

Emerging Markets Equity and Its Emerged Problems —with a Focus on China

Emerging markets, often characterized by developing economies with significant growth potential, have enticed investors with the promise of higher returns. However, these markets also come with heightened volatility and inherent risks. History shows the outperformance or underperformance by Emerging Markets Equity (EME) can be significant (refer to chart 1 and chart 2). When deciding to overweight or underweight EME, it is important to assess the overall attractiveness of the asset class and its main constituent regions. In the last 30 years, China has emerged as a prominent player in the global economic landscape and become the largest constituent in the EME index, representing 25–30% of the index. Given its equity’s recent underperformance, let’s explore the factors impacting investment decisions in EME with a focus on China.

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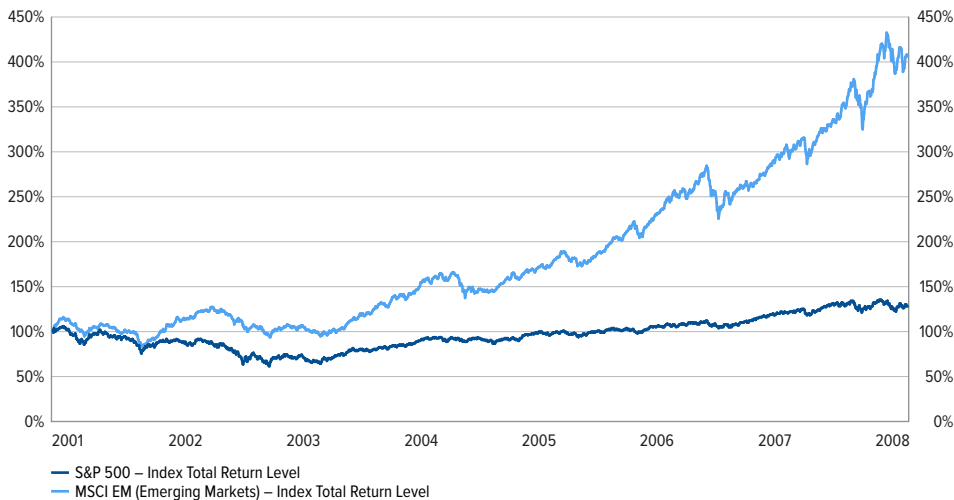
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Chart 1: EME outperformed the S&P 500® index from 2001 to 2007

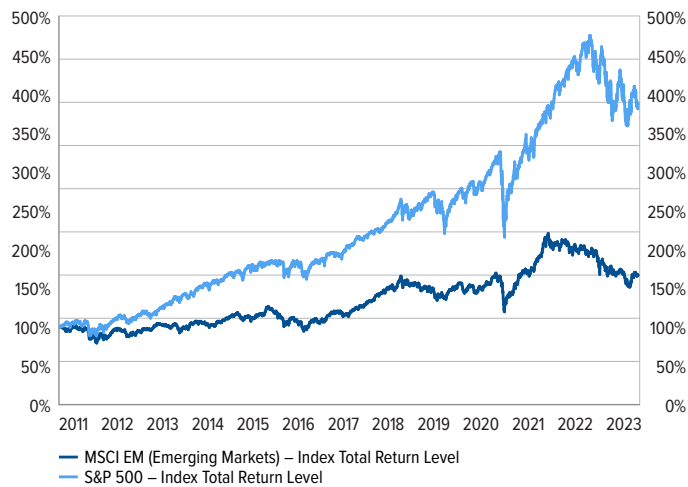


Source: FactSet

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Chart 2: EME underperformed the 500 index from 2011 to 2023

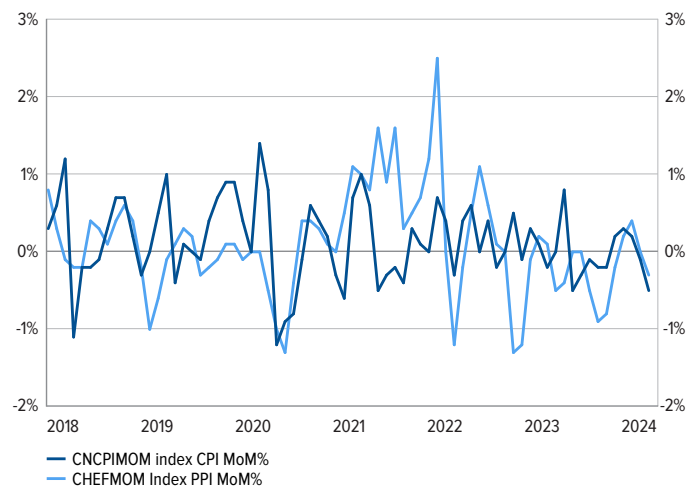


Source: FactSet

China’s Recent Economic Growth Is Disappointing

China’s economic growth during the past few decades was remarkable. However, under the zero-COVID policy, its growth stumbled. After the lift of the zero-COVID policy, the economy briefly recovered with a 2.3% quarter-over-quarter gross domestic product (GDP) growth rate in Q1 2023, but the robust growth faded away after a few months. Q2 and Q3 real GDP growth rates were 0.5% and 1.3%, respectively. Inflation data also is worrisome, as both the consumer price index (CPI) and producer price index (PPI) month-over-month numbers have been in and out of negative territory (chart 3). The Chinese economy might be on the verge of deflation.

Chart 3: China’s CPI and PPI are too low

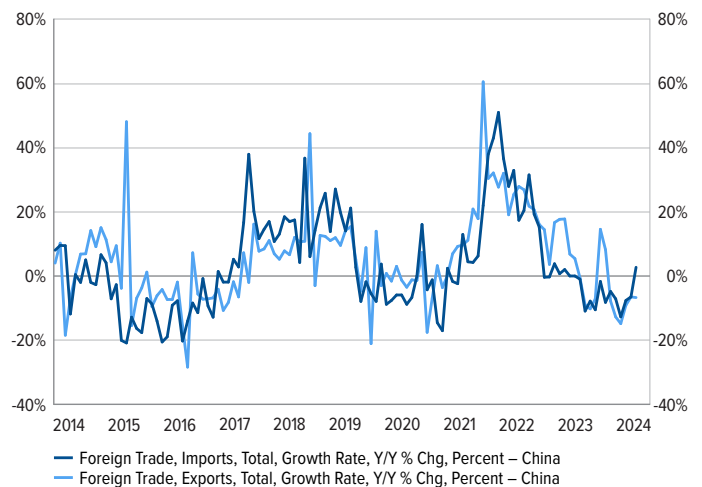


Source: Bloomberg

Two major growth pillars—the property and exports sectors—are cracking and may be on the verge of collapsing. Many property sector companies took on too much debt, and quite a few of them have defaulted. With a depressed residential real-estate market, consumers do not feel as financially secure as before, thus deterring consumption. Additionally, local governments used to receive funding from land sales, but they are no longer able to do so, resulting in dire fiscal conditions. The deleveraging of local governments will take quite a few years, which we will elaborate on further in our next segment about debt issues.

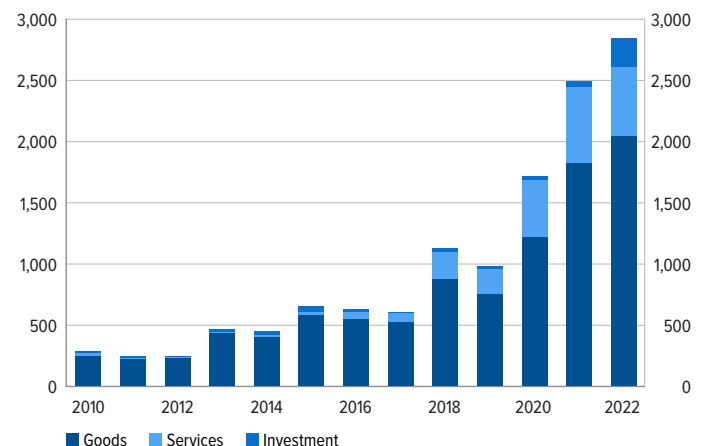
The exports’ growth picture is discouraging as well (chart 4). “Re-shoring” and “friend-shoring” by many countries have dragged down China’s exports and economic growth. With trade restrictions still on the rise, we predict these “re-shoring” strategies will continue to hurt China’s growth (chart 5).

Chart 4: China’s foreign trade picture is worrisome



Source: FactSet

Chart 5: Number of trade restrictions continue to rise



Source: IMF

China's Debt Problem

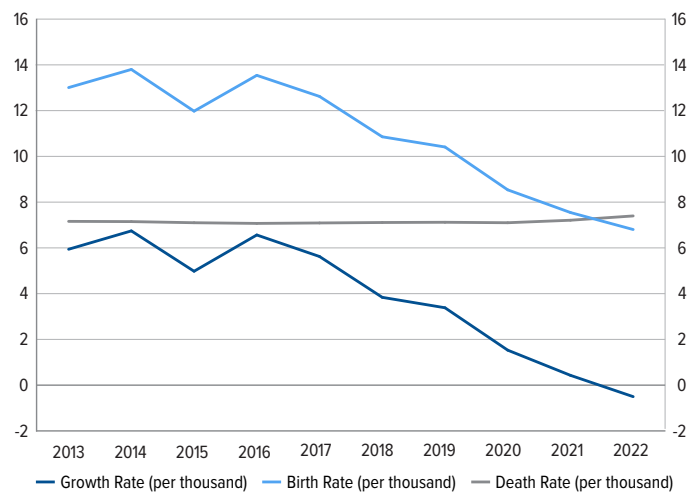
On December 5, 2023, Moody's Investors Service lowered its outlook on China's sovereign credit rating from stable to negative. Moody's rationale: "The change to a negative outlook reflects rising evidence that financial support will be provided by the government and wider public sector to financially stressed regional and local governments (RLGs) and state-owned enterprises (SOEs), posing broad downside risks to China's fiscal, economic, and institutional strength. The outlook change also reflects the increased risks related to structurally and persistently lower medium-term economic growth and the ongoing downsizing of the property sector."

Moody's assessment points out the linkages among the Chinese central government, RLGs, and SOEs. Many important Chinese banks and financial institutions—such as ICBC, Agricultural Bank of China, China Construction Bank, and others—are state-owned and are sometimes encouraged or required to lend to SOEs. The banks also are holders of bonds issued by RLGs and local government financial vehicles (LGFVs), which are companies set up by local governments to invest in infrastructure and social-welfare projects. Moreover, some of the underwriting for these loans and bonds was poor—and when these loans and bonds go bad, who will be on the hook? These potential bad loans and bonds are very large, and the resulting fallout would put some state-owned banks under extreme pressure. Various analysts estimate that the outstanding off-balance-sheet debt of the Chinese government is around \$7 trillion to \$11 trillion, with a big portion being LGFV-issued debt. Estimates put the potential bad debt in the range of \$400 to \$800 billion. As for the size of the SOE debt, Moody's estimates that around one third of the amount of SOE debt outstanding—equal to about 40% of GDP—has interest coverage below 1, which generally indicates weak debt sustainability. We don't believe the central government would allow the state-owned banks, important SOEs, or major local governments to go bankrupt, which would cause instability to the economy and society. This prediction is supported by recent policy announcements, which have showed the central government is planning to use its balance sheet to help out RGLs and LGFVs. However, given the large size of these loans/bonds, the central government itself will be under a lot of pressure fiscally as a result. It might take a few years—if not more—to sort out the debt problem. In the meantime, these debt overhangs would hurt the overall performance of the equity market.

Demographic, Confidence, and Geopolitical Issues

Another problem China faces is its aging population. China's population is believed to have peaked in 2021. Though the government has reversed its one-child policy and encouraged people to have more children, many—especially younger people—have chosen to either delay having children or to not have children at all, as raising children is very expensive in China. The birth rate has decreased from 1.36% in 2016 to today's 0.68%, pushing the overall population growth rate to -0.06% as of 2022 (chart 6). The marriage rate also has declined over the past 10 years: In 2013, roughly 13.5 million couples got married, while only 6.8 million couples wed in 2022. The unfavorable demographics will continue to hurt China's overall growth for a long time, as it takes decades to reverse demographic trends. This also will hurt the already-struggling residential real-estate market, as demand growth from population growth would continue to weaken.

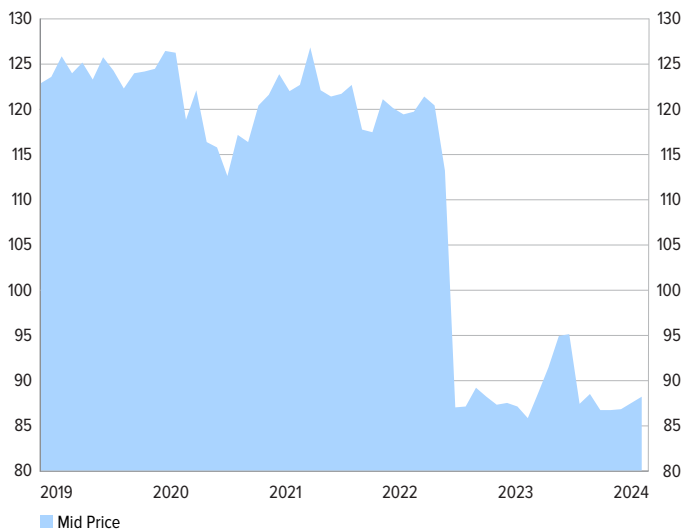
Chart 6: China's demographic trend is worrisome



Source: Bloomberg

There is a confidence issue too (chart 7). There seems to be an erosion of confidence from consumers, companies, and investors (both domestic and overseas). The lack of confidence in the government’s policies is deterring consumer spending and investors’ appetites for Chinese equity. These policies—such as the zero-COVID approach and crackdowns on technology and education companies—are often viewed as failures. People do not have confidence that the government can turn things around and maintain consistent policies going forward.

Chart 7: Consumer Confidence Index



Source: Bloomberg

Related to the confidence issue is the unfavorable sentiment on Chinese equity. The low sentiment is attributed not only to economic concerns but also to geopolitical risks, as tensions between nations, trade disputes, and political instability can significantly influence investment sentiment. With the 2024 U.S. and Taiwan elections approaching, geopolitical risks may remain elevated or even escalate. The current leading candidate in the Taiwanese election supports Taiwan’s independence, a red line for Beijing. While a war in Taiwan is not the base case, the risk is not zero, and the potential damage to emerging markets and the global economy could be substantial.

Government’s Recent Economic Policies

The recent Central Economic Work Conference (CEWC)—a pivotal government meeting on economic matters—reflects heightened concerns about the economic landscape. Despite a pro-growth stance symbolized by phrases like “growing to stabilize” and “building before breaking,” policymakers did not advocate for stimulus targeted to consumers, which is urgently needed. Instead, the emphasis is on supporting the mitigation of downside risks, ensuring a measured recovery, and maintaining growth quality over speed primarily through industrial policies.

The central government also reconfirmed its recent commitment to expedite local government debt restructuring, specifically refinancing. A housing rescue package with explicit support pledged for developers’ reasonable funding needs is currently in the works. The CEWC aims to actively address risks in the property sector and accelerate social housing construction, but the success of this initiative will hinge on the size and structure of the package.

While specific numeric targets for GDP growth and fiscal deficit remain elusive, signals suggest a potentially high growth target of “around 5%” and an on-budget deficit ratio exceeding 3%. The CEWC, in line with recent practices, defers these details to the National People’s Congress in March.

These policies are encouraging, but we don’t predict them to be game changers for the Chinese economy or equity markets. A catalyst is still yet to be found.

Conclusion

Deciding whether to overweight or underweight emerging markets equity requires a nuanced analysis of various factors. Given China’s substantial weight in the emerging markets equity index, investors must closely monitor China’s recent developments and its long-term challenges. At present, there is no clear resolution to the numerous issues China faces—particularly those of a more prolonged and secular nature. Despite the current cheap valuation, it is prudent to avoid overweighting emerging markets equity due to the prevailing uncertainties and challenges in China. It may be wise to wait patiently for a major catalyst.

PLFA Process

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