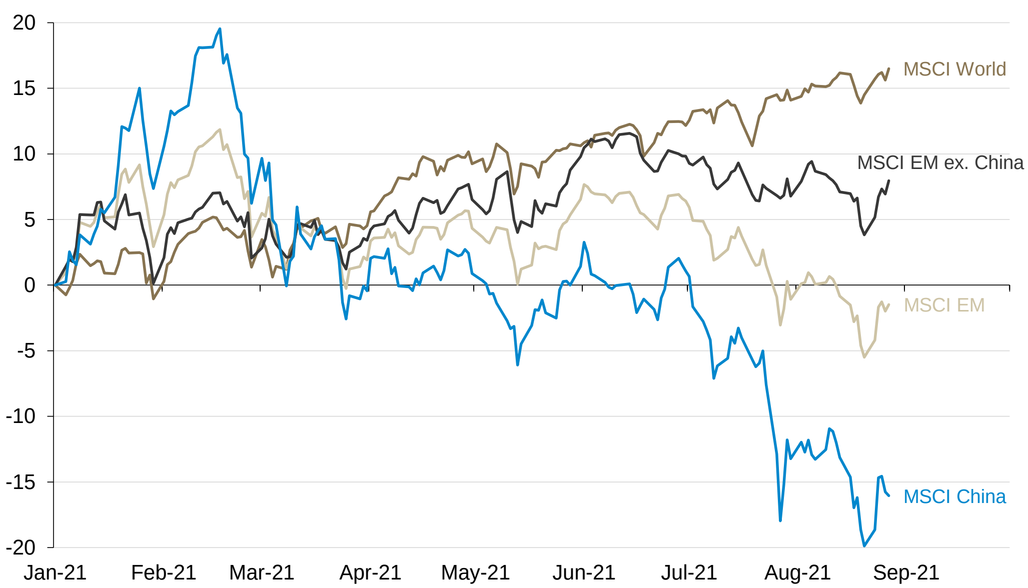
China in a Bull Shop

Emerging Markets (EM) typically benefit disproportionately from improved global growth given their role as a major supplier of inputs to production and finished goods (especially consumer goods). Yet the surprising and persistent underlying firmness in economic data seen so far this year has not generated the normal results. Upgrades to the outlook for Developed Markets (DM) have significantly outpaced those in EM, which has resulted in a sharp narrowing of the anticipated growth premium (not only for the current year but in 2022 as well).

While fundamental economic factors such as a comparative lack of progress on the pandemic and rising price pressures have undoubtedly weighed on the relative performance of EM investment assets in recent months, the magnitude of the underperformance predominantly reflects political risks emanating from China, which have intensified significantly of late. The MSCI Emerging Markets Index is down 1.5% year-to-date versus +16.5% for the DM benchmark in US dollar terms – stripping out China, the EM index is +8.0% on the year.

Year-to-date equity market performance
(percent, US dollar basis)



Data to August 27, 2021
Source: Bloomberg, Guardian Capital

Tensions between the US and China remain elevated and the trade actions imposed by the previous American President largely remain in place. Recent efforts at thawing diplomatic relations between the world's two largest economies have proven unsuccessful and recent sparring does not give hope that a more conciliatory tone to proceedings is imminent.

That said, as important as these geopolitical developments are for EM — and the last four years have shown investor risk appetite tends to ebb when tensions on this front rise, leaving EM economies and assets vulnerable to the crossfire — it is the recent shift in domestic-focused policies in China that have had the greatest impact on the embedded risk premium across EM as a whole.

The Chinese government has taken swift action recently to combat what it views as sources of systematic inequality that pose a threat to social stability — anti-competitiveness and areas like education and housing — as well as address concerns over financial risk and data security, while also ensuring that businesses and their leaders always uphold the Party line.

These measures have been consistent with the long-standing goals of the Chinese Communist Party, but that does not change the fact that they have had a material impact on the valuations of Chinese-domiciled companies and have significantly raised the regulatory uncertainties associated with investing in the Middle Kingdom.

Party officials have tried to quell market concerns over broadening government overreach while emphasizing the country's strong economic fundamentals and ample capacity for monetary and fiscal policy to support domestic growth. However, investors understandably remain incredulous, and trying to forecast and time further efforts for market intervention is inherently difficult.

The elevated risk premiums currently, provide opportunities for taking a more selective approach to managing exposures to China and EM more broadly.

The crackdowns have been focused on industries that are perceived to threaten long-term sustainability and social fairness in China — further moves in areas such as healthcare and real estate seem likely, and markets appear to have already priced in a tighter regulatory backdrop.

At the same time, the overarching positive macroeconomic drivers within the Chinese economy remain in place and Beijing appears likely to increase its promotion and support of industries and companies that are advancing the interests of China (and thereby the Party) — those that are innovating and driving the rotation of the economy toward higher value-added production and technologies, and supporting a stronger consumer class.

The increased policy risk may be a deterrent to some investors and businesses, but it also creates opportunities for other EM economies that can fill the void — the tech-biased and export-oriented markets of South Korea and Taiwan would appear to be well positioned.

Moreover, continued above-pre-crisis-trend growth (underpinned by a broader reopening in DM) should support the more cyclically sensitive areas of the market to which EM are traditionally skewed. This would continue to be a particular benefit for Emerging Europe, Middle East and Africa (EMEA) and Latin American economies for which momentum has improved in recent months.

As the recovery matures into next year and DM policy supports begin to be withdrawn, structural factors will again dominate cyclical forces and global growth dynamics will revert to something with more of a resemblance to pre-pandemic tracks. Market focus, therefore, will return to those areas that can generate sustained above-average growth in a world where growth will be far more scarce than it is currently — such an environment would be positive for EM assets given the expectation that less-developed economies will re-establish their growth premium over DM.

Patience is warranted for now, given that clouds are obscuring the vision of forward-looking financial markets and confidence intervals around EM growth forecasts remain persistently wide, especially relative to DM.