RBC Global Asset Management

Emerging markets outlook

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Emerging-market equities rose in January but fell back in February, and we expect stocks to remain volatile. The positive outlook for Chinese equities, due to a renewed focus on economic growth, is offset by uncertainties about the global macroeconomic environment, notably the likelihood and extent of a global recession. A difficult 2022 meant that a rebound in equities was to be expected, especially given that inflation appeared to be easing from a very high level. However, a resurgence of inflation could lead to higher interest rates, slower global growth and a new sell-off.

We believe that the outlook for emerging-market equities is brighter compared with developed markets for several reasons. These include a view that maximum pessimism was reached at the end of October of last year, when Chinese financial markets were considered largely uninvestable. At that point, the Chinese government surprised investors by announcing that it would do away with COVID-19 restrictions, leading to a large rally in stocks. We expect further upside for Chinese equities due to pent-up domestic consumption, and the Chinese property market should stabilize now that the focus on an economic recovery has been made apparent by the government.

The Chinese economy could get a hand from the significant savings of its citizens. Private savings increased by 15 trillion yuan (US$2 trillion) in the first 10 months of 2022, and came on top of the 10 trillion saved in both 2020 and 2021. Savings rates are high in China due to a lack of social safety nets such as pensions and health insurance, but we still estimate that about US$3 trillion of those savings will be pumped into the economy over the coming years. As was the case with people when other parts of the world emerged from pandemic lockdowns, many Chinese will direct their spending to travel, either for tourism or family visits in other provinces or abroad.

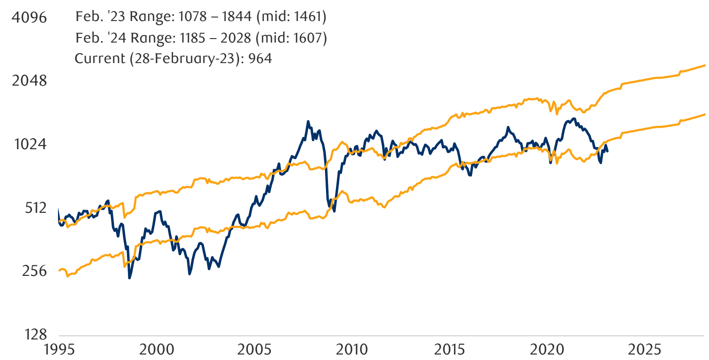
Another reason to be positive are attractive equity valuations. Chinese equities trade at 1.4 times book value, below the long-term median of 1.8. From a positioning standpoint, foreign investors have relatively low exposure to Chinese equities, and we expect flows into Chinese equities to ramp up in the coming months. Another bullish sign is the decision by officials in December to broaden the scope of the Hong Kong Connect program to include large companies such as Alibaba, Baidu and Samsonite (Tencent and Meituan were already accessible). The expansion of the program should enable mainland China investors to buy these companies on the Hong Kong Stock Exchange by the end of 2023's first quarter and further stimulate stock investments.

China's U-turn on COVID led to a consensus that favours emerging markets versus developed markets in 2023. The growth outlook is much clearer in emerging markets, valuations are very attractive and China's recovery will help the global economy, but especially growth in China's neighbours. We expect the gap in economic growth between emerging markets and developed markets to widen to 2.6 percentage points this year, up from an expected 1.2 points in 2022 and the largest since 2016. Emerging markets tend to outperform developed markets when this margin widens.

Another trend favouring emerging-market stocks is the expected depreciation of the U.S. dollar, which is strongly associated with emerging-market outperformance. Our view is that the U.S. dollar has peaked after a 12-year bull market, and that the greenback's overvaluation is starting to catch up with it.

We are also entering a new inflation regime after a dozen years of emerging-market underperformance. Left behind will be a period of low inflation, low commodity prices and historically low interest rates. In our view, emerging markets are better equipped to deal with periods of higher interest rates due to their long experience with them.

MSCI Emerging Markets Index Equilibrium
Normalized earnings and valuations



Source: RBC GAM

Countries

Over the coming months, the best positioned countries will be China, South Korea, Taiwan and the Philippines, while India, Saudi Arabia and Indonesia look unattractive. We are cautious on Latin America due mainly to political instability and the emergence of populist regimes in several countries. We note that valuations are attractive.

Sectors

We expect the Information Technology sector to rebound due to long-term growth in digitalization. However, this growth will be cyclical and we may not have seen the worst for the sector. Consumer Discretionary stocks are still expensive despite sell-offs in 2021 and 2022. The outlook for retail is particularly murky because this area is home to ecommerce companies, whose earnings growth will be lower in the next few years.

Valuations in the Real Estate sector are off their lows but still in the 90th percentile on a historical basis. There are still many uncertainties on steps that the Chinese government will take to assist private developers. The sector is small in terms of weight in the index but crucial for the Chinese economy. The way listed developers are treated will send signals to foreign investors on how China intends to deal with problematic segments of the economy.

The Financials sector is still attractively valued, and these companies should benefit if interest rates stabilize at higher levels. Valuations in the Industrials and Materials sectors are cheap and both sectors are exposed to deglobalization and decarbonisation. We expect these sectors to continue to outperform in the coming years.

Styles

Value stocks should continue to outperform due to their large underperformance since the financial crisis of 2008-2009 and cheap valuations. There has been a large change in the composition of the emerging-market index since the end of 2020, with fewer Chinese and new-economy companies, and more representation from the Materials and Industrials sectors.

High-quality stocks are extremely cheap and medium-quality stocks trade at a similar valuation to low-quality ones. Both anomalies should correct, especially as higher interest rates mean that companies with strong returns and healthy balance sheets are rewarded.

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