RBC Global Asset Management

Emerging Markets Outlook

NEW YEAR 2021

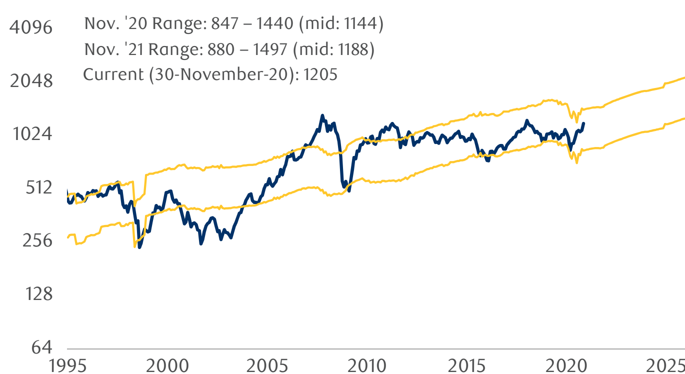
Veronique Erb
Portfolio Manager
Emerging Market Equities
RBC Global Asset Management (UK) Limited

The emerging-market equities team has been focused on two aspects of index performance and their impact on the outlook for stocks. The first is the increasing concentration of Chinese stocks in the MSCI Emerging Markets Index and the second is the extreme underperformance of emerging-market value stocks relative to growth stocks.

The concentration of the benchmark has become a much discussed topic, as the inclusion of China A shares means that China's weight in the MSCI equity benchmark has surpassed 40% and is set to reach 57% in 2027, according to MSCI forecasts. In addition, the weight of the 10 largest constituents in the 1,400-member emerging-market benchmark has increased from below 15% in 2015 to over 30% today, with eight of them being Chinese. Investor discussions continue about the creation of an emerging-market benchmark that excludes Chinese stocks.

The second development that we want to point out is the huge variation in performance among emerging markets this year. While markets in China and Taiwan have risen about 30% so far in 2020, Brazil and Chile are down about 30%. Moreover, traditional growth sectors such as Information Technology, Consumer Discretionary (the sector that e-commerce calls home) and Health Care have outperformed significantly versus traditional value sectors such as Energy, Materials and Financials. As a result, emerging-market value stocks have underperformed growth by 40%. If valuation history is any guide, it is likely that value stocks will perform strongly going forward.

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 we can make a strong case for value stocks, we believe the market will continue to move back and forth between the growth and value styles depending on where we are in the recovery. In addition, we feel that the outperformance of growth can be ascribed to fundamental reasons such as earnings growth and balance-sheet strength. For example, in the past decade, index-level earnings for the MSCI emerging-markets benchmark have been flat, and all the growth in earnings has come from technology stocks.

In emerging markets, it is clear that the stock markets of countries that have done a good job controlling the coronavirus are outperforming. China, Taiwan and South Korea, which account for two-thirds of the emerging-markets index, have all but eliminated the virus within their borders and are reaping the benefits of superior stock returns relative to equity markets such as those in India, South Africa and Brazil. Given that emerging markets have as a whole spent less than 5% of GDP on coronavirus-related fiscal stimulus compared with about 30% for developed markets, there is the potential for fiscal stimulus should it be required.

Clearly we might now be about to see a major reflation as deglobalization and higher fiscal expenditures likely result in faster inflation and GDP growth after decades of falling money velocity. During periods of reflation, equities tend to outperform bonds and emerging markets generally outperform developed markets. Also during times of reflation, we can expect classic value sectors such as Financials, Materials and Energy to perform solidly.

E-commerce and health care are key industries that have benefited from the COVID-19 pandemic. Consumer behaviour changed irrevocably and we can expect long-term trends in place before the pandemic to accelerate their earnings.

While e-commerce has clearly taken off, adoption accelerates when the percentage of retail transactions handled online reaches 5%. China and South Korea already have online adoption rates in the range of 35%, and many emerging-market countries are about to enter this hyper-growth phase in e-commerce. India, Mexico, Russia and Brazil have much lower levels of penetration, but all have reached the 5% threshold.

Furthermore, trends in the emerging-market Health Care sector are very supportive as emerging markets as a whole spend 5.6% of GDP on health care, compared with 12.5% in developed markets. We expect, therefore, that the rising affluence of expanding emerging-market middle classes will bolster further outperformance in the sector.

We expect emerging-market earnings to rebound over the next two years after three years of weakness.

Earnings projections are hard to forecast at the moment, and we therefore prefer to look at price-to-book (P/B) as a valuation measure. On this metric, the MSCI Emerging Markets Index is trading at 1.7 - in line with the historical average and at a 35% discount to developed markets.

Emerging-market earnings tend to rotate between long periods of under- and outperformance, largely based on broad U.S.-dollar trends. Emerging-market stocks generally rise when the U.S. dollar declines, and vice versa, correlations we can see in four periods dating to 1988. We are just coming out of a decade of underperformance for emerging-market equities and U.S.-dollar strength, and we believe this is about to reverse. We can see the case for a weaker U.S. dollar, which is positive for emerging markets as they have US$5.4 trillion of debt denominated in U.S. dollars and other developed-market currencies. Supporting emerging-market currencies are strength in the Chinese renminbi, inventory restocking, a relatively low oil price and an upswing in technology usage.

Disclosure

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to investors in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate and permissible, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.
© RBC Global Asset Management Inc. 2020

Publication date: December 15, 2020

(12/2020)
EMERGING MARKETS OUTLOOK _NEW YEAR 2021_E 12/17/2020