RBC Global Asset Management

Emerging markets outlook

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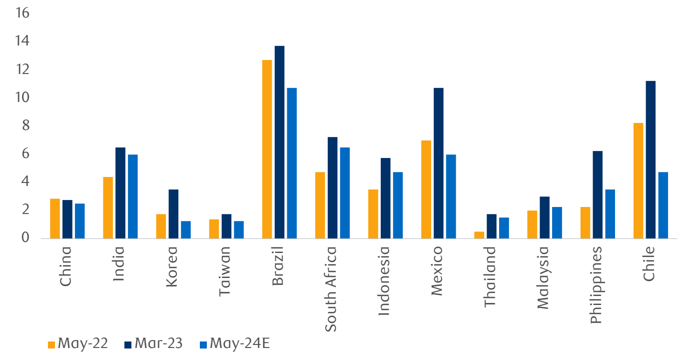
The shorter-term outlook for emerging-market equities will be dictated largely by inflation and interest rates, the direction of the U.S. dollar and earnings growth, all of which we expect to become tailwinds for emerging markets. China's relaxation of pandemic-related restrictions and recent measures aimed at stabilizing the country's property market should also be positive for emerging markets.

In the medium to longer term, many investors fear that geopolitical tensions affecting global trade and the semiconductor industry could become material headwinds for emerging markets. Concern is increasing that populism, the U.S.-China conflict, and the drive to develop self-sufficiency in sectors crucial to national security will reverse globalization, reducing growth and profit margins for emerging-market companies. Global trade and the global supply chains that support it are undergoing a transformation in which supply chains are becoming less dependent on China. We expect emerging markets to retain their advantage with respect to semiconductor manufacturing over the medium term, with Taiwan and South Korea continuing to dominate.

Emerging-market governments have in recent years tightened monetary and fiscal policy, in many cases faster than the U.S. At this stage, most Asian and Latin American economies appear to be past the peak of inflation. The expected deceleration in inflation, along with a moderating outlook for economic growth, could allow many emerging-market central banks to lower interest rates over the next 12 months. The fact that many emerging-market central banks got out in front of inflation with rate hikes suggests that monetary policy could move from a headwind to a tailwind (Exhibit 1).

Exhibit 1: EM Monetary Policy
Normalized earnings and valuations



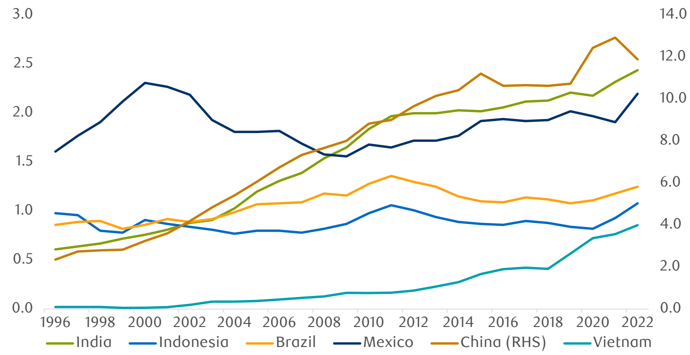
Note: As of April 2023. Source: UBS, CEIC

In addition to the more favourable inflation and monetary-policy backdrop, emerging-market equities are expected to benefit from improving returns on equity and earnings growth, and in both areas emerging market should outpace developed markets. Returns on equity are rising at about 14% after falling to 9% during the pandemic. In our view, most of the expected improvement in returns on equity and earnings-per-share growth over the next 12 months will be driven by the Information Technology sector in South Korea and Taiwan, and by economic recovery in China.

The direction of the U.S. dollar remains a critical influence on the path of emerging-market equities. The U.S. current-account deficit is at its widest relative to emerging markets over the past two decades and is expected to continue deteriorating through 2025. The U.S. fiscal position is also weakening compared with emerging markets, which should support emerging-market currencies. The U.S. dollar is extremely overvalued on metrics including real effective exchange rates and purchasing power parity. While such levels of overvaluation do not in themselves predict currency movements, the fact that U.S.-dollar valuations are extreme in an environment where emerging markets have an edge in trade and fiscal policy indicates that emerging-market currencies can expect to enjoy good support.

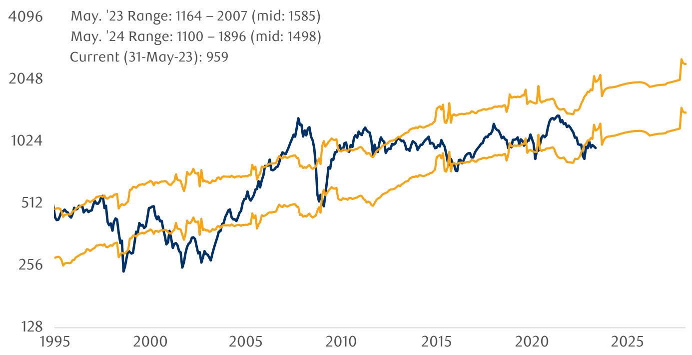
What we expect to be a restructuring of global trade will not in our view cause a reduction in global trade but rather substitute many of the China-centred supply chains that have developed over the past two decades. The result is likely to be a zero-sum game for emerging markets. China's share of global exports increased to 12.5% from 2.5% since the early 2000s, overtaking the U.S. at 9.2%. The U.S. case to push for reducing its trade reliance on China are twofold: 1) the desire to slow Chinese economic growth; 2) the belief that China has exploited the global free-trade system to strengthen its autocratic institutions and increase its appeal to non-democratic regimes. In this context, emerging-market countries such as Vietnam, Mexico, Malaysia, Indonesia and India are likely to continue to gain share in global exports at China's expense (Exhibit 2).

Exhibit 2: Country's share in World Exports
(Goods and Services)



Note: As of April 2023. Source: JPMorgan

MSCI Emerging Markets Index Equilibrium
Normalized earnings and valuations



Source: RBC GAM

The bulk of supply-chain relocations and the resulting reductions in China's share of exports will initially be driven by the Information Technology sector, an area that is subject to U.S. restrictions. In fact, the rivalry between the U.S. and China, and the related U.S. restrictions on technology exports to China, often referred as the "tech war," is a trend that is here to stay. Related are attempts by the U.S. to increase domestic production of semiconductors.

From a macroeconomic standpoint, we anticipate that there will be no major change to global semiconductor manufacturing in the next few years. As of 2022, 92% of leading-edge semiconductor production comes from Taiwan and 8% from South Korea. There are two key reasons why we believe the status quo will be maintained for the foreseeable future.

First, we do not believe that the U.S. will be able to recreate Asia's semiconductor ecosystem. Even with the CHIPS Act, passed last year and aimed at boosting domestic chip production, it would take years for the U.S. to reproduce Asia's knowledge base and supply chains built up over four decades. Higher costs and a lack of scale are likely to be formidable obstacles. While funding is important to semiconductor development, it does not guarantee success because the key factor is technological capability. Ultimately, subsidies tend to make industries and companies less competitive because they come to rely on subsidies instead of focusing on relentless self-improvement.

In terms of sectors, we continue to have a favourable view of the Consumer Staples and Financials sectors while we continue to have no or low exposure to Energy, Communication Services and Materials. In terms of countries, we view India favourably and South Korea in a somewhat less favourable light.

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