RBC Global Asset Management

RBC Emerging Markets Equity Outlook 2020

Themes, Sectors, Countries & Style

Summary

A significant overhang for the performance of emerging markets (EM) equities in recent years has been U.S. dollar strength. There are several reasons to believe this may be about to reverse: the U.S. Federal Reserve's (the Fed) move from quantitative tightening to aggressive balance sheet expansion, a diminution of international risks, and a rally that looks very extended, both in terms of duration and degree. There is also a powerful case that EM currencies can perform well, driven by extremely cheap valuation, high real rates and strong current accounts. Outside of currency, there are two key positive factors which should support EM performance over the medium term. First, both earnings and relative EM growth look set to improve from cyclically low levels as a result of improved productivity, structural reforms and from an increase in growth-friendly fiscal policies. Second, the valuation case for EM remains strong, particularly relative to developed markets (DM), following the significant underperformance of recent years.

Despite the relatively disappointing performance from EM indices recently, there have been clear winners and losers. As such, the need for active fund management in this environment, including emphasising Environmental Social and Governance (ESG) factors and considering opportunities outside of the benchmark, is vital if returns to investors are to be satisfactory.

In terms of style, we believe that currently the middle segment of returns on equity (ROE) looks particularly attractive from a valuation standpoint. There is a strong case for caution on both the most expensive parts of the market, which have become crowded, and for deep value areas where returns struggle to meet the cost of capital. We also believe that both higher dividend-yielding stocks and EM smaller caps, which have historically performed well over longer periods but have underperformed more recently, look attractive.

Our top-down positioning is driven by long-term themes. We currently have five main themes in the portfolio: Domestic Consumption, Financialisation, Health and Wellness, Infrastructure and Digitalisation. Over the last year we have revisited and expanded our work on infrastructure and financialisation. In terms of sector positioning we favour consumer sectors driven by high returns and supportive tailwinds such as rising incomes, positive reform momentum, attractive demographics, rising urbanisation and positive employment trends. Within cyclicals we have a preference for financials on the grounds of valuation, improving asset quality, low penetration and structural growth.

Country divergences in EM have been high in recent years and those countries that embrace structural reforms will end up as the winners. We are particularly positive on the outlook for India. In addition to an improving top-down outlook, India offers a good choice of high quality franchises. Otherwise, in terms of reforms, Brazil has seen positive momentum in 2019 in contrast to Mexico and South Africa where progress has been disappointing. At the time of writing we are underweight in China, South Korea and Russia. In China, the rapid build-up of debt since the financial crisis of 2008 represents a significant risk, but at the same time there are positive developments in terms of market liberalisation and financial reforms. We also believe that ultimately the trade war between the U.S. and China will provide China with a strong impetus to achieve its longer-term goals of technological leadership and self-sufficiency. In South Korea and Russia, while these markets and their currencies are cheap, we do not like the poor corporate governance and can find better quality opportunities elsewhere.

For the full RBC Emerging Markets Equity Outlook 2020, please contact your local representative or reach us at:
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