Market Performance

For the week ended September 10, 2021, Emerging Market (EM) equities, as measured by the MSCI EM Index, declined by -0.5%. EM Growth and EM Value performed equally with -0.5% returns for the week. The strongest sectors for the week were Energy (+2.4%) and Utilities (+1.2%), while the weakest sectors were Communication Services (-1.5%), Health Care (-1.1%) and Information Technology (-1.0%). The best performing countries for the week were oil rich UAE (+3.6%) and Saudi Arabia (+1.1%), while the worst performing countries for the week were Brazil (-3.6%), Chile (-2.8%), South Africa (-3.8%) and Korea (-3.6%).

For the YTD period, the MSCI EM Index returned +2.9% overall, with both EM Growth and EM Value returning -1.6% and +7.8%, respectively. The strongest sectors continue to be Energy (+19.6%), Materials (+18.7%), Industrials (+13%) and Financials (+11.1%), while Consumer Discretionary (-15%) and Real Estate (-14%) remain the weakest. Over the same period, UAE and Saudi Arabia led performance with returns of +39.2% and +36.2%, respectively. China is still the worst performer among large countries with a YTD return of -10.5%, while Brazil and Chile have once again returned to negative territory with returns of -4.5% and -3.2%, respectively.

Finally, although EM equities outperformed Developed Markets (DM) equities for the week with a return of -0.5% versus -1.3%, DM equities continue to outperform EM equities for the YTD period with return of +17.3% versus +2.9%, respectively. EM equities continue to be challenged by the regulatory oversight which started in China and has now expanded into other countries such as Korea, while DM equities continue to be supported by accommodative fiscal and monetary policies on both sides of the Atlantic.

Can Emerging Markets succeed without China?

Chinese equities have underperformed YTD due to a combination of heightened regulatory oversight by Beijing, resurgence of the Delta variant, and a new U.S. administration that is proving to be more hawkish on China than the Trump administration. New regulations and multiple spats between the U.S. and Chinese administrations have continuously caused investors to reduce their exposure to China with many openly sharing their concerns in the Western media. We acknowledge that investing in China has been challenging this year and in the short term, the cross currents have caused investors to move to the sidelines. However, longer term, we see China growing in importance for emerging market and global investors. Already, China represents almost 40% of the MSCI EM Index (37.5% as of 6/30/21) and almost 5% of the MSCI All Country World Index (4.85% as of 6/30/21). If investors were to include the China onshore equity market at its fullest liquidity, China would represent very close to 50% of the EM benchmark.

It is unlikely that EM equities as an asset class can succeed without China. China is the second largest economy globally, with its demand representing more than 50% of metals and other commodities, which other EM countries produce and depend on. China's equity market is undergoing rapid development. China is home to the deepest and most liquid equity market in EM. The on-shore A-share market is composed of companies listed in Shanghai and Shenzhen. This market is larger than the off-shore market (shares listed in Hong Kong and the U.S.) both by market capitalization and number of companies. The A-share market is more broadly diversified and is tilted towards domestic consumption. In 2014, Chinese regulators opened the A-share market to foreign investors through the Hong Kong Connect. Two years ago, China launched its own NASDAQ market called the STAR market and recently announced the upcoming launch of a new equity market focused on small and medium size enterprises. In essence, China's financial markets will continue to grow in importance for emerging market and global investors.

Why should long-term investors consider an allocation to China?

The China A-share market is liquid, uncorrelated to both EM and U.S. markets, and thus, we believe, a source of diversification and alpha for long-term investors.

1. **Diversification** – For the 10-year period ending 12/31/2020, China A-shares had a correlation of 47% with MSCI EM Index and only 33% with U.S. equities.

2. **Underrepresented in global indices** – China as the second largest economy globally is underrepresented in global indexes and as a result, China exposure is underrepresented in most portfolios. The China equity market has a total market cap of $12.5 trillion, compared to the U.S. market cap of $51 trillion.

3. **Higher Alpha** – China's on-shore market is in the early stages of development leading to market inefficiency.

4. **Economic Growth** – China's economy is larger than most other countries in emerging markets (EM) and developed markets (DM). This could enhance the earnings growth outlook for Chinese companies exposed to the domestic economy.

5. **Low Valuation** – Chinese equities trade at 11.4x 2023 earnings estimates or a 40% discount from the U.S. multiple of 19.1x 2023 estimates.

What is then the best way for investors to have exposure to Chinese equities?

In our opinion, the best way to get exposure to Chinese equities is through an active EM manager with an unconstrained and disciplined investment process. Chinese equities are best captured by disciplined active managers who are able to research and buy not only A-shares, but also H-Shares (Chinese equities listed in Hong Kong), Chinese ADRs listed in U.S. equity markets, and developed companies with material exposure to China, such as Western luxury brand companies. The market sell-off experienced YTD gives investors an opportunity to invest in great Chinese companies at FCF yields in the high single digits up to low double digits. Not only is today's valuation of Chinese companies compelling, but we believe the low correlation and high liquidity of Chinese equities has the potential to offer great diversification benefits and alpha generation, especially to U.S. investors.

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