Insights
Emerging Markets

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Including China

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China's uniqueness, size, continuing growth story, and low correlation profile suggest that investors would be well-served by a dedicated China portfolio allocation.

China's size and share of the global economy make it impossible for institutional investors to ignore. Recent market headwinds emanating from the country's COVID lockdown policy, regulatory actions, friction with US regulators, and geopolitical positioning have led some investors to reassess their portfolio allocations to China.

Messaging from the China Politburo's[1] recent quarterly economic meeting was about policy easing and supporting growth — and the country's 5.5% GDP growth target was re-affirmed. This is at odds with the hawkish tone and less accommodative policies seen in many developed countries, and also provides an example of the unconnected business cycle playing out in the Chinese economy.

Despite China's economic backdrop and recent market drawdowns, we believe the country's growth story will continue, although that story is changing and becoming more complex. China's contribution to global growth is increasing — though at a slower pace — and we believe that the China investment opportunity remains compelling over the long term, even as we remain cautious in the short term. With that as context, we hope the thinking below can help you to clarify your view on China's role within your broad asset allocation framework.

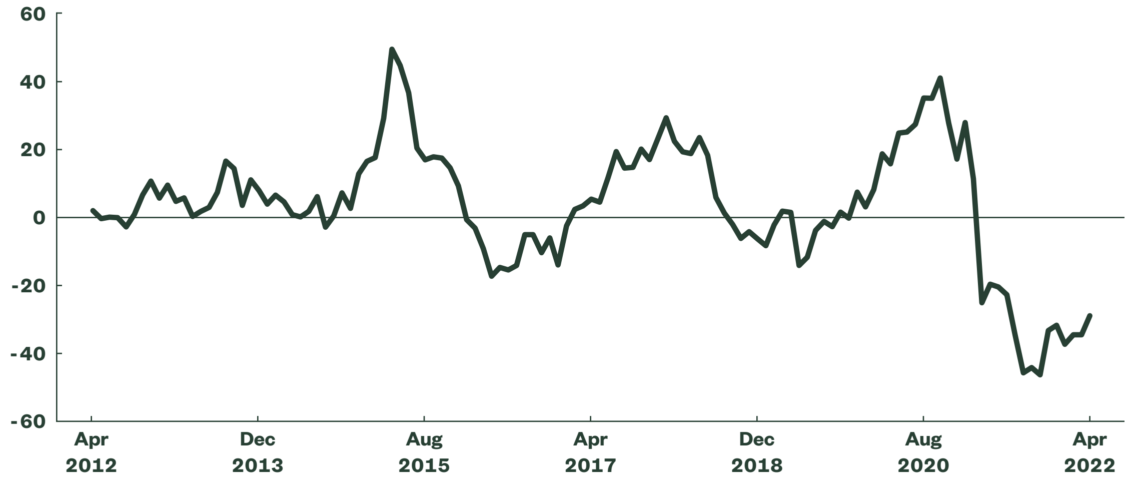
Case for a Standalone Equity Allocation

China makes up 30.57% of the MSCI Emerging Market Index.[2] When such a concentrated position is embedded within an index, it is generally a prudent portfolio decision to disassemble the concentration and create appropriate levers by which targeted re-allocations are possible. If the only China exposure an investor has is within a broad EM index, when that investor wishes to make a trading decision on a specific China view they would also be selling/buying the other 70% of the EM index along with it — an action that may not be desired.

The last twelve months provide an example of substantial differences among the constituents of an EM allocation. China experienced multiple challenges, which has put systematic downward pressure on stocks. However, outside of China, strong commodity production by other EM countries was highly supportive during the current period of high inflation.

Looking back over the last 10 years, there were instances where the return differences between China and the rest of EM were more than 40% (see Figure 1). With this amount of deviation, the ability of investors to take targeted profits or preventive losses becomes an important portfolio construction tool. Having separate China and EM ex-China asset allocations will provide this flexibility.

Figure 1
Return Differential of MSCI China versus MSCI EM ex-China
Rolling One-Year Basis

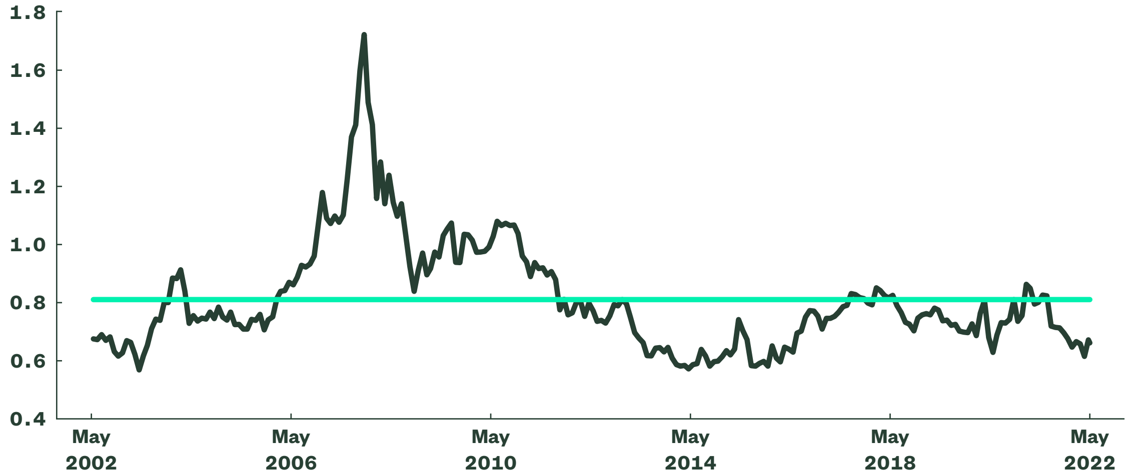


Source: State Street Global Advisors, MSCI, FactSet. As of April 29, 2022.

Returns Profile

China equities are currently trading at a comparatively deep discount not only to themselves, but also to developed markets — largely due to the aforementioned headwinds (see Figure 2). While valuations can remain abnormal for a prolonged period of time, we think they are particularly important when looking at a long-term horizon. Additionally, while economic growth and equity valuations often become disconnected in the short term, we believe there is a connection over a longer horizon. From this perspective, China continues to have a superior economic growth advantage over developed markets, now and in the future.

Figure 2
P/E of MSCI China Relative to P/E of MSCI World
Next Twelve Month Basis



Source: MSCI, FactSet, State Street Global Advisors. May 2002–May 2022.

Quality Style Bias

Within China, we continue to believe a structural quality style bias is important, as it can dampen volatility when further risks arise. Specifically, we see opportunities in the new economy that pick up on technology and rising consumer themes, as well as in industries that were named as a priority in the "Made in China 2025" plan (see Figure 3).

Figure 3
Priority Industries Named in "Made in China 2025" Plan

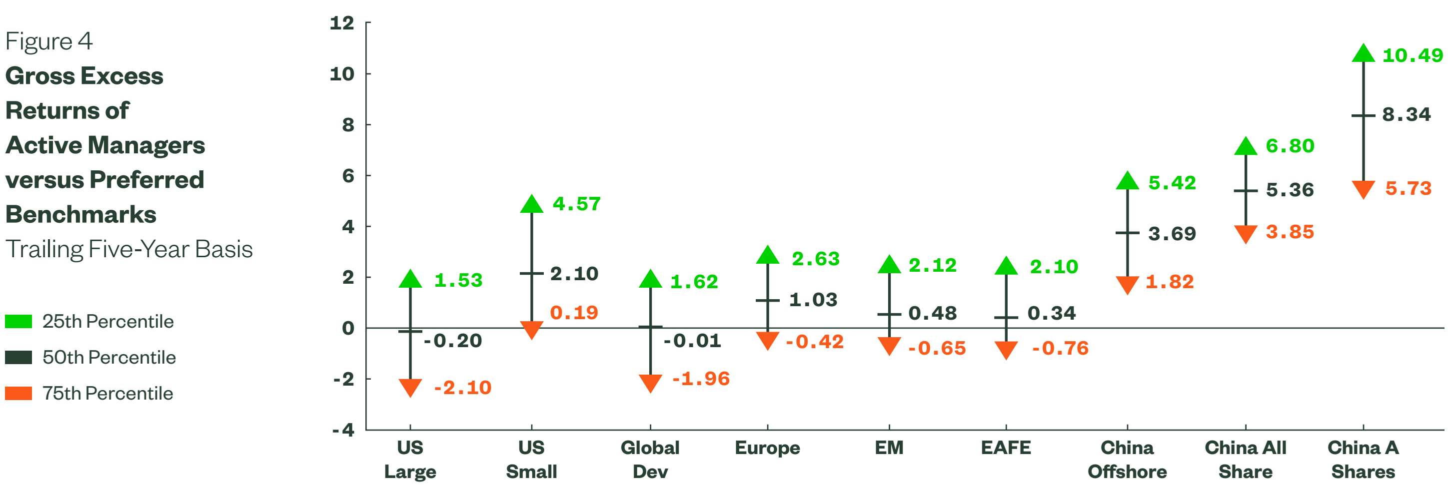
Information technology	Electrical/power equipment
Robotics/numerically controlled machine tools	Farming equipment
Energy-saving vehicles and EVs	Ocean engineering equipment/vessels
Aerospace equipment	Rail transportation equipment
Bio-medicine and medical equipment	New materials/polymers

Source: english.gov.cn.

Active Management

To help navigate China's unique and evolving landscape, we have a strong preference for active management. For example, the Chinese regulatory rule-making process has little transparency, e.g., often lacking public debate or open hearings as part of the process. This means markets can be caught off-guard by unexpected announcements. However, we believe quality active managers can better navigate this landscape by picking up on subtle messaging, or other signals that regulatory changes may be on the way. Also, a less efficient market with lower analyst coverage and higher retail ownership is typically a ripe environment for experienced active management. Figure 4 shows the opportunities being realized by active management in the China equity markets versus other global markets.

Figure 4
Gross Excess Returns of Active Managers versus Preferred Benchmarks
Trailing Five-Year Basis



Source: Evestment. Five-year universe returns through March 2022.

And while we do have a preference for active management, we also believe there is an essential role for index allocations. Index investing offers a low-cost and liquid way of gaining exposure, allowing for quick and nimble adjustments without disturbing an active program. As a general guideline, we recommend that between one-third and one-half of an overall EM equity exposure be held in index strategies.

Diversification

A China allocation provides strong portfolio diversification benefits. In 2020, China emerged from the worst of the pandemic before most of the rest of the world. As populations remained homebound and started spending on goods rather than services, China's manufacturing and exporting sectors benefitted. The Chinese business cycle entered recovery mode before much of the rest of the world. And currently, from a monetary policy perspective, much of the world is increasing policy rates while China is going the other direction and implementing an easing policy.

The China business cycle is frequently idiosyncratic in nature, and often moves in an asynchronous way. Return correlations show these effects, and China stands out on a relative correlation basis (see Figure 5). Much of the developed world sees intercorrelations of 0.75 and above, while China correlations to these same regions are in the 0.50 range. Further, by extracting China from the rest of EM, the MSCI EM ex-China correlations to other regions are much the same as intercorrelations within the developed world. This shows that EM ex-China is generally more sensitive to the global growth environment, while China's economy exhibits a bit more independence.

Figure 5
Return Correlations of MSCI China with Other Major Global Indexes

Description	MSCI EM ex China	MSCI China	MSCI World Index	MSCI AC World	S&P 500	MSCI Europe	MSCI Japan
MSCI EM ex China	1.00	—	—	—	—	—	—
MSCI China	0.61	1.00	—	—	—	—	—
MSCI World Index	0.83	0.55	1.00	—	—	—	—
MSCI AC World	0.86	0.60	1.00	1.00	—	—	—
S&P 500	0.77	0.53	0.99	0.98	1.00	—	—
MSCI Europe	0.86	0.52	0.93	0.94	0.87	1.00	—
MSCI Japan	0.72	0.49	0.82	0.82	0.77	0.79	1.00

Source: MSCI, S&P, FactSet, and State Street Global Advisors. Correlations using monthly returns from 04/28/2017 through 04/30/2022.

China Bonds

The past couple of years has seen growing inclusion of Chinese bonds in some of the major fixed income benchmarks, spurred by a series of Chinese policy changes that has opened up the country's onshore bond market. Historically, China bonds have exhibited a yield pick-up over much of the developed world. During the pandemic, when global central bank policy rates were lowered, the relative level of China yields was particularly appealing. More recently, however, as US rates have risen, the yield advantage has diminished — though it remains in place versus some major regional benchmarks (see Figure 6).

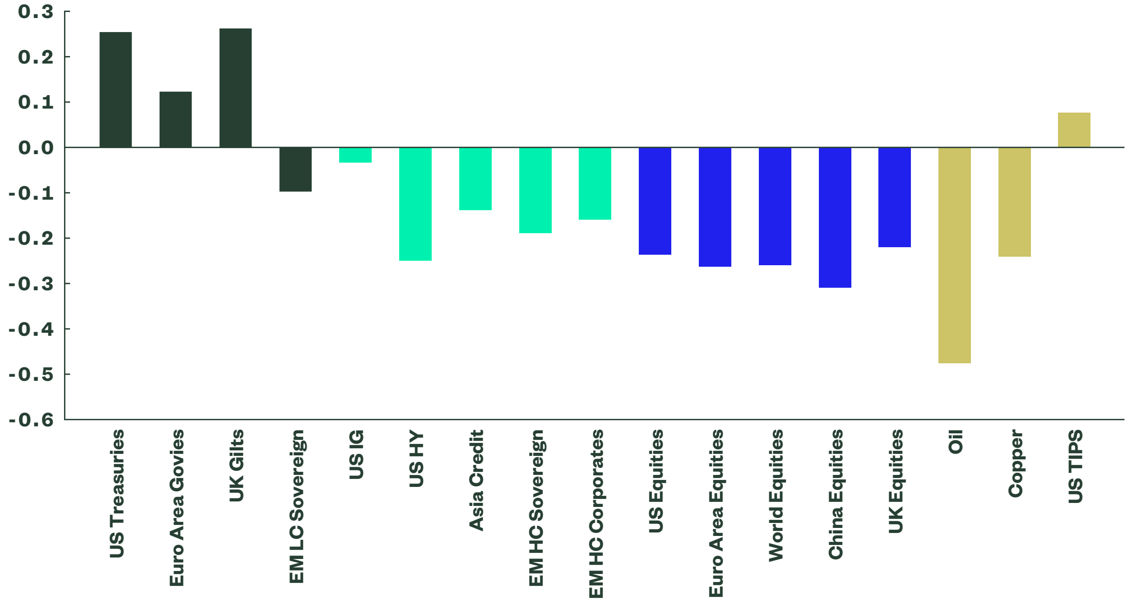
Figure 6
Chinese and Regional Bond Yields
As of April 30, 2022

	Yield to Maturity (%)	Index Rating	Modified Duration	Yield/Duration
China Treasury and Policy Bank	2.77	A1	5.80	0.48
Global Aggregate	2.57	AA3/A1	7.13	0.36
US Aggregate	3.48	AA1/AA2	6.48	0.54
Euro Aggregate	1.47	AA3/A1	7.14	0.21
Japanese Aggregate	0.27	A1/A2	9.59	0.03
Sterling Aggregate	2.22	AA3/A1	10.41	0.21

Source: Bloomberg, State Street Global Advisors. Bloomberg Barclays use the middle rating of Moody's, S&P, and Fitch.

However, beyond yields, China bonds exhibit low volatility and impressive diversification, even more so than their equity cousins. They deliver an appealing mix of characteristics from a portfolio construction perspective.

Figure 7
Correlation of China Government Bonds with Various Asset Classes
As of April 29, 2022



Source: Bloomberg. Correlations and returns in USD terms. Last 5-year monthly correlations shown.

The Bottom Line

Given China's idiosyncratic path, the ongoing evolution of its growth story and associated return opportunities, and the unique risks involved, we believe that investors would be well-served to give particular consideration to a dedicated China portfolio allocation — one which would allow them to tailor and adjust their China exposures to meet their particular return and risk objectives over time. Within China, we find appeal in quality companies, new economy sectors, and priority industries declared in the Made in China 2025 plan. In addition, the low correlation profile of both equities and bonds are particularly appealing from a risk perspective.

Endnotes

1 Group of 25 top officials who oversee the Chinese Communist Party.

2 As of April 30, 2022.

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- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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