December 10, 2020

RBC WEALTH MANAGEMENT

Global Insight

Weekly

Emerging markets: A ripe climate

Frédérique Carrier – London

The development of safe, effective vaccines and a weak U.S. dollar solidify our constructive view of emerging market equities, and undemanding valuations further burnish their appeal. We maintain our long-standing preference for Asia (ex-Japan).

It's been a long year of turmoil and turbulence, but the development of COVID-19 vaccines allows us to end the year on a note of optimism. Much of the newsflow about the vaccine rollouts and their positive impact on the recovery has focused on the U.S. and Europe, the genesis of these innovations and among the first nations to roll out the protection against COVID-19. The UK is the first country in the West to have already started its vaccine campaign.

The vaccines will be a shot in the arm for emerging markets (EM) as well. Rollouts are widely expected in the second half of next year. Some Asian countries enjoy a well-established health care infrastructure and should have little difficulty with vaccine logistics.

For many EMs, however, distributing the vaccine is a tall order, particularly in view of the ultra-cold storage requirement of the Pfizer/BioNTech vaccine (-70 degrees Celsius). The rollout of the Ebola vaccine in 2003 provides a somewhat encouraging precedent: it was successfully distributed in parts of Africa, despite requiring a similar storage temperature. Vaccines with less complicated logistics may well become available down the road too.

One can be forgiven for thinking that as the vaccines are initially rolled out in advanced economies, EMs stand to lose out. But that is not necessarily the case.

Many EMs, including Thailand, South Korea, and Turkey, rely heavily on exports, accounting for a hefty 60 percent, 40 percent, and 33 percent of GDP, respectively. So, as the global cycle picks up, these economies should benefit. Countries like Thailand, Mexico, and Turkey, which generate 23 percent, 16 percent, and 12 percent of GDP, respectively, from tourism, could enjoy an incremental recovery on the return of freshly vaccinated tourists.

Our national research correspondent points out that EM equities tend to outperform when global Purchasing Managers' Indexes, gauges of economic activity, increase thanks to companies' high operating leverage or high fixed-cost base, and because of pronounced exposure to cyclical sectors, which account for some 50 percent of the MSCI Emerging Markets Index.

EMs as a whole have been severely affected by the pandemic, based on daily new confirmed cases. However, Asia has made progress reducing infection levels due to the early, stringent measures in several countries. Over the past two months, the surge in daily infections in developed markets has surpassed that experienced in EMs. India's infection numbers, which

Market pulse

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seemed to spiral out of control midyear, are falling, even as Europe and the U.S. grapple with a second and third wave, respectively.

Early this year, many, including us, were concerned that the COVID-19 outbreak could spark a new EM financial crisis with a wave of defaults and devaluations. These fears have proved overblown. Thanks to authorities, including the International Monetary Fund, stepping in, that situation has been avoided. Vaccine rollouts in EMs should further underpin the EM economic recovery, even though the rollouts will happen later than in developed nations.

According to the Organization for Economic Co-operation and Development, emerging market Asia will top the economic growth leaderboard in 2021, thanks to China, which is expected to grow eight percent in 2021, while India should come in just under that at some 7.9 percent. Latin America is likely to lag, with Mexico growing 3.6 percent and Brazil an even more meager 2.6 percent.

Weak greenback, strong EM currencies

The prospect of a weaker U.S. dollar is another key reason why we're constructive on EM equities.

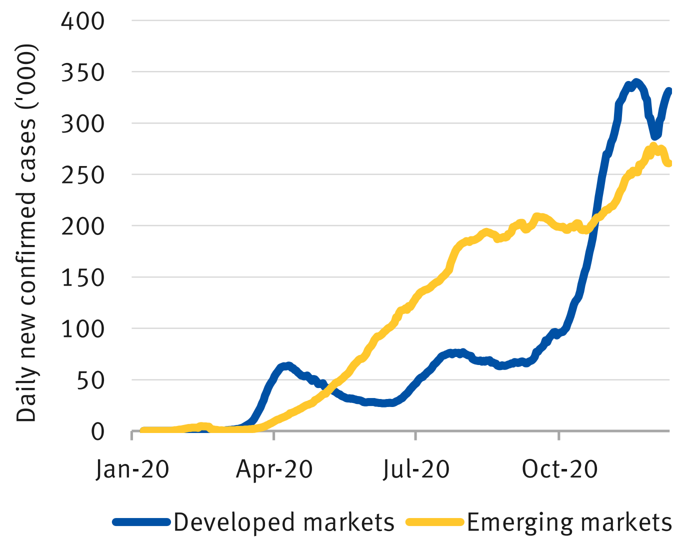
Since vaccine breakthroughs were announced in November, investors have become increasingly confident in the return of economic growth. A less fearful outlook is visible in the performance of the U.S. Dollar Index, which has weakened by four percent against a basket of major currencies in that time. Since the peak of the COVID-19 crisis in March, the Dollar Index has weakened by some 12 percent.

According to consensus forecasts, dollar weakness could persist into 2021. Ultralow interest rates could make the dollar less attractive, while more predictable trade policies under a Joe Biden presidency could further dull the greenback's luster as a "safe-haven" currency.

As investors gain confidence in the global economic outlook, they will likely seek higher-yielding assets. Q4 2020 is already shaping up to be one of the strongest quarters for inflows into EMs since 2013, with non-resident portfolio flows totaling some $76 billion in November, significantly above October's $23 billion. These capital flows are likely to continue as EM currencies are undervalued and government bond yields are higher.

According to our national research correspondent, EM currencies are nearly as undervalued as they were during the Asian financial crisis despite some countries' balance of payments surpluses being close to a 20-year high. In addition, the interest rate on EM local government debt compared to that of the U.S. is significantly higher, even adjusting for inflation. This higher spread should attract foreign investors.

Q4 surge in COVID-19 infection rates more virulent in developed markets than in emerging markets



Note: Calculated as the 7-day moving average of daily infections
Source - RBC Wealth Management, RBC Global Asset Management, European Centre for Disease Prevention and Control, Macrobond; data through 12/10/20

Moreover, Chinese government bonds will be included in the FTSE World Government Bond Index in October 2021. This reflects China's ongoing progress with market reforms and increased access for global investors. China is the world's second-largest bond market with some $16 trillion outstanding. According to our national research correspondent, foreign investors own only three percent of Chinese government bonds against a benchmark weighting that could potentially rise to approximately 15 percent.

A conducive environment

Strengthening EM currencies and undemanding equity valuations underpin a constructive case for EM equities.

Historically, there has been a distinct positive relationship between strong currencies and equities. Our national research correspondent finds that over the past 15 years most EM equities have outperformed as currencies in these countries strengthened. This occurs because a stronger national currency makes it easier for EMs to cope with heavy external debt loads, which our national research correspondent estimates at around $5.2 trillion.

EM equities also appear undervalued. Our national research correspondent calculates that on a sector-adjusted price-to-earnings basis, EM equities trade at a discount of some 20 percent to developed markets, close to a 15-year low, with most sectors trading at a discount to their developed market equivalent. Looking at price-to-book value shows a similar picture, with EM equities trading at a 30 percent discount to developed markets.

For China, we believe the current valuation looks fair, with the onshore index, the CSI 300, trading at 14.7x the consensus forward earnings estimate, in line with the five-year average.

Parting thoughts

Risks to this constructive outlook include a difficult vaccine rollout and a take-up that's too low to allow social-distancing measures to be relaxed in both developed nations and EMs. Perhaps less likely, a decision by the Federal Reserve to tighten policy sooner than expected would also upset the outlook. Countries that have ratcheted up debt to finance government spending, such as Brazil, would be particularly vulnerable, in our view.

Overall, we believe that the prospects for EM equities look attractive for 2021. They've had a good run recently, surpassing their year's high, achieved in January, and the MSCI Emerging Markets Index is up 67 percent since the March lows, in line with the gains generated by the S&P 500. Better entry points are possible, but on a one-year view, we are positive on the asset class, with a preference for Asia (ex-Japan), and China in particular. Having weathered the COVID-19 crisis more successfully, this region's finances make it less vulnerable to an eventual Fed tightening cycle.

With contributions from Juan Carlos Cure.

United States

Ben Graham, CFA – Minneapolis

- **U.S. equities have built on their 2020 gains in December despite modest declines for the week**. The small-cap Russell 2000 is the only index to advance thus far this week with its 1.6% move higher. The Nasdaq and Dow Jones Industrial Average are down similar amounts between 0.4% and 0.5%, while the S&P 500 is the worst weekly performer with a 0.8% decline. **Energy remains the only sector on track to close higher for the week** with a gain of 2.3%. All other sectors are lower, but **defensively oriented sectors such as Health Care, Consumer Staples, and Utilities are providing relative leadership**. REITs, Financials, and Communication Services are the worst-performing sectors thus far this week.
- In the Dec. 8 Daily Deck, RBC Capital Markets, LLC Chief U.S. Economist Tom Porcelli looks at small business activity and prospects for inflation in 2021. He sees surprising activity on the labor resource side of the equation—specifically, **small businesses' plans to increase employment jumped to recent highs in the latest report and are actually back to February 2020 levels**. He also points out that job openings remain elevated and that the share of small firms able to find qualified talent remains around 50%. Quality of labor is the number one challenge for small businesses, with 24% reporting difficulty in this area. As Porcelli notes, the labor market appears to be tightening, and something has to give.

Despite lagging in 2020, small caps have been rallying in Q4

Relative performance of S&P Small Cap 600 to S&P 500

Note: Indexed to 100, falling lines represent large-cap outperformance, rising lines represent small-cap outperformance
Source - RBC Wealth Management, FactSet; data through 12/9/20

That something is wages. With wages on the rise, Porcelli's team is looking for **a year-over-year inflation increase next year**, with the potential for a smooth vaccine rollout to accelerate wage and goods inflation beyond current expectations.

- A week of light economic data means **jobless claims** have received the lion's share of attention. Initial claims **hit 853,000, which was an acceleration from last week** and well above the consensus expectation of 712,000.

Canada

Carolyn Schroeder & Arete Zafiriou – Toronto

- According to RBC Economics, **the Canadian economy isn't likely to return to pre-pandemic levels before 2022**. The COVID-19 shock varied across industries and regions as border closures, disrupted supply chains, and shutdowns weighed heavily on Canadian exports during the early part of the pandemic. So far, **the manufacturing sector has been less impacted by second-wave restrictions**, and strong demand for goods rather than services has helped non-energy exports. Now, **Canadian energy and travel exports face the steepest climb ahead**. The massive shock to global oil prices in 2020 continues to drag down energy exports. While the return to a new normal could lift energy volumes and prices, the sector faces an uncertain future as renewable power prices are falling and governments globally have committed to billions of dollars in green investments aimed at decarbonizing economic activity. In addition, hard-hit industries like accommodation and food services are suffering in part from a lack of international tourism, which remains limited by travel restrictions—underscoring the fact that **Canada's services sector isn't just domestically focused**. Recovery in these export sectors will depend on not just Canadian but global success in containing the virus, in our view.
- **At its final meeting of 2020 on Dec. 9, the Bank of Canada (BoC) made no policy changes**, as was widely expected. It kept the overnight rate at 0.25% and will maintain its pace of Government of Canada bond purchases of at least CA$4 billion per week. The BoC reiterated that it will hold rates steady until economic slack is absorbed and its 2% inflation target is sustainably reached. Based on October's Monetary Policy Report, this isn't anticipated until 2023. However, **RBC Economics expects steeper growth after the first quarter of 2021** to bring this timeline forward. The BoC noted that the global rebound has been unfolding as forecasted and developments on the vaccine front are positive, but added that recent waves of infections pose a risk to the pace of the recovery.

Europe

Frédérique Carrier & Alastair Whitfield – London

- **The Financial Times described the hastily arranged in-person meeting between UK Prime Minister Boris Johnson and European Commission President Ursula von der Leyen as a "damp squib"**: significant obstacles remain and yet again a new deadline, this time Dec. 14, was set to resolve them. Businesses which export to the EU look on, aghast, aware they have to be ready for the end of the current trading relationship with the EU at the end of the month, but not knowing yet what the new requirements might be … the country awaits …
- **UK GDP for October pointed to some resiliency**. Despite social-distancing measures, the economy expanded 0.4% m/m, better than consensus estimates, boosted by Brexit stockpiling. RBC Capital Markets calculates that the economy is still 8% below its immediate pre-crisis level. The tighter restrictions imposed in November will affect readings going forward, though the risk to RBC Capital Markets' estimate of a Q4 contraction of 3.6% looks skewed to the upside, in our view.
- **The ECB** delivered on market expectations in providing its own injection to the euro area economy, **increasing the size and tenor of its Pandemic Emergency Purchase Plan** by €500 billion to €1.85 trillion for a further nine months through to March 2022. Additionally, the ECB announced another series of targeted longer-term refinancing operations (TLTROs) that are slated to run to the end of 2021. This comes in spite of recent renewed optimism on the rollout of vaccines as efforts are being made by the central bank to dampen an expected significant economic contraction in Q4.
- The ECB also announced updated economic forecasts for the region, now **projecting a contraction of 7.3% in GDP for 2020** (decline of 8% previously), with growth **expected to rebound next year to +3.9%**. The central bank expects inflation to pick up gradually, but forecasts it will continue to undershoot the near 2% target through to 2023 at just 1.4%.

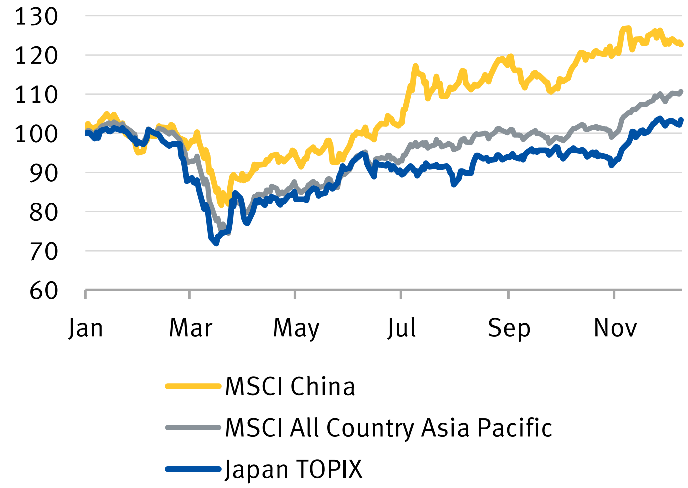
Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets traded mostly higher during the week**, except for the Chinese markets. Investors' confidence in the Chinese stock market was shaken at the beginning of the week by index provider **FTSE Russell's decision to remove eight Chinese companies from its benchmarks**. Meanwhile, there is lingering fear that other index providers may follow FTSE Russell in removing companies that are deemed by the U.S. to have ties to the

China leads the Asia Pacific region despite recent underperformance

YTD performance, indexed to 100



Source - RBC Wealth Management, FactSet; data through 12/9/20

Chinese military. We believe the actual impact on the fundamentals and cash flow of the affected listed companies should be limited, as they have limited exposure to the U.S. However, **we think there could be a greater impact on future fund flows**, particularly from the U.S., creating an overhang on the stocks.

- **China's exports jumped 21.1% y/y in November**, the largest increase since February 2018. Meanwhile, imports rose 4.5% y/y, missing consensus expectations. Together, these numbers brought China's November trade surplus to $75.4 billion, the highest on record. **The latest data suggest that the economic rebound in China remains on track**.
- **Japan's government has announced its third fiscal stimulus of 2020**, a JPY 30.6 trillion package aimed at speeding up the economic recovery. In contrast to the two previous packages, which focused on direct support for businesses and households, **the new stimulus has a stronger emphasis on investment with a focus on new digital and green technologies**. The new focus suggests there is likely sufficient direct support for businesses, and the government is ready to move towards investment for the future.
- **SoftBank Group (9984 JP) is considering a "slow-burn" buyout**, according to an unsubstantiated Bloomberg report. The company is reportedly considering a new strategy to go private by gradually buying back outstanding shares until founder Masayoshi Son has a big enough stake to enable him to squeeze out the remaining investors. According to the report, the approach would likely take more than a year and would mean the Japanese company would continue to sell assets to fund successive buybacks. However, the Bloomberg report as well as other media reports noted that some analysts are skeptical about the buyout.

MARKET SCORECARD

Data as of December 10, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,668.10	1.3%	13.5%	17.1%	39.1%
Dow Industrials (DJIA)	29,999.26	1.2%	5.1%	7.6%	22.8%
Nasdaq	12,405.81	1.7%	38.3%	44.0%	76.7%
Russell 2000	1,922.70	5.7%	15.2%	17.8%	33.2%
S&P/TSX Comp	17,593.34	2.3%	3.1%	3.8%	19.5%
FTSE All-Share	3,708.98	4.7%	-11.6%	-7.4%	1.0%
STOXX Europe 600	393.15	1.0%	-5.5%	-3.0%	16.0%
EURO STOXX 50	3,522.31	0.9%	-6.0%	-4.1%	16.7%
Hang Seng	26,410.59	0.3%	-6.3%	-0.1%	2.6%
Shanghai Comp	3,373.28	-0.5%	10.6%	15.6%	30.5%
Nikkei 225	26,756.24	1.2%	13.1%	14.3%	26.1%
India Sensex	45,959.88	4.1%	11.4%	14.2%	31.5%
Singapore Straits Times	2,824.96	0.7%	-12.3%	-10.7%	-8.1%
Brazil Ibovespa	115,128.60	5.7%	-0.4%	4.0%	34.0%
Mexican Bolsa IPC	43,518.71	4.2%	-0.1%	2.1%	5.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,835.64	3.3%	21.0%	25.4%	47.5%
Silver (spot $/oz)	24.00	6.0%	34.4%	44.0%	65.2%
Copper ($/metric ton)	7,705.50	1.8%	25.3%	26.9%	26.6%
Oil (WTI spot/bbl)	46.78	3.2%	-23.4%	-21.0%	-8.3%
Oil (Brent spot/bbl)	50.30	5.7%	-23.8%	-21.8%	-16.1%
Natural Gas ($/mmBtu)	2.57	-10.7%	17.5%	13.6%	-43.4%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.906%	6.7	-101.1	-93.5	-195.1
Canada 10-Yr	0.737%	6.6	-96.5	-86.3	-132.1
U.K. 10-Yr	0.201%	-10.4	-62.1	-59.8	-99.8
Germany 10-Yr	-0.603%	-3.2	-41.8	-30.8	-84.9
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.21%	-0.4%	6.9%	6.9%	19.2%
U.S. Invest Grade Corp	1.87%	-0.7%	8.7%	9.0%	25.6%
U.S. High Yield Corp	4.40%	1.0%	6.1%	7.6%	16.4%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	90.7840	-1.2%	-5.8%	-6.8%	-6.6%
CAD/USD	0.7850	2.1%	2.0%	3.8%	5.2%
USD/CAD	1.2739	-2.0%	-1.9%	-3.7%	-4.9%
EUR/USD	1.2141	1.8%	8.3%	9.5%	6.9%
GBP/USD	1.3298	-0.2%	0.3%	1.1%	5.9%
AUD/USD	0.7538	2.6%	7.4%	10.7%	4.8%
USD/JPY	104.2300	-0.1%	-4.0%	-4.1%	-8.0%
EUR/JPY	126.5500	1.7%	3.9%	4.9%	-1.7%
EUR/GBP	0.9130	2.0%	7.9%	8.3%	1.0%
EUR/CHF	1.0764	-0.7%	-0.9%	-1.4%	-4.3%
USD/SGD	1.3350	-0.5%	-0.8%	-1.7%	-2.8%
USD/CNY	6.5440	-0.5%	-6.0%	-7.0%	-5.3%
USD/MXN	20.0110	-0.8%	5.7%	3.9%	-1.5%
USD/BRL	5.0192	-6.3%	24.5%	32.8%	27.9%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 16:35 pm ET 12/10/20.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 2.0% return means the Canadian dollar rose 2.0% vs. the U.S. dollar year to date. USD/JPY 104.23 means 1 U.S. dollar will buy 104.23 yen. USD/JPY -4.0% return means the U.S. dollar fell 4.0% vs. the yen year to date.

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As of September 30, 2020

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Buy [Outperform]	788	52.96	248	31.47
Hold [Sector Perform]	619	41.60	135	21.81
Sell [Underperform]	81	5.44	11	13.58

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