RBC Global Asset Management

Emerging Markets Outlook

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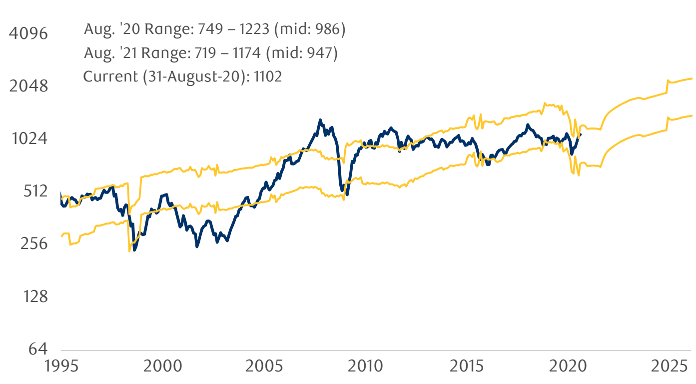
COVID-19 in emerging markets

Over the past 20 years, emerging-markets equities have gone from being dominated by Latin America and commodity producers to being driven by North Asia and technology. China now makes up over 40% of the MSCI Emerging Markets Index and China, Taiwan and South Korea together account for two-thirds of the benchmark. The "internet enabled" sectors of Information Technology, Consumer Discretionary (e.g. Alibaba) and Communication Services (e.g. Tencent) represent just under 50% of the index, while sectors historically associated with emerging-market equities, namely Energy, Materials and Industrials, now account for less than 20%. North Asian 'Internet enabled' stocks will be the key drivers of emerging-market equities over the next 12 months.

Latin American countries have been particularly affected by the COVID-19 pandemic. However, the emerging-market countries with the three largest stock markets – China, Taiwan and South Korea – have had relatively low infection and death rates compared with the global average. They also avoided the blanket nationwide lockdowns seen in Europe and suffered less economic pain. On a market capitalization-weighted basis, emerging markets as a whole have had a much lower infection rate than the U.S.

MSCI Emerging Markets Index Equilibrium

Normalized earnings and valuations



Note: Fair value estimates are for illustrative purposes only. The bands' boundaries capture one standard deviation of movement above and below this estimate. 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

Recent emerging-market performance

From the start of the year until the end of August, and in line with developed-market equities, the emerging-market equity benchmark had recovered almost all of its recent losses, and was down only 0.5%. Excluding China, emerging-market equities were down 11% during the same period, reflecting China's strong performance on the way into and out of the pandemic-driven correction.

So far this year, China, Taiwan and South Korea are the three strongest performers, with the China and Taiwan indexes both up over 10% so far this year. The weakest markets have been Latin American ones most affected by COVID-19 and Russia, which was hurt by a drop in the oil price. Predictably, North Asian currencies have significantly outperformed those in Latin America, Eastern Europe, the Middle East and Africa. Brazil, South Africa, Russia, Mexico and Turkey all have all had large currency depreciations this year, reflecting their exposure to commodities, weak current-account balances, or both.

Performance is being driven by trends similar to those witnessed in developed markets, namely the strong performance of the Information Technology, Consumer Discretionary and Communication Services sectors, with all three up over 15% so far this year. The Health Care sector is another strong performer, up over 30% so far this year, but it makes up only 4.3% of the emerging-market index.

Current valuations

Given the rebound in emerging-market equities, the index is now at its 20-year median level based on price-to-book values, but is near a historically low discount of 36% relative to developed markets. Divergences in country and sector valuations are at an all-time high within emerging markets, reflecting the issues highlighted above. Markets in China and Taiwan, even with relatively strong performances, are only slightly above their long-term median valuations, while South Korea is below its median.

On a sector basis, the price-to-book valuation divergence is more extreme, with Health Care and Consumer Discretionary near 20-year highs and Energy and Financials at long-term lows. The Information Technology sector, even with its strong year-to-date performance, rests just below its 20-year median.

The preceding valuation analysis prompts us to pose the question: are we starting to see a bubble form in parts of the emerging-market universe, particularly in China? While the price-to-book ratio for the Chinese equity market is only slightly above its 20-year median, some sectors look stretched, even when using a 2021 price-to-earnings multiple. The multiple for the Health Care sector has risen to about 38 times next year's earnings from 21, and some individual companies look overvalued. However, the Health Care sector makes up only 5.5% of the Chinese stock index. In contrast, valuations in Financials have continued to fall and the sector now trades at 5.6 times next year's earnings. Financials makes up a relatively large 14.6% of the Chinese index. There are parts of the market that look overvalued, but they are concentrated in technology and the smaller Health Care sector.

12-month outlook and the U.S. dollar

Equity markets seem to be pricing in low growth and inflation over the next decade. As a result, emerging-market equities can continue to rise given historically low foreign-exchange levels versus the U.S. dollar and relatively cheap equities, as ultra-loose monetary policy in developed markets will pull down the discount rate for 'internet enabled' growth stocks. If growth and inflation do not pick up, China, South Korea and Taiwan will likely drive the market over the next 12 months. However, if the unprecedented fiscal and money stimulus in the U.S., Europe and Japan results in an economic-growth rebound and higher inflation expectations, we could see a sharp rotation in the relative performance of asset classes, regions and styles.

A strong rebound in global growth with a weaker U.S. dollar would likely result in strong emerging-market outperformance. Moreover, an increase in inflation expectations, and thus U.S. interest rates, has historically benefited emerging-market value stocks over growth stocks, and could point to a preference for value stocks after an almost 10-year period during which growth has been in favour.

Does recent weakness in the U.S. dollar portend to a change in market expectations around growth and inflation? If it does, Latin America, Eastern Europe, the Middle East and Africa would likely outperform given their exposure to value sectors such as Energy, Materials and, to a lesser degree, Financials.

Conclusion

The recent performance of emerging-market equities has represented a continuation of the trends that we have seen in recent years. 'Internet enabled' growth stocks continue to outperform, benefiting countries and sectors most exposed to this area. This trend in style, country and sector performance has only accelerated during the pandemic.

Over the next 12 months, these trends will likely persist if markets continue to price in low global growth and inflation. However, the unprecedented fiscal and monetary stimulus in the U.S. means that the supply of U.S. dollars is expanding at double the rate of any other major economy. We would expect this to lead to a continued weakening of the U.S. dollar.

A weak U.S. dollar often signals the outperformance of emerging-market equities, given their historical relationship to the U.S. dollar and economic growth. The risk for us, managing money relative to a benchmark, is that this could lead to a style rotation where value starts to outperform. We therefore believe a barbell-type portfolio that avoids the most expensive growth stocks and offers exposure to higher-quality value companies is most appropriate to manage this risk.

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