RBC Global Asset Management

Emerging markets outlook

FALL 2022

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All major equity benchmarks recorded losses through August, with emerging-markets equities slightly underperforming developed markets. The backdrop was one of many challenges including Russia's invasion of Ukraine, COVID-19-related lockdowns in China, U.S.-dollar strength and monetary tightening by the U.S. Federal Reserve.

China's equity-market performance has been particularly volatile this year. Between January and May, China was by far the weakest major emerging market (aside from Russia), descending to record-low valuations as it was negatively affected by its extreme efforts to stamp out COVID-19, speculation that it might invade Taiwan and monetary, fiscal and regulatory tightening. Beginning in May, the Chinese equity market staged a strong recovery as the government introduced stimulus measures, eased financial conditions and started to gradually reduce COVID-19 restrictions. Toward the end of the three-month period, Chinese stocks resumed their decline on weaker housing sales due to concerns about developers' ability to deliver pre-sold housing projects.

Looking at different segments of the MSCI Emerging Markets Index reveals that the most expensive decile of stocks built up a significant valuation premium in 2019-2020. Stocks of companies in the most expensive decile plunged in 2022 but their valuations still look elevated given that profitability also declined. This relationship suggests that caution on the most expensive companies is still warranted and a focus on slightly cheaper areas of the market with similar levels of profitability makes sense.

Emerging markets have been underperforming developed markets for more than a decade, and with this in mind it is natural to contemplate what the next decade might look like. Over the past 35 years, the performance of emerging markets has tended to follow very long 'super-cycles,' of which there have been four varying in length of six to 11 years. The key determinant of these cycles has been emerging-markets earnings growth measured in U.S. dollars. During the two bull cycles, emerging markets had a compounded annual growth rate of more than 13%, but this measure was negative during the two bear cycles.

The question on our minds is whether emerging markets can find their way to a new long-term positive cycle driven by a sustained period of superior U.S.-dollar earnings growth. Some of the themes to drive a new emerging-market earnings cycle could be U.S.-dollar weakness and/or improving relative growth and profitability versus developed markets. Another factor that is likely to be important is productivity growth. Emerging markets' productivity growth has been faster than developed markets for some time, and developed countries' productivity growth recently slowed significantly. There is room for emerging economies to improve productivity further through labour reforms, both in terms of what we call labour formalization as well as labour-market flexibility. Regarding the first, we note that informal labour accounts for a large share of the workforce in many emerging countries: bringing workers into the formal economy increases the tax base for government social spending in areas such as health care and education. Labour formalisation can help improve working conditions, reduce corruption and improve access to credit. Improvements in labour-market flexibility are important for tackling unemployment, accommodating larger working-age populations and improving productivity.

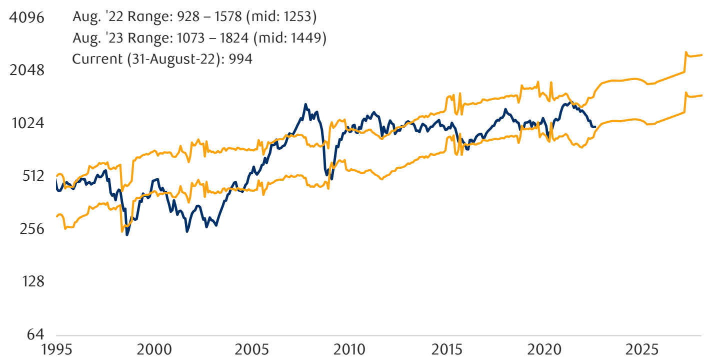
An important area to watch for emerging markets' near-term performance is real interest rates. Many emerging countries have positive real rates after their central banks were ahead of the curve in tightening monetary policy last year to fight inflation, putting a number of the largest emerging-market economies in a stronger position to rebound than developed-markets. Brazil, Mexico and China, for example, are showing positive real rates, with the first two exhibiting the highest.

We also note that the underperformance of emerging markets makes their valuations appear increasingly cheap. Looking at price-to-book ratios, emerging-market equities trade at a 43% discount to developed markets. This level of discount is one of the highest it has been historically and should be supportive if we see an improvement in emerging-markets earnings growth. Additionally, emerging-market currencies are attractive if we look at real effective exchange rates, which adjust currency rates for purchasing power.

Regarding specific emerging-market countries, there are reasons to believe that the worst may be behind for China, and that the easing of financial conditions could partially offset the risk of a global recession. We expect China to eventually abandon its "zero-COVID" policy. Equities in

MSCI Emerging Markets Index Equilibrium

Normalized earnings and valuations



Source: RBC GAM

Taiwan and South Korea have sold off since the beginning of the year, primarily because companies in the Information Technology sector have been weak. Taiwan's stock market had become the most expensive since 2000, but they remain above the long-term median even after this year's declines. South Korea has been a disappointment as the election of a new pro-business president has been insufficient to offset the market's exposure to technology. South Korean equities are now close to the cheapest they've ever been. A number of Latin American countries also appear cheap, with Chile at especially attractive levels after a left-wing leader was elected.

Two sectors that appear relatively expensive compared to history are Consumer Discretionary and Utilities, while Financials look cheap. We continue to like the Financials sector because of its attractive valuations, stable assets and the potential for new customers as relatively few people use banks in some regions.

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