RBC Global Asset Management

Emerging markets outlook

SPRING 2025

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Looking back at 2024, MSCI Emerging Markets posted a 5% USD price return and underperformed the MSCI All Country World Index. The underperformance was however largely due to strong U.S. equity performance while MSCI Emerging Markets performed better than developed market stocks as proxied by the MSCI World ex-U.S. Index last year. From a longer-term perspective, we observe a similar pattern of two extremes. Emerging market (EM) equities underperformance over the past five years was driven by U.S. exceptionalism and China weakness.

Looking ahead to 2025, earnings growth should become a key driver of emerging market equities returns. Following the high growth in 2024, earnings per share (EPS) for EM are also expected to grow strongly in 2025. The robust EPS growth recorded in 2024 and expected in 2025 represents a significant shift and major acceleration from the previous ten-year average of 2%. EM valuations have also become particularly attractive. EM Equities now trade at a 35% discount to DM equities in terms of price-to-earnings ratio, the largest discount in the last 15 years. While valuation does not drive short term performance it should offer longer term support.

We see three key structural and cyclical drivers for a change in the EPS growth for EM: China's return-on-equity (ROE) recovery, monetary policy easing and continued strong global investments in technology, given a large part of the value chain is in EM.

Despite the macro headwinds, Chinese corporates delivered very strong EPS growth in 2024, the third strongest among EM markets, and expectations are for EPS to also grow strongly in 2025 as the EPS recovery broadens out from Internet and Tech companies to Industrials and consumer names.

The underlying factor supporting the strong EPS growth is a recovery in ROE. China's ROE bottomed between 2021 and 2022, with a strong recovery in 2024. The improvement has been driven by excess capacity normalization across most industries, including property, and better asset turnover, driven by improved consumption and regulatory environments. The Chinese government has lately stepped up their game in terms of policy announcements and measures to support the economy. One key difference from the prior measures taken by the Chinese government is that the new measures are increasingly directed at the consumer and property markets, deviating from their usual playbook of pouring funds into infrastructure projects aggravating an already rather large excess supply issue.

Another key driver of growth for EM economies in 2025 is domestic consumption. This is the result of two factors: lower inflation and lower rates. Inflation has halved in EM from its peak in 2022 but real wage growth has remained very robust. The latter dynamic, coupled with low unemployment, supports a benign environment for consumer spending. In addition to that, virtually all EM central banks should cut rates in 2025 which will also be supportive of consumption.

Emerging markets – Recommended sector weights

	MSCI Emerging Markets	
Energy	4.2%	-4.2%
Materials	5.7%	-1.6%
Industrials	6.3%	-2.0%
Consumer discretionary	14.8%	-0.4%
Consumer staples	4.6%	8.5%
Health care	3.3%	0.2%
Financials	23.5%	4.0%
Information technology	23.0%	-1.0%
Communication services	10.5%	-0.6%
Utilities	2.5%	-2.5%
Real estate	1.7%	-0.4%

-10.0% -5.0% 0.0% 5.0% 10.0%

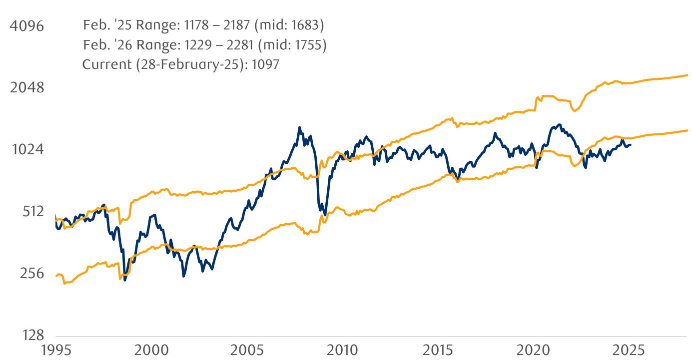
Underweight Overweight

Note: As of February 28, 2025. Source: RBC GAM

> “Despite the macro headwinds, Chinese corporates delivered very strong EPS growth in 2024 and expectations are for EPS to also grow strongly in 2025...”

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

The technology sector is also expected to continue to deliver very strong growth in 2025, as investments in artificial intelligence (AI) continue to be elevated. While U.S. companies are typically thought of as key AI beneficiaries, what is often overlooked is the fact that the bulk of the tech and AI supply chain sits in emerging markets like Taiwan, South Korea and China. The AI industry has become an important and structural driver of earnings growth and equity performance for the asset class. Demand for semiconductors, however, has fundamentally shifted. Smartphones, tablets, PCs, and other consumer gadgets accounted for the majority of demand over the past decade. But now, the majority of demand growth is driven by servers and, in the last 1.5 years, artificial intelligence. Tech products have become more complex to produce with shorter products lifecycles and higher capital requirements resulting in consolidated market structures and higher profitability.

The key risk to the positive outlook described above remains geopolitical, specifically trade tensions which could arise from the introduction of tariffs on U.S. imports. While circumstances may change quickly, our sense is that Tariffs are a negotiation tactic more than a revenue generation tool for Trump. Trump is more concerned with negotiating agreements and far less ideological, hence his regulation may be simpler for China and other countries to live with. When asked why he only mentioned tariffs on Canada and Mexico, he stated that the two nations were reportedly allowing "vast numbers of people" and fentanyl into the United States.

Trump's threats against Mexico and Canada demonstrate that tariffs are likely to be used primarily as negotiating leverage to get concessions from allies. Likewise, tariffs on Colombia in late January lasted less than 48 hours, after the Latin American government agreed to the U.S. terms on repatriation of migrants. Many of the areas in which the U.S. is interested (more border controls, purchasing more U.S. goods, intellectual property protection, fentanyl, corporate business deals and investments in the U.S., etc.) can be negotiated with Mexico, Canada and China in our view, and tariffs are Trump's bargaining chip.

We acknowledge that there is a possibility that conversations and negotiations between the parties involved will not go as planned, and that extra or new tariffs, whether temporary or long-term, may be imposed. In this respect, Mexico, Vietnam and Thailand appear to be most at risk based on their sizeable exports' exposure to the U.S. China is also at risk given Trump's objective to reduce the U.S. current account deficits, of which nearly half is with China. There are some mitigating factors, one of which is that the decoupling of EM trade from DM trade continues. Historically, the great bulk of EM exports have been to DM end markets. However, intra-EM trade continues to expand fast with about half of EM exports going to other EM. This has two positive implications for EM economies as it lowers the correlation to the DM economic cycle and also on USD funding requirements, reducing the impact from U.S. rates and USD strength.

Disclosure

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Publication date: March 15, 2025

(03/2025)
EMERGING MARKETS OUTLOOK-SPRING 2025-E 03/13/2025