

EM Spotlight

JOHCM Emerging Markets Opportunities Fund



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This update is mostly about things that didn't happen in 2019, specifically in China, and those non-events are important given what was expected by some investors and market commentators.

Chinese policymakers didn't stimulate in 2019. Hopes were raised at the start of the year, when the January all-system financing print came in at CNY 4.6trn, but subsequent growth in financing was much milder, and the average monthly increase in all-system financing in the first 11 months of 2019 was below CNY 2trn. Policymakers held back, partly because of a desire to control credit/GDP levels, and partly because economic growth was really okay: retail sales in January-November were 8.0% higher than a year before, industrial production for the same period was up 5.6%, fixed asset investment was up 5.2% in the year to November, and reported GDP has stabilised around 6.0% year-on-year. 2020 GDP growth forecasts have been mixed, with current consensus at 5.9%.

The Chinese banking system didn't collapse. Non-performing loans in H1 2019 for the major banks remained at about the 1.8% level they have been at in recent years, while estimated tier-1 capital ratios for the major banks are between 11% and 14%. From a liquidity viewpoint, the required reserve ratio for major banks was cut three times in 2019 (and again in the first few days of 2020), but liquidity coverage ratios for the major banks remain well above regulatory limits.

The renminbi did not undergo a massive devaluation, despite trading through CNY 7/USD 1 in August 2019. This relative stability was substantially made possible by the restrained credit creation. The Chinese current account is in a small but declining surplus, which, with stable terms of trade and moderate domestic growth, suggests to us that the currency is about fairly valued.

Chinese reformers were not able to make substantial progress towards extending the role of markets in the economy. The two-stage introduction of a more flexible loan prime rate (LPR) was intended to allow bank loans to be priced below the benchmark one-year lending rate. In reality, though, commercial banks have been slow to adopt the new loan pricing mechanism, and policymakers struggled to achieve monetary policy transmission in 2019, with banks remaining cautious to in the context of weak economic growth.

The protests in Hong Kong did not spread beyond Hong Kong, nor did China's repressive policies in its Western provinces have any consequence in its international relations, nor did the trade war between the US and China spiral out of control. Of all of these, only the trade war had any substantive effect on the Chinese economy, and the mid-year weakness in exports eased as Chinese exporters found new markets for their goods, such as Vietnam and other South-East Asian nations.

In the context of stable economics and politics, and a generally positive environment for emerging market equities, how did Chinese equities perform? The MSCI China index returned 23.7% in US dollar terms, slightly outperforming the MSCI Emerging Markets index, but within this the internet-heavy information technology and consumer discretionary sectors were very strong (+43.7% and +52.8% respectively), as was the real estate sector (+38.3%). A-shares also performed well, rising 37.5% in dollar terms, but this gain almost entirely came in the February-April period, after which A-shares drifted lower.

In terms of positioning, then, we do not see China as dramatically exciting in either a positive or negative sense. Without stimulus and credit growth, we do not see the potential for a pick up in the economy in 2020, and while China has some excellent companies in the internet and consumer space, we generally find these relatively expensive in valuation terms. We continue to find opportunity in the quality end of the real estate sector and in the SOE (state-operated enterprise) oil industry. Overall, we think China is a source of opportunities rather than an opportunity in and of itself.

Source: JOHCM/MSCI Barra/Bloomberg as at December 31, 2019.

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