RBC Global Asset Management

Emerging markets outlook

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Last year was a historic period for emerging-market fixed income: interest rates set by central banks were for the first time on a par with those in developed markets. The convergence resulted largely from decisions by emerging-market central bankers to eschew less aggressive fiscal and monetary expansion during the pandemic, which held inflation low relative to developed markets.

This convergence in interest rates – which meant that emerging-market rates were falling – might suggest that emerging-market equities would have outperformed given an improving economic-growth outlook. That was not the case, as emerging-market stocks at the benchmark level were held back in 2023 by the disproportionately large impact of China. Outside China, emerging-market equities performed well, with Brazil, Taiwan, South Korea, Mexico and India all returning more than 20%. For the first time in two decades, emerging-market benchmark stock and bond indexes did not move in lockstep.

The question is whether equities in emerging markets will catch up to bonds this year. Our view is that emerging-market central banks have room to continue easing this year, and that most emerging-market central bankers outside China will lean toward lowering rates, which will tend to support equities.

The intensifying threat of deflation in China, weak GDP growth and subdued lending have hurt the country's property sales, even with modest economy-bolstering measures. A key question we ask ourselves is: what might trigger a more aggressive response to the incremental easing that we have seen to date? We believe that it will become increasingly clear to China's leadership within the next two months that a more aggressive response is required.

Other risks in China are both demographic and debt-related. The aggregate emerging-market population declined last year for the first time in 60 years, and the working-age population has been coming down since peaking in 2012. On the debt side, non-performing loans have soared into the trillions of renminbi as state-controlled companies and consumer borrowers fall behind on their debt.

Meanwhile, many western investors are opting to leave China, as foreign direct investment is falling for the first time since 1998 amid overcapacity in most sectors and a Sino-U.S. trade war. At the same time, an increasing number of Chinese companies are setting up overseas, with Chinese outward direct investment increasing 35% year over year to a seven-year high of US$53.4 billion in the third quarter of 2023[1]. Investments have been mainly flowing from Chinese businesses into the 10 countries that make up the Association of Southeast Asian Nations, as well to India and Bangladesh.

[1] Source: China Ministry of Commerce, December 2023.

Against this backdrop, China's trade surplus has surged, driven primarily by China's growing exports to other emerging markets. The country's annualized trade surplus rose as high as US$910 billion in April 2023 from US$361 billion in March 2020[2]. Simultaneously, the renminbi has emerged as the fourth most-active currency for global payments after the U.S. dollar, the euro and the British pound, accounting for 4.6% of all foreign transactions in November of last year.

China is making inroads in its effort to bring more countries within its sphere of economic influence. Saudi Arabia, the world's largest oil exporter, and the United Arab Emirates, where Dubai is located, have joined the emerging-market bloc that includes China, India, Russia, Brazil and South Africa (BRICS), and the bloc has expressed its desire to create a system to settle payments between member countries.

Even so, the deterioration in China's economy has affected its importance in the benchmark emerging-market equity index and raises questions about China's ability to maintain its dominant position. China's weight in the MSCI Emerging Markets Index has dropped to 26% today from 44% in October 2020. At the same time, India's weight is now 18%, up from 9%; Latin America accounts for 9%; and Saudi Arabia, Qatar, the United Arab Emirates and Kuwait collectively contribute 7%.

India is set to become the world's third-largest economy by 2026 and the third-largest stock market by 2030. The government of Indian Prime Minister Narendra Modi has laid out a road map for expanding the economy to US$5 trillion by 2026[3], which would enable India to overtake Japan and Germany and leave it behind only the U.S. and China. India's capital markets are expanding as well, driven by a spate of IPOs and a steady stream of private companies that will at some point be ready for the public equity markets.

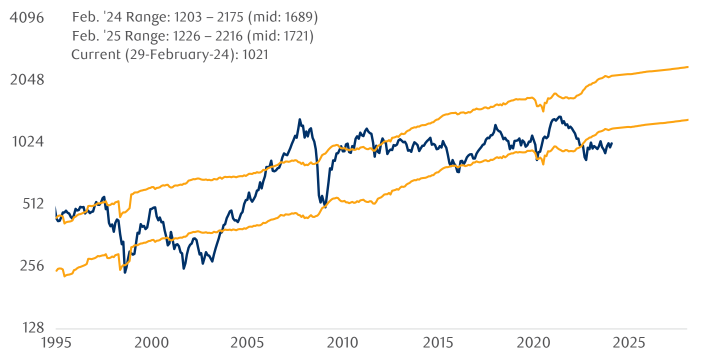
One significant development in India over past decade has been an explosion in the number of people with sufficient financial resources to open bank accounts and invest. Assets under management in mutual funds have risen fivefold since 2018 – more than double the growth in bank deposits - and the number of individuals holding mutual funds has risen to 140 million. Systematic investment plans have driven much of the growth in household savings, especially for affluent savers.

The importance of countries beyond China to both the world economy and the emerging-market equity benchmark is becoming clearer. Recent gains from oil producers in the Middle East and exporters in Southeast Asia will be bolstered by Vietnam and other Latin countries. Saudi Arabia, for example, is poised to double its weight in the emerging-market benchmark to 9% by 2027, as foreign ownership limits are removed and the number of IPOs increases.

We feel, therefore, that there are enough supportive factors for emerging-market stocks to maintain performance as China's influence on the index recedes.

MSCI Emerging Markets Index Equilibrium

Normalized earnings and valuations



Source: RBC GAM

[2] Source: China Ministry of Commerce, December 2023.
[3] Source: Government of India – Ministry of Finance (note roadmap put into effect in 2014).

Disclosure

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