RBC Global Asset Management

Emerging markets outlook

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Emerging-market equities dropped 2.5% in U.S.-dollar terms in 2021, underperforming developed-market equities by close to 25 percentage points and delivering the second largest underperformance versus developed markets since the MSCI Emerging Markets Index was created in 1999. In the three-month period ended February 28, 2022, emerging-market stocks lost 3.0%.

China was the main contributor to the poor performance during 2021, notably as a stricter regulatory environment hit the large internet sector. Latin America was another region that weighed on returns, and excluding China the emerging-market benchmark was up 11%. Emerging markets with lower rates of vaccination suffered from rising rates of COVID-19, and lockdowns continued to lead to lower-than-expected economic growth in many countries.

After about 10 years of underperformance, investors have started to question the need to own emerging-market equities. We believe that emerging-market assets offer both diversification and superior economic growth, which should translate into stronger equity returns over the long term.

Since the beginning of the year and despite the weakness in Russian stocks, we have started to see better relative performance from emerging-market equities. Between January 1, 2022, and February 28, 2022, emerging-market equities as measured by the MSCI Emerging Markets Index have fallen 4.8%, compared with declines of 7.7% for the MSCI World Index and 8.1% for the S&P 500 Index.

A major risk for 2022 is the zero-COVID policy pursued by the Chinese government. We may see large lockdowns in China, which could lead to weaker growth in the country and affect global growth and demand for commodities.

A policy mistake by the U.S. Federal Reserve (Fed) could also lead to a sell-off in equity markets, and emerging markets would probably underperform in this scenario. Finally, the situation in Ukraine brings the prospect of even higher inflation and the risk that more countries could be involved in the conflict.

A major headwind is the very small gap in growth between emerging markets and developed markets forecast for 2022. At about 1%, this difference would be the smallest in 20 years. Traditionally, outperformance in emerging-market equities is highly correlated with the relative economic performance of emerging markets compared with developed markets. We believe, however, that this bleak number had already been priced into valuations.

Emerging-market valuations are very attractive with the largest discount to developed markets in 20 years at 45%, compared with a long-term average of 25%. Furthermore the economic picture is fairly positive for emerging markets, and continued strong global economic growth driven by higher-than-expected consumer demand, increased capital expenditures and inventory rebuilding as COVID fades away are all positive for emerging-market equities.

Other positive data points are:

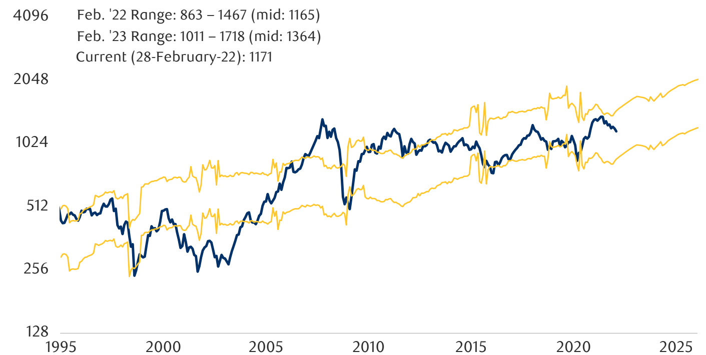
- Wage pressures are contained in emerging markets, where we haven't seen the same increase in demand for goods during the pandemic as in the developed world.
- For the same reason, inflation should generally remain within central-banks targets and has probably peaked now that economies have re-opened.
- Interest rates are already higher in emerging markets than in developed markets, giving credibility to emerging-market policymakers in the fight against inflation. China is actually easing rather than tightening, supporting economic growth in the country.
- Current accounts for Asia have considerably improved since the last round of tightening, while currencies are attractively valued apart from a few exceptions. This situation is very different from the one that was in place at the time of the Fed tapering in 2013.

We expect that a weaker U.S. dollar will lead to the outperformance of emerging-market equities in 2022, as emerging-market stocks tend to rise when the U.S. dollar falls. We have called for a depreciation of the U.S. currency for a few years, but major U.S.-dollar indexes now stand at roughly the same level as they did at the end of 2019. We would expect to finally see a lower U.S. dollar in the months ahead.

In 2022, we may continue to see weakness in the Chinese internet sector. We believe, however, that the sell-off won't be as severe as last year, and the impact of any decline would be smaller as the sector's weighting in the index has dropped significantly since February 2021. But growth stocks may face further pressure as expensive stocks are still too expensive compared to their fundamentals, and only part of the growth bubble has been deflated. The 10% of the most expensive stocks in the emerging-market equity benchmark still trade at 15 times their price-to-book value for a return on equity of 25% - a number that we believe is excessive.

In terms of quality, we find that the middle segment trades at multiples that are too low. These stocks generate a median return on equity of almost 13%, but at a median price-to-book value of only 1.7, just above the lowest-quality companies at 1.5 times. We would expect valuations of low-quality stocks to fall in the coming months and valuations of middle-quality companies to rise.

MSCI Emerging Markets Index Equilibrium
Normalized earnings and valuations



Note: The 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

Value stocks could continue to outperform growth stocks, as the valuation gap is still too wide. Only half of the underperformance of value in 2020 was closed in 2021, and, as economies re-open, we would expect the gap to narrow further from the current 70% level closer to 50%. Value stocks will be driven by the trend toward decarbonization, inventory rebuilding and higher interest rates. However, we believe that there will be a wide divergence in performance between value stocks that are most exposed to an economic slowdown, which look overvalued, and less cyclical value companies, which look the most attractive.

In terms of countries, we believe that the strong underperformance of China should come to an end. We expect Chinese financials, cyclical and decarbonization-centred companies to perform best.

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