RBC Global Asset Management

The changing face of emerging markets

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> **"Demographics, growth potential, valuation, and diversification make EM an attractive proposition."**

As always, the only constant in emerging markets is change. Anthony Kettle talks to us about investment opportunities in Asia, demographic trends, and how these economies are navigating the ESG journey.

Many emerging markets ("EM") are undergoing dynamic economic growth. In addition, EM equities are cheap right now. What are some of the key reasons for their appeal?

Demographics, growth potential, valuation, and diversification make EM an attractive proposition. In terms of demographics, these markets generally have younger populations in comparison to developed markets ("DM"), particularly in Africa though less so in Asia, but the theme holds true overall.

On balance, the growth potential in EM is also higher when compared to DM, despite Chinese growth normalising over the last few years.

From a valuation perspective, EM countries trade cheaply versus their peers in DM, in both fixed income and equities.

And finally, with EM consisting of a huge number of countries and accounting for approximately half of global GDP, there are obvious diversification benefits.

In our view, now is a particularly good time to invest in EM. The reasons for this are threefold: attempts to curb inflation in EM are a lot more entrenched than in DM, because of EM central banks taking more of a proactive stance to hike rates in comparison to peers in DM. At the same time, default rates in EM credit markets are falling, coupled with better valuations in EM versus DM credit on both a ratings and fundamentals-adjusted basis.

Delving a bit deeper into demographics, how are shifts in this trend impacting EM?

Demographics, urbanisation, and economic development are all key themes driving change in EM. These trends favour the asset class and make for a positive investment case. However, navigating the transition is also complicated, for example, tackling the transition to cleaner energy while dealing with resource scarcity at the same time as populations are growing and economic development is advancing.

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In the fixed income space, there are opportunities to work with countries and companies on innovative solutions to help fund some of these transition opportunities, while engagement on the ESG side can also help mitigate some of the challenges associated with these trends.

Moving on to countries and regions, which markets do you believe offer opportunities for fixed income investors? Is Asia a region that you're interested in?

Asian assets represent a relatively low beta part of the asset class. This is because most Asian countries have relatively well developed local markets but also relatively low yields in a global EM context, while in credit there is more of an investment grade bias to the issuers.

At present, we feel that the best opportunities lie outside of Asia, with Latin America, the CEE region and parts of Africa standing out as offering the most compelling risk/reward.

In terms of the best bottom-up opportunities in economies that are often under-represented, often these will come from the less researched parts of the market, which naturally means there is a greater level of market inefficiency. Some of the best opportunities over the last year have come from the lower rated segments of the EM credit markets, particularly those rated B and below.

China has been in the headlines over the last few years and its uncertain outlook continues. Where do you sit on the optimism-pessimism scale?

While growth is picking up, we currently do not expect this to bail out the property sector, nor do we expect a large-scale stimulus or support package towards the sector. Instead, our view is that it will be a multi-year process to clear the excess inventory and allow for consolidation within the industry. On a higher level, the government has clearly shown it is prepared to take a high degree of economic pain to achieve its broader objectives.

ESG also remains a hot topic in the investment industry. How are EM countries navigating the ESG journey?

While the complexity of the industry means that ESG standards are still evolving, there have been some high profile examples over the last few years of countries with negative ESG profiles defaulting or inflicting large losses on investors, which means investors are increasingly integrating ESG into the core of their decision-making process. This trend is very likely to continue. We also see the opportunity to have a positive impact on EM by engaging with issuers and encouraging better ESG standards where possible.

Do you expect a steady upward trajectory in EM over the long term?

In the long term, we expect to see a steady upward trends in EM. However, the path to getting there is likely to be a bumpy one, given some of the challenges described above.

What would you say are the potential risks around EM investing?

From a risk perspective, EM countries have different regulatory regimes, which at times may prove tricky to navigate. That said, this can be mitigated through a skilled and experienced team with a deep fundamental research capability.

For frontier markets there may also be liquidity challenges, but this is less relevant to traditional EM, and in EM credit the standard structure of eurobonds mitigates this particular risk. Currency risk and higher levels of volatility are also factors that need to be considered.

However, it is worth noting that these risks can also carry with them potential rewards. For currency risk, the key is the ability to manage that risk and there are numerous instruments available to help achieve this. While EM are perceived to be a higher beta asset class (though volatility is not always assured), with greater volatility comes greater dislocation and greater opportunity for outsized returns.

And finally, in terms of EM equities and bonds, which asset class looks more attractive at the present?

As bond investors, we see yields as attractive in a historical context, although we would note that certain regions stand out as being more attractive than others. As mentioned, we feel that Latin America, the CEE region and parts of Africa stand out as having the most compelling risk/reward.

Having said that, it is worth bearing in mind that there is a large difference in the universe composition on the EM equity and fixed income sides, and therefore they can be seen as complementary investments rather than being mutually exclusive.

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