

Emerging Markets after the pandemic

The RBC Emerging Markets Equity team

The final economic impact from the coronavirus outbreak and the timing of an end to the pandemic is difficult to predict, but we are confident that a cure will be found, almost certainly within the next one to two years.

Previous market shocks have taught us that:

- Markets will bottom well before the crisis has been contained, that timing the low point in markets is impossible, and that panic selling eventually leads to panic buying; and
- Markets tend to over-react to short-term news flow and under-react to longer-term implications.

With this in mind, in order to make sure that we are well positioned in areas of sustainable growth, we believe it makes sense to examine the areas that may experience long-lasting effects, and how life after the pandemic might impact our long-term themes. We have therefore asked ourselves 3 questions:

1. As a result of the crisis will the world be different in the future? Will people's behaviour change?

Most things should go back to normal once the pandemic is over, but there are likely to be some areas where the pandemic will leave a lasting mark. Some of the more obvious examples are:

The rising dependence on technology in all aspects of our lives

This pandemic is likely to accelerate the pace of technological adoption across a broader range of applications:

- **Remote Working:** The outbreak of the coronavirus is causing many organizations to re-examine their remote work policies as the benefits in terms of increased productivity and convenience are becoming apparent. It is likely that after the current pandemic this trend will accelerate further. Virtual meeting platforms have successfully replaced business travel and this, along with increasing awareness of the impacts of travel on climate, could impact long-term business travel.
- **Offline to online migration:** The virus has caused some online migration in areas such as e-commerce, online entertainment and digital banking and this is likely to become permanent as consumers realise the ease and added convenience, as well as financial perks, of online solutions.

De-globalization

The virus has also highlighted the lack of local economic and social control that has resulted from globalization and we can therefore expect some reversal in this trend driven by three factors:

- **Re-localization:** The reliance on long supply chains has exposed vulnerabilities. Local production is likely to increase, and this will impact the manufacturing sector and support automation as a substitute for local manufacturing which may be costly. This will highlight the attractiveness of truly differentiated and innovative technological leaders.
- **Localized Tech/Digital Infrastructure:** The fight against the virus has highlighted technology's critical role. It has also renewed China's determination to reach independence in the digital era and, as a key part of the government's policies to stimulate growth, China has recently announced that it will speed up the construction of a "new (digital) infrastructure", namely 5G base stations, data centres, artificial intelligence (AI), industrial internet, ultra-high voltage grids, intercity high-speed railways, metro, and new energy vehicle (NEV) charging stations.
- **Future of food:** Food supply chains have begun to face headwinds due to high transport costs and the associated carbon footprint, lengthy production timelines and insufficient arable land. With 80% of countries reliant on imports to feed their populations, the coronavirus pandemic is likely to accelerate a global-to-local trend that we believe is inevitable.

Country differentiation

Unprecedented levels of government intervention in our economies may be more permanent than we think. We have seen several governments, particularly in developed markets, intervene in their economies to an extent not seen in peace time. It seems unlikely that governments will simply be able to stop these measures when we emerge from this crisis and the decision to do this will become highly politicised. There will also be pressure on some governments to address issues of inequality and social unrest, and particularly for increased government spending on social/public services. We could therefore be in for an extended period of government interference in some markets which could be costly to businesses who will be expected to contribute their share. Pressure on the corporate sector to pay more tax, or the introduction of new regulations, could well be a headwind in many markets. Corporations that think beyond the bottom line and prioritise non-financial factors will be in a relatively stronger position.

2. How will our themes be impacted? Are there any new themes we should consider and are any themes redundant?

We expect the pandemic to accelerate existing trends rather than create new ones, and that the long-term changes that we anticipate will principally occur within existing themes. Acceleration will occur particularly in digitalization, and health and wellness, while some aspects of financialization may see headwinds.

Domestic Consumption¹

Our consumer theme is driven by long-term domestic demand and wage growth in emerging markets leading to a boom in the emerging markets middle class. We do not believe that this theme will be significantly impacted, but the way we play the theme may change (see below).

Financialization²

Within this theme, we have increasingly recognized the threat posed by fintechs on incumbent banks and insurance companies, and concluded that, in this area, selectivity is key together with a focus on cutting edge digital platforms. Pressure on banks with inferior legacy systems, fat fee income, and large branch networks is likely to accelerate although there are also clear signs that fintechs with weaker balance sheets are coming under pressure. A further headwind could come from permanently low interest rates. On the other hand, life and health insurance providers could benefit from heightened awareness.

Digitalization

Digitalization, which encompasses all aspects of technology, has been an increasingly growing theme for several years. Despite the strong growth already seen in this sector we would expect the pandemic to support even stronger growth in future and for new avenues of growth to emerge. Offline to online migration, reshoring and increased working from home will all, to some extent, boost technology growth. China also looks set to increase efforts to develop the country's IT sector and digital infrastructure. Other countries are likely to follow suit.

Health and Wellness

COVID-19 is likely to bring a renewed sense of importance to being healthy (sport, fitness and nutritional food) and also to highlight the value of the pharmaceutical industry (diagnostics, treatments). Health systems could benefit as every country will need to ensure that it has sufficient beds, equipment and supplies ahead of the next crisis. Healthcare in general has been under pricing pressure for several years due to constrained government budgets, regulation and a lack of innovation, and these pressures are likely to be relieved.

Infrastructure

Infrastructure growth is driven predominantly by urbanization and population growth as well as government support. While increased working from home may reduce urbanization in some countries, this is likely to be more in developed markets with high urban populations. Efforts to grow certain aspects of infrastructure, such as smart cities and social infrastructure, are likely to see further

support, as the pandemic has emphasized the importance of having good social infrastructure in general - not just healthcare, but also areas such as hygiene, sanitation, education and housing.

3. Should there be any changes to the way we play the themes?

Domestic Consumption

We would expect to see some changes in consumer behaviour. The pandemic is likely to accelerate the migration from offline to online in a number of areas including e-commerce, online education, online entertainment and social media. Indeed we believe that a key way of playing our consumption theme in the future will be driven by a permanent increase in people deciding to stay at home. People are realizing that staying at home is actually an attractive option as everything can be delivered to their homes including exercise, food, studying, and social interactions. In a new era where anxiety, stress levels are high and there is a heightened awareness of potential risks, staying at home will increase. A further aspect to consider is that of global brands, as globalization looks set to take a backward step and local brands may benefit.

Financialization

Banking and insurance penetration will continue to grow, but the need for extreme caution in terms of stock selection in these areas will be increasingly important as threats from new competition, macro-economic policy and regulation rise. Within this theme we will increase our emphasis on areas such as stock exchanges which are more immune to such risks.

Digitalization

Many of the significant changes we see occurring in the post pandemic world will boost digitalization:

Localization: will support automation and highlight the benefits of truly differentiated and innovative business models.

- Working from home: will require good digital infrastructure boosting relevant hardware and software sectors.
- Acceleration in China's digital infrastructure build: will support leading edge tech companies geared to China.
- Offline to online migration: will boost internet stocks.

We are already exposed to many of these areas but have decided to add one new way to play the theme, and that is 'connectivity'. Connectivity encompasses many of the changes we envisage and have commented on above. One consequence of greater connectivity will be a requirement for more surveillance and cyber security.

Health and Wellness

This theme should see broad growth, but new areas to consider would be online medical services and sportswear, healthcare and gym equipment companies.

Infrastructure

Two of the key ways we play this theme - smart cities and social infrastructure - should, on balance, get a boost from any changes.

¹Domestic consumption: Domestic Consumption has been an important theme in Emerging Markets for the past decade. Although it has already come a long way, this theme still has significant growth potential. The combination of factors including rising incomes, increasing urbanisation, an under-levered consumer, increased digital services and improving education are all factors supporting the case for EM consumption over the next decade.

²Financialisation: We define financialisation as the increasing size and importance of the financial sector within an economy. We believe continuing demand for credit and financial services supported by factors such as rising disposable income, an expanding middle class and increasing access to financial products, should continue to support financialisation in Emerging Markets.

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RBC Global Asset Management (UK) Limited

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