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Looking beyond emerging market jitters to China, India

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Rather than offer investors genuine diversification, the vastly different outlooks for individual countries (deteriorating terms of trade, currency vulnerability, political and economic turmoil) have introduced an uncomfortable level of volatility to the emerging market (EM) universe. The net result has been to weaken long-term risk-adjusted return profiles, rather than enhance them, leaving investors questioning their initial decision to allocate to EMs.



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In our view, these outcomes have added credibility to, and underpinned, the original rationale behind our decision to focus on China and India as a blended investment approach, giving clients access to what we consider the two standout markets globally in terms of long-term return potential. The visibility provided by political stability and extended policy runways in both China and India, coupled with governments willing to implement bold reforms and incentivise improved corporate management decision-making are just a handful of the many factors supporting the investment case.

What's been happening in the past few months?

As investors, we operate in a world of probabilities rather than certainties. One exception to this rule is the uncanny ability of capital markets to confound consensus thinking, creating a shift in psychology. Heading into 2018, the mood amongst financial market practitioners was ebullient, with equities soaring on the back of abundant liquidity, an extended period of ultra-low volatility, a 'Trump bump' and Fang and Bat mania (US and Chinese stock acronyms in the internet & e-commerce sectors). Fast forward to the time of writing and equities are stumbling, with nervousness and anxiety prevalent across the EM universe.

Politics has supplanted global central bank activity as the point of focus for markets, with the US decision to escalate the trade agenda with China appearing to be the rationale underpinning the latest sell off. Yet it also coincides with a resurgence of worries over; Eurozone stability, prompted by Italian politics; a potential EM debt crisis (notably Argentina, Turkey and Brazil) and flagging global growth, in particular European indicators.

When assessing the potential impact from a China perspective, the market is now starting to look beyond the immediate tariff impact and is asking whether the decades-old WTO-based global trading system could be unravelling. As a result, any sectors that sell meaningfully overseas, have long offshore supply chains, or benefit from global trade, could suffer a significant de-rating in the medium term. This may include; technology, home appliances, apparel, transport (shipping, port, shipyard, toll road, airline & airport). Relatively speaking, domestic service sectors e.g. telecom, defence, fertilizer, domestic tourism, should be less affected.

Our message in early June, at a purely economic level, was that the worse-case scenario at the time (a possible 25% tariff increase on $200bn worth of Chinese export goods adjusted for price elasticity of -1 = $30bn) would have a largely immaterial impact on China in the context of her $12.2trn economy and $2.3bn worth of total export goods. With that said, we also highlighted possible tail risks to that scenario, predicated around Trump's negotiating team (notably Peter Navarro who has explicitly stated his intention to 'go after China's 2025 Development Goals' – a non-negotiable party led-slogan) and the list of demands from both sides. In short, we felt a swift resolution was unlikely, and that the issue would remain a source of market risk in the short to medium-term.

Chances of a serious trade conflict (or worse) developing between the US and China have certainly risen more recently. Our probability of this scenario in early June was 10% or less. This is arguably closer to 25-30% as we stand here today. Unwelcome developments between the two countries will almost certainly outweigh short-term considerations over China's fundamental market backdrop.

From an Indian angle, the trade wars rhetoric is a nuisance rather than leading to structural changes. India's major trade partners include South East Asia, the Middle East, Europe and of course China, so her more domestic focused economy should be sheltered from any international trade tightness. However, negative sentiment is currently in the ascendancy, and with oil prices heading upwards, India has suffered a period of corrective moves despite the underlying micro factors continuing to show improvements through 2Q18. Over the past quarter, foreign investors sold close to $3bn of Indian equities, taking foreign investment towards 2011 levels; markets were 50% lower than current valuations.

How are these global manoeuvres being addressed in the Chindia Equity Fund?

Our China market model seeks to provide timely buy and sell signals, on balance, through cycles.

In recent weeks we have experienced a weakening in momentum in our market timing model that has motivated us to move from a modest overweight China allocation to a neutral weighting. Should our China market timing model continue to deteriorate, we will be swift to act. This will likely include reducing the country allocation to a significant underweight position via a move to the safety of cash and/or through the use of put options.

In terms of the equity composition, there is a strong bias to domestically focused China companies. Real estate, industrials and healthcare are major overweight positions, almost entirely funded by an underweight to the technology and e-commerce sectors. It should be noted that the sector allocation is a function of bottom-up stock selection, not a discretionary view.

Turning to India, the Fund remains underweight Indian equities at this time, a position it took in early 2018 as valuations, particularly in the mid-caps began to rollover and profit-taking along with external factors were taking prices lower. Volatility is likely to remain, and market direction in the short-term to be uncertain, especially given the global external factors such

as oil and President Trump adding pressures to the emerging markets.

Where are we headed?

For China observers, the key question is whether the spectre of financial stability manifests into a significant market event, creating dislocation and stress. What has been interesting in the latest sell-off has been an absence of government intervention to support the domestic capital markets, despite the psychologically important level of 3,000 on the Shanghai Composite being decisively broken. Other surprises to investors include a strengthening (rather than a loosening) of financial deleveraging efforts in recent weeks (indicated by policy initiatives targeting the property market, aggregate financial leverage and local government debt vehicles), and rapid currency devaluation, both against the US dollar and a trade-weighted currency basket since the tariff announcement in mid-June.

If Beijing is moving more rapidly towards addressing the longstanding issues in the banking and credit system than the market has anticipated, two key issues will need to be monitored:

1. The renewed threat of capital flight
2. Public confidence will need to be managed if a genuine removal of the implicit guarantee that has backstopped profligate lending in recent years is enforced.

We expect India's equity market to continue to be buffeted around as the oil price moves, President Trump tweets, currency fluctuates and European woes raise the volatility in global markets. These periods of uncertainty often give rise to opportunity. We continue to seek to deploy capital to areas aligned to the government programmes, such as infrastructure and the consumer, supported by an expanding financial services offerings.

The underlying fundamentals of India remain intact. Strong demographics, with a burgeoning middle class that will surpass most other nations on a purchasing power of parity (PPP) basis in the coming decade. A reform-minded government that heads into the upcoming elections with confidence that they will be returned to power to continue investing in India's future.

Opportunity

The current latest sell-off is creating an attractive entry point. Short-term pressures may persist for a while longer, but attempting to time perfect entry is likely to be a difficult exercise.

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