WHERE WE STAND ON INVESTMENTS IN EMERGING MARKETS AND CHINESE ECONOMIES

By: Don McArthur, CFA®

WHAT IS YOUR VIEW ON EMERGING MARKETS?

We're less bullish on the outlook for Emerging Markets – those areas of the world that generally have a lower per capita income and are moving to be a more developed economy connected with the world. For a long period, Commerce Trust was overweight Emerging Markets believing they had better prospects than Developed International Markets. This move proved successful as Emerging Market economies grew faster than Developed economies and their equity markets reaped the benefits. We recently removed our overweight to Emerging Markets shifting the funds into Developed International Markets. Part of the reasoning was faster COVID vaccination rates in Developed International Markets would likely lead to a faster recovery. As Emerging Markets struggle to get effective western vaccines, their recovery will likely trail more developed areas. Thus, we wanted a more balanced approach between Developed Markets and Emerging Markets for our International Equity exposure. Additionally, Emerging Markets have relatively high exposure to Commodity markets which appear to be rolling over from high levels. The other rationale is concern on exposure to China.

WHAT IS GOING ON IN CHINA?

For reference, China represents roughly one-third of the exposure to Emerging Market benchmarks; however, the country drives many other adjacent areas as it procures goods and services. Upon acceptance into the World Trade Organization in 2001, China grew rapidly and propped up many other markets, such as commodities, as it built out its infrastructure. International companies invested heavily in China due to significantly lower labor costs and exported goods to the rest of the world. In recent years, investment spending in China appears to have peaked at roughly 47% of GDP. Its decline likely reduced economic growth and demand for commodities, which hurt other Emerging Markets. Additionally, labor rates have risen to levels closer to other areas of the world. When adding in transportation costs, logistics, time, tariffs, etc., there are less incentives for International companies to invest in China. Plus, there are other risks.

WHAT ARE THE OTHER RISKS IN CHINA?

The Chinese Communist Party (CCP) is exerting its power in many areas of the country; both politically and economically. Overall, it appears the government wants to exert more control, collect and maintain more data, and create a unified China. We see on the news the issues with control over Hong Kong, Taiwan and the South China Sea. Such moves make business and citizens less sure about the future, which restricts activity and investment. The CCP recently pushed-back on recent IPOs on stock exchanges in the U.S citing concerns on data. Additionally, overnight the CCP made for-profit education and tutors "not-for-profits," sending those company's shares into a free fall. In short, uncertainty and pushing back on capitalism isn't good for business.

WHY TALK ABOUT CONCERNS WITH CHINA NOW?

Looking back, the Commerce Trust Company has not been recommending Chinese ADR shares (shares of Chinese companies listed on U.S. exchanges) for some time. In addition to some U.S. government restrictions, there are issues with lack of audits and many shares are actually Variable Interest Entities (VIEs). VIEs don't own equity in the companies, but own shares in offshore entities which have non-voting interest. While this all sounds complicated, there is a lack of transparency and rule of law that is concerning.

WHAT HAPPENS GOING FORWARD?

Clearly, we're not sure. The Chinese government seems to push hard on reforms, then step back and let the rest of the world get comfortable before pushing again. It seems like the pushing has stepped-up in recent months. With Beijing hosting the winter Olympics in February 2022, I would expect rhetoric to slow down later this fall into the games to keep them in a good light. We are also watching China's COVID cases and the potential for further lockdowns impacting economic growth.

WHAT DOES ALL THIS MEAN FOR MY INVESTMENTS?

With low and improving per capita income leading to rising living standards we believe there are attractive opportunities in Emerging Markets. There will be ups and downs, but those trends should lead to attractive investment returns over time. We continue to recommend clients work with their portfolio managers to help understand the risks and opportunities in financial markets and develop a plan that fits their needs.

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