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Highlights

- There has been substantial media and analyst commentary around the changing political and regulatory environment in China.
- We think it is at risk of overshadowing what economic data releases in July and August have shown about the Chinese economy: genuine economic weakness across the board.

September 2021

Emerging Markets Spotlight

There has been substantial media and analyst commentary around the changing political and regulatory environment in China. Important as this is, we think it is at risk of overshadowing what economic data releases in July and August have shown about the Chinese economy: genuine economic weakness across the board.

Almost every Chinese economic release in those months was both weaker than the previous data point, and below expectations. A selection of this month's would include retail sales for July, +8.5% year-on-year (compared with consensus expectations of +10.9% and a previous print of +12.1%); industrial production for July of +6.4% year-on-year (compared with consensus expectations of +7.9% and a previous print of +8.3%); year-to-date property investment sales for July +12.7% year-on-year (compared with consensus expectations of +12.9% and a previous print of +15.0%); Caixin Manufacturing PMI survey in August down to 49.2 (compared with 50.1 expected and 50.3 in July).

More ominously, the datapoints that we believe lead the real economy were also soft. M2 money supply growth in July declined to 8.3% year-on-year and growth in claims on the financial system declined to 7.4% year-on-year. These together reflect monetary policy as tight as that in the 2018/2019 period. Bond yields are also suggesting a slowdown, with Chinese government ten-year yields lower by 0.3% year-to-date, in a period when most countries' sovereign bond yields have risen.

Despite this, commodity prices have not reacted as might have been expected. Copper has remained at around the US$9,400/t level, having started the year at around US$7,700/t. The iron ore price has come back to US$145/t from its US$235/t peak in May, but is only slightly lower than its US$156/t start of 2020. From an equity investor's viewpoint, MSCI EM Materials has performed well both year-to-date and in the last two months. We cannot see this lasting and remain zero-weight industrial metals producers in the portfolio.

However, we also continue to hold overweight positions in Brazil and South Africa, both of which are major commodity producers. Why are we less concerned about these markets, given our view on the direction of the Chinese economy?

Emerging economies can, in general, be thought of as having a trend rate of economic (or earnings) growth, and then a business cycle around that trend. Even if the medium-term trend is less attractive, markets undergoing a strong business up-cycle can offer compelling opportunities for investors. This is what we believe is the situation in Brazil and South Africa.

In the eight years that followed the 2002-2011 commodity boom, Brazilian GDP growth averaged just 0.5% year-on-year, and unemployment climbed from 5.2% to 11.3%. This period saw a significant slowdown in credit growth and a strong increase in the trade balance (reflecting weak domestic demand). Domestic demand had begun to recover towards the end of this period (for example, car sales bottomed in 2016 and unemployment bottomed in 2017), but the impact of Covid then delayed the recovery. Whilst risks remain, including the timing of the peak in inflation and interest rates, and also political risk from the October 2022 election, we continue to see Brazil as an economy with the economic and financial conditions to stage a near-term recovery in domestic demand, back towards what we fully recognize is a mediocre trend rate of growth. A slowdown in China, with lower commodity prices, may further reduce that trend growth rate but will not, we believe, prevent the recovery.

South Africa finds itself in a similar position. 2012-19 saw average GDP growth of 1.4%, also with weak credit growth and a deleveraging of the private sector, and rising unemployment. South Africa had not even begun to recover before Covid hit, and the improvement in the trade balance was much stronger than in Brazil. We feel that South Africa will also stage a recovery back towards trend growth levels in the quarters ahead, and find opportunities in domestic demand, whilst recognizing that urban unrest and new Covid variants are risks that must be monitored. And, again, we do not see a 2021 slowdown in China as preventing that recovery.

Some emerging markets are commodity exporters, but neither the economies of those countries, nor their equity markets, have mechanical linkages to commodity prices, and there will be times of opportunity in the face of softening export prices. We believe that the second half of 2021 will be such an opportunity.

Source for all data JOHCM/Bloomberg (unless otherwise stated)