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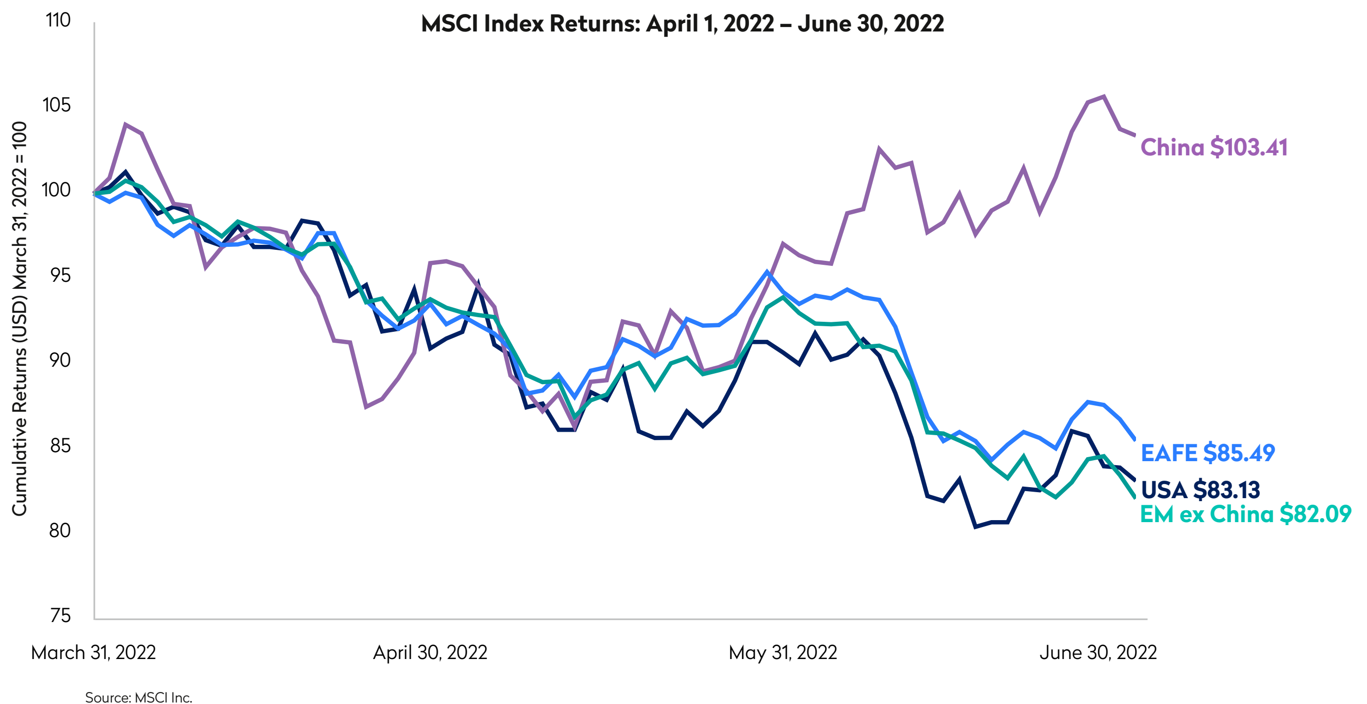
Quarter 2, 2022

Emerging Markets Investment Outlook

Over the last few months, we have written extensively, and discussed at length with clients and consultants why we thought China was arguably the most attractively valued emerging market, if not global market. After a sustained period of underperformance over the year leading up to Q2, China delivered what we hoped for. In a quarter where stock markets globally fell under the pressure of escalating inflation and higher interest rates, MSCI China gained 3.4%. In fact, China was the only stock market within MSCI developed and emerging indices to appreciate in Q2 in USD. MSCI EM ex-China fell 17.9%, MSCI USA lost 16.9% and MSCI EAFE 14.5%.



Source: MSCI Inc.

Why this sudden change of fortune for China?

Firstly, we must acknowledge that in the 12 months to end Q1 2022, China had underperformed MSCI EM ex-China by 34%, one of the largest levels of rolling twelve-month underperformance on record. China itself was down 32.5% in the period. This of course meant that there was a lot of bad news and unusually low sentiment already in stock prices. Not only therefore was the absolute level of valuation in China low, in our opinion, but the relative attractiveness against other emerging markets and global markets was even more appealing. For China to start to perform better though, it needed some triggers to make investors rethink their China positions.

Beyond the chance of mean reversion given the level of undervaluation, we felt there were several catalysts that could reverse China's underperformance.

1) China's market problems began with tech regulations linked to President Xi's 'common prosperity' goals. More recently we have begun to hear a more conciliatory tone apropos the China leadership's regard for the major tech companies, acknowledging how important they are for the nation's growth and prosperity. We get the sense that the tough regulatory stance will now soften as the major protagonists are now clear on how they need to behave and operate and have already adjusted business models to accommodate this. The recent lack of negative news flow has proved a catalyst in and of itself.

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2) Sentiment has been at a low across the technology sector and therefore there was very little expectation coming into results season. When Alibaba and Baidu, for example, issued quarterly results at the end of May, investors were cheered to see they weren't as bad as feared. They both also exhibited a willingness and intent to control costs in a more challenging environment. When expectation is so low, sometimes 'not that bad' is good and can hence be a catalyst. Both stocks rallied over 10% that day and continued to outperform over the remainder of the quarter.

3) While the rest of the world has been coming out of lockdowns and witnessing a relative return to normal life, China has continued to struggle with the Omicron variant this year. Their zero Covid policy stance has created great pressures on society and critically the economy with targeted lockdowns in Shanghai and Beijing. This was of course weighing heavily on the market, but equally of course, we knew it couldn't last forever. Signs of lockdowns being eased this quarter have provided a catalyst for more positive sentiment.

4) China is committed to meeting it's 5.5% GDP growth target for 2022, although it will be a severe test. Given the obstacles the economy has faced this year we felt it likely that policy stimulus would ensue. We have seen a plethora of announcements in Q2 to help boost growth. Key areas being interest rate and RRR cuts; funding and support for infrastructure projects; and various consumption support measures eg, auto purchase tax cuts and a relaxation in certain property regulations. All have been another catalyst for more positive sentiment.

5) If the above showcases itself, and investors start to share our view on China's relative and absolute attractiveness, then a key catalyst can be the beginning of a reversal of investors underweight allocations to the country. It would seem that must have begun given the markets performance in Q2, and our understanding is that the majority of EM funds remain underweight, some quite substantially so.

Elsewhere in EM, there was weakness across the board as the supply driven inflation shock weighed heavily on stocks as investors reassessed global growth prospects and the likelihood of a recession in the US and beyond. Outside of China there was no hiding place. Latin America fell 22%, EMEA 17% and the other large Asian markets of Taiwan and Korea both fell c.20%.

We share investors concerns for global growth, but this leads us to three main takeaways as we look towards the rest of the year.

a) As long-term investors we value investments not on the next 1-2 years outlook but on longer term sustainable earnings, cash flow and dividends. On that basis, valuations across emerging markets look particularly compelling after this year's drawdown, especially in Asia and Latin America.

b) We continue to believe that China should outperform given all the above (and other features we have written about historically) alongside cheap valuations and hence maintain a significant overweight to the market.

c) China is 35% of MSCI EM. If we are right on China, then EM can continue to outperform developed markets given China's sizable contribution to returns.

We maintain our strict valuation discipline, focusing on companies with attractive long-term fundamentals, strong balance sheets and value accretive capital allocation.

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