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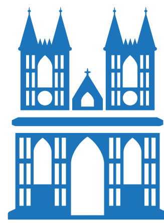
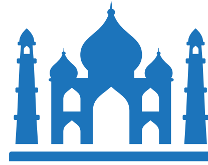

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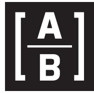

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STRONGER

Emerging markets pass their recent stress test and look poised for a solid year

Fears about emerging market vulnerabilities have kept many investors on the sidelines for the past several years, and some of those fears still linger. What about the falling dollar? What about rising rates? The push-back can be strong.

"It helps to look at these issues in historical context," said Todd McClone, a portfolio manager with William Blair. "In almost every Fed tightening cycle going back to 1970, emerging markets have outperformed developed markets, except in three instances in 1972, 1982 and 1994. Those were termed 'violent tightening cycles,' because the timing or the magnitude of the U.S. rate hike surprised the market. When rates have come roughly as advertised, however, emerging markets have outperformed every time."

The reason is that rising rates usually indicate strong U.S. growth, which is a good backdrop for emerging markets, especially export-orientated companies and countries.

"People are just terrified that if the Fed hikes, or surprises the market, then EM could suffer significant losses," said Matthew Murphy, an institutional portfolio manager at Eaton Vance. "I try to highlight that in 2013, during the taper tantrum, the Fed actually changed positions. They started to tighten on the margin. They indicated that eventually they would stop being super loose, and that's a tightening. It came as a surprise and EM took it on the chin."

Murphy pointed to the years 2004 to 2007, when the Fed hiked rates 17 times, and emerging markets just "kept on ripping." When the Fed reverses course and surprises markets, that's when EM gets hurt.

He believes that it won't matter much if the Fed is off by one or two tightenings. "Even if the Fed hikes four times, and the market only expects three, or the other way around, it won't be too devastating for EM," Murphy said.

In this context, McClone sees the current macro environment as a positive factor, with strong economic growth across much of the emerging market universe, including Brazil, South Africa, India, and all the countries in the CEE3 (Poland, the Czech Republic and Hungary) and the Association of Southeast Asian Nations.

"We are unlikely to see rapid rate increases across EM, and so I think, given this backdrop, expectations for EM growth are much stronger for longer," he said.

Emerging markets are also more resilient today. In a recent bout of volatility, in late January and early February, EM outperformed on a cross-asset basis — including in credit, rates and equities.

"If you look back to the taper tantrum of 2013, the beta of EM rates vs. the 10-year Treasury — that is, how much EM rates moved in sync with Treasury rates — it was 1.2 times," McClone said. "It was only 0.3 times during this latest bout of volatility, because EM current account balances are stronger today than in past crises."

Growth and Volatility

For a lot of reasons, among them Federal Reserve rate hikes, political risk and increasing trade tensions, 2018 may be a year of heightened volatility.

"In our view, volatility will be a big driver in 2018, but we still believe EM is going to do fine, because emerging markets have done a lot of work addressing their external vulnerabilities over the last few years," said Shamaila Khan, director of emerging market debt strategies for AllianceBernstein.

According to Khan, current account deficits are much better than they were in 2013. EM countries are much less reliant on portfolio inflows. Rather, current account deficits are being funded by foreign direct investments, which are long-term in nature. So, in her view, emerging market vulnerability to external risk events has diminished significantly.

"That is a key reason why we believe that emerging markets will withstand this period of volatility much better than in the past," she said. "In fact, this view has been borne out by the performance of EM risk assets so far this year, when EM equities and EM local currency debt, typically the more risky and more volatile sectors of emerging markets, have outperformed their developed market counterparts."

Looking at equity markets during what some market analysts called the "stress test" of late January/early February, the most severe bouts of volatility were seen in U.S. equities. Equity volatility across emerging

FOR LONGER

markets increased but less than in the S&P 500, according to Michael Orzano, senior director of global equity indices at S&P Dow Jones Indices.

The 30-day trailing volatility of the S&P Emerging BMI as of late March was approximately 17% compared with about 23% in the S&P 500 index.

"While there has been an increase in emerging market volatility, the most severe volatility in the last couple of months has really been in U.S. equities," Orzano said. "Historically, those numbers are normally reversed, with EM more volatile than the S&P 500 by a factor of approximately one-third."

Another thing to be aware of, according to Orzano, is the impact that currency has on volatility. He said that about 25% of the volatility of the S&P Emerging BMI has been driven by currency moves vs. the U.S. dollar, so the volatility of the local currency index is significantly less than the U.S. dollar version. "That just highlights the fact that a currency-hedged exposure to emerging market equities has historically removed much of their volatility," he said.

Looking at growth, the other theme for 2018, one sees a newly resilient EM being buoyed by steady growth around the world. U.S. growth has been robust and rising since 2016, even if it may slow slightly from here. Europe is growing, and last but not least, China is targeting growth of 6.5%.

"This is the first time since the global financial crisis that we have seen all three of the world's largest economic blocks growing at the same time," said Teresa Kong, a portfolio manager with Matthews Asia. "That puts us solidly in a synchronized global reflation instead of fighting deflation. We're talking about going from zero to around 2%, which is healthy inflation. It's exactly at this stage of the macroeconomic cycle that emerging market economies tend to do the best."

EM is seeing an acceleration of demand pull from developed countries, especially in the case of smaller, open economies. Last year, currencies in countries such as South Korea, Malaysia and Thailand appreciated substantially.

"As export industries do better, it filters through to local economies," said Kong. "Workers consume more local services and goods, reinforcing a positive domestic demand cycle." •

NO LONGER SO MIGHTY

As the dollar continues its retreat, emerging markets rev their engines

The dollar fell 10% in 2017, as of January this year it hit its lowest level in three years, and it still may not be done falling. For emerging market investors, that may not be such a bad thing.

"Yes, the U.S. dollar has weakened, but from a long-term perspective, it has not overshot fair value," said Teresa Kong, a portfolio manager at Matthews Asia. "Moreover, if you look at currency cycles as multiyear phenomena, we believe there's room for the dollar to depreciate further, which is a positive development for emerging market investors."

Kong said she believes the total decline for 2018 will likely end up in the low- to mid-single digits relative to many EM currencies, about half of what investors saw last year. The decline, however, is likely to be accompanied by increased volatility.

"When I think 'dollar,' I think less about monetary policy, like we did in 2014 with Fed tightening, and more about good old-fashioned macroeconomics," said Matthew Murphy, an institutional portfolio manager at Eaton Vance. "What's more important in driving the dollar today is America's widening budget and trade deficits. At this point in the cycle, the U.S. economy is like a car going the speed limit, and now we're stepping on the accelerator."

The recent U.S. tax cut is likely to stimulate significant domestic demand, which the U.S. won't be able to meet without increasing imports, according to Murphy. And selling dollars to buy foreign goods and services may exert steady downward pressure on the dollar for the rest of the year.

Murphy believes that investors should be focused on the local level to understand how a falling dollar might affect EM currencies. For example, targeting EM countries that are not susceptible to big capital flows driven by the dollar and where external balances (such as current account deficits) are narrowing or in surplus.

"We are looking for countries that have already experienced growth, but where the politics and policy mix would suggest expectations of further growth," Murphy said. "Because if you have growth, and you have improving external balances, you generally get currency appreciation. In our experience, you just need those two things. If you're growing and the external balance is improving, you become a more hospitable place for capital. As capital finds a home there, it's using the local currency."

"The dollar typically experiences a big appreciation cycle into the first Fed rate hike and then sells off afterward. That's exactly what we have seen this time around," said Todd McClone, a portfolio manager with William Blair. "This effect is exacerbated by twin deficits. So now it feels like we are in a bear market for the dollar."

Still Strengthening

McClone pointed out that emerging market equities tend to outperform when the U.S. dollar is weak, with nearly a -0.9 correlation vs. the trade-weighted dollar. And during the market pullback in late February — an event McClone called an EM "stress test" — EM rates and currencies barely budged, and equities fell less than in developed markets, suggesting strong EM fundamentals.

"The market is taking a structural view in reassessing the medium-term trajectory of the dollar, taking into account that the U.S. is now a twin-deficit country and fiscal deficits are going to increase substantially," said Shamaila Khan, director of emerging market debt strategies for AllianceBernstein. "By contrast, the positive fundamentals in emerging markets are causing EM currencies to remain very well supported as the dollar depreciates."

Khan's overall view of EM local markets, plus currencies, has been positive for the past couple of years, and remains so. She is especially focused on countries where her team has identified solid fundamentals, such as Brazil, Russia and South Africa, as well as attractive frontier countries with lower correlation to the dollar. Still, she cautions, "currency exposures need to be actively managed. When we see too much depreciation, or possible political disruptions, those are times to consider taking down EM FX." •

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BABY BULL?

As emerging market equities begin an upward climb, investors wonder if it's the start of a long-term secular shift

Several years of outflows left many investors under-allocated to emerging markets, but fund flows turned positive in late 2016 and have been accelerating ever since.

In addition, EM equities typically outperform when the Federal Reserve is hiking interest rates slowly and predictably, as we are seeing today. Current accounts have improved. Economic growth, measured by GDP, across emerging markets is forecast to outpace that of developed markets this year. Historically, when the emerging market-developed market growth differential is widening in emerging markets' favor, EM equities tend to outperform, as they are now. To top it all off, the current EM equity bull market is barely halfway through its typical 65-month period for EM equities.

Those are a lot of tailwinds, which Todd McClone, a portfolio manager at William Blair, believes are providing a "feast" of opportunity in spite of sentiment that is, at best, average.

"Emerging markets are early in the cycle, with a big output gap, so there is potential to see noninflationary growth for a much longer period of time, with an earnings trajectory that is stronger for longer in EM equities compared to the U.S., Europe or Japan," McClone said. "And valuations are still attractive, being about one standard deviation cheap relative to developed markets."

Shifting Composition

Judging valuations on a historical basis can be tricky, according to Michael Orzano, senior director of global equity indices at S&P Dow Jones Indices. "Today's valuations may not appear as compelling as they were a year ago," he said, "but one has to understand the shifting composition of EM indexes before deciding whether they have more room to run."

Looking at trailing PE, emerging market equities are trading somewhat above their long-term average, he said, but from a sector standpoint, benchmark constituents today are much different than they were 15 years ago.

"Drawing clear-cut conclusions based on simple comparisons may be difficult," Orzano said. "Benchmark constituents today are more heavily weighted toward sectors that typically command higher valuations, like technology and consumer companies. There are also regional differences to take into account. Emerging Europe is trading at a deep discount relative to other regions, primarily due to its heavy weighting to Russia."

So while the overall EM opportunity looks fundamentally positive, one has to dig into the details to understand where EM's outperformance is coming from.

"One thing I would highlight is huge performance differentials across different segments of the Chinese equity markets," Orzano said. "Offshore listed shares, as measured by the S&P China BMI, were up 49% in 2017, but the broad mainland index rose just 14%. And then within A-shares, the largest companies outperformed mid- and small caps. There were also huge performance differentials across sectors, where information technology was up almost 100% last year, led by big Chinese tech giants, but other sectors, like telecom, were flat."

According to Orzano, one doesn't often see such drastic dispersion across different segments of the market.

McClone of William Blair said he believes that the opportunity set for high-quality growth investors in EM has expanded. "With Thailand, Brazil, South Africa and China all growing, it's a bit of a feast at the moment in terms of countries that are doing well," he said. "India may be suffering as assets rotate toward hotter markets, but aside from lingering interest rate concerns, we view India as a great long-term growth story."

To make his case, he cited factors such as favorable demographics, political and economic reform, huge market inflows from domestic retail investors and strong earnings. McClone added that investors cannot overlook frontier markets either, which he does not distinguish from EM. "We have always pushed ourselves to access those opportunities," he said. "In Argentina, for example, reform is taking root, and we believe it will be upgraded to full EM status soon."

He also pointed to Vietnam, which enjoys 6%-plus GDP growth, booming exports, in-migration of production from China, and dramatically lower inflation and policy rates. "Everybody is underweighted in Vietnam and now wants in," he said. "Those of us who are not constrained by the index benefit from these kinds of re-rating stories."

On the Cusp: Emerging EM

As much as EM has evolved over the past decade, its evolution is certainly not over. S&P Dow Jones' Orzano pointed out that China's A-shares, at full weight, would make up about half of a standard EM benchmark. If Saudi Arabia were to enter the S&P Emerging BMI, it would be the eighth-largest country out of 23, with about a 3% weight.

"Index providers are planning to make these changes gradually to prevent disruption in investor portfolios,"

he said. “But there are still large countries emerging within EM that will significantly expand the opportunity set.”

Another emerging opportunity within EM is Chinese small-cap equities, and it’s the sole focus of Tiffany Hsiao, a portfolio manager with Matthews Asia. Chinese small caps may offer very attractive characteristics for EM investors, especially given today’s concerns over rising rates, slowing Chinese growth and escalating trade rhetoric.

“These are the least [leveraged] companies in the Chinese economy, and the least [leveraged] small caps in the world, including India,” Hsiao said. “They tend to be value-adding, high-cash-flow businesses. They generally have very high return on capital because they had nothing to waste as they grew up and were forced to pick strong sectors in which to participate. As a result, over the past 10 years, the volatility of Chinese small caps has been lower than both that of Chinese large caps and U.S. small caps.”

The reason for this unique profile is historical. When the Chinese economy was dominated by large state-owned enterprises, small companies had no access to bank financing, never mind private equity or venture funding.

“Without access to financing, these companies were effectively barred from the centrally controlled, [capital-expenditure]-heavy ‘infrastructure’ parts of the economy, like the telecom, utility, banking and construction sectors,” Hsiao said. “Growth had to be supported by internal cash flow, which itself was supported by picking fast-growing sectors that could support high margins. So rather than making low-margin consumer goods for export (such as toys and shoes), these companies typically offer value-added goods and services for domestic markets. Small-cap industrials, for example, might include companies in the logistics, e-commerce and process-automation businesses.”

Hsiao noted that as Chinese small caps have emerged on the EM scene, the investable universe of China small caps has increased nearly five-fold in the past 10 years. She also believes that the new “cross connect” programs that allow foreigners to invest in A-shares and Chinese to invest in off-shore-listed Chinese companies, will help with price discovery and re-rating of small caps in China. •

Extreme Makeover – EM Edition

Emerging market equities have undergone a great deal of structural change over the past decade. Michael Orzano, senior director of global equity indices at S&P Dow Jones Indices, runs down what investors need to know about evolving benchmarks, and how they may impact EM investing strategies.

How have emerging market benchmarks evolved?
EM equity markets, and therefore EM benchmarks, are much more diverse than they were even five years ago. For example, five years ago, technology was 10% of the S&P Emerging BMI, while energy and materials represented a combined 25% of the index. Today it’s almost the reverse, at 25% for tech and 15% for energy and materials. EM economies are more diverse and, broadly speaking, stronger fundamentally, making them more resilient to traditional vulnerabilities.

What are some key benchmarking issues that investors need to be aware of?
Two of the biggest issues are how benchmarks treat South Korea, and whether they include small caps. Korea is not in our emerging index — we have treated it as a developed market for 15 years. But if you are using an index that includes Korea, be aware that it will represent about a 15% weight, which can crowd out smaller and potentially faster-growing markets.

Small caps pose another challenge for EM investors. Many widely used benchmarks only include large- and mid-cap stocks. Small caps have outperformed historically, so your choice on whether to include or exclude small caps can have a meaningful impact on your benchmark’s performance over time.

Why are EM benchmarks so different and proliferating so rapidly?
The evidence shows that there are ways to add value by digging deeper into emerging markets, and toward that end, EM benchmarks have evolved significantly as the investible opportunity set in EM has expanded.

Today’s benchmarks capture the vast differences among markets. For example, Taiwan, is heavily weighted toward technology, while Peru is focused on mining and financials. Whether one wants to capture the entire broad opportunity set, or just narrow slices of it, investors now have a range of options.

Index providers are flexible, offering indices that can reflect a sector focus, thematic focus (e.g., emerging consumer), country focus, etc. And any of these indexes can be used independently or blended together to express specific views on EM, depending on the different investment styles and needs of specific institutions. •

Threading the Needle on Trade

Tough talk is making markets nervous, raising concerns over just how far trade spats might escalate and who could get hurt

Since the end of World War II, the U.S. has had some of the least restrictive trading policies in the world, but that status quo may be changing under the administration of President Donald Trump.

"The U.S. basically agreed to 'take it on the chin' in order to win the Cold War," said Matthew Murphy, an institutional portfolio manager at Eaton Vance. "So, historically, the administration has a point about 'unfair' trade. But in truth, we consume a lot, we can't produce it all here, and so we need imports. The beautiful thing is that the dollars we spend on imports get recycled back into the U.S. Treasury because we have the exorbitant privilege of being the reserve currency of the world. If we want to let somebody else pick up the free-trade reins, fine. But they will benefit and we will suffer."

It feels like a shock — the U.S. "moving off zero" to start clamping down on trade — but Murphy argued that random targeted tariffs (such as washing machines, solar panels, aluminum and steel) are insignificant in the grand scheme of things, especially to smaller emerging market countries that trade very little with the U.S. In addition, where the U.S. pulls back, others will step in.

"We thought Vietnam would benefit from the Trans-Pacific Partnership when the U.S. was in it, and they will still benefit even though the U.S. is out of it," said Murphy. One of Mr. Trump's first executive orders, signed in January 2017, was to pull the U.S. out of the Trans-Pacific Partnership, a 12-nation trade deal negotiated under former President Barack Obama.

The real danger would be a broad-based border adjustment tax, which has vocal advocates within the U.S. administration, and which Murphy argued would be crippling to the global economy.

So how close are we to an all-out, growth-crippling trade war?

"There's probably more bark than bite coming out of the United States," said Teresa Kong, a portfolio manager with Matthews Asia. She sees tariffs not as an end game, but rather a negotiating tactic. And she argued that to the extent the U.S. can gain concessions, particularly from China, that might be a good thing for all parties.

"China can use the external pressure to force domestic reform and open some strategic sectors," she said. "For example, it would be a win for the U.S. if China allowed in foreign credit card companies. But China has already catapulted past credit cards to embrace mobile payments. So China can technically 'open' those markets to U.S. banks and credit card processors with little threat to entrenched Chinese mobile players."

Not the first movers

What's more, the U.S. is not doing anything that other countries haven't done. India and Brazil both impose tariffs on imported steel.

"Tariffs themselves are not unusual," said Shamaila Khan, director of emerging market debt strategies for AllianceBernstein. "And the U.S. seems to be using tariffs to make the argument that a number of actors have, in the past, taken advantage of U.S. trade policy."

Khan said she believes that the ultimate outcome of the recent tariff announcements has been benign. Moreover, the new penalties against China are not immediate, and they are fairly vague, allowing plenty of room for negotiation.

"A trade war would be mutually destructive not just to global growth, but also to U.S. equity valuations," said Khan. "Given the pro-business reputation of the administration, it does not seem to be incentivized in this direction. So while we may see continued headline risk, a mutually destructive path does not seem likely from the actions taken so far."

The key words being "so far."

"New tariffs affect only about 4% of U.S. trade, or half a percent of U.S. gross domestic product," said Todd McClone, a portfolio manager with William Blair. "But they do raise the possibility of a full-blown conflict. China's response has been relatively measured, targeting only $3 billion of U.S. exports. And our base case is that it's not in China's interest to escalate the trade spat dramatically at this point."

A bigger issue for McClone, however, is that trade protectionists and China "hawks" are gaining the upper hand in the Trump Administration. As they gain in policy influence, the risk of a destabilizing trade conflict between the world's two largest economies increases.

"One can only hope that these actions are tactical, aimed at achieving a negotiated settlement of trade issues before things escalate further," McClone said. "But markets are fearful and have begun pricing that growing concern into risk assets." •

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Don’t Fence Me In

For emerging market debt investors, the best place to find alpha may be in off-benchmark local markets, but caution is key

The opportunity set in emerging market debt is getting larger all the time, and so far this year, emerging market risk assets have performed well. But the story in EMD is one of selectivity: Issuance is high, but high-quality issues may be sparse; in addition, investors may end up finding the strongest opportunities for alpha in a vast sea of off-benchmark local bonds.

"There will be a day of reckoning in the dollar-debt space," said Matthew Murphy, an institutional portfolio manager with Eaton Vance. "A lot of the new issuance is coming out of weaker countries, in our view, and we don't think spreads on emerging market dollar debt offer adequate compensation for the risk."

It makes sense that EMD issuance would be high, given the backdrop: Rates are still historically low, credit spreads are average to below average and the dollar continues to depreciate.

"It's still a great time to borrow," said Teresa Kong, a portfolio manager with Matthews Asia. "The very low cost of capital is driving a high quantity of issuance. The quality of issuance, however, has been mixed."

Kong said the market is full of mid-tier borrowers, and she has noticed countries and sectors that were shut out returning to the market following an uptick in commodity prices. "Given the weakness in the overall cohort of borrowers, I believe active management and security selection will be critical for EMD investors going forward," she said.

Opportunities Abound

Despite the questionable quality of new issues, Murphy sees tremendous opportunity across EM and frontier markets as long as investors can explore the full opportunity set. To put it in perspective, the market cap of J.P. Morgan's three EMD indexes (local, sovereign and corporate) is estimated to total approximately $1.5 trillion. Murphy and his team, however, can access bonds in 80 countries that total $4 trillion in market cap.

He also noted that the J.P. Morgan GBI-EM eliminates traditional debt shorter than 13 months and all "linkers" (such as inflation-linked securities) regardless of maturity.

"Sometimes in EM countries, you just want to get long inflation without getting long nominal rates," he said. "An effective way to do that is using linkers, but for many investors that would be considered off benchmark."

Looking to the widest possible opportunity set fits with Murphy's modus operandi of scouring the globe for higher Sharpe ratio opportunities, where he might get more return for the same risk.

"A good example is Poland, which is 9% of the GBI-EM benchmark, but yielding under 1%," he said. "Why not go to Serbia instead, where you might get a 5% yield and trade the currency vs. the Euro to reduce volatility? That's an example of a potentially higher-Sharpe ratio, higher-returning position relative to a terrible benchmark country that everybody has to own."

"Investors may find their best opportunities by picking countries that are on the move from terrible to bad, and from bad to mediocre," Murphy said. "When countries are moving from good to great, the highest-returning opportunities are likely over."

Again he pointed to Serbia, where only 10 years ago rates were above 14%, with inflation at 10%, and nobody wanted to own it. He admitted that those numbers look "scary," but he felt at the time that 14% return was adequate compensation for the risk. Today, a lot of people want Serbia at 4%, according to Murphy, because it's paying more than Hungary, the Czech Republic or Poland.

"And when J.P. Morgan adds Serbia to the EM benchmark, a lot of investors will run in and there will be a big yield compression," Murphy said. "That will be a happy day. But almost like seeing your kids going off to college — exciting but a little sad. Then we have to find the next Serbia."

To get those kinds of re-rating calls correct, investors have to be smart and informed about the political context and potential reforms that make such stories possible, according to Shamaila Khan, director of emerging market debt strategies for AllianceBernstein. And over the last few years, she pointed out, many investors have not gotten political risk right.

"One has to be careful about where you are being adequately compensated for risk," said Khan. "Where we are early in the re-rating storyline, and where we see potentially positive political change is in places like Brazil, Argentina, Ukraine and South Africa. Where we are cautious and see potential deterioration is in Mexico, which has been an EM favorite for several years. But there are potential dangers on the horizon for Mexico, with upcoming presidential elections, NAFTA talks, and other critical economic and political issues."

For Khan, the most attractive opportunities in EMD today are in currencies, where she believes many still have room to run. The story last year may have been one of disinflation and rate cuts, where this year EMD is attractive for the carry and currencies.

"The gap between EM and DM [developed market] rates was very high, but it has stabilized," Khan said. "The carry is still attractive and currencies are still attractive, even though we may not get the same kind of rate-cutting cycle that we got in many EM countries last year."

Global Growth Beneficiaries

The best carry and currency stories, she added, are in places like Nigeria, Sri Lanka and the Dominican Republic, where valuations do not yet fully reflect improving fundamentals. "Those countries may also be very good diversifiers for broad EMD portfolios," noted Khan. "Overall, we have been looking hard at the growth theme, overweighting markets where growth has been rebounding reasonably, where countries are beneficiaries of global growth and where we see improvement in the political outlook. On the other hand, we have been underweighting countries where we think there is not a lot of value. For example, China, the Philippines and some Eastern European countries are fundamentally fine but trading extremely tight."

For Teresa Kong, of Matthews Asia, some of the best EMD opportunities may be found in the Chinese onshore local market, which she sees as attractive from a credit, rate and currency perspective.

"The government pushed banks to raise lending rates to levels that are unusually high and, we believe, unsustainable, so it is a good time to lock in relatively high interest rates," Kong said. "From a credit-spread perspective, the higher cost of capital has led to higher spreads along the entire curve, especially for relatively safe government-owned entities — and we believe the Chinese renminbi has more room to appreciate."

In sum, all three stars of credit, currencies and interest rates look aligned for onshore local Chinese bonds, where Kong said investors may find 5%-plus yields on quasi-government credit in an appreciating currency. •

Power Play

China's economy may be slowing — slightly — but it's still growing, awash in assets and flexing its muscle across the globe

Its growth may be slowing, but don't count China out. Absolutely it is an economic superpower, and only just beginning to come into its own as a dominant actor in the global market.

"Everybody focuses on debt levels, which are high, but I think that misses several key issues," said Shamaila Khan, director of emerging market debt strategies for AllianceBernstein. "The private sector is not highly leveraged. The consumer is not highly leveraged. A lot of the bad debt is between government-owned banks and government-owned enterprises, which makes it a lot easier to rationalize and restructure. It's also a country very rich in assets."

Khan pointed out that China has stabilized its overall debt levels and reduced its servicing costs. So she believes that China will continue to "muddle through" for quite some time with growth only slightly below current levels.

"In our view, China is unlikely to do anything that causes a significant decline in growth rates, which has been a big concern of the market over the last couple of years," she said. "The process of rationalizing the debt level is something that will happen slowly and very gradually. Our base case is that it will have some negative impact on growth, but nothing dramatic."

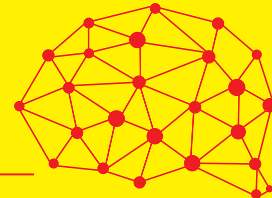
For investors, the larger questions should be: Where is all that economic muscle being put to work? and What kinds of opportunity does it create?

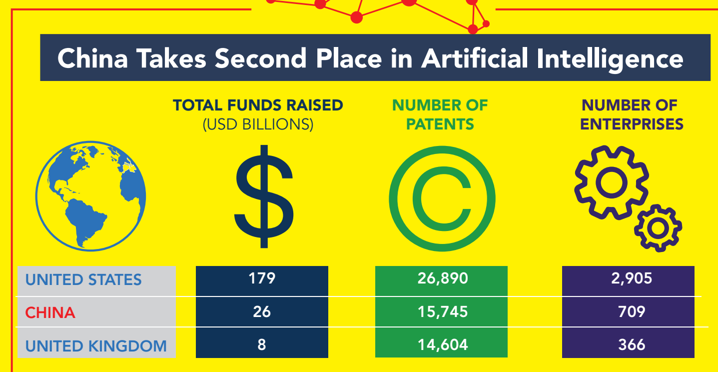
To begin with, the size of the market is staggering. The China A-shares market is currently the single largest factor affecting the emerging markets opportunity set as it represents a substantial expansion of the investible universe, according to Michael Orzano, senior director of global equity indices at S&P Dow Jones Indices.

"To put this in context, China currently represents about 30% of the broad emerging market benchmark, the S&P Emerging BMI," Orzano said. "Giving full weight to the A-shares market, China would increase to about 50% of the index, so it would compose about half of a typical market-cap weighted EM benchmark."

In addition, that growing opportunity set is more diverse than ever. Growth in "new China" has been outpacing "old China" for years, according to Todd McClone, a portfolio manager with William Blair. Those "new China" investment opportunities span a range of sectors, from education, to travel and leisure, to gaming, to healthcare and information technology. In just one industry, artificial intelligence, China has leapfrogged most developed markets to take second place.

Finally, and perhaps most important, as the U.S. pulls back on international trade and investment, China is stepping in on a scale perhaps orders of magnitude larger than what the U.S. was prepared to do. Chinese savings are flooding EM markets, not only as consumers travel and spend more, but as the government sets its sights on global economic influence.





China Takes Second Place in Artificial Intelligence

	TOTAL FUNDS RAISED (USD BILLIONS)	NUMBER OF PATENTS	NUMBER OF ENTERPRISES
UNITED STATES	179	26,890	2,905
CHINA	26	15,745	709
UNITED KINGDOM	8	14,604	366

Source: Goldman Sachs Global Investment Research and William Blair, as of Sept. 2017.

"China's One Belt One Road program is really the Marshall Plan of the 21st Century," said Teresa Kong, a portfolio manager with Matthews Asia. "It will have a material economic impact across all of Asia, all the way out to Eastern Europe and Istanbul, and down to the Maldives and Sri Lanka through India. If implemented at the scale envisioned, it will be transformative."

For example, China has made a $50 billion commitment to Pakistan, stepping in where Saudi Arabia and the U.S. have stepped back. It's extremely important for EM investors who own Pakistan government bonds to understand that debt package and its potential impact, as well as Pakistan's underlying creditworthiness, according to Kong.

Khan at AllianceBernstein also pointed out that the huge inflow of Chinese capital is having an impact on Pakistan's balance of payments. Pakistan now has to import a lot of raw materials to do much of the construction being funded — a double-edge sword in terms of positive and negative impact.

The political consequences cannot be ignored either.

At William Blair, McClone contrasted the experiences of the Philippines and South Korea. When the Philippines instituted a "visa on arrival" program for Chinese tourists, the flood of money boosted all kinds of tourism-related companies, especially gaming companies. But when the U.S. installed its anti-ballistic missile defense system in South Korea, China cut off tourist traffic there, wounding Korean travel, gaming, duty-free and other tourism-related companies.

"China will wield much greater strategic influence as Chinese capital becomes more entrenched in these economies," McClone said. •

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