12 months, whereas in developed markets the first increases are expected no earlier than 2023. In addition to a healthier debt outlook, many emerging markets have shown significant improvement in their current accounts and fiscal balances, and now appear to be in a stronger positon than the U.S. We believe that these factors, combined with the increasing pace of vaccinations, will enable emerging-market economies to expand faster than developed markets.

Over the last 12 months we have also seen a large dispersion of performance at the sector level. More recently, there has been reversal in the performance of sectors that benefited from the COVID-19 pandemic such as Health Care, Consumer Discretionary, Communication Services (notably social media) and Information Technology. As a result, stark valuation differences exist throughout emerging markets at the sector level, the most notable being between Information Technology and Financials. Emerging-market technology stocks now trade at a 220% premium to financial stocks. This valuation difference has narrowed in recent weeks but remains significantly higher than historical levels.

Among cyclical sectors, we have a preference for Financials. Emerging-market financial companies, particularly banks, have undergone an extended cyclical slowdown for most of the current decade, exacerbated by the pandemic. We are, however, positive on the sector longer term and believe that these companies are well positioned to benefit as the number of businesses and individuals making use of loans, insurance and other financial services continues to expand. In recent years, we have broadened our exposure from banks to include insurance, where there is also a low level of market penetration compared with developed markets.

**MSCI Emerging Markets Index Equilibrium**
Normalized earnings and valuations




Note: Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM

In the near term, we believe that emerging-market banks are likely to be supported by reopening economies, a resumption in loan growth and improving asset quality. Moreover, expectations that interest rates will rise are likely to bolster banks' profit margins. Over the years we have consolidated our holdings in emerging-market banks to focus on the highest-quality companies, which face fewer competitive threats from new financial technology and demonstrate sustainability of returns. We believe that banks with strong deposit bases will maintain a significant competitive advantage and therefore higher and more sustainable returns over time.

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