



Emerging markets outlook

Emerging markets, emerging opportunities

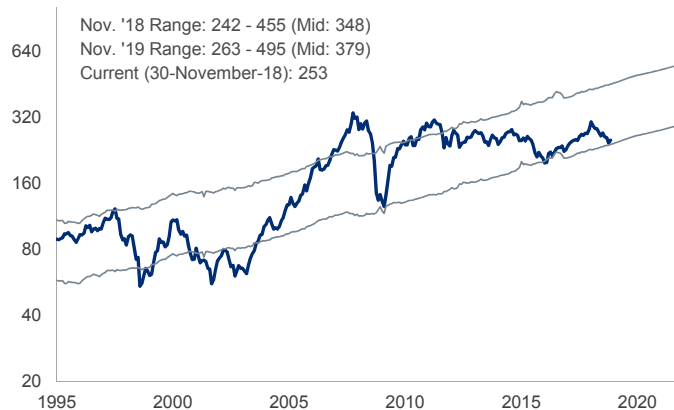
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Four interrelated headwinds have negatively impacted the recent performance of emerging markets: U.S./China trade tensions, rate hikes by the U.S. Federal Reserve, U.S. dollar strength and powerful U.S. economic data driven by tax reform. We believe that the negative impact of all four will diminish in 2019. Aside from these challenges, there are several positive factors which should support emerging-markets performance over the medium term. First, both earnings and relative emerging-market growth look set to improve from cyclically low levels due to improved productivity and structural reforms. Second, there is a powerful case that emerging-market currencies can perform well – even in the current strong-U.S. dollar environment – given cheap valuations, high real interest rates and strong current accounts. Third, the valuation case for emerging markets remains strong, particularly relative to developed markets following the significant underperformance of recent years.

Despite the disappointing performance of the MSCI Emerging Markets Index, there have been clear winners and losers. The need for active fund management in this environment, including consideration of opportunities outside the benchmark, is vital if returns to investors are to be satisfactory. In this regard, we believe that both emerging-market smaller caps and frontier markets, which have tended to do well over longer periods, but which have underperformed more recently, look attractive. Three to four years ago we felt that frontier markets appeared overvalued as numerous funds were launched to chase a relatively limited number of stocks. The situation has since improved, and valuations in many frontier markets have become much more attractive. Our research suggests that Bangladesh, Vietnam and Sri Lanka, in particular, offer many high-quality companies with good growth prospects.

Faster economic growth has historically been the key reason for investing in emerging markets and has driven long-term performance. For much of the last seven years, however, the emerging-market index has traded in a relatively tight range. We believe the key reason behind this has been a slowdown in the relative growth of emerging markets compared with developed markets, and the change in relative growth rates

Emerging Market Datastream Index
Normalized earnings & valuations



Source: Datastream, RBC GAM

has been the crucial driver of emerging-market cycles during the period. Over the long term, emerging-market performance relative to developed markets appears to be cyclical with a strong upward trend. Shorter-term economic indicators suggest, however, that aggregate emerging-market growth is slowing. Citi's Economic Surprise Index for emerging markets, which counts the number of positive economic surprises and

subtracts the number of negative economic surprises in a month, has turned negative. The six-month rolling average is now negative after having been positive since the start of 2017, suggesting a risk of further economic deceleration that is reflected in falling economic growth rates into 2019.

We believe that an important factor supporting medium-term growth in emerging markets is economic reform. Countries including Malaysia, Mexico and China are showing signs of implementing meaningful reforms, and we believe that significant political change could take place across emerging markets over the next five years.

In terms of investment style, 2017 saw strong performance from 'growth,' driven by the Information Technology sector at the expense of 'quality' and 'value.' This has reversed in 2018 with better performance from value as Information Technology has declined and the more value-orientated Energy sector has outperformed. We believe that the middle range of returns on equity currently looks particularly attractive from a valuation standpoint. In countries including China, South Africa and Indonesia, and areas such as telecommunications and the Information Technology sector, we can find relatively good-quality companies trading at the same multiples as low-quality ones.

Our top-down positioning is driven by long-term themes, with domestic consumption being the most promising since the inception of the strategy. We have been increasing exposure to domestic consumption over the past 18 months as valuations, particularly in the Consumer Staples sector, have become more attractive.

In the last three years, cyclicals have outperformed more defensive sectors. Looking to 2019, we believe that any cyclical outperformance will be less pronounced due to

the elevated valuation of cyclicals and lacklustre earnings momentum. Among cyclical sectors, we have a preference for Financials, where we believe valuations remain attractive and have therefore increased our overweight over the course of the year. In the Information Technology sector, we reduced exposure last year on excessive valuations and concerns about regulation. These concerns have begun to be reflected in share prices, although we believe it is still crucial to be very selective.

Emerging-market country divergences have been high in recent years, and countries that embrace structural reforms will likely end up as the winners. Our overall country exposures have not changed significantly in the past 12 months and our favoured markets are India and South Africa. We are particularly positive on the outlook for India as the country offers a good choice of high-quality companies and economic growth is relatively strong. Economic policy has also improved under the reformist regime of Prime Minister Modi, providing a further basis for optimism. We also maintain overweight positions in South Africa and Chile, driven by companies offering attractive valuations and earnings prospects. We have underweight positions in China, South Korea and Russia. In China, the rapid build-up of debt since the financial crisis represents a significant risk, even though there are some positive developments such as government moves to reduce the cost of wages in the private sector. In Russia and South Korea, the appeal of cheap valuations is not sufficient to overcome poor corporate governance, and we believe that we can find better investment opportunities elsewhere.

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/gio>.

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