EMERGING WEALTH UPDATE

Week Ending June 4, 2021

GW&K INVESTMENT MANAGEMENT

Market Performance

For the week ended June 4, 2021, Emerging Market equities increased by 1.6%. EM Growth outperformed this week with a 1.9% return versus EM Value with a 1.3% return. Energy was surprisingly strong with an increase of 5.1% on the week, but its small weight in the benchmark resulted in a modest impact on the Index compared to Consumer Discretionary with an increase of 2.8%. Commodity and Energy rich countries were among the best performers for the week with Russia, Brazil, Columbia and South Africa among the best performers. China underperformed with a return of 0.8%. For the year-to-date, Materials, Energy, Industrials and Utilities all have returns above 10% with Materials outperforming all sectors with a return of 21.8%. Consumer Discretionary is the only sector that is down year-to-date with a return of -2.7%. By country, commodity and energy rich countries have the strongest returns with the United Arab Emirates, Saudi Arabia, South Africa and Russia among the top performing countries for the year-to-date with returns between 15% and 29%. Value, with a return of 11.3%, continues to be well ahead of Growth which has a return of 4.4%. There are some signs that the shift to Value has run its course with Consumer Discretionary performing better over the past week, but a meaningful shift back to Growth is likely to take several quarters.

China – Policy Reset and Regulator Headwinds Cause Equity Returns to Lag

China's equity market is among the worst performing equity markets globally. There are 50 countries in the All Country World Index, and China with a return of 1.1% ranks 38th as far as year-to-date returns. This is well behind the 11.6% return for the Index and the 12.2% return of the United States. In Emerging Markets, China lags the 7.7% return of the Index and ranks 18th out of 27 countries in the Emerging Market Index.

The weakness in China's markets has been driven by several factors. Many countries hit hardest by Covid-19 in 2020 are in the midst of a rapid recovery. Growth in developed markets is in the process of being revised up on a consistent basis. In the U.S., this has been driven by massive policy stimulus. Commodity prices are on the rise and this favors many of the commodity rich countries that experienced severe declines in 2020. There is also a shift to the Value style of management away from the Growth style. Value had underperformed for many years reaching an extreme in 2020. As the global economy recovers in 2021, many of the worst performing companies are experiencing a recovery from depressed levels. China is out of favor both in terms of investment style, Value being in favor over Growth, and in terms of economic recovery, as China is one of the few countries that posted positive GDP growth in 2020. But, there is more to the story.

China, having performed so well in 2020, is in the process of tempering economic growth. In 2020, exports from China boomed as most other manufacturing around the world was shut down and China, opening early, benefited as demand shifted from services consumption to goods consumption. But now, as the developed market, especially the U.S., becomes vaccinated, consumption is in the process of shifting from goods to services. China's export engine is in the process of decelerating and economic policy is tightening in resumption of previous polices to temper excesses in the market. In the midst of a strong global economic rebound, China is capitalizing on the opportunity to contain leverage and risks. China will have a smaller fiscal deficit in 2021 and monetary policy will shift to tighter rules on shadow credit and internet finance. This translates to slower credit growth leading to a negative credit impulse. Property policies will be tighter and it is likely defaults will rise as the government continues the multi-year policy of cleaning up smaller banks. In addition to economic policies designed to improve China's economic position globally, smaller fiscal deficit and reducing debt to GDP, China is in the midst of regulatory reform in several industries designed to elevate competition, reduce monopoly powers and reduce or eliminate exploitation of markets and consumers in several industries. Furthermore, China has launched several initiatives to improve the country's competitive position in several industries while at the same time accelerating environmental cleanup. In essence, on multiple fronts, China is capitalizing on its strong performance through the pandemic to improve the country's competitive position and set the stage for sustaining growth in future years. Instead of prioritizing growth in 2021, China is setting a better foundation for sustainable growth in the out years.

So Where Does That Leave Us?

As investors, it is always difficult to resist what is working now. Clearly, as 2021 progresses, Value is working, commodities are working, countries with weak long-term fundamentals are working and the U.S., in the midst of a massive stimulus package, is working. China on the other hand, is not working so far. In our view, the policies being pursued position China more favorably than all other countries around the world with respect to sustainable economic growth. In 2021, the Chinese economy is expected to grow in excess of 9% real and 11% in nominal terms - still very attractive. But, beneath the surface, it is continued consumption growth that will lead the economy this year and for the next several years. This is consistent with the objective of the Chinese government. Increasingly, consumption growth will be the driver of growth in the years ahead and companies positioned to capitalize on domestic consumption will benefit from rising per capita income, a reduction in the savings rate and the economy fully reopening over the next 12-24 months. We have not reduced our position in China, but instead, have been gradually increasing our position in companies that have sold off on macro and regulatory headlines.

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