RBC Global Asset Management

Emerging markets outlook

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All major equity benchmarks have recorded relatively large losses so far in 2022, buffeted by rising interest rates, the negative economic impact of Russia's invasion of Ukraine and continued economic weakness in China after COVID-19 lockdowns in some of the country's largest cities. Emerging-market equities have traded largely in line with those in developed markets against a backdrop where they might have been expected to underperform, as emerging markets were supported by stronger corporate cash flows, resilient currencies and attractive valuations.

Excluding Russia, China was the weakest-performing emerging market, down 10.7% during the three months ended May 31, 2022. Emerging markets excluding China performed better, with a 5.7% decline, as commodity-exporting countries posted positive results.

China, whose economy has been battered by the COVID-related lockdowns, finds itself in a difficult position. The country's economic situation requires the government to loosen monetary and fiscal policy at a time when the U.S. Federal Reserve and other major central banks are tightening. As a result, any efforts on the monetary front to counter the negative impact of the lockdowns on growth are limited by concerns over capital outflows.

There are four factors that are likely to shape the performance of Chinese equities for the remainder of the year, three of which are potential positives.

First, China appears to be less of an immediate threat to geopolitical stability than many analysts had assumed at the beginning of the year, as evidenced by ebbing Chinese support for Russia's invasion of Ukraine. It is likely that the strong Western sanctions imposed on Russia have forced Beijing to reconsider the potential economic impact of a similar response should China launch an invasion of Taiwan. Our view is that China's goal of becoming the world's largest economy – a key aspect of President Xi's plan to extend the country's geopolitical influence – requires a conciliatory stance. This is because the path towards economic supremacy is based in part on maintaining a non-hostile global environment and avoiding isolation or sanctions that would jeopardize the technological and financial transfers necessary to maximize China's self-sufficiency over the longer term.

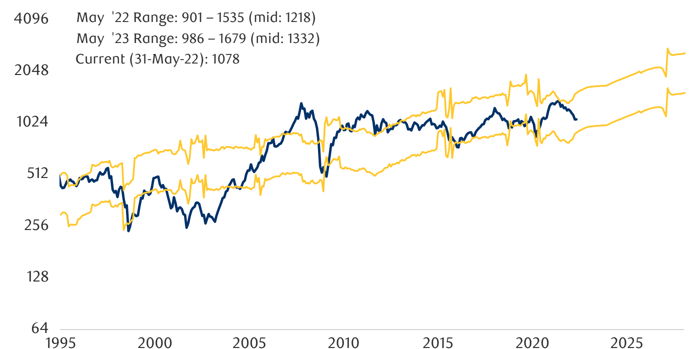
The second supporting factor is valuations. China earnings estimates have been cut by analysts for 15 consecutive months and the current level of equity valuations in terms of price to book value is at the lowest relative to the MSCI World Index in the past 20 years. A lot of negative news has been priced in.

The third supporting factor is that fiscal policy is becoming more accommodative. While Chinese authorities may not have the same leeway as they have in the recent past, there are signs that government spending is having more of an economic impact. Historically there has been a strong positive relationship between growth in government spending (known as "total social financing") and credit and profit growth.

The negative factor in the short term is the re-emergence of COVID-19 cases in the country and the government's strategy for managing outbreaks. China's approach since the onset of the pandemic has been one of "zero COVID," meaning draconian lockdowns even if they stifle the economy. Attention remains focused on Shanghai, a city of 26 million people, where authorities have started to ease restrictions as cases appear to have peaked. Clearly a repeat of a similar lockdown in other Chinese cities would crush economic growth. China will have to find ways to deal with the fact that its vaccine has proven ineffective and that the country's failure to prioritize the elderly for inoculations has worsened what might have been a more manageable situation. As long as Chinese officials retain their hard-line COVID policies, growth will be hampered and equities will have difficulty rebounding – even as valuations become more attractive.

In terms of how we position our funds, the key phrase at the moment is "pricing power." One very important area to consider is inflation, and food inflation in particular. Food is a special concern because Ukraine and Russia are the largest producers and exporters of wheat, barley and other key agricultural commodities. Secondly, Belarus is the largest producer of fertilizers, the prices of which have skyrocketed, as sanctions curb supply and extraordinarily high fuel prices raise production costs elsewhere. Many farmers around the world are not able to afford fertilizer at current prices, reducing crop yields. The FAO Food Price

MSCI Emerging Markets Index Equilibrium
Normalized earnings and valuations



Source: RBC GAM

Index is now higher than it was in 2011 at the time of the Arab Spring. We are seeing economic instability and social unrest in more fragile emerging economies such as Sri Lanka, Pakistan, Peru and Egypt. The step from social unrest to political revolution can be a short one, and if supply is not restored, we could see famines unfolding in emerging markets, where food accounts for about 35% of consumer expenditures versus 10% in the developed world.

After a decade of almost no inflation, the next 10 years may be characterized by a higher level of inflation. In this environment, it's important to be positioned in businesses with strong pricing power. We therefore favour businesses with low leverage, cost structures that have low exposure to commodity prices, high market shares, relatively few fixed assets and products that are not easily replaceable. A sector that generally tends to have pricing power is Consumer Staples. The technology sectors have been very weak and their valuations are becoming more attractive, so they could offer investment opportunities later this year.

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