RBC Global Asset Management

Emerging markets outlook

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Emerging-market equities have been negatively affected by the weak performance of China, which accounts for about a third of the emerging-market benchmark and has been the weakest-performing emerging-market country over the past 12 months. The decline in Chinese stocks since the start of 2021 has been driven primarily by regulatory uncertainty surrounding technology and the impact of relatively tight monetary policy. The impact of internet stocks has been particularly pronounced given that its weighting in the Chinese benchmark peaked at almost 50% a year ago.

The regulatory measures aimed at technology companies include banning unfair competition, restricting the use of personal data, and banning fake reviews and cash incentives to attract positive ratings. These moves have caused many investors to question whether Chinese authorities will allow capitalism to thrive. Our belief is that such fears can be alleviated when consideration is given to the crucial role played by the economy's private sector, which accounts for at least 80% of new jobs and is needed to help upgrade the economy in areas such as semiconductors, automation and renewable energy.

It is difficult to predict how long the regulatory overhang will last. However, recent official criticism of internet companies has been less strident, and there has been a number of announcements by mainland authorities indicating that they want to encourage foreign investment in Chinese equities, with Hong Kong's stock market remaining an important conduit.

That said, we do believe that the Chinese government's priorities have shifted in recent years from an emphasis on economic growth to the primary goal of greater equality and social stability. Going forward, we believe that it will be important to be cautious in areas that are vulnerable to government intrusion and to be positioned in areas that the government is likely to support such as renewable energy, electric vehicles and technology that reduces the country's dependence on foreigners. Companies that are truly innovative and that can compete on the global stage should fare well. This environment should ultimately favour high-quality companies with strong management teams and clear competitive advantages.

The other key issue hurting Chinese equities has been monetary and fiscal policies that have been relatively tight in contrast to what has occurred in the developed world since the onset of the pandemic almost two years ago. The growth rates of both Chinese money supply and bank lending have fallen to multi-year lows, and, as a consequence, so has GDP growth.

Part of this weakening has been due to recent efforts to reduce property companies' debt burdens through adherence to much tighter leverage restrictions as well as measures to cool property prices. These rules led to

the much publicized financial stresses facing Evergrande, China's most leveraged developer with debts exceeding US$300 billion. The Evergrande situation has driven concerns that China may face a "Lehman moment" leading to a collapse in debt markets. But unlike U.S.-based Lehman Brothers in 2008, China's current debt crisis was triggered by authorities, and there is every reason to believe that Chinese policymakers can deal with the fallout through a managed liquidation.

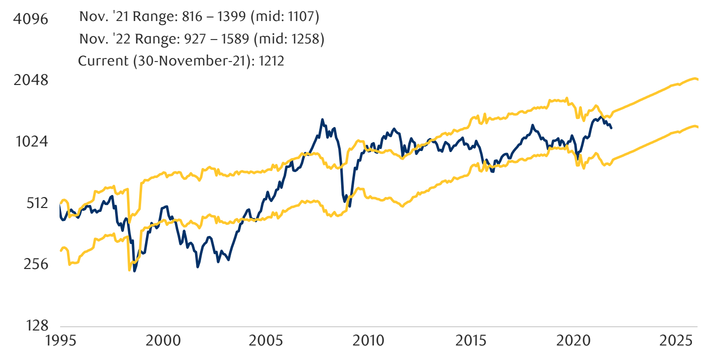
Given the economy's relative weakness, some monetary-easing measures seem likely although policy should remain relatively conservative to avoid further debt build-ups. The growing political desire to upgrade the economy and secure technological independence should also support an acceleration in investment and infrastructure spending.

China's struggles come against a global economic backdrop that has been brightening somewhat. The reopening of economies has led to the strong outperformance of value and cyclical stocks following several years of underperformance, supported by pent-up consumer demand and rising inflation due in part to loose U.S. monetary and fiscal policies. Sustained strength in energy prices has the potential to intensify any inflation scare and could lead to uncomfortably high bond yields and the underperformance of high-valuation stocks. Emerging-market stocks would benefit most from a situation in which economic growth remains strong, with value and cyclical stocks leading. If, on the other hand, we enter a stagflationary environment, defensive stocks trading at reasonable valuation levels would outperform. The course of the pandemic, and the emergence of any new COVID-19 variants, will of course also affect the cyclical recovery that is unfolding. There continues to be much uncertainty as to the extent to which existing vaccines can contain new variants such as the recently discovered Omicron strain.

Stark valuation differences remain in emerging markets at the sector level. Sectors that have benefited from the pandemic such as Health Care, Consumer Discretionary, Communication Services and Information Technology continue to look very expensive relative to history. On the other hand, the Financials and Energy sectors trade at relatively low valuations even after rallying last year. In terms of sector positioning, we favour consumer sectors driven by high returns and tailwinds such as rising incomes,

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

positive reform momentum, attractive demographics, rising urbanization and positive employment trends. Among cyclical sectors, we prefer Financials based on valuation, improving asset quality and the scope for growth in customer numbers and expanded services. We have reduced our exposure in recent months to the more expensive internet-related parts of the market. In addition to concerns on valuation, we see increasing signs that internet companies will face headwinds in terms of competition, regulation and higher taxes.

Much of the difference in emerging-market country performance can be attributed to the sectoral make up of individual indexes, with Chile, Turkey and other markets whose companies tend to be cyclical and exposed to Financials looking relatively cheap. Taiwan, with its high technology weighting, looks expensive, but we are optimistic about the outlook for India. Not only is India's economy expanding quickly, but the country offers a good choice of high-quality companies. However, we recognize that the Indian stock market's recent strong performance means that it is beginning to look expensive. Latin America's equity markets have disappointed investors over the past year, but a combination of attractive valuations, economic recovery and policy improvements support a more optimistic outlook. That said, political instability remains a larger risk in Latin America than in many of our markets.

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