RBC Global Asset Management

# Emerging Markets Outlook



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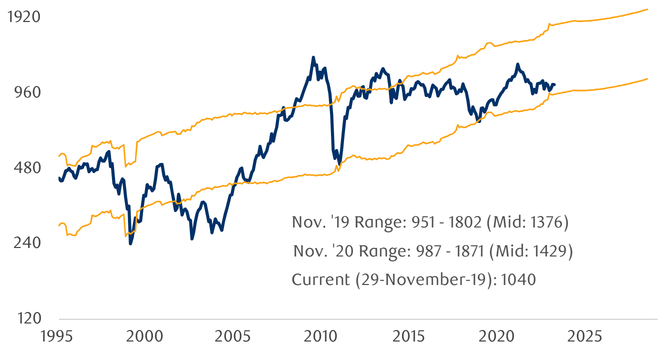
**Emerging-market equities have underperformed developed markets over the past nine years given a strong U.S. dollar and slowing earnings and GDP growth relative to developed markets. We believe that these factors will reverse over the coming years and will ultimately support an improvement in emerging-market stock performance relative to developed markets.**

There are several reasons to believe that the period of U.S.-dollar strength may be coming to an end: the U.S. Federal Reserve's (the Fed) move from quantitative tightening to balance-sheet expansion; a diminution of international risks; and a stock rally that looks extended, both in terms of duration and degree. Additionally, earnings and relative emerging-market economic growth appears set to improve as a result of improved productivity, structural reforms and more growth-friendly fiscal policies.

Earnings growth in recent years in emerging markets has been relatively subdued, despite strong longer-term growth. The period of 2012-2015 saw average earnings growth of 2.9%, which improved to 7.8% in 2016. In 2017, emerging markets saw their fastest earnings acceleration since 2010 with 22% growth, while profit growth in 2018 slipped back to 7.4%. The recent improvement lies in strong contrast to the 2011-2016 period, which was characterized by declining earnings and persistent earnings downgrades. The recovery in earnings in 2017 and 2018 was driven by revenue gains but, in particular, by margin improvements as margins normalized after the cyclical collapse that occurred between 2011 and 2016. Persistent earnings downgrades have occurred in 2019 although the pace of downgrades does seem to be stabilizing.

**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

While 2019, on the face of it, would seem to mark a halt to the earnings progression seen in 2017-2018 with only 1.3% growth expected, a closer look at the composition of this year's earnings growth shows that memory-chip stocks accounted for much of the decline and that emerging-market earnings in areas other than the Information Technology sector and the two commodity sectors have been largely respectable. A similar story is true at the country level. South Korea has stood out as having negative growth in 2019, whereas earnings were not too bad overall, and growth in 2020 is expected to be much more broad-based.

The underperformance of emerging markets relative to developed markets over the past few years has left emerging-market equities looking attractive from both an absolute and relative valuation perspective. There is also a powerful case that emerging-market currencies can perform well, driven by cheap valuations, high real interest rates and strong current accounts.

In terms of style, we believe that companies in the middle segment of returns on equity look particularly attractive from a valuation standpoint. There is a strong case for caution on both the most expensive part of the market, which has become crowded, and for deep-value areas where returns struggle to meet the cost of capital. We also believe that both higher-dividend-yielding stocks and smaller-cap companies, which have underperformed recently but tend to do well over longer periods, look attractive.

Five longer-term themes dominate our thinking on where investors can best position themselves in emerging markets: domestic consumption; the increasing accessibility and uptake of financial products in emerging markets; health and wellness; infrastructure; and the spread of digital technologies. In terms of sector positioning, we favour consumer companies that are driven by high returns and supported by tailwinds such as rising incomes, economic reform, attractive demographics, rising urbanization and increased employment. Within cyclicals, we have a preference for the Financials sector on the grounds of valuation, improving asset quality, the expanding use of financial products and structural growth.

There has been a wide disparity in performance among emerging-market stock markets in recent years, and we believe that countries that embrace structural reforms will end up as the winners. We are particularly positive on the outlook for India, which benefits from both macroeconomic trends and economic reform, but also offers a good choice of high-quality companies. Brazil is also benefiting from economic reform in contrast to Mexico and South Africa, where progress has been disappointing.

We are underweight China, South Korea and Russia. In China, the rapid build-up of debt since the financial crisis of 2008 represents a significant risk. At the same time, there are positive developments in terms of market liberalization and financial reforms. We also believe that the trade war between the U.S. and China will ultimately provide China with a strong impetus to achieve its longer-term goals of technological leadership and self-sufficiency. South Korea and Russia are not currently attractive, as poor corporate governance offsets the appeal of weak currencies.

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