NATIXIS
INVESTMENT MANAGERS

Why investing in emerging markets begins with a view on China. For now, at least.

Key Highlights:

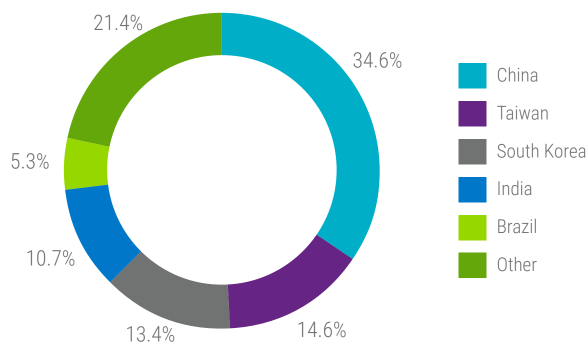
- The inexorable rise of the Chinese economy over the last decade means that investing in emerging markets starts with having a view on China.
- And having a view on China today requires an assessment of the risks and opportunities related to two key themes: growth and regulatory reform.
- Hurdles to growth are clear to see, over both the short and the long term. So too are those associated with regulatory reform, which has already resulted in significant disruption in recent months.
- But if China's attempts at propping up growth fail and international investors become spooked by an ongoing regulatory crackdown, does that sound the death knell for emerging markets? Not necessarily. After all, just because emerging market indices are dominated by China, it doesn't mean active portfolios need to be.
- Over the short term, as vaccination rates improve and infected populations recover, the recovery in emerging markets should offer selective opportunities for both bond and equity investors. But clearly, they should not be exclusively preoccupied with prospects for the Chinese market.
- Longer-term, structural growth tailwinds such as the continued economic transition from export manufacturing to domestic services, rising personal incomes and maturing patterns of consumption and an increasingly healthier, more educated and better-connected workforce all look set to continue as the emerging world emerges from the pandemic.
- Add to this emerging trends such as supply-chain decoupling and ESG, and developing countries still offer fertile hunting grounds for investors.

The unavoidable truth

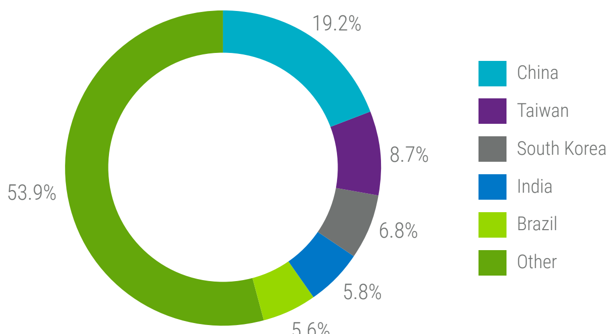
"When you're investing in emerging markets, you have to have a view on China.

James Beaumont, Head of Multi Asset Portfolio Management, Natixis Investment Managers Solutions

MSCI Emerging Markets Index – Country Weighs



FTSE Emerging Markets Broad Bond Index – Country Weights



Source: MSCI, FTSE Russell as of 31/07/2021

At the end of July 2021, China was the largest country weight in the MSCI Emerging Markets Index, representing nearly 35%. The second largest was South Korea, representing less than half that amount.[1] China was also the largest country weight in the FTSE Emerging Markets Broad Bond Index, represented close to 20%. Again, the second largest, Mexico, represented less than half that amount.[2]

The inexorable rise of the Chinese economy over the last decade means that investing in emerging markets starts with having a view on China. In general, emerging markets are to a certain extent dependent on China and this is especially true for emerging Asian economies such as Thailand, Vietnam and the Philippines.

Having a view on China today requires an assessment of the risks and opportunities related to two key themes: growth and regulatory reform. However, the balance of any such assessment will almost undoubtedly be a function of time horizon.

Hurdles to growth are clear to see, over both the short and the long term. China 's annual GDP growth has slowed to single digits, from a peak of 14% in 2007.[3] The Covid-19 crisis has depressed fertility to a record low of 1.3[4] and the 2020 census found that close to 20% of the population are now over the age of 60 – a figure expected to rise to one-third by 2033.[5] China is also grappling with clusters of the Delta variant and has reinitiated local lockdowns, raising the risk of a slowing recovery in the economy that was first in and first out of the pandemic.

The threat of regulation and reform is another obvious hurdle. President Xi's bold attempts to reform everything from political corruption and the private sector, to the property market and shadow banks have often been watered down or even reversed when unintended consequences ensued. The regulatory curbs that began on financial technology firms such as Alibaba and Tencent have more recently extended to the education sector, in a bid to force tutoring firms into becoming non-profit. On July 26, the day of the announcement, the Hang Seng plunged over 5%.[6] And by August, Taiwan Semiconductor Manufacturing Company (TSMC) overtook Tencent as Asia's most valuable company after Tencent's share price fell 42% from its February high.[7]

If Xi's "Common Prosperity" campaign aimed at wealth redistribution is to prove successful, investors should expect more regulatory and policy disruption in the marketplace.

While the hurdles are clear, so too are the opportunities. China is home to nearly one and a half billion people; it has a burgeoning domestic economy and looks set soon to escape the middle-income trap that has befallen countries such as South Africa and Brazil. Services now account for over half of its Gross Domestic Product, and the percentage of the labor force with a university education has doubled over the last decade. President Xi's admission that "the first-mover advantage will go to whoever holds the 'nose of the ox' of science and technology innovation" has sparked huge investment in research and development with China emerging as the global leader in gene therapy innovation,[8] to cite just one example.

But if China's attempts at propping up growth fail and international investors become spooked by the ongoing regulatory crackdown, does that sound the death knell for emerging markets? Not necessarily. After all, just because indices are dominated by China, it doesn't mean active portfolios need to be. What's more, the recent pandemic is likely to have some profound structural effects on the global economy and its supply chain that could create opportunities decoupled from the fate of the world's second largest economy, as a review of recent history reveals.

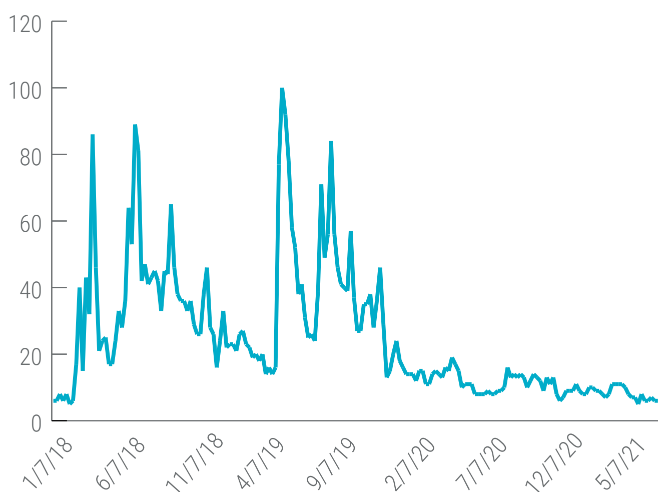
1 Source: MSCI as of 31/07/2021
2 Source: FTSE Russell as of 31/07/2021
3 Source: World Bank
4 Source: National Bureau of Statistics, May 2021
5 Source: Office of the National Working Commission on Aging, July 2018
6 Source: Bloomberg as of 26/07/2021
7 Source: CNBC.com as of 18/08/202
8 Source: Pacific Bridge Medical, July 2020

Trade war, what trade war?

We had the first phase-one trade agreement that lifted some of the tariffs, but not many. And then everything stopped with Covid.

James Beaumont, Head of Multi Asset Portfolio Management, Natixis Investment Managers Solutions

Index of Google searches for "Trade War"



Source: Google Trends as of 31/07/2021

Stepping back in time to the summer of 2019, emerging market countries had become collateral damage in the escalating tensions and threat of a drawn-out trade war between China and the US. As a BIS paper analyzing trade sentiment between January 2018 and June 2019[9] put it, "In the trade war no equity market wins… Looking at the effects across jurisdictions we find that the effects of trade tensions are larger in Asia, especially those playing an important role in the US-China value chain."

Sentiment towards emerging markets had soured and investors had already begun fleeing emerging market mutual funds and ETFs early in the third quarter of 2019. Lipper's Emerging Markets Funds peer group (including both mutual funds and ETFs) experienced net outflows $4.1 billion left during the fund-flows week ended August 7, marking the worst weekly net outflow in its history (Lipper began tracking fund flows data for this group in 1993).[10]

Following the implementation of a raft of tariffs imposed by Donald J. Trump over the previous 2 years, the United States and China officially signed an historic phase one trade deal on January 15, 2020.

Just one week later, the World Health Organization convened an Emergency Committee to assess whether the outbreak of Covid-19 cases in China and Thailand constituted a public health emergency of international concern.

Between the summers of 2019 and 2021, as the world battled the largest global pandemic since the Spanish Flu, fears of a US-China trade war have almost entirely dissipated.[11]

In short supply: time to change the chain

The pandemic wrought havoc on global supply chains and may end up changing the way countries think about the supply of essential goods and services.

James Beaumont, Head of Multi Asset Portfolio Management, Natixis Investment Managers Solutions

The Coronavirus pandemic wrought havoc on global supply chains. What started with shortages of toilet paper and PPE in the early days of the pandemic has now evolved into a shortage in everything from used cars and lumber to rare earth metals and semiconductors as economies around the world struggle to reopen. The concept of re-onshoring had already been raised in the US under President Trump, who vowed to bring manufacturing and therefore jobs back to the US. In fact, China's share in US imports declined by 4 percentage points in 2019.[12] However, as the fragility of global supply chains was illustrated first by the pandemic and then by the ship *Ever Given* that blocked the Suez Canal, it might not be long before other countries follow suit, especially for what are considered essential goods and services.

A potentially confounding trend that is more prevalent at a company level as opposed to the level of government relates to Environmental, Social and Governance factors. Company ESG ratings and reporting increasingly mean that a company's whole supply chain will come under scrutiny when ascribing an overall rating. Relocating supply chains away from countries with lax corporate governance, carbon-intensive electrical feedstock and low standards of workers' rights might not only avoid reputational risk posed by buyers and suppliers, but also act as a means to improve ratings and access to capital.

Clearly these changes will not happen overnight, but these could provide positive tailwinds for countries like Mexico, South Korea[13] and Vietnam.

9 Source: BIS Working Papers No. 917, January 2021
10 Source: Investors Flee Emerging Markets Funds during the Third Quarter, Pat Keon, September 2019
11 Source: Google Trends, August 2021
12 Source: Decoupling US-China supply chains: High tech on the move, Michiel van der Veen, July 2020
13 It is worth noting that while MSCI still classifies South Korea as an emerging market, FTSE Russell reclassified it as a developed market in 2009.

The long and the short of it: an investor playbook

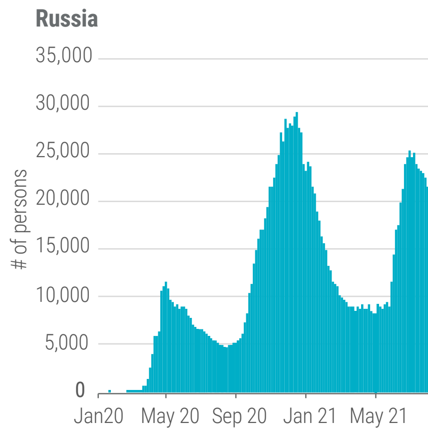
"Short term: Selectivity is key.

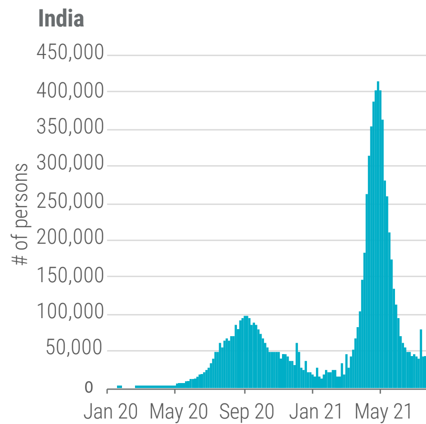
James Beaumont, Head of Multi Asset Portfolio Management, Natixis Investment Managers Solutions

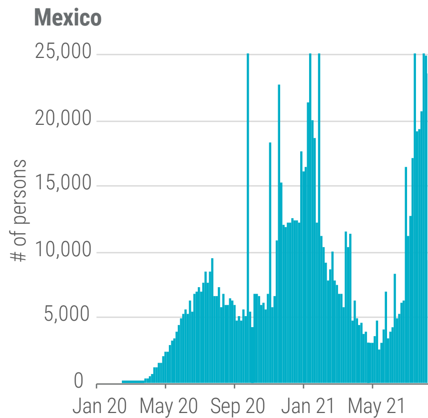
"Long term: Structural growth is supportive.

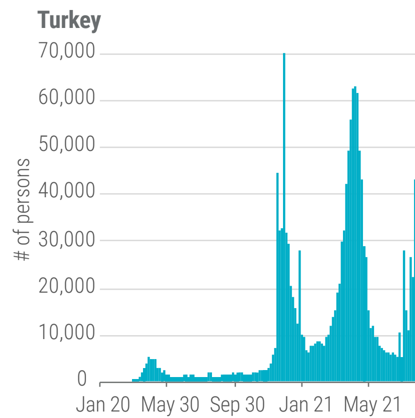
James Beaumont, Head of Multi Asset Portfolio Management, Natixis Investment Managers Solutions

EM Hot Spots – Daily Change in Confirmed Cases









Source: Portfolio Analysis & Consulting, WHO, Johns Hopkins University, Bloomberg. Data from 1/12/20 to 8/16/21.

While access to and availability of vaccines in the developed world have enabled countries like France, Canada and the UK to reach full vaccination rates of over 60% of the population,[14] emerging market countries tell a different story. India is recovering from a second wave of infections that was four-fold larger than their first wave. Russia, Mexico and Turkey are all suffering third waves that are at or close to record high infection rates. And Thailand has cut its 2021 GDP growth forecast as a wave of infections in July forced factories to close, delayed tourist arrivals and muted local demand.

As vaccination rates improve and infected populations recover, the recovery in emerging markets should offer selective opportunities for both bond and equity investors. But, as stated previously, investors will likely need to keep an eye on the prospects for growth and reform in the Chinese market. For now, it seems that a number of hurdles remain, including the slowdown in China and the ongoing regulatory crackdown, but also persistent clusters that are preventing a full reopening. Still, with a lot of bad news priced in, investors may want to keep an eye out for interesting entry points for the longer term.

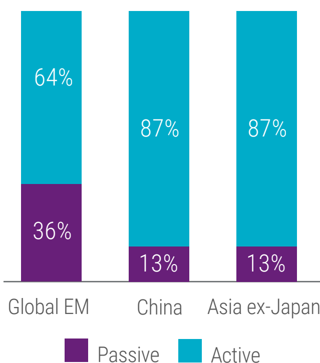
The long-term case for emerging markets is a much easier one to make and may rely less on having an equally constructive view on China for reasons highlighted earlier. Over the past 30 years, emerging markets have not only substantially outpaced their developed counterparts in terms of economic growth,[15] but often also in terms of market returns.[16] Structural growth tailwinds such as the continued economic transition from export manufacturing to domestic services, rising personal incomes and maturing patterns of consumption and an increasingly healthier, more educated and better-connected workforce all look set to continue as the world emerges from the pandemic. Add to this emerging trends such as supply-chain decoupling and ESG, and developing countries offer fertile hunting grounds for investors. Indeed, appetite for mega-trends, whether innovation or resources, has only grown. As a result of the pandemic, we are all communicating, working and consuming more online and investors are looking to have exposure to the real economy and the more digital world we now live in. Resource scarcity, innovation and demographics are all long-term considerations for investors.

14 Source: Natixis Investment Managers Solutions, Our World in Data as of 15/08/2021
15 Source: IMF Data Mapper
16 Source: The Future of Emerging Markets; Dimitris Melas; MSCI Research Insights; April 2019

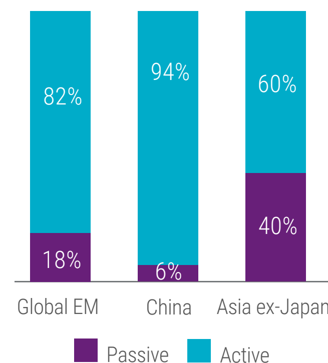
The increased volatility and cross-sectional dispersion that EMs provide can generate opportunities for skilled active managers as the payoffs for those that can identify the winning sectors, industries and companies of tomorrow are enhanced. It's perhaps unsurprising, therefore, that 82% of net assets in global emerging market fixed income and 64% of net assets in global emerging market equities are actively invested. These figures rise to 94% and 87% respectively when it comes to investment in China.

Source: Morningstar Direct as of 31/07/2021

Equity – 2021 Net Assets: Active vs Passive



Fixed Income Net Assets: Active vs Passive



Source: Morningstar Direct, data as of end of July 2021, All European-domiciled funds classified in EAA categories whose geographic focus are mentioned in the chart.

For active investors prepared to look beyond the near-term headlines, emerging markets can offer fertile hunting grounds. What's more, short-term market volatility could uncover interesting entry points for investors looking for exposure to the structural growth trends of the future. – James Beaumont, Head of Multi Asset Portfolio Management, Natixis Investment Managers Solutions

References:

https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111

https://research.ftserussell.com/Analytics/FactSheets/temp/17959967-d928-49b5-86c7-75cf0ae0156e.pdf

https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=CN

https://www.reuters.com/article/china-society-census-fertility-idUSL4N2MY140

http://www.xinhuanet.com/english/2018-07/20/c_137338328.htm#:~:text=According%20to%20Wang%20Jianjun%2C%20also,and%20400%20million%20by%202033.

https://www.bloomberg.com/news/articles/2021-07-26/chinese-tutoring-firms-extend-selloff-as-beijing-cracks-down

https://www.cnbc.com/2021/08/18/taiwan-tsmc-valuation-overtakes-tencent-amid-chinas-tech-crackdown.html

https://www.pacificbridgemedical.com/news-brief/china-takes-leadership-in-cell-and-gene-therapy-research-commercialization/

https://www.bis.org/publ/work917.pdf

https://lipperalpha.refinitiv.com/2019/09/investors-flee-emerging-markets-funds-during-the-third-quarter/

https://trends.google.com/trends/explore?date=2018-01-01%202021-08-20&q=trade%20war

https://economics.rabobank.com/publications/2020/july/decoupling-us-china-supply-chains/

https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

https://www.msci.com/documents/10199/239004/Research-Insight-The-Future-of-Emerging-Markets/

NATIXIS
INVESTMENT MANAGERS

Additional Information:

This material has been provided for information purposes only to investment service providers or other Professional Clients or Qualified Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.
In the E.U. (outside of the UK and France): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. Italy: Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via San Clemente 1, 20122 Milan, Italy. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Senckenberganlage 21, 60325 Frankfurt am Main. Netherlands: Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. Sweden: Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: Natixis Investment Managers, Sucursal en España, Serrano n°90, 6th Floor, 28006 Madrid, Spain. Belgium: Natixis Investment Managers S.A., Belgian Branch, Gare Maritime, Rue Picard 7, Bte 100, 1000 Bruxelles, Belgium. • In France: Provided by Natixis Investment Managers International – a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. • In Switzerland: Provided by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich. • In the British Isles: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258) - registered office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. When permitted, the distribution of this material is intended to be made to persons as described as follows: in the United Kingdom: this material is intended to be communicated to and/or directed at investment professionals and professional investors only; in Ireland: this material is intended to be communicated to and/or directed at professional investors only; in Guernsey: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Guernsey Financial Services Commission; in Jersey: this material is intended to be communicated to and/or directed at professional investors only; in the Isle of Man: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Isle of Man Financial Services Authority or insurers authorised under section 8 of the Insurance Act 2008. • In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market Counterparties as defined by the DFSA. No other Person should act upon this material. Registered office: Unit L10-02, Level 10, ICD Brookfield Place, DIFC, PO Box 506752, Dubai, United Arab Emirates. • In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 34F., No. 68, Sec. 5, Zhongxiao East Road, Xinyi Dist., Taipei City 11065, Taiwan (R.O.C.), license number 2020 FSC SICE No. 025, Tel. +886 2 8789 2788. • In Singapore: Provided by Natixis Investment Managers Singapore Limited (company registration no. 199801044D) to distributors and institutional investors only. • In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only. • In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only. • In New Zealand: This document is intended for the general information of New Zealand wholesale investors only. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand. • In Latin America: Provided by Natixis Investment Managers S.A. • In Chile: Esta oferta privada se inicia el día de la fecha de la presente comunicación. La presente oferta se acoge a la Norma de Carácter General N° 336 de la Superintendencia de Valores y Seguros de Chile. La presente oferta versa sobre valores no inscritos en el Registro de Valores o en el Registro de Valores Extranjeros que lleva la Superintendencia de Valores y Seguros, por lo que los valores sobre los cuales ésta versa, no están sujetos a su fiscalización. Que por tratarse de valores no inscritos, no existe la obligación por parte del emisor de entregar en Chile información pública respecto de estos valores. Estos valores no podrán ser objeto de oferta pública mientras no sean inscritos en el Registro de Valores correspondiente. • In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors. • In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity, securities intermediary, or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. While shares of certain ETFs may be listed in the Sistema Internacional de Cotizaciones (SIC), such listing does not represent a public offering of securities in Mexico, and therefore the accuracy of this information has not been confirmed by the CNBV. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority. Any reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of its investment management subsidiaries, which are also not authorized by or registered with the CNBV or any other Mexican authority. • In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorized and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. • The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialized investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. The analyses and opinions expressed by external third parties are independent and do not necessarily reflect those of Natixis Investment Managers. Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. May not be redistributed, published, or reproduced, in whole or in part. Amounts shown are expressed in USD unless otherwise indicated.