EMERGING MARKETS: AN EVOLVING LANDSCAPE

MARTIN CURRIE
A Franklin Templeton Company

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For institutional investors in the US only

CHINA

REASONS FOR OPTIMISM IN CHINA

The changing shape of China

In this instalment of our Evolving Landscape series, we discuss the disconnect between share prices and fundamentals, creating a significant investment opportunity.

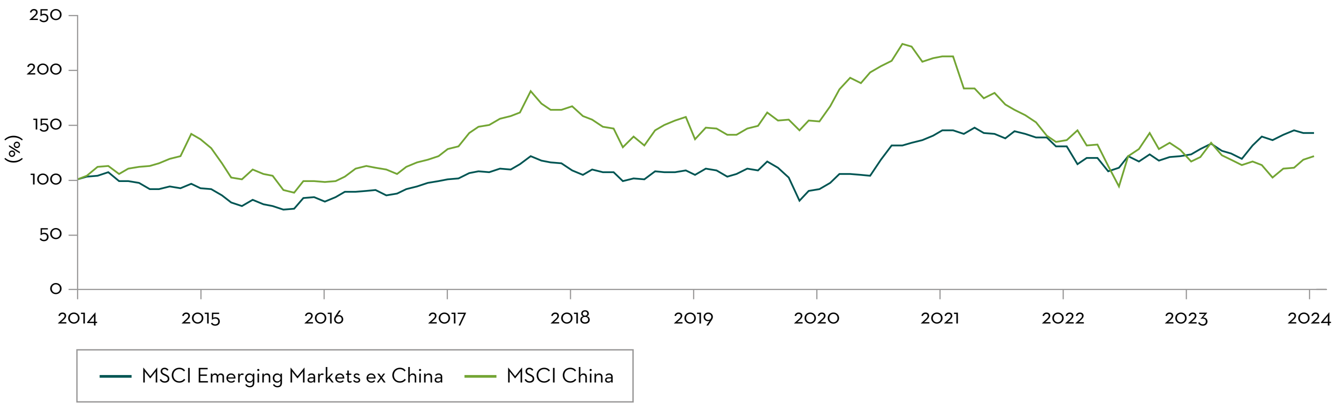
In 2023, the MSCI China index was down 11%, while MSCI Emerging Markets (EM) ex. China Index was up 20% – a performance gap of over 30%. From the end of 2018 to the end of 2023, this performance gap had increased to over 50%.[1]

This recent underperformance of China versus other EM countries has dragged down asset class returns, causing some investors to question their overall allocation to it. There are three primary concerns relating to the performance of Chinese equity markets:

1) The domestic economy and the real estate market in particular
2) Geopolitics (especially China-US relations)
3) Finally, the direction of domestic policy as it relates to the private sector

These concerns have led to a material valuation derating in equity markets – a persistent selloff evidenced by the MSCI China Index performance below.

Performance of MSCI China Index and MSCI Emerging ex China Index over the past 10 years

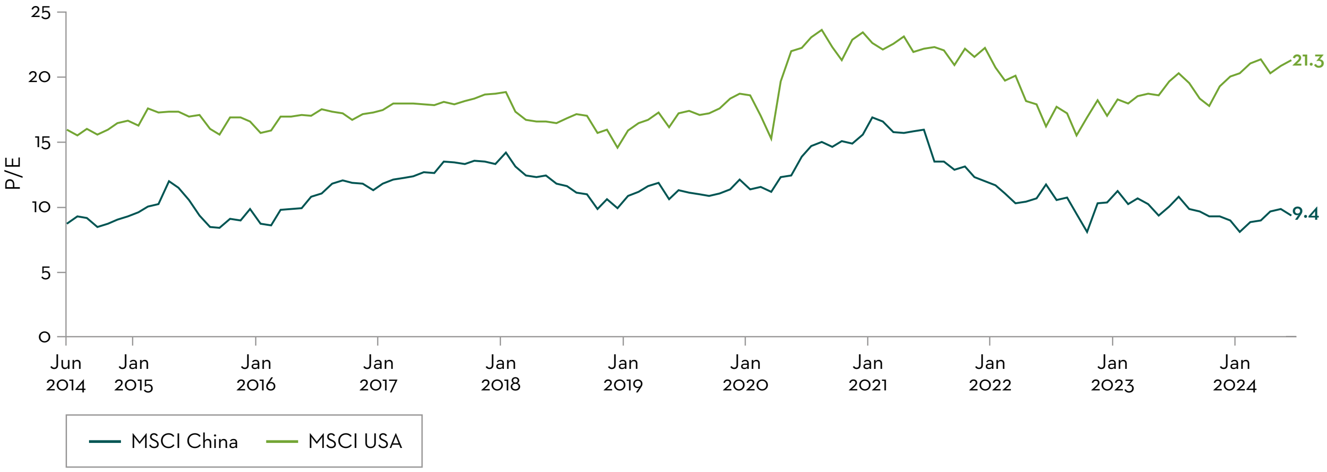


Source: FactSet, as of 31 May 2024.

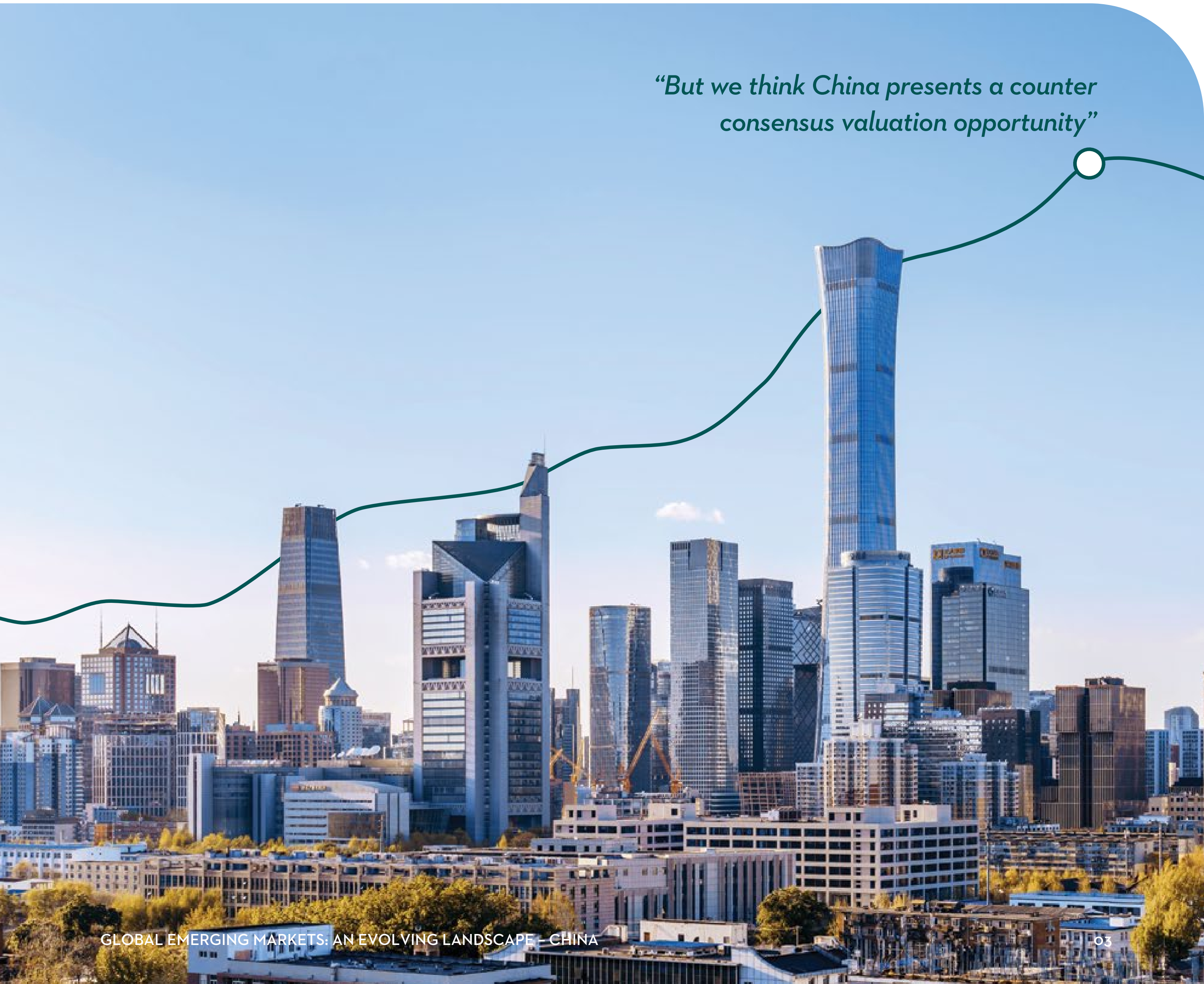
[1]Source: FactSet, as at 31 May 2024.

But we think China presents a counter consensus valuation opportunity. An analysis of the Price/Earnings (P/E) multiple yields interesting results, especially in the context of the strength which we have seen in US markets and can be illustrated in the chart below. China is trading on 9.4x – less than half of the multiple of the US at 21.3x. Put into the context of a ten-year history, we see that, compared to the US market, China has more valuation upside to its average and maximum P/E, with less downside to its minimum P/E.

P/E Multiples of MSCI China and MSCI USA over the past ten years



Source: FactSet, as of 30 June 2024.



"But we think China presents a counter consensus valuation opportunity"

Chinese companies are delivering on fundamentals

At Martin Currie, we use bottom-up, fundamental analysis to identify what we believe to be the best opportunities in EM equities. By examining all our Chinese equity holdings, it is clear that despite the broader valuation derating in the Chinese market, there are many companies which continue to deliver operationally. The table below shows this at a stock level – the projected earnings growth for 2024 for each stock, alongside current P/E in the context of its five-year average (range and mean). For all our strategy's Chinese holdings, the P/E sits within the range seen in the past five years and every stock is near or at its five year low.

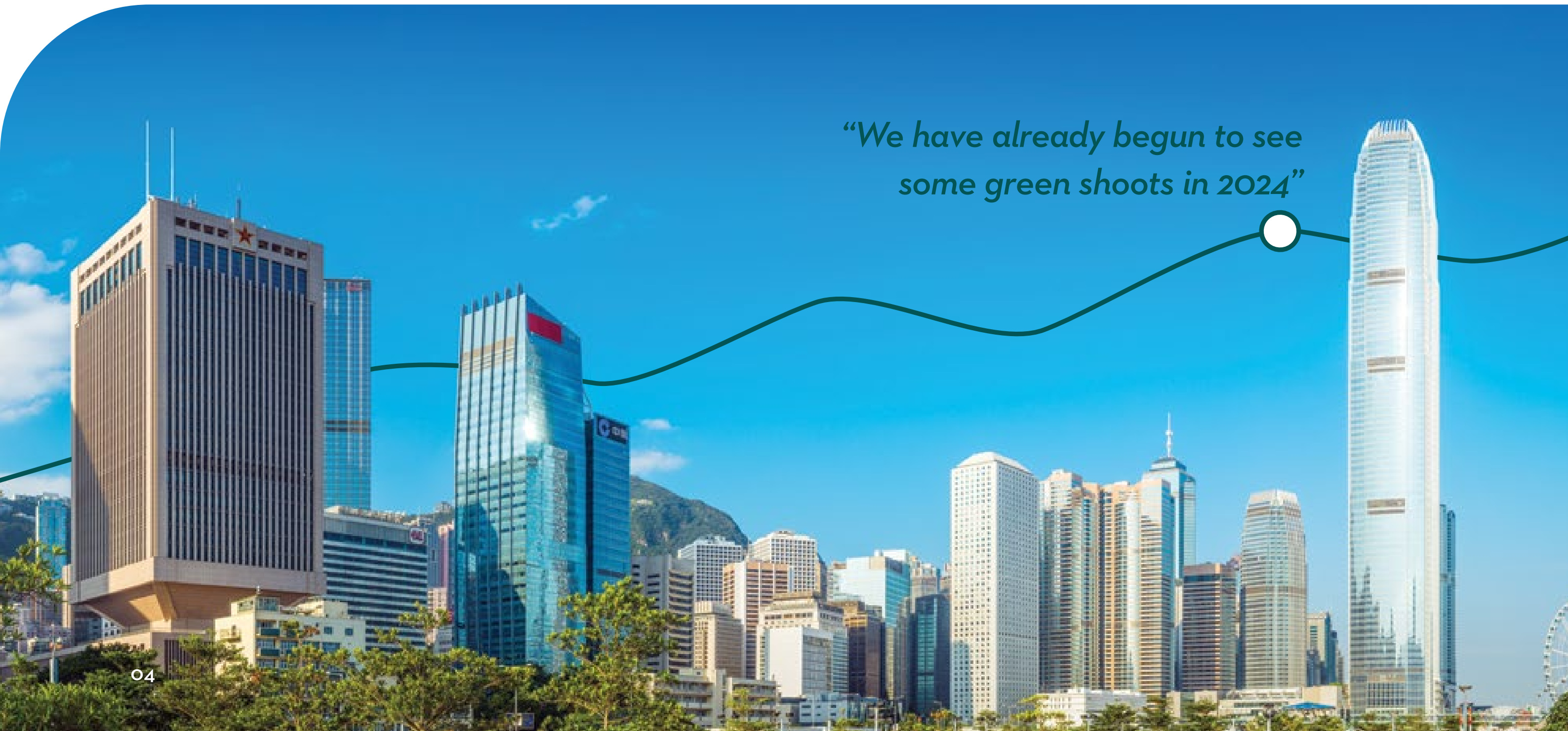
Strategy portfolio holdings P/E and earnings

	2024 Projected Earnings Growth	5 Yr Historical Mulitple Range from 31 May 2019 to 31 May 2024: Low	High	Current P/E as at 31 May 2024	5 year average from 31 May 2019 to 31 May 2024
Tencent	+25%	12.7x	36.1x	16.2	22.5
Alibaba	-8%	7.2x	29.7x	9.1	16.5
China Merchants Bank	+4%	4.4x	13.0x	5.8	8.0
AIA	+60%	9.6x	24.1x	11.9	17.2
Meituan*	+47%	2.2x	22.0x	4.3	8.0
Ping An Insurance	+37%	3.5x	10.9x	5.7	6.9
Minth Group	+20%	4.8x	22.1x	6.6	12.1
CATL	+10%	11.4x	127.7x	17.0	48.0
Shenzhen Inovance	+15%	22.9x	71.6x	23.9	37.5
JD.com	+7%	6.9x	47.9x	9.5	27.0
Proya	+27%	21.1x	68.5x	27.0	44.8
Xinyi Solar	+25%	5.7x	29.7x	7.7	15.8
Shanghai Fosun Pharma	+32%	12.5x	47.6x	16.0	21.4
Shenzhen Mindray	+20%	22.0x	75.9x	23.9	41.3

Current

Source: Bloomberg and FactSet, 31 May 2024. *Meituan shows the P/B multiple instead of P/E due to data availability.

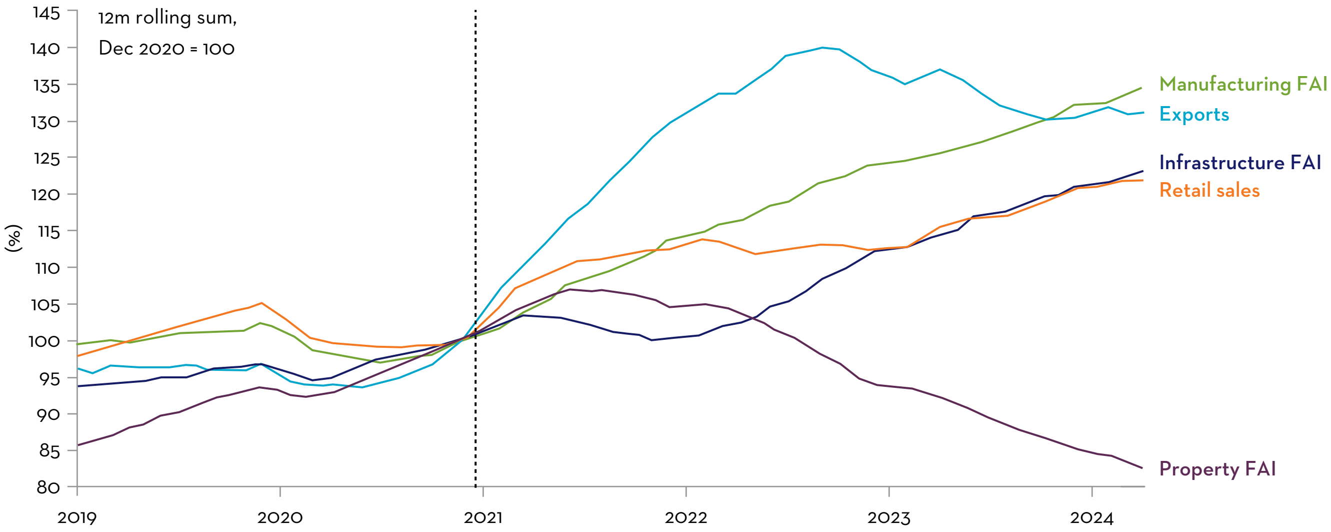
We have already begun to see some green shoots in 2024 as the market began to reward operational delivery in the Chinese market. During the first quarter results season, companies meeting or beating consensus estimates saw a positive market response, which is not something we saw consistently across 2023 when companies derated regardless of the nature of their results. Although this has not been consistent in 2024 so far, we are optimistic that this is the start of a more rational period in which markets return to fundamentals rather than sentiment alone.



Government intervention will support the real estate market

The recent weakness in the Chinese real estate market has become apparent due to years of unsustainable growth. This has had a domino effect in terms of sentiment across all other industries. However, as evidenced below, the main sectors of the Chinese economy outside of real estate have actually grown between 2018 – 2024 as illustrated by the chart below, despite the shorter-term weakness during the 2020 pandemic.

Performance of key segments of the Chinese economy



Source: Macquarie as of 31 May 2024. China Customs, WIND, Macquarie Macro Strategy. December 2020=100, 12 months rolling sum.
FAI = Fixed Asset Indicator, an economic indicator.

The worry is that the real estate sector is going to cause the broader Chinese economy to spiral out of control because it is such a key part of the Chinese market, an influencing factor in the market's derating.

But we think this is unrealistic.

We believe that the government will act to stabilise the real estate market, a key step which should also improve consumer confidence. In doing so, it will unlock a positive virtuous cycle on the Chinese economy. This is the single biggest thing that the Chinese government can do. We have already seen a steady flow of policy support and we expect it to intensify, given that a lot of the excess has already been taken out of the real estate sector.

US-China relations are improving

We believe we are heading towards a more stable relationship between the US and China – a sufficiently positive step for the market. A crucial example of this improvement was in November 2023 when Chinese president Xi Jinping stated that the "earth is big enough for both our countries to succeed" following a meeting with President Joe Biden.[2] This positive signal is not unique and we expect that it signals a calmer period of geopolitics, which should be supportive of equity markets.

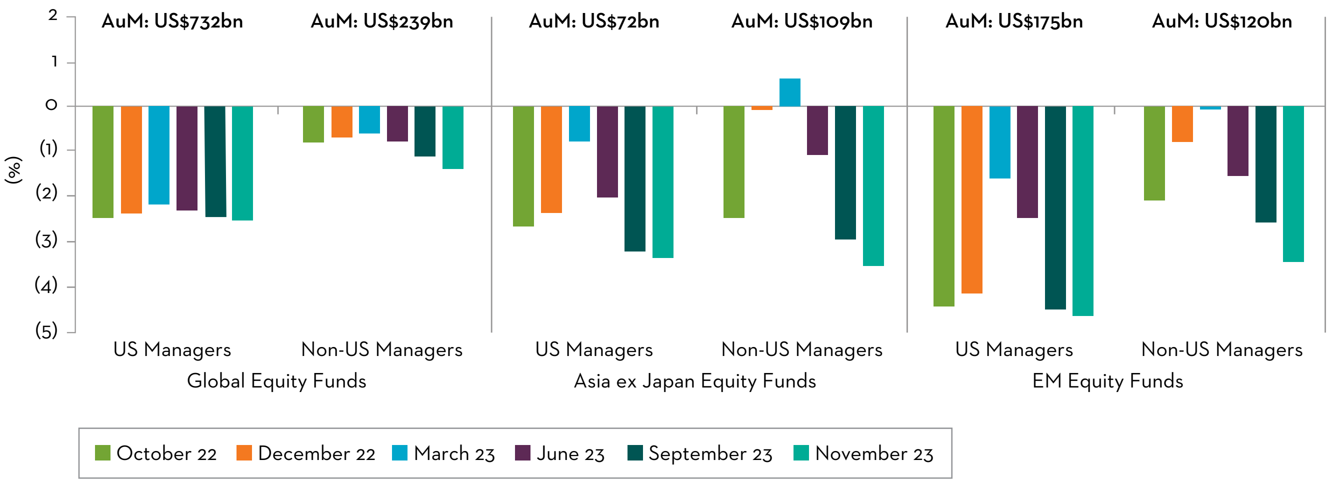
[2]Source: Sky News as at 16 November 2023, https://news.sky.com/story/biden-xi-talks-chinas-president-says-earth-is-big-enough-for-both-our-countries-to-succeed-13009244

Domestic policy increasingly supportive of private sector

China's policymakers are increasingly signalling that private firms are needed in China and economic growth remains a priority. China knows that private firms are needed to achieve their economic desires. The electric vehicle battery sector is an example where the government has provided subsidies, tax breaks and buyer incentives to promote investment, growth and export success of private sector companies. This has helped China become a world-leading producer and consumer of both EV batteries and battery-powered cars.[3]

While the private sector is poised for government-encouraged growth, investors are very negatively positioned. A structural underweight to Chinese equities is one of the most consensus trades in global equities, as shown below. Across all main allocator buckets, investors are on average three to four percent underweight China. Simply moving towards a neutral position in China would represent billions of dollars of inflows into Chinese equities. This creates significant upside potential.

Positon of active long-only managers in China/Hong Kong



Source: Morgan Stanley as at 5 December 2023. Position of Active Long-Only Managers in China/HK.

Positive sentiment

Despite the challenges presented by the Chinese market, there are several indicators that suggest a positive outlook for investors. The government's anticipated stabilisation of the real estate market, the decrease in geopolitical tensions with the US, and the return of an equity market driven by fundamentals rather than flows, all of which should help to reduce uncertainty and raise confidence in China. This may then encourage global allocators to shift towards a more neutral or even overweight position in China. In our opinion, these factors will increase positive sentiment towards China and, by extension, the EM asset class.

[3]Source: Statista and EV-Volumes, May 2023. Reuters,
https://www.reuters.com/business/autos-transportation/china-announces-extension-purchase-tax-break-nevs-until-2027-2023-06-21/

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- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. Accordingly, investment in emerging markets is generally characterised by higher levels of risk than investment in fully developed markets.
- The strategy may invest in derivatives Index futures and FX forwards to obtain, increase or reduce exposure to underlying assets. The use of derivatives may result in greater fluctuations of returns due to the value of the derivative not moving in line with the underlying asset. Certain types of derivatives can be difficult to purchase or sell in certain market conditions.

MARTIN CURRIE
A Franklin Templeton Company

Martin Currie Investment Management Limited, registered in Scotland (no SC066107)
Martin Currie Inc, incorporated in New York and having a UK branch registered in Scotland (no SF000300), 2nd Floor, 5 Morrison Street, Edinburgh EH3 8BH

Tel: (44) 131 229 5252 Fax: (44) 131 222 2532 **www.martincurrie.com**

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