

Emerging markets outlook



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Emerging-market equities have started to outperform developed markets in a reversal from the trend of the past few years, catalyzed by an early 2024 rebound in Chinese equities. Since China's stock market touched a multi-year low on January 22, the MSCI Emerging Markets Index has returned about 10% in U.S. dollars, compared with a 9% gain for the MSCI World Index.

It is likely that emerging-market equities will continue to narrow the gap with developed markets in the coming months as emerging-market economies and earnings improve, especially since huge valuation differences exist between the two. At the end of 2023, the return on equity (ROE) in developed markets, as represented by the MSCI World, was 16.0%, the highest ever versus emerging markets, whose ROE stood at 11.3%. The large difference is due in part to emerging markets' lower exposure to technology and a slower economic recovery from the pandemic as government stimulus in emerging markets was more limited. We foresee a rebound this year in emerging-market ROEs, while ROEs in developed markets should not change much.

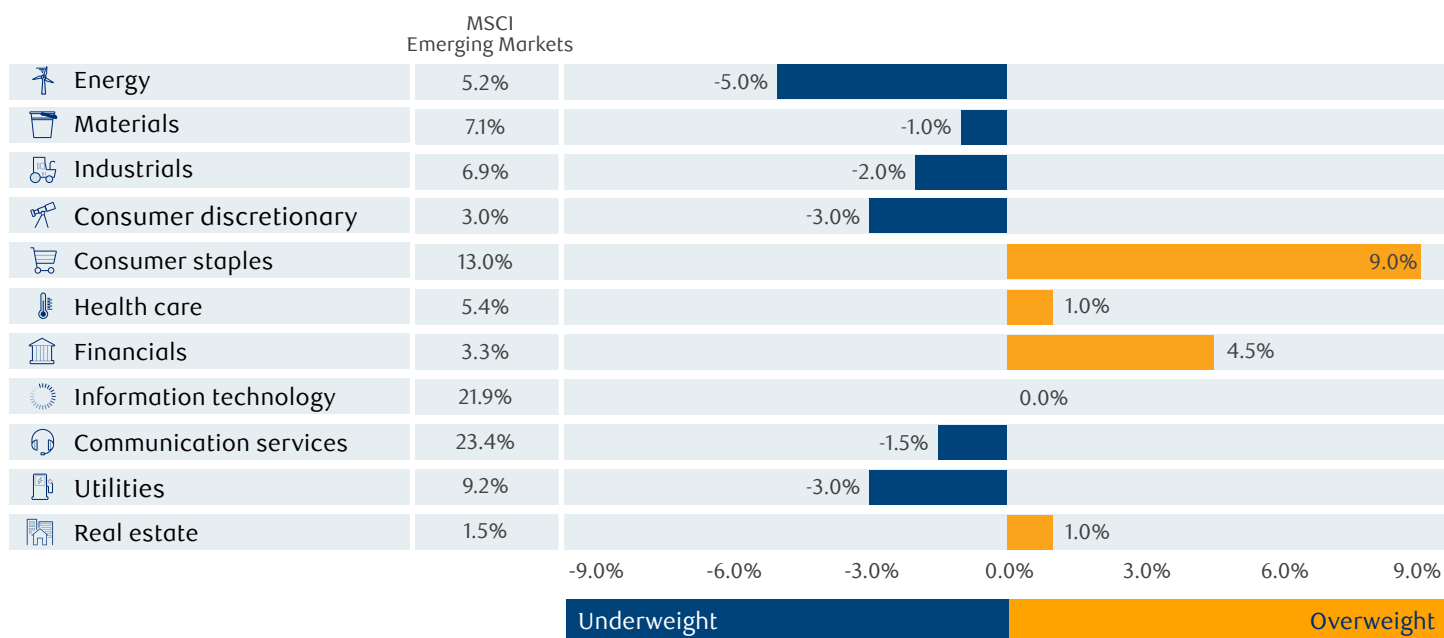
Discounted valuations are also seen on a price-to-book basis (PB), where emerging markets trade at the highest discount ever – 50% – versus developed markets. The average discount over the past 25 years has been 30%. India was the most expensive emerging market at the end of 2023, and valuations measured based on PB were at their highest levels since 2007, just before the financial crisis. India's stock benchmark has added another 9.5% so far in 2024, triggering questions about near-term performance. It seems clear that there is some froth in the small- and mid-cap areas of the

market, prompting India's stock-market regulator in February to request that local mutual funds address ways to better protect investors.

India's business-friendly prime minister, Narendra Modi, recently lost his parliamentary majority in elections that reflected what some political analysts said was disgruntlement among the poor over job losses and inflation. His political party, the BJP, should in our view be able to continue pursuing its policy goals, but will now have trouble enacting proposals that ease land transfers and encourage large-scale farming.

There is no doubt about India's impressive development under Modi, who since winning power in 2014 has focused on the country's woeful infrastructure and made it much easier to do business. But it is also clear that India faces many challenges in the coming years. Education remains a concern, with half the population quitting school at the age of 10, while female make up less than 30% of the workforce – one of the lowest rates in the world. Faster job creation will be needed to absorb the growing population and boost economic growth above the levels of the past decade. In this environment, investors should focus on areas of the market where valuations are not stretched.

Emerging markets – Recommended sector weights

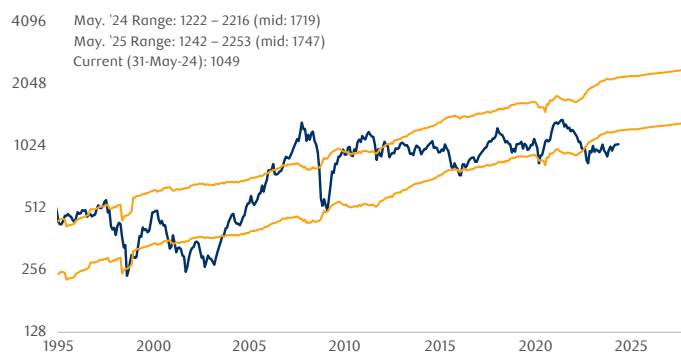


Note: As of May 31, 2024. Source: RBC GAM

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MSCI Emerging Markets Index Equilibrium

Normalized earnings and valuations



Note: The fair value estimates are for illustrative purposes only. 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

China's economy, in contrast to India's, has been weak since 2020. That was the year that China started to stress the quality of its economic expansion via productivity and domestic demand, rather than simply the pace of growth. While this change is necessary to ensure that growth is accompanied by sustainably rising incomes, policymaking has so far been mostly ineffective in restoring investor confidence. The severity of the government's two-year-old regulatory crackdown on many parts of the economy caught many investors by surprise, and there is now concern that high debt levels and a shrinking population could lead to deflation. The result is that valuations of Chinese equities at the end of January of this year fell to their lowest since the 2008-2009 financial crisis.

Since the start of the year, Chinese stock valuations have fallen mainly in fast-growing technology-related issues and private companies, while state-owned enterprises and more cyclical areas have done better. These trends were largely reflected in foreign investors selling widely held, quality stocks and a delayed recovery in consumption. So far in 2024, however, concerns about China's big-picture challenges have taken a back seat to investors wanting exposure to a market that may be undervalued from a long-term perspective.

Indeed, the MSCI China Index has outperformed the emerging-market index by 9.6 percentage points and the MSCI India Index by 9 percentage points since January 22 of this year as the government increased support for the economy and the Real Estate sector. The rally could well continue if China's central bank eases policy at a time when inflation-adjusted interest rates are relatively high. One key positive is that the savings rate is down amid a modest recovery in consumption and consumer confidence.

Beyond China and India, investors can expect the run-up to November's U.S. presidential election to result in financial-market volatility. A notable risk is the imposition of tariffs and other trade restrictions in areas where China has been ramping up exports, regardless of whether Biden or Trump wins the election. The longer-term direction remains a more polarized world, with trading blocs increasingly dictated by geopolitics.

In conclusion, it is important to remember that it's emerging-market countries that are driving global GDP growth. While China's growth rate is declining, investors expect the country to remain the main contributor to global GDP growth in the coming years as it accounts for 30% of emerging-market economic growth. India's economy is now expanding faster than China's, but China's economy is about 4.5 times bigger.

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