Patience with China and the unlikely leaders of the next economic cycle

Global Emerging Markets
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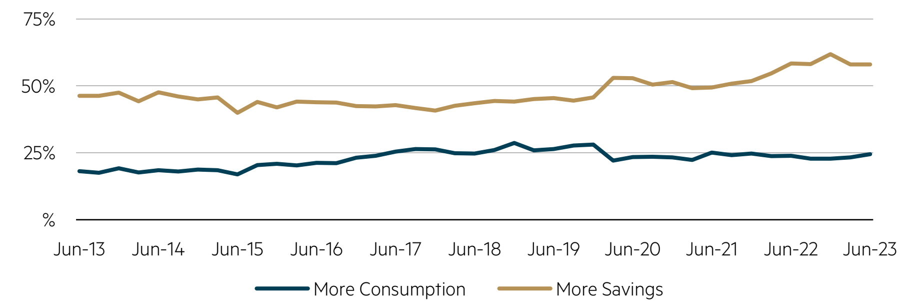
China, with a weighting of over 30% of the MSCI Emerging Markets Index, fell more than 9% over the quarter, creating a significant hurdle for the entire emerging index to rise. China's fall also masked a number of positives happening across other emerging markets, most notably Brazil, which rose over 20% and India which rose almost 13%.[1]

In our view, it is fair to say the reopening of China has disappointed. Years of lockdowns combined witha weak property market seem to have sapped consumer confidence. This is evidenced by weak loan growth numbers and an increasing trend for Chinese consumers to repay debt early, rather than spend their savings into the reopening. This is a continuation of the trend showing consumers continue to prefer to save rather than consume.

People's Bank of China survey – consumers preferring to save over consume



Source: PBOC, Bloomberg, Maple-Brown Abbott, 6 July 2023

In recent months members of our team made two trips to China. We found it will be some time before the self-employed recover their confidence. This requires an increasing overall spend on services, such as restaurants, which then employ more staff, which creates more income to spend on consumption – and so on. In the meantime, lead indicators for China's manufacturing and exports, such as the PMI Manufacturing Index, have been running below 50 (indicating contraction) since the start of the second quarter. That said, the S&P Global PMI for Emerging Markets sits at 51.1, remaining in expansionary territory, while developed markets are currently at 46.3.

Doubt is not a pleasant position, but certainty is absurd – Voltaire

There is indeed doubt that exists over the Chinese economic recovery. In our opinion, therein lies the current opportunity for its equity market over the medium term. China is currently priced for a lot to go wrong, and not much to go right. The upcoming first half 2023 reporting season will be key – expectations are already low, but we will be monitoring for management teams to give any positive outlook in their commentary, or perhaps increase cash returns to shareholders. Contrast that negativity with India today, where the positive fundamentals of growth and reform are well known and – by our reckoning – rather at risk of not living up to lofty expectations. We continue to be patient holders of select Chinese equities as we wait for the reopening to progress.

1 Bloomberg, country returns within MSCI Emerging Markets Index, June 2023

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Are emerging markets on a different cycle to developed markets?

Having worked through the 'China can decouple' investment thesis of 2008, we are sceptical of the concept that emerging markets can actually de-couple from developed markets and tread an idiosyncratic path. That said, there are objective differences in the economic cycles across emerging markets and developed markets today that give us reasons to consider that perhaps emerging markets will be the leaders of the next economic cycle.

Brazil was the first country to raise interest rates in this cycle. Perhaps with emerging market central bankers being more recently conditioned to dealing with high rates of inflation, emerging markets have in general been ahead of developed markets in raising interest rates. Additionally, when it comes to fiscal spend, the Congressional Budget Office in the US forecasts a fiscal deficit in 2023 of over 5.0% of GDP,[2] surely adding fuel to the inflationary fire. In comparison, Brazil is targeting an equivalent deficit of 1.0%. Raising rates and controlling spending has led to a number of emerging markets bringing0áinflation back within their target ranges. Some countries including China and Vietnam are already moving to cut their central bank lending rates in order to stimulate growth. Correspondingly, Brazil is currently running at close to 10% real interest rates. While this has been negative for the Brazilian equity market and valuations, we believe this creates longer-term opportunities in Brazil and it is one area where we have recently been doing additional research to develop potential new portfolio inclusions.

Emerging market central banks moving early on rate rises

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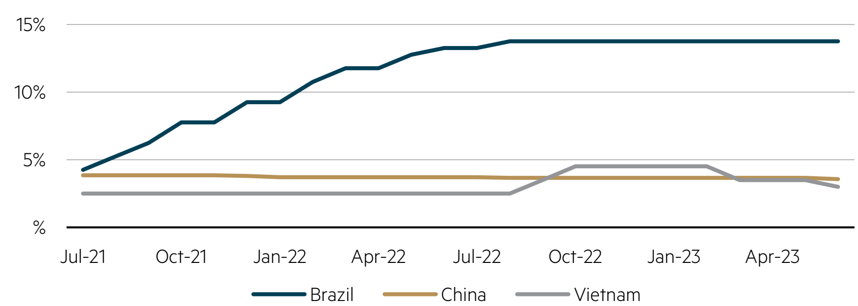

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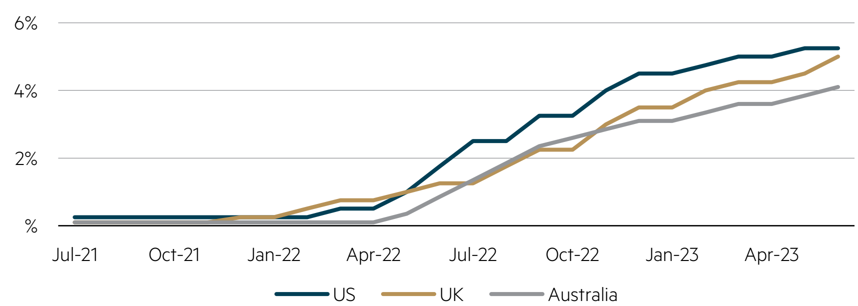

Source: FactSet, Maple-Brown Abbott, 5 July 2023

Parting thought

Emerging economies have generally been ahead of the curve in fighting inflation, without the need for additional fiscal spending. That leaves many emerging market governments and central banks well placed to stimulate for growth, should there be any economic slowdown. At the same time, many emerging market equity markets are still trading below long-run average valuations, as judged by price to book. In aggregate, this combination presents us, as active investors, with a myriad of longer term investment opportunities.

2 Congressional Budget Office

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