RBC Global Asset Management

Emerging markets outlook

FALL 2023

Ashna Yarashi-Shah
Portfolio Manager
RBC Global Asset Management (UK) Limited

Emerging-market equities returned 4.6% in the eight months ended August 31, 2023, underperforming the 16.1% return for developed markets during period. Much of this relative weakness was driven by the poor performance of China, which accounts for 28.6% of the emerging-market equity benchmark. In the three-month period, emerging-market stocks returned 3.5%, underperforming developed markets. All figures are in U.S.-dollar terms.

China's economy has experienced broad weakness following its re-opening from the pandemic in late 2022. High levels of youth unemployment and significant weakness in the residential property market have kept Chinese consumers cautious. We believe that the weak consumption raises the potential for aggressive monetary and fiscal stimulus in the coming months. From a valuation perspective, Chinese stocks trade at 10 times their 12-month forward earnings versus an average of 11.6 since 2006.

Emerging-market equities have experienced four major performance cycles over the past 35 years, each ranging between six and 11 years. The periods when emerging markets have outperformed developed markets share a few characteristics: Emerging-market growth exceeded developed-market growth, and emerging-market price-to-book ratios were below those in developed markets at the same time that earnings per share in emerging markets were accelerating in U.S.-dollar terms. Conversely, slower emerging-market growth in earnings per share has underpinned the underperformance cycles.

During the most recent bear-market cycle, which started in 2010, earnings per share in emerging markets have contracted by 1.1% and emerging-market valuations have fallen by 5.6 percentage points more than those in developed markets. Looking at profitability, we find that emerging-market margins have been lower than in developed markets since July 2013. We expect earnings growth in emerging markets to rise faster than in developed markets over the next two years, mimicking the 2016-2018 trend that coincided with 26 percentage points of outperformance. Looking ahead, we believe that emerging-market earnings growth will be driven by countries such as South Korea and Taiwan, where we see strong prospects for a cyclical profit recovery amid production cuts, leaner inventories and demand for semiconductors linked to the explosion of artificial intelligence.

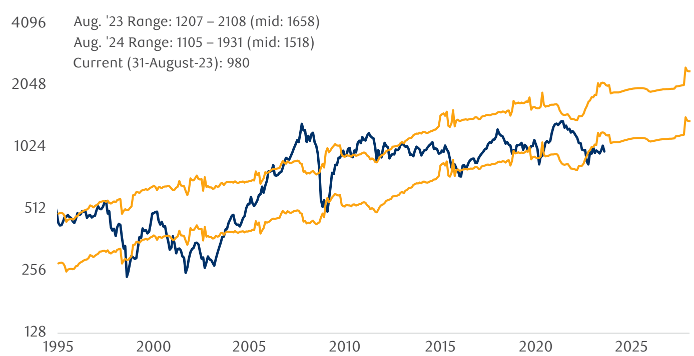
Inflation has been a global phenomenon in recent years, driven by fiscal and monetary responses to the COVID-19 pandemic, supply-chain disruptions and the Russia-Ukraine war's impact on food and commodity prices. One of the reasons for the dramatic surge in inflation in the U.S. and other developed markets may have been due in part to a surge in the money supply triggered by the unprecedented policy response to the pandemic. The response was far more contained in emerging markets than developed markets. For instance, in China and India, the increase in broad money supply between February and December 2020 was significantly less than in the U.S.

A rapid tightening of monetary policies in developed markets, especially the U.S., has historically caused financial stress in emerging markets, forcing them to also tighten policy to defend their currencies and forestall inflation. We have seen in this cycle that central banks in Brazil, Mexico and elsewhere tightened policy at a much faster rate than the U.S., and both emerging and developed markets have experienced a drop in inflation. This deceleration in inflation combined with a moderating outlook on global growth will likely prompt many emerging-market central banks to focus on lowering interest rates rather than increasing them over the next 12 months. We are expecting swift cuts in Brazil and Chile, which serve as a sharp contrast to developed markets, where there is a greater likelihood that central banks will continue hiking rates over the next 12 months.

U.S.-dollar strength has represented a significant challenge for the performance of emerging-market equities in recent years. We see several reasons why this trend may now reverse. First, U.S.-dollar valuations seem extreme on many metrics. On a trade-weighted basis, the U.S. dollar now trades at historically expensive levels. Second, U.S. economic fundamentals are generally worse than they are in emerging markets. In the U.S., there are concerns about the country's current-account and budget deficits and the longer-term sustainability of the country's debt remains uncertain.

On the other hand, many emerging markets have significantly improved their current-account balances through sales of commodities or, in the case of India, via strong demand for computing services and pharmaceuticals. Longer term, we expect emerging-market currencies to rise versus the U.S. dollar. Rising geopolitical tensions have accelerated the recent "de-dollarisation" trend in commodity transactions, with many emerging economies reaching deals to settle trade in their own currencies rather than relying on the U.S. dollar.

MSCI Emerging Markets Index Equilibrium
Normalized earnings and valuations



Source: RBC GAM

We expect a shift in the West's global trade away from China – a trend known as re-globalisation – to provide long-term opportunities for emerging-market exporters. Increasingly, we find global businesses diversifying their supply chains as they face significantly higher geopolitical risks, largely in the form of escalating trade tensions between the U.S. and China. As China's exports to the U.S. have declined, so have they risen to other emerging markets. Since 2018, the percentage of Chinese exports destined for Latin America, Africa, India and Southeast Asia has grown to 36%, while the U.S. share has fallen to 15%.

Economies in Southeast Asia and India continue to be the biggest winners of this shift in supply chains, as they benefit from cost competitiveness, industrial development, linkages to existing manufacturing hubs and rising middle-income consumers. Over the past two years, countries in Southeast Asia have gained from Chinese foreign direct investment and are now increasing orders from U.S. companies abandoning China. In the past decade, U.S. direct investment in Southeast Asia has increased at an average annual rate of 10%, and we expect the Philippines, Indonesia and Thailand to be on the Biden administration's list of "friendly" countries as the U.S. government tries to reconfigure supply chains.

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to investors in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, and RBC Global Asset Management (Asia) Limited, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate and permissible, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

Publication date: September 15, 2023