CHINA'S GREAT REOPENING: OPPORTUNITIES AND RISKS

GW&K INVESTMENT MANAGEMENT

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Bill Sterling: Hi all, I'm Bill Sterling, GW&K's Global Strategist. I'm joined today by my colleagues, Andrea Clark and Nuno Fernandes, to discuss some of the implications of China's reopening after nearly three years of very strict Covid repression.

Andrea is a client portfolio manager for our Global Equities Team, with broad knowledge of both developed and emerging market equities. Nuno is an equity portfolio manager for our Emerging Market Wealth Strategy, which has a substantial exposure to Chinese equities.

Andrea and Nuno as you know, I believe that China's reopening is shaping up as one of the most important global macro stories for 2023. I just released a piece to our website, which reviews the mounting evidence that China's recovery is underway and is surprising to the upside.

This includes things like mobility data on subway ridership and road congestion in China. But it's also been confirmed by very strong purchasing managers' survey reports with the official data that's been released for January and February, which is among — in terms of the February data — among the strongest in the last decade.

We've seen economic forecasts for China be revised up very substantially. It looks like China may do something like 6% year-on-year growth by the fourth quarter of this year. We think this has a lot of implications for global markets. For Asia in general, it's got to be good news that you're seeing a resumption of the flow of goods, people, and capital across borders.

It should also be a positive for Chinese equities, because you're starting with Chinese equities with very depressed profit margins, so potentially room for earnings leverage to come out of the recovery; and relative to the S&P 500, China is trading it something like a 45% discount — 11 times earnings versus close to 20 for the S&P 500. That compares to a historical discount of about 28%. So, we think that's an intriguing setup for Chinese equities to outperform, if you get both a recovery in margins, and a strong economic recovery, which looks likely.

Andrea, I know you look at China from both a company perspective and also from a country-risk perspective. Maybe you could share some of your thoughts on how you think the opportunities are shaping up versus some of the risks that have to be considered.

Andrea Clark: Thank you, Bill. Well, it does appear that the easy equity gains in China's reopening trade have already been captured. The market has rallied quickly, and fairly substantially, from admittedly oversold conditions. As you mentioned, there are a number of unresolved issues which have probably caused the rally to pause a bit recently, particularly Beijing's increased involvement in the private sector, and how that might play out going forward.

But there are always risks associated with investing in emerging markets. This is why we're very selective when investing in China, and are constantly evaluating our investments, to be sure that the companies are extremely well managed, that they can navigate these near-term headwinds, and that they are also pursuing profitable business strategies that position them well for the country's continued economic advancement.

Bill Sterling: Thanks, Andrea. Turning now to you, Nuno, I know you focus on Chinese companies, really — a bottom up-perspective on a company-by-company basis. Maybe you could share with us some of your insights, and how you think the profits outlook in China is shaping up with this recovery scenario, particularly against the backdrop I mentioned of depressed profit margins as well as depressed valuations.

Nuno Fernandes: Thanks, Bill and Andrea. From a bottom-up perspective, our team is finding in China some of the most compelling earnings operating leverage ideas for the next couple of years. What we saw in the last two years, where we had a strict zero-Covid policy, as well as a regulatory blitzkrieg, is that Chinese corporates turned their attention to costs and controlling costs. And that's really what makes them so exciting as the top line roars back in 2023 and 2024, with the reopening of the economy.

The question is really, what have we seen so far in this earning season? For the companies that we follow in China that have reported so far, the overwhelming majority is guiding estimates higher. That's really leading to higher earnings upgrades for 2023 and 2024. For the companies that we follow in China, we're expecting earnings growth of 15% or higher for the next couple of years, which makes it very compelling, considering the valuations.

Bill Sterling: Well, thanks, Nuno, as important as this macro story might be, it sounds like taking advantage of it will require very solid company research, as well as some easing, potentially, of some of the geopolitical and regulatory risks that everyone's concerned about. I think we'll have to leave it at that for today, but I want to thank both you and Andrea for joining me today. For viewers who are interested in more detail, please check out the Gwkinvest.com website under Global Perspectives or Emerging Wealth Insights for more information. Thank you.

Nuno Fernandes: Thanks, Bill.

Andrea Clark: Thank you, Bill.

Disclosure