Global Asset Management

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SPRING 2018

Emerging markets outlook

Room to grow for emerging markets?

In 2017, emerging-market equities had their best year since 2009, returning 37% in U.S. dollar terms. Here we look at the reasons for such a turnaround and what we should expect for 2018.

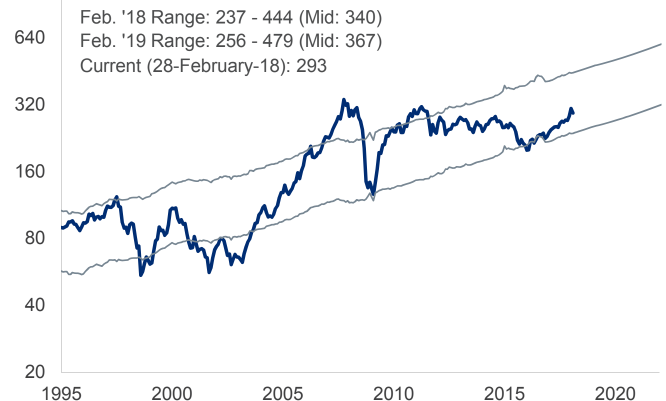
We have identified three main drivers for the better performance of emerging-market equities, and we expect all three to continue to support the market. The first is better fundamentals. Economic growth has accelerated all around the world, but the strongest acceleration is found in emerging markets, notably due to Brazil and Russia coming out of recession. This improving backdrop is very important when considering the strong relationship of the difference in economic-growth rates between emerging markets and developed markets, and the relative performance of the two broad equity markets.

Another positive aspect of the fundamental backdrop is the improved political environment that we have witnessed in emerging markets. Usually reforms come in waves and happen after periods of crisis, and we saw this pattern repeating itself after the global financial crisis of 2008-2009 and the sovereign-debt crisis of 2011.

In the past few years, we have seen several emerging-market political leaders impeached on charges of corruption, with Brazil and South Korea being the most striking examples. In South Africa, against all expectations, the reformist candidate Cyril Ramaphosa was elected leader of the ruling African National Congress and he is now the new president, creating huge optimism in the country. In Brazil, the very popular former President Lula is likely to be jailed for corruption, leaving space for much needed reforms to be implemented by a more pro-business government. Those events have been well received by investors and continue to add to the positive perception of emerging markets.

China has proved over the past few years that far-reaching reforms can transform both the economy and the outlook of a country. In China's case, years of reform targeting corruption, overcapacity and low wages have enabled a country with a bloated public sector and focus on low-value manufactured exports to transition to an economy geared towards consumption. The private sector now makes up the majority of the market capitalization of the country.

Emerging Market Datastream Index Normalized earnings & valuations



Source: Datastream, RBC GAM

Globally, the better macroeconomic environment since 2016 is now translating into better performance at the company level. Notably, we have seen an increase in returns on equity in 2017 after five years of collapse. Returns on equity stabilized in 2016 and improved in 2017, rising by 15% to approximately 11.5%. The main driver for this turnaround was higher profit margins. This improvement was the result of better top-line growth in a recovering economic environment, but also the fact that companies have worked hard to cut costs and become more efficient during difficult times. The reward should be seen in the coming years and we expect returns on equity to continue to rise.

In a similar vein to the recovery in returns on equity since 2016, we have seen an increase in earnings growth in emerging markets. Historically, such gains have been the main reason for investors to allocate money to emerging markets. However, since 2011 emerging markets have actually seen earnings declines, which explains the poor performance of our markets. Again, 2015 was the low point and earnings growth has since picked up significantly.

Also, in terms of top-down positive drivers for emerging markets, we expect capital spending to start to recover in the coming years.

The second driver for the sustained outperformance of emerging markets is their still attractive valuations in absolute and relative terms. Emerging-market equities trade at 1.8 times price-to-book-value, higher than the low of 1.3 reached in the core index in January 2016, but still in line with the long-term average.

Looking now at relative valuations, emerging-market equities still trade at a 25% discount to developed markets, and we would argue that going forward this discount will narrow. In the future, it is unlikely we will again see such a large gap, as emerging countries have changed from cyclical plays to consumption-driven economies.

Finally, emerging-market currencies are still trading at attractive levels, having hardly recovered from five years of devaluation. We expect stronger emerging-market currencies to add to emerging-market performance.

We also believe that technical indicators are and will continue to have an impact on emerging markets. Particularly strong inflows are adding to performance, which in turn is leading to a virtuous cycle of even more buying. We estimate that at least another US$100 billion will be invested into emerging-market equities in the coming months, potentially pushing markets higher.

Another technical reason for continued inflows is the fact that emerging markets still have room for improvement versus developed markets, given that the gap in favour of developed-market outperformance has not closed over the past two years. It is also interesting to note that global equity funds remain underweight emerging markets despite a rise in the weight of emerging-market equities in the MSCI All Country World Index over the past two years.

Risks to our outlook exist, and they are mainly geopolitical. In particular, U.S. relationships with many large countries have deteriorated since President Trump was elected in November 2016. Tensions with North Korea seem to have receded recently, but we do not rule out the potential for further escalation.

In terms of the macroeconomic environment, the risks to our outlook would be a significant slowdown in economic growth in the developed world, notably in the U.S., or conversely, a significant rise in inflation that causes central banks to tighten policy quickly in order to slow growth. Under those scenarios, we would probably see the U.S. dollar appreciate and emerging-market currencies weaken. Emerging-market equities would also be weak. Those are two realistic scenarios for after 2019.

The increase in U.S. 10-year bond yields is not negative for equities as some may perceive, but rather a signal that global economies are doing well. There is a strong correlation between the global purchasing managers' index and 10-year bond yields, and a positive correlation between price-to-earnings ratios and U.S. 10-year bond yields.

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

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