Global Asset Management

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SPRING 2019

Emerging markets outlook

Emerging markets, emerging opportunities

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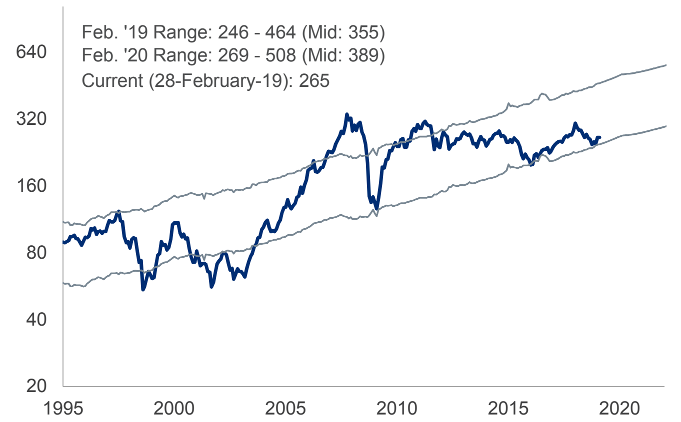
We are cautiously optimistic about emerging-market equities and do not believe that the performance pattern witnessed in 2018, when the market peaked at the end of January and collapsed for much of the rest of the year, will be repeated in 2019. There are three main reasons for our guarded optimism: valuations are more attractive after the MSCI Emerging Markets Index dropped 15 percent in 2018 while earnings per share rose about 10 percent; emerging-market currencies are much cheaper than they were a year ago; and investment inflows have started to increase as investors sell U.S. equities and shift the proceeds to emerging markets. We expect some of the worst-performing emerging-market countries, such as Turkey, China and South Africa, and sectors such as Consumer Discretionary and Real Estate, to perform better. We are also encouraged by progress in trade talks between China and the U.S. on tariffs.

The three-month period ended February 28, 2019, was an eventful time for emerging-market equities as the benchmark stock index rebounded more than 10 percent following a large sell-off in October. Emerging-market equities were seen as oversold, and the rotation away from U.S. equities magnified the large rebound in January 2019 after volatility led to a further round of global equity losses in December.

Until early November 2018, the U.S. Federal Reserve's (Fed) tone was hawkish, and monetary tightening in the U.S. and China was a major reason for the poor performance of emerging-market equities as the currencies and stock markets of the most fragile countries suffered. However, we have since witnessed a marked change in the mood of the Fed to dovish, benefiting emerging markets and signalling a major adjustment in the outlook for the U.S. dollar and its relationship with emerging-market currencies. A more dovish Fed has also made currencies of countries with the highest current-account deficits more attractive.

Unsurprisingly, 2018 proved disappointing in terms of investment flows as the euphoria from the January rally faded quickly and we saw constant outflows until October. Positive flows have resumed and outflows from U.S. equities into emerging markets amounted to about US$80 billion during the three months ended January. We note that most of the U.S. outflows has gone into ETFs, raising questions about investors' conviction in the rally.

Emerging Market Datastream Index
Normalized earnings & valuations



Source: Datastream, RBC GAM

The emerging-market stock index remains very attractive in terms of valuations even after the recent gains, as last year's stock decline collapsed the price-to-earnings ratio to just above 12 from 16 - well below the long-term average. Emerging-market stocks are also more attractive on a price-tobook-value basis than they were a year ago given a recovery in returns on equity.

While our outlook for emerging market equities is generally positive, we note that there have been earnings downgrades, particularly in the Information Technology and Communication Services sectors, as well as in some parts of the Consumer Staples sector (mainly in China) and Consumer Discretionary (mainly autos in China and South Korea). The overall downgrades have reached 5 percent since September 2018 and the current consensus EPS growth for 2019 now stands at 5.8 percent. The uncertainties around downgrades are centred on two topics: technology and China. We saw large downgrades in both hardware (semiconductors) and services (e-commerce and gaming). While some weakness is linked to the economic slowdown in China, other causes may be the somewhat saturated market for global smartphones and the fact that some new models were priced too high, leading to disappointing sales.

Looking in detail at earnings expectations for 2019, the 5.8 percent earnings-growth forecast seems quite low, but this number is heavily affected by the 20 percent earnings drop expected from the Information Technology sector. This sector represents close to 15 percent of the index even after gaming and e-commerce companies were transferred to the newly created Communication Services sector.

Energy (8 percent of the emerging-market index) is expected to show limited growth, although the forecast would rise if oil prices continue their recovery. All other sectors have attractive growth potential, notably Utilities, the consumer sectors and Real Estate. Emerging markets look attractively valued overall assuming that the downgrades in the Information Technology sector are largely behind us.

We remain cautious about political changes in Brazil, South Africa and India and, despite recent progress in trade talks, are concerned that trade tensions between the U.S. and China could at some point trigger a sell-off in emerging markets. In India, it is difficult to predict the outcome of the national elections, and it is increasingly likely that the incumbent prime minister, Narendra Modi, may even lose power if he is challenged. In Brazil, we are optimistic about the economic impact of the new pro-business government and its agenda, which outlines plans to privatize most state-owned enterprises, reform the pension system, open up the country to foreign investment and reduce the corporate tax rate to about 15 percent from 34 percent. Pension reform will be key as the level of social security spending has almost doubled as a percentage of GDP in the past 20 years, even with the country's relatively young population. About 10 percent of Brazil's population is over the age of 65, compared with 38 percent of Japan's – and yet the countries spend about the same on social security.

China continues to be the key emerging market, due both to the size of its economy and the size of its equity market, which now represents 31 percent of the MSCI index, up from 18.5 percent in 2013 and less than 1 percent 20 years ago. In 2018 the Chinese stock market lost 19 percent, one of the worst-performing emerging markets, mainly because of liquidity tightening, some regulation changes in the gaming sector, and the trade tensions with the U.S. Also, for the first time since 2008, car sales fell. Overall, however, we feel that the Chinese market was oversold in 2018 and is now attractively valued.

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