Global Asset Management

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EMERGING MARKETS OUTLOOK

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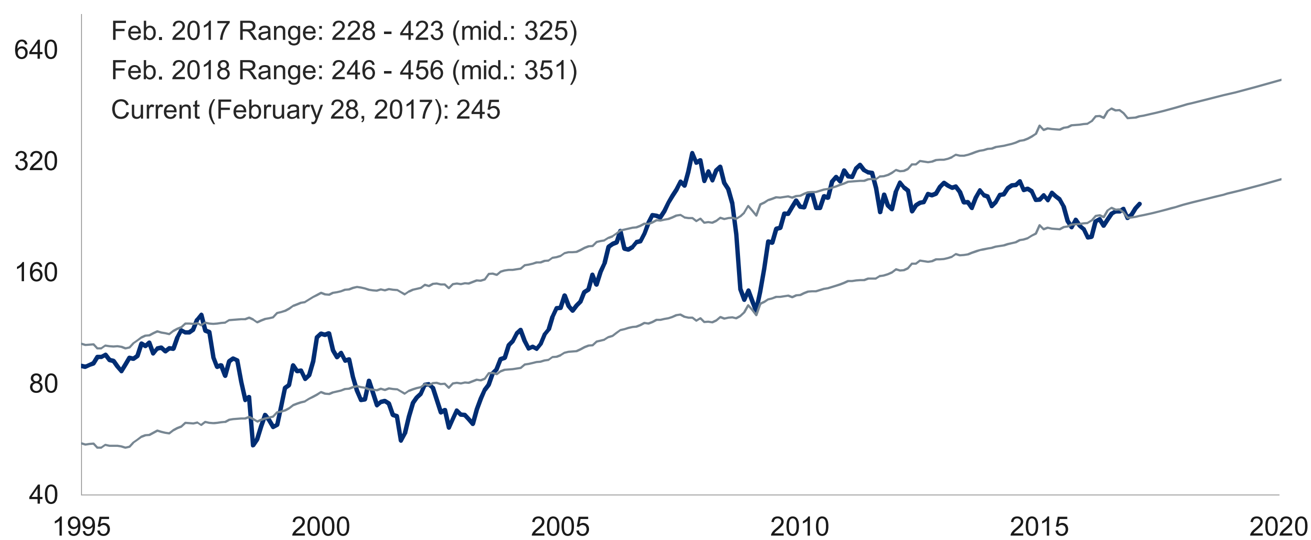
Emerging-market equities outperformed their developed-market counterparts by 3.3 percentage points in 2016 (8.6% versus 5.3%), the first time that emerging markets have led in six years. Last year's emerging-market recovery could have been bigger, but was curtailed by the U.S. dollar rally and bond sell-off triggered by Donald Trump's presidential victory in November.

While the stronger dollar and rising bond yields remain concerns, there are several positive factors that should support emerging-market performance over the medium term. First, commodity prices have been increasing, which along with rising yields supports the view that global growth can accelerate. Second, there is a powerful case that the rally of the U.S. dollar will persist only against currencies of other developed markets as valuations for emerging-market currencies are cheap, and because many emerging markets have high real interest rates and strong current accounts. Third, both earnings and relative emerging-market growth look set to improve from cyclically low levels driven by improved productivity and structural reforms. Finally, the valuation case for emerging-market equities is strong, particularly relative to developed markets, following the significant underperformance of the past six years.

While emerging-market equity performance has been relatively flat overall in recent years, there have been clear winners and losers in terms of sectors and individual

Emerging Market Datastream Index Equilibrium
Normalized earnings and valuations



Source: Datastream, RBC GAM

companies. In this environment, we believe that active fund management should include consideration of opportunities outside of the benchmark if investor returns are to be satisfactory.

It appears that we have reached the stage where monetary-policy options, especially in the developed world, have been exhausted and that future stimulus will be increasingly focused on fiscal policy. While the recent focus on fiscal policy and infrastructure has largely been in developed markets, emerging markets also have a substantial need for infrastructure improvement. Importantly, many emerging-market countries now have sufficient fiscal capacity and more reform-friendly governments, meaning that we are likely to see fiscal stimulus play an increasingly important role in emerging markets as well. The positive outlook for infrastructure has led to increasing expectations that commodities will keep strengthening. Commodity prices have been on the rise since the beginning of 2016, after slumping in previous years, due to optimism over the potential for faster economic growth and increased infrastructure spending. However, the potential impact of such improvements and other fiscal stimulus in developed markets needs to be put in context. The US$1 trillion that Trump has proposed spending over 10 years equates to the amount that China spent in *just the first eight months of 2016*. What happens in China is the key driver for commodity prices.

We are seeing important positives for the Chinese economy as there is a clear transition happening away from investment-driven growth towards a consumption-led expansion, and a strong commitment to reforms and crackdown on corruption by the Chinese government. Furthermore, private enterprises are becoming increasingly important for China's economy, which is positive because it puts pressure on the Communist Party to improve the country's economic, social and legal structures, and to increase the quality and availability of education, health care and environmental protections. However, there are also noteworthy risks for the Chinese economy, particularly due to the rapid build-up of risky credit since the global financial crisis and from overcapacity in a number of industries. Going forward, it is therefore important that credit growth slow and that it be of higher quality. It is also necessary that the Chinese leadership address excess capacity in the economy by continuing to implement reforms.

Emerging markets have traditionally been strongly associated with commodities, but this connection has receded somewhat in recent years. Indeed, overall emerging-market exposure to commodities is not significantly higher than it is in developed markets, although there are still many individual emerging markets that depend on commodities. In this regard, the key point is that emerging markets have become much more domestically oriented over the past decade. Significantly, since 2015 the aggregate market capitalization of the consumer sectors in emerging markets has exceeded that of the resource sectors.

Expectations of a pickup in global growth have led to a sharp rotation out of income-producing equities and the powerful outperformance of cyclical issues and stocks with low valuations. While we have increased our exposure to the more economically sensitive parts of the market, we are wary of companies whose returns are not likely to be sustainable. Cyclicals by their nature can rarely sustain durable returns and will often experience painful reversals when a cycle turns. Nonetheless, we believe there is a strong case for avoiding the most expensive parts of the market, which have become crowded and where valuations have become increasingly stretched in recent years. In terms of defensive equities, we feel it is important to distinguish between mature high-yielding sectors such as Telecommunication Services and Utilities, where we are cautious, and Consumer Staples, which have stable, rising earnings and strong pricing power, and tend to produce very high long-term returns. While growth can appear pedestrian when economic growth accelerates, the fall in valuations of many defensive stocks in 2016 increased the attraction of Consumer Staples in our view. Increasing protectionism is also a concern. Trump's policies are still not clear but a key aim seems to be efforts to bring manufacturing back to the U.S. This reinforces our emerging-market emphasis on stocks that depend on domestic demand.

The relative performance of emerging markets has been diverging and we believe that countries that embrace structural reforms will end up winners. We are particularly positive on the outlook for India, whose business environment is improving amid tax and regulatory reforms and which offers a good choice of high-quality companies that trade at attractive valuations. We like specific stocks in the Philippines, South Africa and Chile. We are less optimistic about markets in China, South Korea and Russia. China's debt represents a significant risk. While valuations in South Korea and Russia are attractive, corporate governance is poor and we can find better opportunities elsewhere.

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