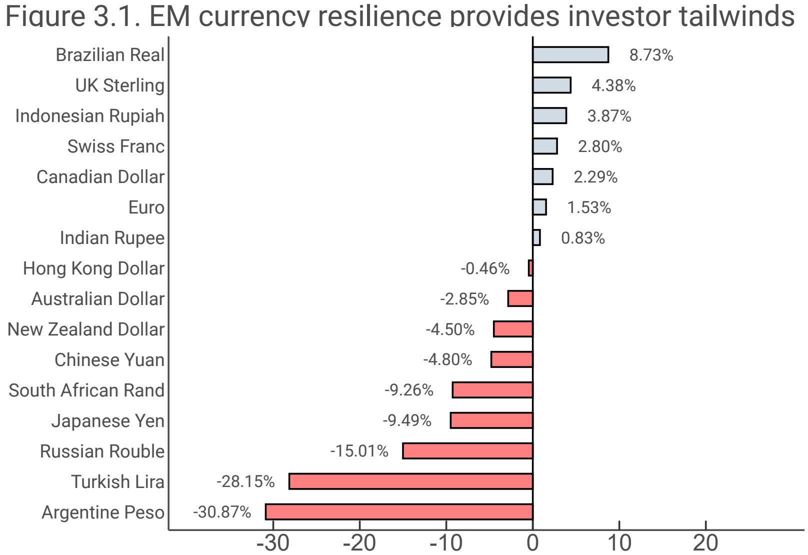
EMERGING MARKETS

In emerging markets, EM ex-China markets performed well in the second quarter and are now up close to 10% for the year. On the other hand, Chinese markets fell behind most emerging and developed markets, with EM (including China) finishing flat over the quarter. Investing in China always carried risks in prior cycles, but its growth curve was more than enough to offset them; this simply isn't the case, as we saw from disappointing second quarter GDP numbers. North American investors are voting with their dollars and have been suspending new investments and/or de-allocating across the board.

Figure 3.1. EM currency resilience provides investor tailwinds



Source:Bloomberg Finance LP.

The slower growth and lack of investment flows begs the question: are Chinese markets going through a permanent re-rating not unlike what we saw with Japan in the nineties? The similarities to Japan's economy of the 80s and 90s are, in some respects, uncanny. Indeed, China's economic development model resembles that of Japan over thirty years ago with a high level of savings, high investment, relatively low consumption, assets at bubble prices, a rapidly aging population, and a strong regulatory framework often influencing macroeconomic outcomes. And while Japan's eventual comeuppance was fueled by a broad-based financial crisis, China's chronic reliance on real estate investment poses an equal, if not more consequential, economic problem.

There are, however, some notable differences. First, China's state-owned financial system has the demonstrated ability to prevent (if it so chooses) significant banks from failing. Second, the country's closed capital account can, for the most part, protect the economy from the risk of significant capital flight. Third, China has historically been more proactive in using its command-and-control regulatory framework to help manage difficult problems – though this same penchant for control has, of late, had a deleterious effect on the trust, confidence, and potential of China's private sector. Lastly, and perhaps of greater significance for the long-term prospects of the country, China's standing as a geopolitical rival of the US and other Western democracies put it at a distinct disadvantage should the West retain its capital edge. On balance, the similarities, and differences between the China of today and the Japan of the nineties don't provide a clear picture of where things will settle – an uncertainty other strategic rivals have been quick to exploit.

The so-called 'China plus one' economies of India, Vietnam, and Mexico have increasingly benefitted from China's broken compass. More and more opportunities in the green tech space are beginning to take center stage, particularly in India. Although China continues to invest significantly in green investments ($60 billion in Q1) and remain a leading market in the EV space, India is well positioned, given its industrial policy, cheap and plentiful labor pool, and FDI environment. We view these developments as a once in a cycle opportunity to go after companies in an area that is currently woefully under-represented in industry benchmarks, just as Chinese tech companies were fifteen years ago. However, investors must be prepared for a bumpy road and take a long-term view, for returns will not be linear.

For instance, while Mexico is one of the best performing equity markets globally this year, India and Vietnam have not done much, adding to 2022 disappointing returns. Mexico in particular has benefited from a rise in manufacturing and "nearshoring" or "friendshoring" that picked up during the pandemic. These trends and deteriorating US-Sino relations helped propel Mexico to the top spot for the US's trading partner for the first time and ending nine years of Chinese dominance.

One market tailwind that investors have been able to rely on is EM currency resilience. By the midway point of 2023, we expected to see rate cuts or at least signaling of rate cuts on behalf of major EM central banks. This has largely not happened outside of China. Inflation (especially food) remains sticky, but we get the sense some central banks are happy to wait for the Fed to take the first step. Until then, EM currencies remain well placed to retain recent gains against the greenback. We view policy normalization as a welcome boost for EM equities but don't expect real movement until Q4.