Emerging markets outlook

Still early in the EM cycle

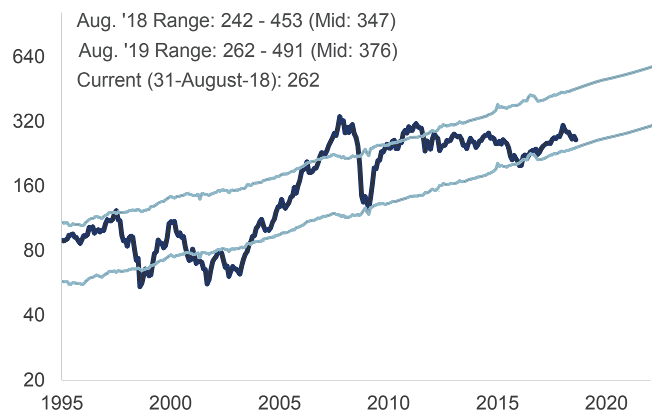
After a strong start to 2018, the MSCI Emerging Markets Index had lost 8.9% as of August 31, 2018, underperforming developed-market equities by 12 percentage points. Relative returns in financial markets so far this year have wiped out about three-fourths of the margin by which emerging markets had outperformed developed markets since early 2016.

Concern about U.S. monetary tightening, U.S.-dollar strength and protectionism have combined to push down emerging-market stocks. Of the three, U.S. dollar strength has had the largest negative impact, in our opinion, since emerging-market stocks tend to have the highest sensitivity to changes in the value of the U.S. dollar. Boosting the U.S. dollar was a U.S. Federal Reserve (Fed) that is by far the most hawkish of the G-7 central banks, as well as rising expectations of further monetary tightening, as U.S. core inflation has been rising and employment and wage data have remained relatively healthy. Moreover, the Fed remains committed to shrinking its balance sheet, with current plans to reduce its debt holdings by a cumulative US$1 trillion by the end of 2019.

Additionally, growth in the money supply (M2) has been slowing sharply, seemingly in line with Fed balance-sheet contraction. Since January, money-supply growth has continued to run below nominal GDP growth for the first time in almost 10 years. This trend is a contractionary signal and means, in essence, that the growth in domestic demand for the U.S. dollar is now greater than the growth in supply: more U.S. dollars are flowing back into the country. The reduction in U.S. dollar liquidity earlier this year magnified gains in the currency as investors who had been betting on a drop in the greenback were forced to cover their wagers by buying the U.S. dollar when it started to rise.

We note that positioning in the greenback suggests that measures of U.S.-dollar bullishness are at extreme levels. At the same time, emerging-market currencies continue to offer attractive yields, and their valuations are relatively low based on purchasing power parity.

Emerging Market Datastream Index
Normalized earnings & valuations



Source: Datastream, RBC GAM

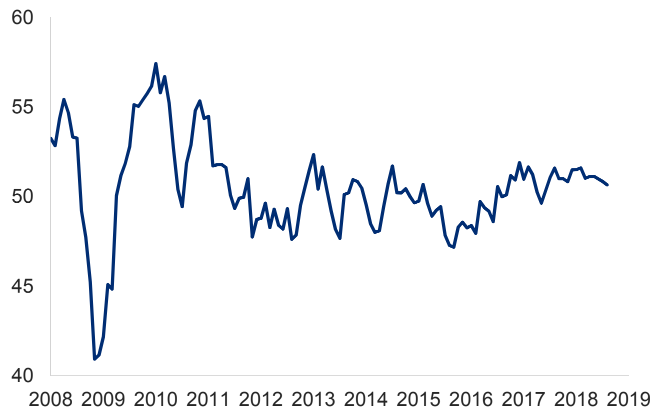
Looking beyond 2018, one of the most important questions to answer in terms of the outlook for emerging-market equities is where we are in the economic cycle. The growth phase of the emerging-market economic and profit expansion is only in its second year at 22 months, while developed markets have been in recovery for about 8½ years. The current decline in emerging-market stocks, which have fallen as much as 18%, seems to have imposed only limited damage on the overall economy. GDP downgrades have been limited and EPS forecasts have remained solid at 15% to 18% for 2018. Economic data such as leverage, earnings and returns on equity point to emerging markets being in the early- to mid-stage of the growth phase of the economic cycle, although it is, of course, possible that the growth phase will be shorter this time around.

For 2018, the biggest growth downgrades so far have concerned Brazil, where economic data has deteriorated in stunning fashion in recent months. Also significant is South Africa, where GDP growth forecasts were recently lowered to 1.2% from 1.8%. Small reductions to 2018 growth forecasts were also made for Indonesia, China and Malaysia, but we have seen upgrades in countries such as Taiwan, Thailand and Chile. On a parallel note, executive optimism as suggested by purchasing managers' indexes has remained robust and has been rising since bottoming out in 2016 (Exhibit 1).

We consider the stability in corporate-earnings forecasts to be the most important sign of limited damage from the recent turmoil. The consensus forecast for emerging-market earnings growth in 2018 has edged up to 15.9% at mid-year from 13.1% at the end of 2017. To be fair, we note that the level of forecast emerging-market earnings for 2018 has fallen since March. Other trends favouring emerging markets are improving operating leverage and rising returns on equity. Capital expenditures have also begun to turn up after three years of declines.

The higher cost of capital caused by higher interest rates and lower global liquidity help explain a drop in valuations in emerging-market equities during the first half of 2018 to the long-term average of 11 times forward earnings, and to 1.68 times price-to-book value, or 10% below the historical average. The current price-to-book value has historically proven to be supportive, as emerging-market stocks have risen in every 12-month period after this level was reached.

Exhibit 1: China – Manufacturing Purchasing Managers' Index (PMI)



Source: Haver Analytics, RBC GAM

Looking ahead, we believe any U.S. dollar weakness, yield-curve flattening and narrower spreads between yields on emerging-market and developed-market bonds should trigger a rebound in emerging-market equities and their valuations.

During the first half of 2018, the Financials sector has been particularly hard-hit, and there has been little differentiation between high- and low-quality financial institutions. This development has opened up an opportunity for us to increase exposure to a sector we like and buy high-quality banks at attractive valuations.

For more on our current view and outlook, please consult the full version of *The Global Investment Outlook* posted on our website at http://www.rbcgam.com/investment-insights/investment-outlook/index.html

Global Asset Management