RBC Global Asset Management

Emerging markets outlook

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We have experienced what has been dubbed "a lost decade" for emerging markets, during which their equities underperformed developed-market stocks. The underperformance can be explained in part by a slowing in the rate of earnings growth in emerging markets relative to developed markets, even if overall profits are still rising.

History tells us that longer-term outperformance in emerging markets is driven by earnings "super-cycles" – periods when superior growth in emerging-markets earnings per share measured in U.S. dollars is sustained versus the U.S. Examples include the early 1990s, when Asia's "Tiger Cubs" industrialized, and the early 2000s after China joined the World Trade Organization.

To create the next long-term upswing or EPS super-cycle, we will need a combination of structural drivers that are just as big as those that propelled earlier ones, although at this point there do not appear to be any broad themes to push this forward in the very near term. Three longer-term developments that could emerge to fill the role include a further acceleration in intra-Asian trade, India's urbanization and the expansion of financial services across larger segments of the population. However, all three will occur over decades rather than years. Near-term drivers focus on China and include a phased relaxation of the country's strict COVID restrictions, a let-up in the clampdown on internet platforms and a comprehensive recovery plan for the country's Real Estate sector. In the medium term, factors such as reform-led productivity improvements and green energy will support earnings growth. While some of these drivers are not yet in place, we believe that a combination of these factors will set emerging markets up for a sustained period of superior U.S.-dollar profit growth.

In the shorter term, it is worth looking at the IMF's GDP growth forecasts for emerging markets versus developed markets.

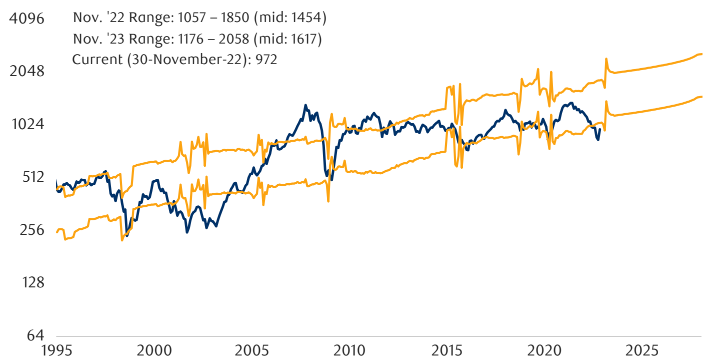
In the fourth quarter of 2021, the difference between earnings-growth rates in developed markets and emerging markets was the smallest since 1989, but has since begun to widen in favour of emerging markets. The gap will widen to 3.4 percentage points by the end of 2023, based on GDP forecasts from the IMF and Oxford Economics, from almost no difference in late 2021. Historically, an environment in which emerging-market economies are growing at a rate that is 3 percentage points faster than developed markets has tended to result in emerging-market outperformance. If the IMF's real GDP growth predictions are correct, then a 3.4% growth differential suggests improved relative performance for emerging-markets equities.

Amid the global monetary-tightening cycle, it's important to look at the difference in real interest rates between emerging markets and developed markets. Many emerging markets have significantly higher foreign-exchange reserves and significantly higher current-account surpluses than in previous U.S. Federal Reserve (Fed) tightening cycles. It stands to reason, therefore, that emerging-market central banks have the room to pause interest-rate hikes while the Fed continues to tighten. Excluding China, emerging markets have maintained real interest rates at a level that is four percentage points higher than developed markets, based on their weighted average.

When we consider emerging-market earnings, it is important to think about returns on equity and profit margins. Value creation, as defined as return on equity less cost of equity, drives emerging-market relative performance over the longer term. This measure has been dropping for emerging markets over the past two years as earning downgrades started earlier than they did in developed markets. However, we expect these comparisons to stabilize, and the consensus view is that they will improve in 2023 and 2024 to the point where there is a 3-percentage-point spread in favour of emerging markets.

There are three potential risks to the more benign emerging-markets growth outlook. The first is that the way investors have been thinking about economic growth over the past 20 years may no longer apply in a world characterized by higher inflation and higher interest rates. That said, emerging-market returns on equity are much higher than they were in the 1980s, when inflation and interest rates were as high as they are now. The business models of many emerging-markets companies are stronger and they are better managed than they were then. Emerging-markets companies in general have greater scale and more entrenched competitive advantages.

MSCI Emerging Markets Index Equilibrium
Normalized earnings and valuations



Source: RBC GAM

China is the second risk. We must ask ourselves whether China's growth slump may be morphing into a structural slowdown more akin to post-1990 Japan than typical cyclical slowdowns. The extent of the GDP growth slowdown in China has been quite sharp this year, and is a risk factor given that China is the largest trading partner for most emerging markets and a key driver of global growth. The combination of extended zero-COVID policies and a spillover from the housing crisis could result in a significant drag not only on other emerging markets but also the global expansion.

The third and final risk to take into account is the heightened scale of geopolitical risks. Taiwan and the war between Russia and Ukraine are just two to mention. Taiwan and South Korea are among the emerging markets most dependent on trade with Europe, where elevated energy prices threaten to deepen next year's recession due to the 10-month-old Russia-Ukraine conflict. Moreover, China's military posturing toward Taiwan, and the dispute's negative impact on China-U.S. relations, has been in part responsible for this year's reduction in valuations for Chinese and Taiwanese stocks. The second risk factor is clearly much harder to quantify.

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