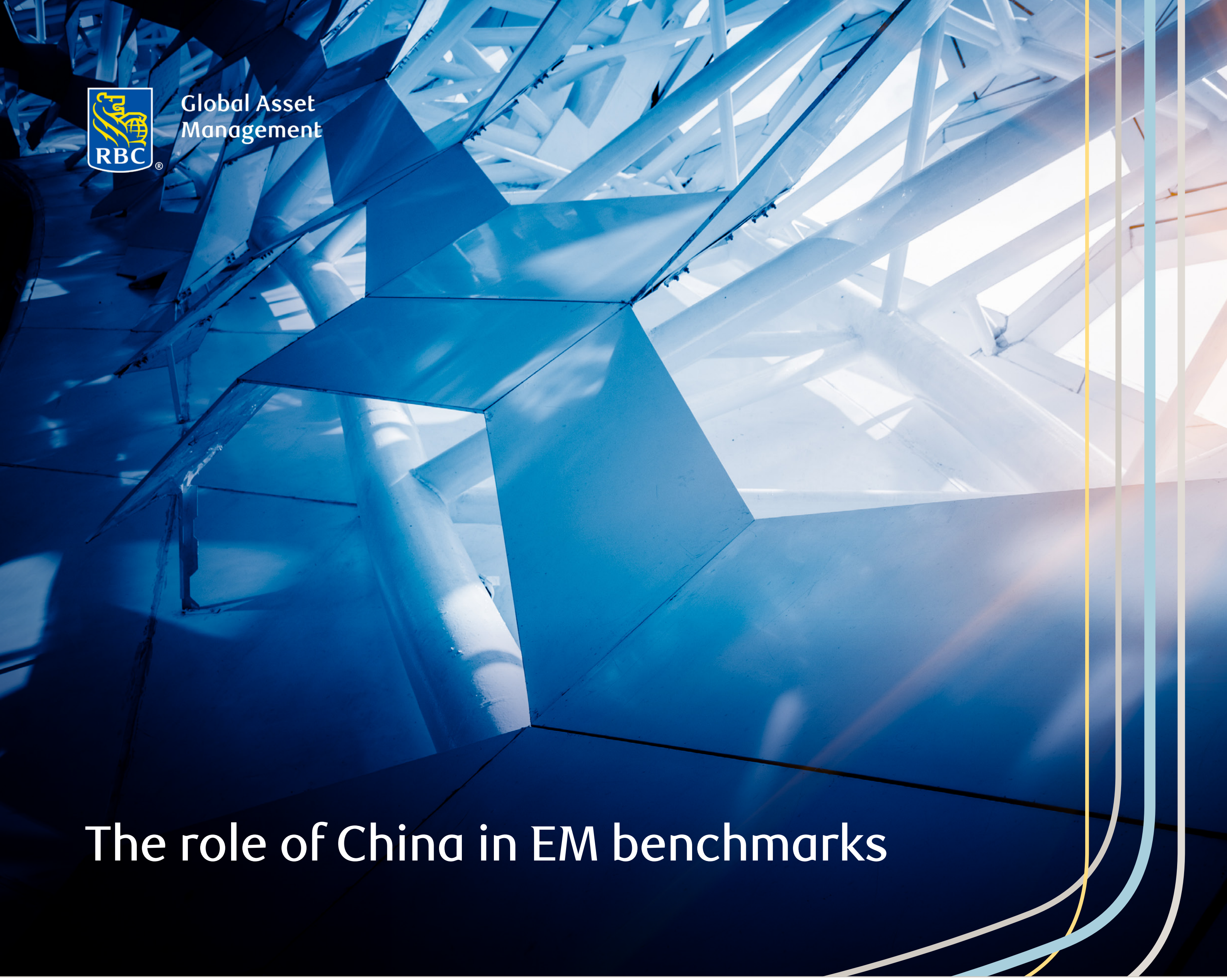

Global Asset Management

The role of China in EM benchmarks

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> "While there are question marks on China's structural outlook, the investment case for many EM countries is strong."

Summary

- The Chinese equity market has significantly underperformed the emerging markets ("EM") equities asset class in recent years. This is due primarily to concerns regarding its long-term growth trajectory, given challenges relating to the four "Ds" of debt, deflation, decoupling, and demographics.
- While structural issues do exist, we believe the potential for strong near-term performance from China should not be underestimated, given extremely low valuations and increasingly supportive government policy.
- One outcome of China's weakness in recent years is that the composition of the EM Equity index has become more diversified, with China's weight falling from 44% in 2020 to 25% today[1]. We have also seen the market cap of the next seven largest EM benchmark countries outpace that of China and Hong Kong. We expect this trend to continue, which should improve the attractiveness of the overall asset class.
- China's decline has also sparked growing interest in EM ex-China equities. While there are question marks on China's structural outlook, the investment case for many EM countries is strong.

[1] MSCI.

Performance overview

Looking back over the past decade, the Chinese equity market outperformed broader EM up until February 2021, and has since seen a period of significant underperformance (Exhibit 1).

At its peak in 2020, China's weight in the MSCI EM Index reached 44% and therefore China's decline in the past three years has had a meaningful impact on the performance of the overall EM equities asset class (Exhibit 2).

Outside of China, many EM equity markets have performed well (Exhibit 3) due to significantly improved fundamentals and strong structural tailwinds, which we highlight in this piece. We have also seen EM currencies do well and outperform developed markets. This is encouraging in the context of an aggressive Fed rate hiking cycle which would have historically caused weakness in EM equity and currency markets.

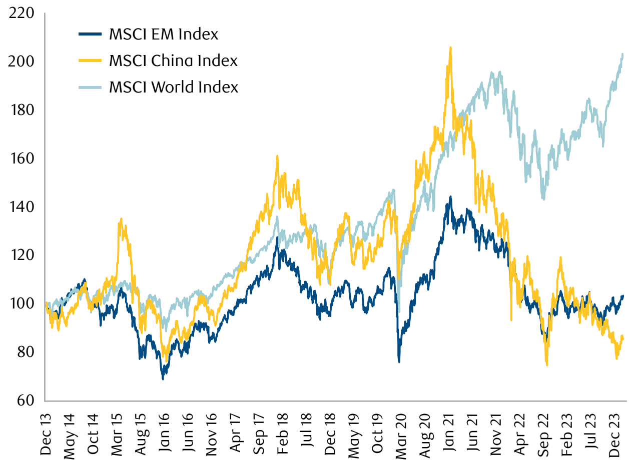
What has caused China's decline in recent years?

Following four decades of rapid development since economic reform in 1978, China started to shift its focus on the economy in 2020 onto quality over pace of growth, through its shift towards a productivity-focused, domestic demand-driven growth model.

While this is a positive and necessary transition in order for China to achieve its next phase of development and progress away from the 'middle-income trap', policymaking has so far been ineffective and has been a key contributor to equity market weakness and diminished investor confidence in recent years. In particular, the pace and severity of the government's regulatory crackdown on industries from technology to property caught many by surprise.

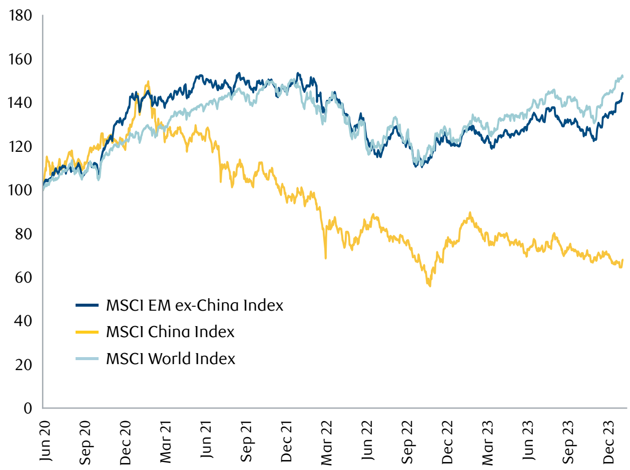
More recently, structural concerns relating to China's growth trajectory and the issues of debt, deflation, decoupling, and demographics, have been a primary cause of the weakness.

Exhibit 1: 10-year performance of China, EM and DM equities



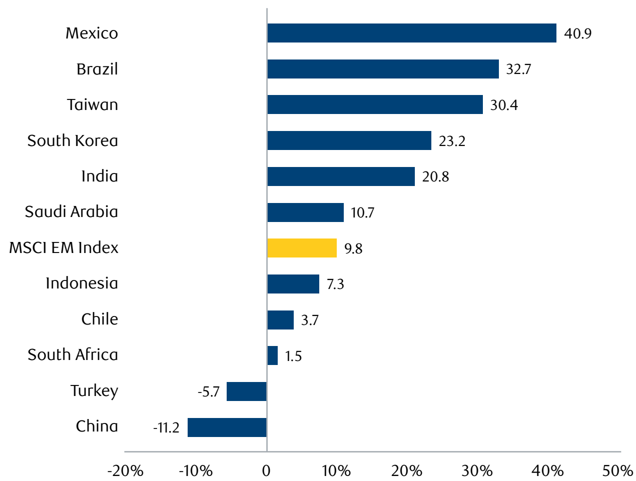
Source: Bloomberg, as at March 2024.

Exhibit 2: Recent performance of China, EM ex-China and DM equities



Source: MSCI, as at February 2024.

Exhibit 3: MSCI EM Index country performance (2023)



Source: Bloomberg, as at December 2023. Performance is in USD terms.

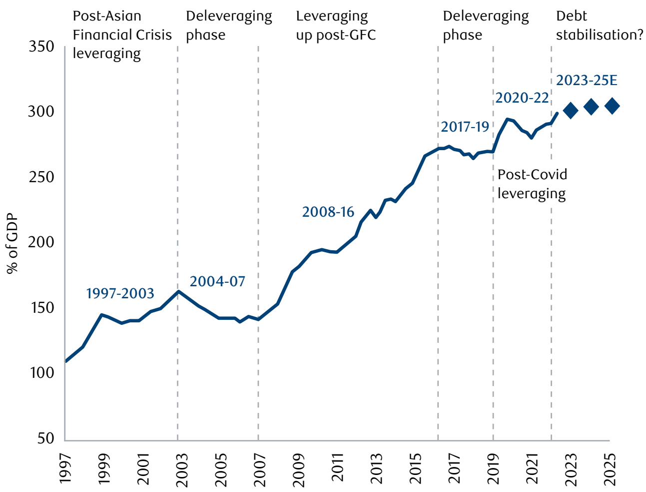
Debt

Over the past decade, China's debt-to-GDP ratio has risen rapidly, largely due to a RMB4 trillion credit-fuelled stimulus package primarily directed at SOEs in the wake of the global financial crisis in 2008[2]. The elevated debts have led to overinvestment and excess capacity. Corporates only started to de-leverage in 2017, when the government launched supply-side structural reforms to rationalise industrial capacity. This resulted in a stabilisation of the debt-to-GDP ratio from 2017 to 2019. However, the Covid-19 stimulus measures in 2020 caused the debt ratio to spike once again (Exhibit 4).

"In our view, private consumption, will become the next key engine for economic growth'."

Looking ahead, the key challenge to China's growth is to transform its economic structure towards consumption and away from the investment-led model of the past. China's household consumption is still only 39% of the country's GDP, compared to 68% in the U.S.. Additionally, Chinese households' savings rates remain high, at around 40%, compared to Japan at 8% and the U.S. at 12%[3]. This is primarily due to fewer government transfers to households, as reflected by China's low expenditure on social benefits, at 32%, compared to other countries, 44% in India or 67% in the U.S.[4]. The sustained transition to the new model therefore demands China's continuous progress on improving the quality of economic growth, as well as reforms in areas of social welfare that enable households to rebalance between consumption and savings at the micro level.

Exhibit 4: China's debt-to-GDP timeline



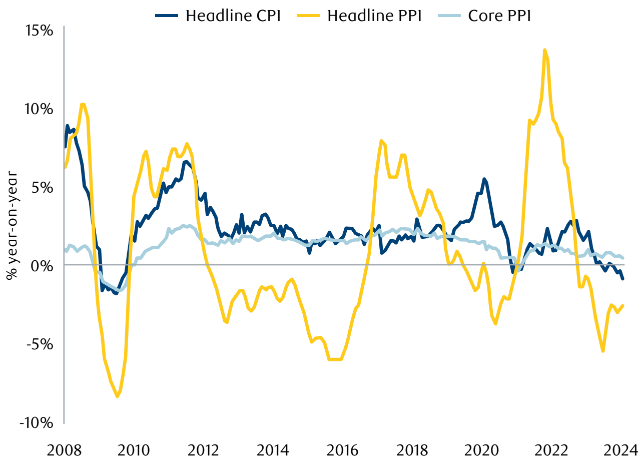
Source: UN Comtrade, BIS data, Morgan Stanley Research, JPMorgan Research, as at October 2023.

Another issue is the economy's overreliance on the property sector. Real estate accounts for nearly 30% of China's GDP and is the single largest contributor to this measure. In addition, 40-50% of China's local government revenue over the past decade has derived from land sales[5]. However, this began to alter in 2020 as the property market entered a downturn. The structural shift was caused by China's overinvestment in the real estate market, which has resulted in an imbalance between demand and supply. As seen in other countries such as the U.S. and Japan which once experienced 'property boom' economies, the property market's growth in China before 2020 was not sustainable.

In the near term, the property outlook largely depends on policy, which has always been instrumental in driving cycles in China. However, from a longer-term perspective, real estate's economic input into China will gradually lessen. While this may put pressure on China's future GDP growth, this structural change could accelerate the country's de-leveraging process, as the real estate sector is one of the most leveraged industries in China. In our view, private consumption, will become the next key engine for economic growth, given the possibility of mobilising savings for consumption.

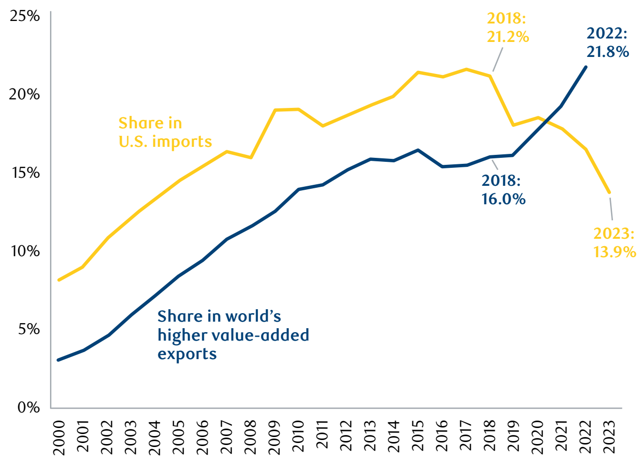
[2] https://www.scmp.com/economy/china-economy/article/3086569/china-pledges-largest-ever-economic-rescue-package-save-jobs
[3] https://data.oecd.org/hha/household-savings.htm
[4] BEA, China National Bureau of Statistics, WIND, MoF, IMF, Macquarie Macro Strategy, as at October 2023.
[5] China National Bureau of Statistics, CEIC, Gavekal Dragonomics, Goldman Sachs Global Investment Research, as at October 2023.

Exhibit 5: China's inflation dynamics (% change, year-on-year)



Source: China National Bureau of Statistics, CLSA, as at January 2024.

Exhibit 6: China's export share to the U.S. and the world (12-month moving average)



Source: UN Comtrade, Morgan Stanley Research, as at December 2023. Higher value-added products are defined by the World Customs Organisation.

Deflation

Another key concern is the potential for China to fall into a debt-deflation spiral, similar to that which Japan experienced in the 1990s. During this period, Japan faced persistent deflation, a rising debt-to-GDP ratio, and stagnant GDP per capita.

Whether history will repeat itself depends on China's strategy to mitigate the risk of 'Japanification'. To prevent deflationary expectations from becoming entrenched, it is necessary to increase the inflation rate through aggregate-demand stimulus. Further monetary easing could also stimulate the economy. Given that China's current real interest rate is significantly higher than the rest of EM and the U.S., we believe there is still room for further monetary easing.

Although the government has not introduced a large stimulus package so far, we have seen incremental policy easing to support economic recovery since last year. The pace of policy rollout is likely to remain gradual, similar to the 2014-16 easing cycle. Nevertheless, the positive aspect is that Beijing is on track to step up measures to tackle the debt-deflation loop issue.

Decoupling

Since the U.S.-China trade war began in 2018, China's exports to the U.S. have seen a significant decline. In 2022, the share of imported Chinese goods as a percentage of total U.S. imports fell to 16.5%, down from 21.2% in 2018. During the same period, China's share in the world's higher valued-added products increased from 16.0% to 21.8% (Exhibit 6). This shift reflects China's progress in transitioning from low-end manufacturing to higher value-added production activities. The transition has been facilitated by industrial upgrading, technology adoption, and enhancements in workforce skills.

The rise in geopolitical tensions with the U.S. and the imposition of tariff barriers have also led to a diversification of supply chains. An increasing number of multinational corporations ("MNCs") are relocating their production facilities to other EM countries. The decrease in the share of FDI in China's total investment, resulting from the increasing relocation of supply chains, implies that China needs to expand its production capacity using domestic or other sources of capital. This is a significant shift in the dynamics of China's economic structure. Meanwhile, many Chinese corporations are establishing or considering setting up manufacturing facilities outside of China to evade tariffs and reduce costs. This will continue to act as a driver to China's higher value-added exports over time. We believe that diversified export destinations, coupled with rising demand from EM, can offset the shrinking demand for Chinese goods from the U.S. and EU amid escalating trade friction.

"Given that China's current real interest rate is significantly higher than the rest of EM and the U.S., we believe there is still room for further monetary easing."

We expect to see continuous relocation of supply chains out of China, primarily in labour intensive and low value-added areas, to countries with lower labour costs across EM. However, higher value-added industries with longer supply chains are likely to remain in China, given the country's industrial ecosystem, well-developed infrastructure, and high labour efficiency. It is also important to remember that for MNCs, China is not only a manufacturing hub but also an attractive consumer market. Hence, those who see China as a strategic market are likely to adopt an 'in China, for China' strategy.

Demographics

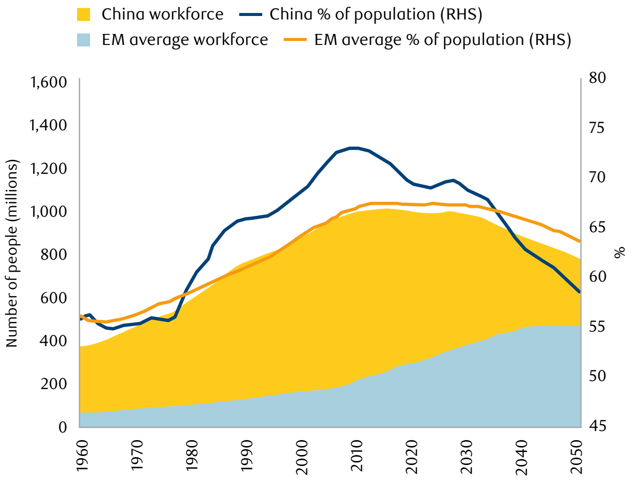
China's deteriorating demographic trend is becoming an increasingly significant concern. In 2022, the country's population declined for the first time in six decades, signifying the beginning of China's long-term population decline. This demographic shift is caused by a falling birth rate and a rapidly ageing population.

Compared to the average level in EM, China's demographic situation is less attractive. The working age population in China peaked in 2010 and is projected to shrink at an average rate of 0.8% from 2020 to 2050, which is 0.5% faster than the overall population (Exhibit 7). Moreover, the population of individuals over 65 years old is expected to double by 2050. An ageing population and decreasing workforce could lead to increased social security costs and a shortage of skilled workers. More importantly, it could present a secular drag on the country's long-term economic growth.

> **"In 2022, the country's population declined for the first time in six decades, signifying the beginning of China's long-term population decline."**

To counteract these demographic headwinds, we have seen an acceleration of manufacturing automation in the country. In 2021, China accounted for nearly half of the global installation of heavy-duty industrial robots. While China's labour force is shrinking, its workforce has seen significant quality improvement, primarily driven by expanded university intakes from the early 2000s. This shift represents a significant evolution in China's economic and industrial landscape.

Exhibit 7: Working age population – China versus EM



Source: UN, Goldman Sachs Global Research, as at October 2023. The average workforce is based on each country's GDP, i.e. a GDP-weighted average of workforce and % of population. The workforce composition is from 15-64 years.

Enhanced labour quality, coupled with a higher level of automation, implies a greater economic input which could counterbalance the drag from a declining labour quantity. More importantly, it lays a solid foundation for a highly productive economy through improved labour productivity. Reforms such as gradually raising retirement ages, which are currently among the lowest globally, could also help increase labour supply and boost growth in the coming years.

Whether these measures will be sufficient for the country to sustain its economic growth over the long term remains to be seen. However, when compared to developed countries like South Korea and Japan, China still has considerable room for improvement on a relative productivity per worker basis. This suggests a potential for further catch up on labour productivity going forward.

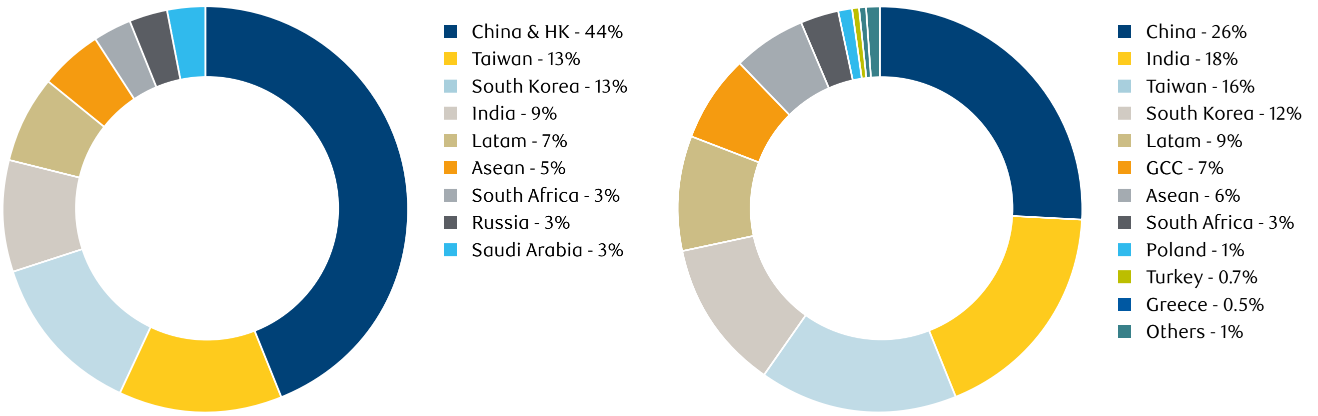
Near-term opportunity?

While China faces several structural challenges, we believe it is important not to be too pessimistic currently. If we think back to several years ago at China's peak, we felt at that time that many investors were overly optimistic on China's prospects and valuations were extremely rich. We now feel we are at the other extreme.

We have also started to see signs that the leadership is changing its stance from recent years and becoming more constructive towards the private sector and the economy. Monetary and fiscal support is also increasing, while authorities have started to reverse some of the restrictive policies in sectors such as technology.

When coupled with the extremely low valuations and underweight investor positioning that we see today, we believe there is upside potential for the Chinese equity market in the near term.

Exhibit 8: MSCI EM Index is becoming more diversified



Source: MSCI, Bloomberg, as at January 2024.

An expanding opportunity set across emerging markets

One outcome of the longer-term challenges China is facing is that it has led to increasing interest in the EM ex-China Equity asset class, as investors seek to gain exposure to the attractive structural growth stories across the EM opportunity set.

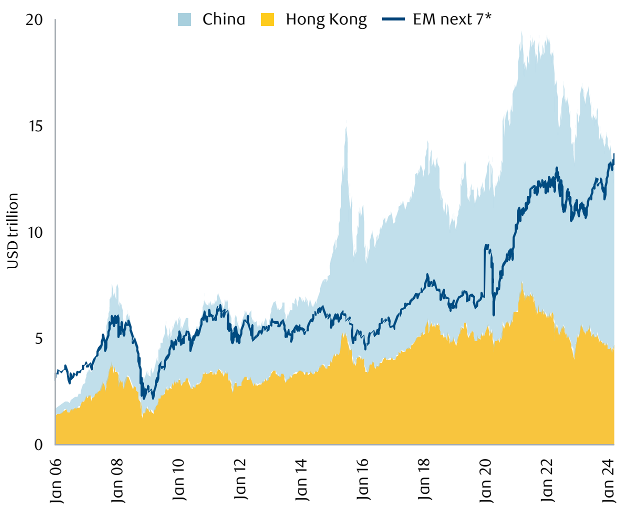
Another outcome of China's weakness is that the EM Equity index is becoming more diversified. As a result of China's underperformance, we have seen its weight in the MSCI EM Index decline from 44% at the peak in 2020 to 25% today. Whilst the index was very unbalanced three years ago, we are now seeing better diversity. India has grown to 18%, Russia is no longer in the benchmark and the GCC countries are now closer to 7% of the index, not far behind Latam at 9% (Exhibit 8).

EM's expanding opportunity has led to the market cap of the next seven largest benchmark countries outpace that of China and Hong Kong for the first time since 2007 (Exhibit 9).

> "Whilst the index was very unbalanced three years ago, we are now seeing better diversity."

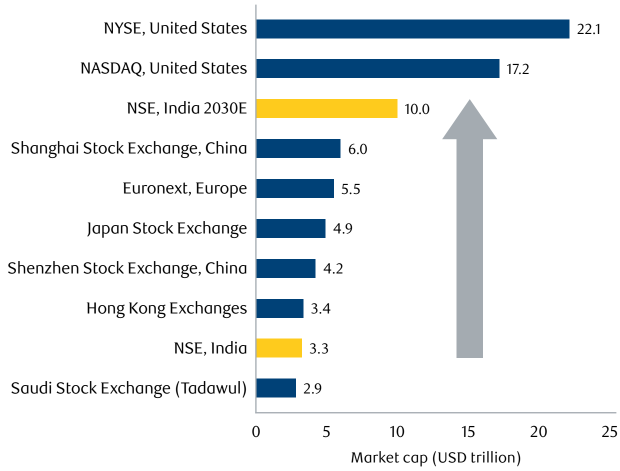
India, in particular, looks set to become a larger proportion of the index and could become the third biggest economy in the world, from its current fifth position, by 2026. Given the spate of new IPOs and unicorns in the pipeline, its stock market is predicted to follow suit and overtake Shanghai to become the third largest globally by 2030 (Exhibit 10).

Exhibit 9: Total market capitalisation



Source: CLSA, Bloomberg, as at January 2024.
*Brazil, India, Indonesia, South Korea, Mexico, Saudi Arabia, Taiwan.

Exhibit 10: India is expected to become third largest stock market by 2030



Source: Statista, Morgan Stanley Research estimates, as at November 2022.

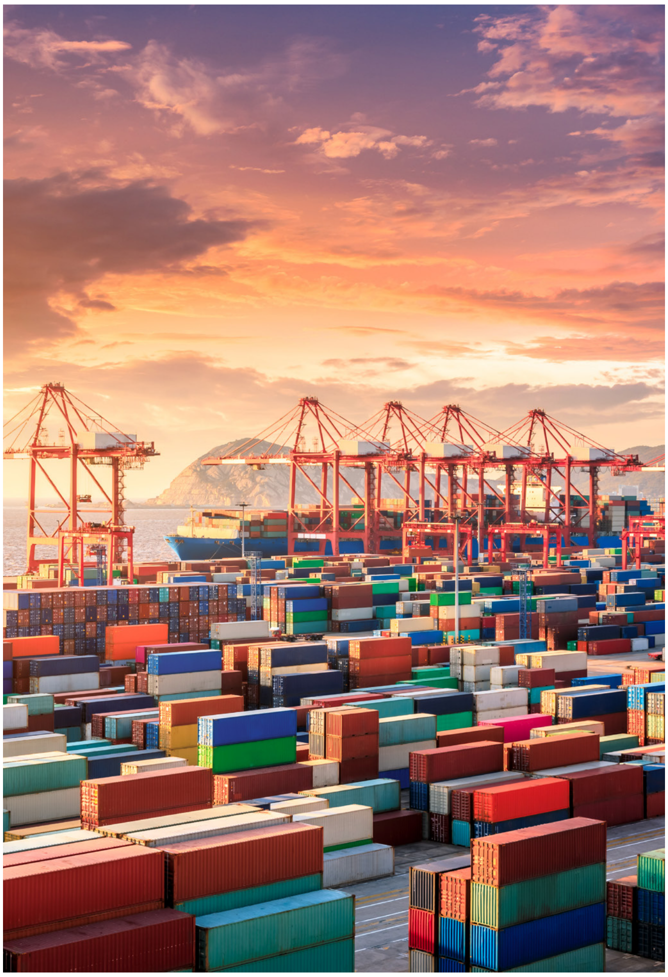
A significant driver of India's impressive development has been the structural reforms implemented under Prime Minister Modi since 2014, which have removed historic bottlenecks, improved infrastructure and significantly improved the ease of doing business in the country (Exhibit 11).

"Economically it makes sense to manufacture in Mexico, given significantly lower manufacturing and labour costs compared with China."

As the benchmark evolves, other markets such as ASEAN and Latin America are also expected to grow in importance, given the inclusion of Vietnam in the index, as well as tailwinds from re-globalisation and de-carbonisation trends.

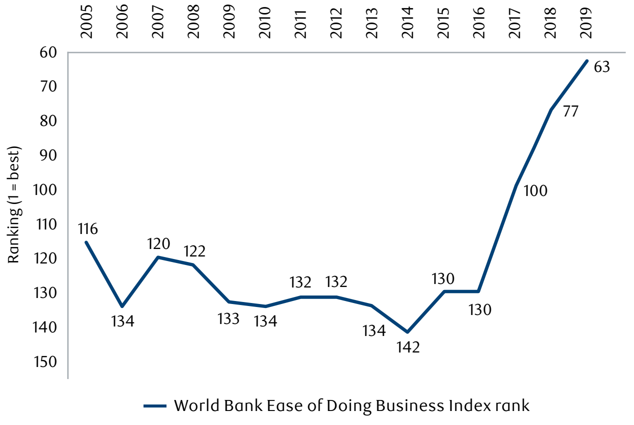
Mexico, in particular, is benefiting from a new investment wave due to re-globalisation trends, as geopolitical tensions cause the U.S. to look for allies that are geographically close and politically aligned (Exhibit 12).

In addition to geopolitics, economically it makes sense to manufacture in Mexico, given significantly lower manufacturing and labour costs compared with China (Exhibit 13).



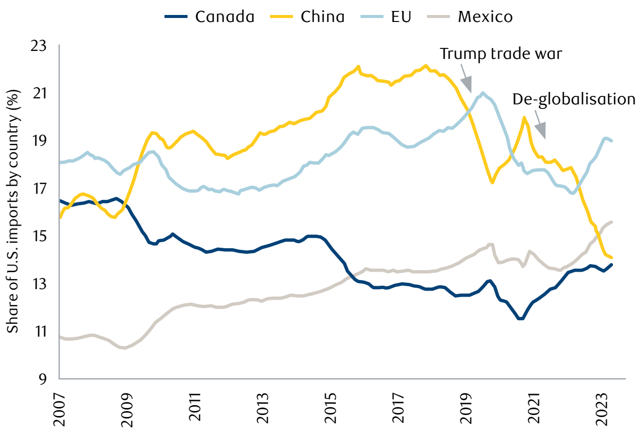
[6] Statista, as at 2023.

Exhibit 11: India jumps up sharply in World Bank's Ease of Doing Business Index



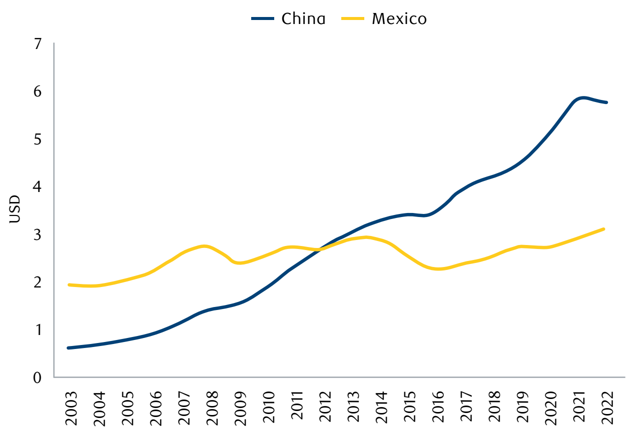
Source: World Bank data (2005-2019), as at 2023.
As of 2021, the World Bank stopped producing the 'Ease of Doing Business Index' as its methodology is being revamped.

Exhibit 12: China is losing market share in the U.S. while Mexico benefits



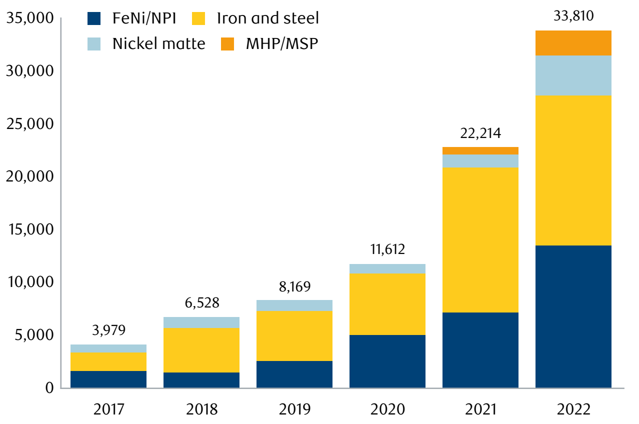
Source: Census Bureau, Haver Analytics, RBC GAM, as at November 2023.
Note: based on 12-month moving average of goods imports.

Exhibit 13: Manufacturing labour cost per hour: China versus Mexico



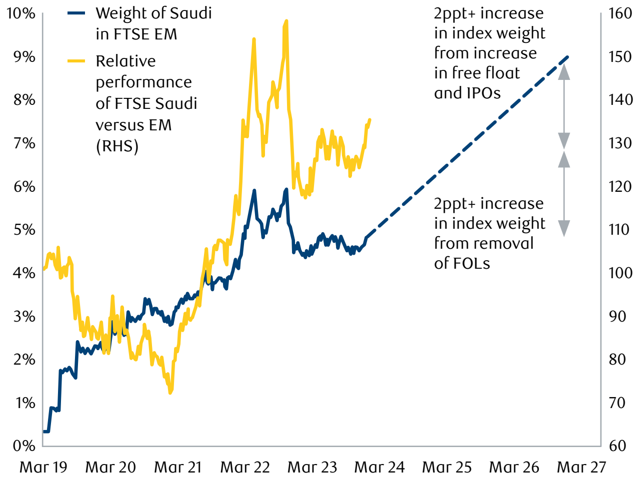
Source: Bloomberg, INEGI, National Bureau of Statistics of China, World Bank, BTG Pactual, as at 2023.

Exhibit 14: Indonesia is moving beyond extraction to value-add in exports – significant increase in nickel downstream exports



Source: Macquarie Research, as at December 2022.

Exhibit 15: Projected future Saudi weight in EM

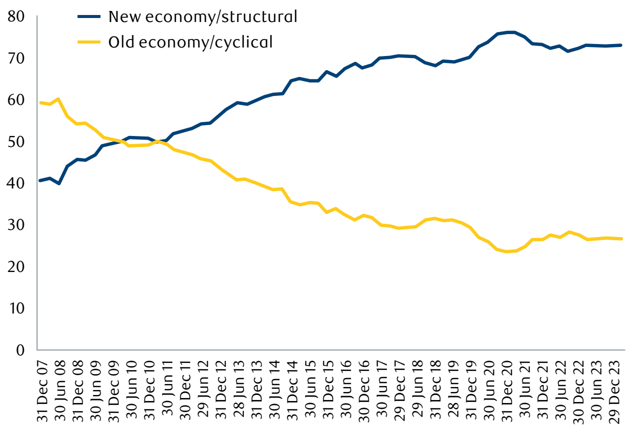


Source: HSBC, FTSE, as at January 2024.

Indonesia has been another target of FDI flows. Home to the largest nickel reserves globally, the country is looking to position itself as a leading EV battery manufacturing hub, by banning the export of raw nickel ore and moving increasingly downstream[6]. This positions it well in an era of de-carbonisation (Exhibit 14).

The GCC will be another region that should see a meaningful increase in its benchmark weight with a pipeline of IPOs, particularly in Saudi Arabia where we are seeing meaningful reform towards a more sustainable and prosperous economy, with diversification of the non-oil economy being a key driver behind this momentum for change (Exhibit 15).

Exhibit 16: MSCI EM Index sector evolution – shift from old economy sectors and cyclicals to new economy and structural opportunities



Source: FactSet, MSCI, as at March 2024.
Note: 'New economy/structural' includes IT, Consumer Discretionary, Consumer Staples, Healthcare, Financials, and Media & Entertainment under Communication Services; 'Old economy/cyclical' includes Energy, Materials, Industrials, Real Estate, Telecommunication Services under Communication Services, and Utilities.

We are also seeing the index evolve from a sectoral standpoint. Historically, the EM equities asset class was associated with commodity-driven industries, and this was reflected in the opportunity set, where the energy and materials sectors dominated the benchmark.
As EM economies have developed, this has broadened the opportunity set beyond materials and natural resources, with service sectors and higher value-add industries growing in importance (Exhibit 16).

The increasing exposure to new economy areas should prove beneficial in terms of earnings and profitability for the EM equities asset class going forward.

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Dijana is a product specialist on the RBC Emerging Markets Equity team at RBC GAM. Prior to joining the firm in 2018, she worked as a vice president at an international bank, where she spent six years in the managed investments business as a product specialist for mutual funds, hedge funds and private equity, and where she positioned investment capabilities for global ultra high-net-worth individuals. Prior to this, Dijana worked in an investment advisory role for pension funds at a global accounting firm. Dijana began her career in the investment industry in 2011, having worked in various international auction houses prior to this.

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