GW&K INVESTMENT MANAGEMENT

Market Performance

Globally, it was a painful week for equity markets. A higher-than-expected Consumer Price Index (CPI) report in the U.S. last week led the Fed to raise rates by 75 basis points (bps). Equity investors are incorporating a slower economic growth outlook putting pressure on profits, with higher interest rates putting pressure on equity valuation as well. For the week ended June 17, 2022, Emerging Market (EM) equities, as measured by the MSCI EM Index, declined -4.7% compared to Developed Market (DM) equities, as measured by the MSCI World Index, which declined -5.7%. All 47 countries in the MSCI All Country World Index were down last week. EM Value and EM Growth were down -4.7%, in line with the Index. Last week, the worst performing countries were Colombia, Brazil, and Chile which all declined 7 – 8%. These countries were also among the leaders for year-to-date (YTD) returns so the decline last week was likely a combination of profit taking, increased uncertainty with respect to the sustainability of high commodity prices and currency weakness against the U.S. dollar. China (-2.7%) was among the strongest performing countries as sentiment towards Chinese equities has been improving. The weakest sectors last week were Energy (-7.3%), Information Technology (-6.5%) and Communication Services (-6.1%). The strongest sectors were Health Care (-2.5%) and Consumer Staples (-2.8%). YTD, EM equities returned -17.6%, which was better than DM equities' return of -22.4%. EM Value (-14.4%) outperformed EM Growth (-20.6%) YTD.

Rotation, Leadership – When does it Change?

The house is on fire. Your house, my house. Multiple asset classes. Fixed income, Equities, and Crypto if you happen to own it. It has been a difficult week and year with multi-decade trends breaking down. Is it an inflection point or an interruption? In the midst of the flames and the smoke, sentiment appears to be turning positive in one part of the world. China, which has been through its own market meltdown for the past 16 months, appears to be experiencing a positive change in sentiment. As noted above, all 47 countries in the MSCI ACWI Index posted negative returns last week. For the month to date (MTD), China (+2%) is the only country that has a positive return while the other 46 countries are down. Brazil (-17.1%) is the worst performing country and the United States (-11%) is not far behind.

As markets go through corrections it is wise to look for signs of change. Market leadership often changes during downturns, but these changes sometimes become clear only after the fact, as investors are usually focused on the challenges immediately in front of them. We articulated many of the positives with respect to investing in China over the past several years. Many of the attributes remain in place for long-term investors. These include a large population base, rising per capita income, an industrial base that can service the domestic economy in a wide variety of industries, a shift to domestic consumption, and an attractive valuation level. This long-term positive outlook has been interrupted over the past 16 months. The Chinese equity market peaked on February 17, 2021. From that point, the market declined -54% in a little over a year, hitting a low on March 15. At the same time, the U.S. equity market went on to hit new highs early in 2022. China's market decline, simply stated, was caused by four factors: unprecedented regulatory reform impacting multiple industries, increased tensions with the United States in 2021, the support for Russia's invasion of Ukraine, and a zero-Covid policy in 2022. We believe these factors caused most investors to exit or reduce their exposure to China and throughout this period, the Chinese government took no action to support the financial markets.

What Changed?

Beginning on March 15, 2022, the Chinese government made the first of a series of announcements intended to restore confidence in the financial markets. It was an important change of policy tone, and it was well received by the market. Since then, while the U.S. market has hit new lows, the Chinese equity market has shown signs of an important bottom. China's market has advanced +13.9% while the U.S. market declined -11.9% — a difference of 25.8%. Investors are once again returning to the Chinese market and the period of intense regulations appears to have come to an end. China is negotiating with the U.S. to allow Chinese companies listed in the U.S. to be audited by U.S. regulators. As the U.S. struggles with rising inflation and raising interest rates, China's CPI is well contained with the most recent reading at 2.1%. China is taking steps to stimulate the economy by reducing rates but, challenges remain, including the China zero-Covid policy, a slowing economy, and rising unemployment. Additionally, policy action will be required to offset the negative impact of the zero-Covid policy. But, most importantly, in the midst of a global market sell-off, investors are beginning to recognize the long-term potential of the Chinese equity market. Investors who labeled China "un-investable" a few months ago are now recommending direct exposure to China.

Emerging Wealth Position

In GW&K's Emerging Wealth Strategy, we continued to allocate capital to Chinese equities as investors were reducing their exposure to China. It is estimated that institutional investors are underinvested in Chinese equities by as much as US$600 billion, which as noted above, is in the process of reversing. We remain conscious that the world is watching China and how its leaders navigate the complexities of war in the Ukraine, a slowing economy, rising unemployment, and the underperformance of Chinese equities. We believe these pressures set the stage for a continued shift in policy that began with the first announcement on March 15. On a longer-term basis, we continue to believe that India and China, the two fastest growing and most populated countries in the world, represent the greatest opportunity for long-term equity investment returns.

Tom Masi
Portfolio Manager

Nuno Fernandes
Portfolio Manager