Insights
Equities

Why It's Time for China Equity to Go Solo

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In emerging markets (EM) equity portfolios, much of the beta is driven by the performance of Chinese stocks. As a result, EM equity index holders may inadvertently be devoting their risk budgets to the macroeconomic and microeconomic dynamics of Chinese corporates, rather than to the overall performance of EM. To ensure broad EM exposure and attain better control of Chinese risks, we believe that investors should consider EM ex China alongside a dedicated China equities allocation.

The EM Index Has a High Concentration of Chinese Stocks

China represents 31.4% of the MSCI EM Index,[1] on par with China's share of the EM economy[2] (Figure 1). China's weight in the MSCI EM Index has grown over the past two decades (Figure 2). In addition, on average, global equity funds' ownership of China is in line with the MSCI EM Index,[3] per Morgan Stanley data. As a result, China heavily influences the performance of the EM Index and the returns of global equity portfolios.

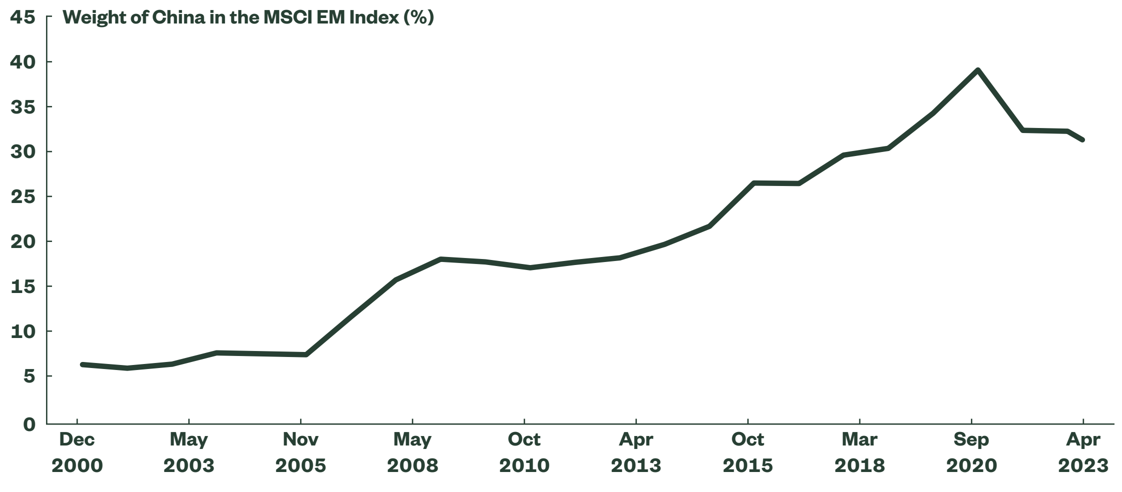
Beyond its sizable concentration, slippage in China's performance often leads to headwinds for other EM names, multiplying China's impact on EM Index performance. For example, weakness in the tech cycle has impacted EM manufacturing, while softer demand for international goods has led to lower orders for EM countries to fill.

Figure 1
China: A Large Driver of EM Index Performance, But Underrepresented on a Global Scale

Weighting Methodology	China (%)	EM Ex China (%)	Developed Markets (%)
MSCI ACWI (free-float)	3	7	89
MSCI ACWI (full-float)	12	13	75
MSCI EM	31	69	N/A
IMF GDP (PPP Weight)	19	40	41

Source: MSCI, IMF, State Street Global Advisors, as of April 28, 2023, except IMF GDP (PPPIMF GDP — PPP forecasts are as of April 11, 2023, release. Projected characteristics are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Figure 2
The Concentration of China in the MSCI EM Index Has Risen



Source: MSCI, as of April 28, 2023.

By contrast, from a global lens, China is *under* represented. China's weight in the MSCI ACWI (3%) is well below its weight in the IMF GDP (19%). This suggests that holding China in an EM Index is overweighting the exposure, but holding it purely through a broader global Index may be underweighting it.

We do acknowledge that China's impact on global markets extends far beyond the PPP weight. Imports remain weak, dropping 7.9% year-over-year in April (well below median projections of -0.2%, per Bloomberg), versus a 1.4% decline in March, as Chinese consumers scoop up less international goods. Furthermore, the Chinese supply chain is integral to a wide range of industries, including technology and renewables, and China is home to manufacturing facilities of many of the largest international businesses. Before the pandemic, Barclays estimated that about 60% of luxury goods purchases from Chinese consumers were done outside the country — mostly in Europe.[4]

Nonetheless, we believe that the exclusion of China from an EM portfolio can be accompanied by a standalone allocation to China elsewhere that is matches each investors' risk tolerances and performance goals, and takes advantage of the current return premium in Chinese equity.

China Risks Call for an Intentional Approach

Given geopolitical and economic challenges in China, we believe that investors should pay close attention to the China-specific risks in their portfolios from an EM Index allocation. At bottom, separating and owning a China exposure alongside EM ex-China will give the allocator better control to manage these risks, which include the following:

- **International Espionage and Security** Chinese tech and other enterprises face intense scrutiny as they aim for global expansion, as nations fear that Chinese apps will be used to collect sensitive information or increase Chinese influence. For example, ByteDance founder Zhang Yiming has for years encouraged global expansion and a "Martian" approach in which the company is truly global, without a peg to any originating nation. This goal is becoming more and more difficult, as evidenced by the grilling taken by TikTok CEO Shou Zi Chew during his testimony before US Congress in March. India has already banned ByteDance, and the US has long considered a ban or a required sale of the business. In the US/China, recent political tensions arising from flying objects over US/Chinese skies and differing policies toward Russia have further increased concerns about the theft of data, the ability of Chinese companies to create international paths and the ability of Chinese tech firms to collaborate on innovations such as AI.

- **Corporate Investment/Divestment From China** Global corporate investment remains vital to the Chinese economy, as private investment remains weak and the shift from public to private investment is slow going. However, investment into China has become more challenging for multinational corporates primarily due to concerns about Chinese ideology. A September report from the European Chamber of Commerce called out these challenges, and also noted that EU foreign direct investment (FDI) into China has become more concentrated, with the top 10 investors now contributing over 70% of the total, versus relatively even distribution five years ago. See appendix for more detail on FDI.

  On the flip side, the report noted that most European companies still plan to use China as a manufacturing hub, and similarly, 74% of US companies say that they are not considering relocating manufacturing or sourcing outside of China.[5] Ideological or operating environment concerns are mitigated by China's cost advantages and its ability to produce in all 666 sub-categories (based on the United Nations classification) in the manufacturing sector, per JP Morgan. Also, a "China+1" strategy, in which businesses supplement their China operations with investments in other Asian countries such as Vietnam and Indonesia, has gained popularity.

- **Global Reshoring** Following the pandemic, countries are aiming to make their supply chains more resilient to shocks and to systemic risks such as climate change. The Biden Administration has enacted a wide range of regulatory changes to bring China supply chains back to the US, including tax credits to boost efforts for clean manufacturing and technological research domestically (see The Inflation Act of 2022: ESG Implications). Reshoring exercises are also happening within China, as President Xi in May said that China should accelerate research to achieve technological self reliance, and "dual circulation" remains a key theme for Chinese policymakers.

- **Property Sector** The property sector remains challenged, as sales and new starts further deteriorated in April, per the National Bureau of Statistics of China. New land acquisition also remains weak, and the stimulus provided by the government to boost the property sector has likely already transmitted and made its impact. This sector accounts for about 20% of Chinese GDP,[6] so slowness in the sector is a substantial drag on the Chinese economy.

Investors Can Take Steps to Harness China's Return Premia

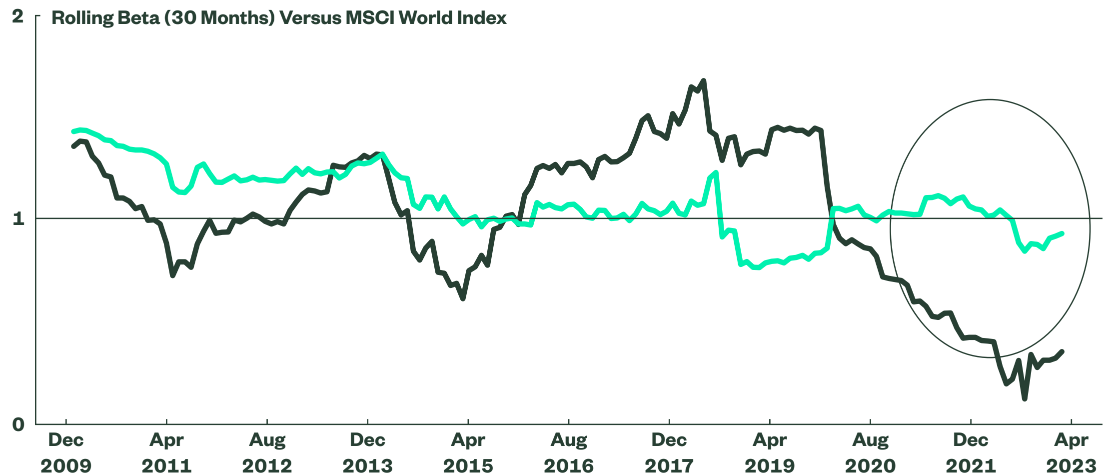
The challenges in the previous section come on top of historical data showing that the risk associated with owning China equities is higher than the risk of owning EM in terms of both historical and forward projected volatility. While our forecasts put forth a long-term standard deviation of 17.2% for EM, the long-term risk forecast for China is 26.9%.[7]

In our view, one of the reasons why China warrants an independent allocation is because it carries greater risk. This could be especially useful to investors who practice a factor-based approach and deploy capital based upon a risk-budgeting framework. By breaking out China from EM, investors can ensure that they budget for China risks and receive a more favorable return from owning the systematic risk.

A Standalone China Strategy Offers Potential Diversification

China's policies, growth trajectory, and other trends distinguish it from other nations and require increased analysis. For example, China is one of the few nations grappling with deflation, rather than inflation, despite the post-pandemic reopening of the country. For April, the CPI print was 0.1% year over year, a more than two-year low, and producer deflation fell further, to -3.6% year over year. While the US and other EM and developed markets are raising rates, China has been on hold and may ease as a fillip to consumer confidence and industrial momentum. The rolling beta of MSCI China versus MSCI EM ex China has fallen sharply since 2021, exemplifying the divergence of China's performance from other EM countries (Figure 3).

Figure 3
China's Equity Performance Has Diverged from Other EM



Source: MSCI, State Street Global Advisors, as of April 30, 2023.

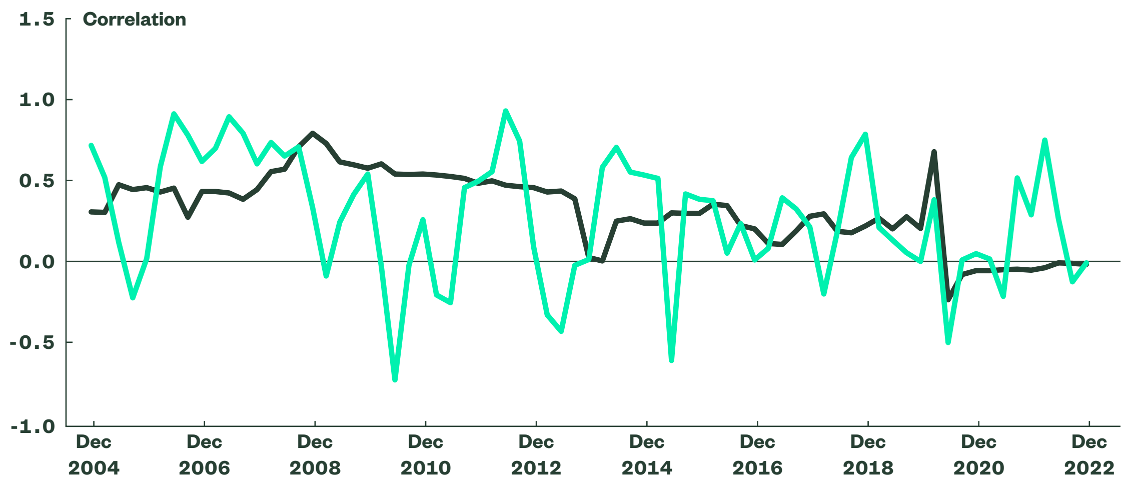
Looking more closely at the diversification potential from owning China, we also compare the rolling return correlations of both MSCI China and MSCI Ex China to the MSCI World Index MSCI Ex China shows generally higher correlations to the developed world, especially more recently (Figure 4) The correlation has bounced around over the years, especially during China's strong market performance in late 2014 and early 2015, when owning China would have provided helpful diversification (as correlation declined). However, it is also apparent that China has become more highly correlated to MSCI EM in recent years.

Figure 4
China Has Provided Diversification Benefits in Some Periods

Source: MSCI, State Street Global Advisors, as of April 28, 2023.

In addition, we note that EM ex China is typically more sensitive to global growth prospects and Fed rate movements, which is often an exposure garnered from other areas of a portfolio (Figure 5). Therefore, China standalone portfolios tends to be more idiosyncratic and diversifying. We believe that investors would benefit from analyzing where various risks are in overall portfolios, how they are budgeted for and whether there are implicit over/underweight views.

Figure 5
The EM Ex China/ US GDP Correlation Is Within a Much Narrower Band Versus China/US GDP Correlation



Source: MSCI, State Street Global Advisors, Quarterly Data, as of December 31, 2022.

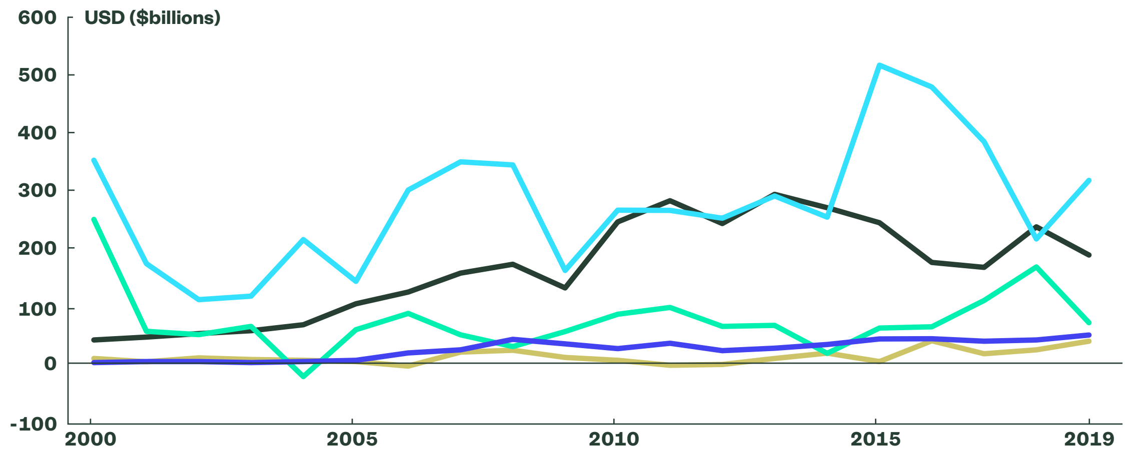
Conclusion

China's growing influence in the global market economy compels investors to reevaluate traditional concepts of asset allocation. We believe a dedicated allocation to China allows investors the opportunity to better meet return objectives, as does the deployment of active management to generate excess return. A dedicated exposure to China helps investors to focus on an increasing source of risk within their portfolios.

Appendix: Foreign Direct Investment Trends

Foreign Direct Investment (FDI), a strong indicator of sustainable growth, within China is trending upward, despite some protection nist policies that run counter to the liberalization of trade in recent years (see Figure 6). Protectionism is not likely a permanent global policy; however, the path toward a resolution can be steep and is unlikely to be linear. We expect participants to find common ground because the benefits of collaboration and efficiency are too numerous. Per recent data from the World Bank, we expect pandemic-based economic disruptions will likely impact the FDI decisions of companies. The full impact on FDI flows will depend upon the success of public health measures to combat the pandemic, as well as economic policy responses.

Figure 6
Foreign Direct Investment Net Inflows, 2000–2019, by Country
Balance of Payments, Current USD



Source: The World Bank, World Development Indicators, State Street Global Advisors. Annual data provided at year-end.

Endnotes

1 MSCI, as of April 28, 2023.

2 China's share of the EM economy is calculated as 19 % (40+19).

3 Data showed China GEM exposure (Country/Market Weight) was -0.6% (slightly underweight) relative to China's weight (Country/Market Weight) in the MSCI EM Index. EPFR Global, Country Allocation Database and Morgan Stanley Research. Fund Weights as of March 2023.

4 Barclays, "China: Why the Fatigue" call, May 4, 2023.

5 AmCham China's 2023 China Business Climate Survey Report.

6 Bloomberg, "China's Home-Price Growth Slows as Property Rebound Fizzles." May 16, 2023.

7 From State Street Global Advisors' March 31, 2023 Long Term Asset Class Forecast.

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* Pensions & Investments Research Center, as of December 31, 2022.
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