RBC Global Asset Management

Emerging Markets Outlook

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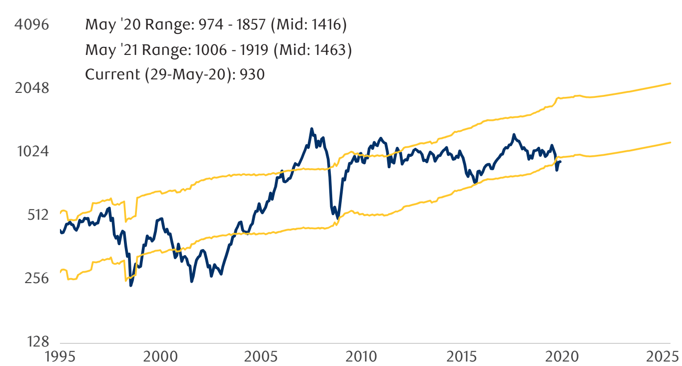
There was substantial financial-market volatility over the three-month period as the world faces its worst economic crisis since the Great Depression. The MSCI Emerging Markets Index fell 6.9% in U.S. dollars during the three months ended May 31, 2020, and has dropped 16.0% since the beginning of the year. As governments focus on restarting the economy, stocks have rebounded in recent weeks because investors do not want to miss the economic recovery when it comes.

This year's declines in emerging-market stocks, which started in early March, have been more significant than in previous crises. Emerging-market equities have lagged U.S. stocks during the rebound, as major countries including Brazil and India are behind the curve when it comes to tackling the spread of the coronavirus. In both countries, it is unclear what the eventual death toll will be, and both may experience humanitarian crises and deep recessions with long-term effects. We note that emerging markets are becoming cheap overall, but a lack of clarity around the impact of the virus in many countries has led us to be cautious. The significant drop from the end of 2019 does provide some protection from further downside, and we do not believe the market will retest the March lows unless the situation deteriorates significantly.

The plunge in earnings expectations provides insight into the market decline. Profit expectations for the emerging-market index in 2020 plummeted from a 16% forecast gain in earnings per share at the start of March to a forecast per-share loss of 10.3% at the end of May, according to JPMorgan.

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

There is a concern that the U.S. stock market will correct significantly if the negative effects of COVID-19 are not properly addressed, and a negative U.S. scenario could lead to poor emerging-market returns since the markets are closely correlated. It is therefore important that the U.S. economy re-open as quickly as possible to avoid a lengthy depression that would have a devastating impact on global equities. One bit of positive news for equity markets is that Joe Biden was chosen as the Democratic candidate for the U.S. election in November. Biden is perceived by investors as more market-friendly than the democratic socialist who was his main challenger, Bernie Sanders.

We turned less negative on equities in late March, in part because the price-to-book value of the emerging-market index fell to 1.3. On the three occasions when this valuation measure dropped below that level during the past 25 years, a significant rebound has ensued. The first time was in 1998-1999 during the Asian financial crisis and the technology-stock bubble, the second in 2008/2009 during the financial crisis, and lastly in 2016 during the so-called ‘taper tantrum.’ Each time emerging-market stocks rebounded, on average, by 50% in the subsequent 12 months. We cannot rule out further stock declines, but in our view the market is now cheap, and over a one-year horizon we can perhaps expect a larger rebound.

There are still large disparities in price-to-book values between individual emerging markets, with most still lower than in 2016 after the ‘taper tantrum,’ but higher than in 2009 following the global financial crisis. The two notable positive exceptions are China, which accounts for 40% of the index weight, and Taiwan, which accounts for 13%. Both countries are ahead of other major emerging-market countries in responding to the pandemic, and they also benefit from lower oil prices. Brazil’s relatively high valuation, despite a 47% drop in its stock market so far this year, is due to the fact that the country performed well in the 18 months following the election of reform-minded President Jair Bolsonaro. Stock markets in Mexico, Turkey, South Korea, Colombia and Chile are still the cheapest they have ever been, and they have led the rebound.

Some emerging-market currencies fell significantly against the safe-haven U.S. dollar during the three-month period, when we had expected the U.S. dollar to weaken. The Brazilian real and the South African rand dropped over 20%, and they are now significantly undervalued. Both currencies should appreciate as the situation stabilizes. We would expect the U.S. dollar to weaken from current levels, and that would be good for emerging-market equities.

A lower oil price is good for emerging markets overall, as many large countries are net importers, but sustained lower prices would be a negative as it would signal a prolonged recession. The price of oil has rebounded above US$30 a barrel, providing evidence of a risk-on environment.

In summary, emerging markets have lagged developed markets in the recent rebound, in part because many countries are seen as behind the curve when it comes to tackling the impact of the coronavirus. Another reason is that the rally has not been a high-conviction one as highlighted by style leadership in the rebound. We would have expected value stocks to perform well during the rally. However, it has been growth stocks that have outperformed, suggesting that investors who came back to the market focused on lower risk/higher growth companies because they feared further drops.

Stocks are still undervalued in our view, even after the strong rebound, and we would expect emerging-market equities to outperform overall in the coming months if there is no resurgence in COVID-19 cases. In the near term, however, markets will remain volatile as bad and good news alternate. For a sustained recovery, the market would need to be sure that the worst was over.

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