Emerging Markets Spotlight

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Shifting Perspectives in the Chinese Equity Market

Emerging market top-down opportunities and strong consumer-driven growth are unlocking the potential of the Chinese equity market.

KEY POINTS

- The top-down opportunity in EM sometimes comes through good stocks being sold down too far
- Parts of the Chinese consumer economy are recovering strongly and that is driving earnings expectations for companies exposed to that
- Stock markets do not seem to have priced this in during a period of indiscriminate selling.

November 2023 | James Syme

One of our core conceptions about the exploitable opportunities within emerging market equities is that the asset class is dominated by bottom-up investors who, in the aggregate, alternatively underreact and then overreact to top-down developments. Sometimes that overreaction can occur to the downside when groups of stocks within markets sell off indiscriminately due to top-down concerns to levels that are unjustified. We believe this is happening within parts of the Chinese equity market, and that real opportunities are being presented at these price levels.

To be clear, this is not a view that the China equity index is set to outperform the broader emerging market benchmark. The country's core problems, where politically-driven decisions have materially negative economic effects, remain. The property sector continues to struggle, and regaining market share in US imports will not be an easy task.

But our process is designed to be alert to top-down opportunities within countries as well as the top-down opportunities of countries. Chinese retail sales in September increased by +5.5% YoY, but this broad measure hides some real strength in particular segments: restaurant and catering sales grew by +13.8% YoY, and tobacco and alcohol sales increase by +23.1%.

The portfolio is exposed to Chinese companies benefiting from the cyclical recovery, the shift of Chinese consumers away from more expensive foreign brands into domestic brands, and a political preference for domestic brands. In recent results, many of these companies have shown strong growth in consensus forecasts for forward earnings but declining stock prices, leading to a combination of growth and attractive P/E ratio valuations.

Another exposure is to the travel and e-commerce spaces. Domestic travel and tourism are recovering very strongly. Chinese Valentine's Day in late August saw very strong hotel room bookings. The third quarter of 2023 saw profitable results from all listed Chinese airlines, and revenue per room reached a record high for Chinese hotels. The shift online was hugely accelerated during the pandemic, helping companies gain market share and achieve economies of scale, which is reflected in rising margins. In addition to domestic and international tourism, recovery in China's music festivals, business conferences and exhibitions should remain supportive.

Elsewhere in the consumer e-commerce space, business success seems to be ignored by equity markets, both for e-commerce and online services. For some of China's leading online players, share price underperformance is particularly stark given the current global investor enthusiasm for stocks with AI exposure. Leading Chinese companies are likely to be global leaders in the space, combining their existing technological strengths with major investment programs in a Chat-GPT-style Large Language Model. You wouldn't know that from share prices, though.

This is not a 'buy-the-dip' argument – we do not trade price signals. It is not a deep value argument – we remain growth-at-reasonable-price investors. However, what we are seeing within the Chinese equity market are stocks with supportive top-down conditions, strong and steady earnings growth, upbeat results and guidance from management, and valuations that look attractive relative to peers and to the stocks' own valuation histories. As always with our process, it is crucial for the top-down and bottom-up investment cases to align.

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

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The Fund invests in international and emerging markets. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Such risks include new and rapidly changing political and economic structures, which may cause instability; underdeveloped securities markets; and higher likelihood of high levels of inflation, deflation or currency devaluations.

The views expressed are those of the portfolio manager as of November 2023, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.