RBC Global Asset Management

# Emerging Markets Outlook

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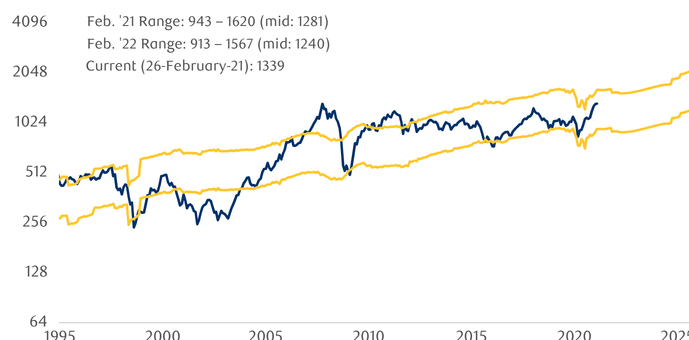
**Emerging-market equities delivered strong overall gains in 2020. However, the returns came from a limited number of markets, with only seven of 27 countries in positive territory. Many emerging-market country indexes fell 10% to 20% over the past 12 months. We have seen better performance across most sectors. However, a handful of stocks was responsible for the improvement.**

The concentration of the MSCI Emerging Markets Index has increased in recent years, and five stocks now account for 25% of the benchmark's market capitalization. Six of the 10 largest stocks are in China. Those stocks have been pushed even higher by Southbound Connect, the program that made it possible for investors in mainland China to shift assets into Hong Kong-listed shares from low-interest savings instruments, expensive property and high-valuation shares traded on mainland exchanges. The Hong Kong market is home to companies such as Tencent and Alibaba, which cannot be bought on mainland exchanges. There are mounting concerns that there is a bubble in the Chinese stock market and that the Chinese government may remove liquidity soon to deflate it.

Flows have been driving emerging markets higher recently with close to US$100 billion being invested in emerging-market debt and equity over the past 12 weeks – the third-largest amount ever for a three-month period.

In the near term, we remain cautious on equity markets as the consensus is pricing in a best-case scenario and excess liquidity is bolstering performance. We believe there are a number of uncertainties that could lead to declines in stock markets.

**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

In the medium term, we remain positive on emerging-market equities. We believe they should continue to outperform developed markets, after 10 years of underperformance, due to a combination of better emerging-market economic growth and a weaker U.S. dollar.

Faster economic growth will likely be the main driver of outperformance for emerging-market equities. The powerful recovery in the Chinese economy, which accounts for 40% of the emerging-market benchmark, illustrates how China has managed to master the pandemic. The Chinese economy was hit in the first quarter of 2020, one quarter before the developed world. However, the Chinese recovery has been much faster as the virus was controlled more swiftly, enabling China to avoid further major lockdowns.

Another positive driver for emerging-market equities compared with developed markets is the health of the balance sheets of central banks and governments. Emerging-market countries did not implement huge fiscal packages, which in developed markets has led to a significant increase in debt and, given falling interest rates, means that further action may be difficult to implement. On the other hand, many emerging markets countries have the fiscal space to increase spending if necessary.

On average, the overall number of COVID-19 deaths in emerging markets compared with developed markets has been much lower, and more limited lockdowns mean that any recovery is likely to occur sooner than in developed markets. The consensus is that emerging markets will grow more quickly than developed markets in 2021 and 2022. We believe that the U.S. dollar is overvalued considering the weak U.S. fiscal and trade balances, and we expect any further dollar weakness to be very positive for emerging-market equities.

Value stocks in emerging markets and the U.S. underperformed growth stocks by the most since style indexes began in 2000. The underperformance was attributable entirely to China and Taiwan and was caused by a handful of stocks that have become so large that they influence overall style performance. The stocks with outsized influence are “new economy” companies and performed well even before the pandemic. They are not in the value Index, which is full of financial and cyclicals stocks.

We have argued that certain segments of the new economy seem overvalued because they face increased competition and regulation. Moreover, were we to see more fiscal spending, notably targeting climate change and infrastructure, we could see cyclicals – and therefore value stocks – perform better.

Quality companies with returns on equity of around 10% are also interesting as they are priced at similar levels to lower-quality stocks. We believe that deeply discounted value stocks have already priced in a strong recovery.

The variance in performance among countries was never so large as it was in 2020. The success of Northeast Asia countries – China, South Korea and Taiwan – in containing the virus was reflected in the strong performance of those markets in 2020. We believe, however, that their valuations are more than priced in, with Taiwan the most expensive it has ever been. Countries that have struggled with the virus haven’t performed well. Brazilian markets were down 20% in 2020 and Colombia 22%. We expect a rebound in Latin American economic growth in 2021. The rise in prices for metals and oil should also be positive for Latin American economies.

Sectors that have benefited from the impact of the pandemic are Health Care, Consumer Discretionary, Information Technology, Communication Services and Consumer Staples. On the other hand, the Financials and Energy sectors have underperformed since the onset of COVID-19, and these sectors now look attractive based on valuations.

Performance in the Energy, Materials and Industrials sectors might be poised to improve if the “green revolution” unfolds as some analysts predict. Climate change is now a major focus for the largest countries in the world. China recently announced that renewable energy will comprise 25% of the country’s electricity generation by 2030, and by 2060 the country expects to be carbon-neutral. We have noticed that China has historically achieved or exceeded such targets, and it is also worth keeping in mind that the quantity of copper, nickel and other commodities needed to achieve carbon-neutral status exceeds the projected growth in their supply. Rising demand for these commodities would be very positive for emerging-market growth, and in this scenario, cyclical stocks and the Financials sector would perform well as any significant rise in commodity prices could fan inflation. We are very positive on the outlook for prices of copper, for which a lack of new projects could lead to a shortage just as sales and the use of electric vehicles and renewable energy accelerate.

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