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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

AUGUST 2024

China's economy and equity market have suffered a prolonged downturn over the last four years, leading to growing structural concerns, as policymakers attempt to confront overinvestment in property and manufacturing capacity at the same time the domestic population is rapidly aging.

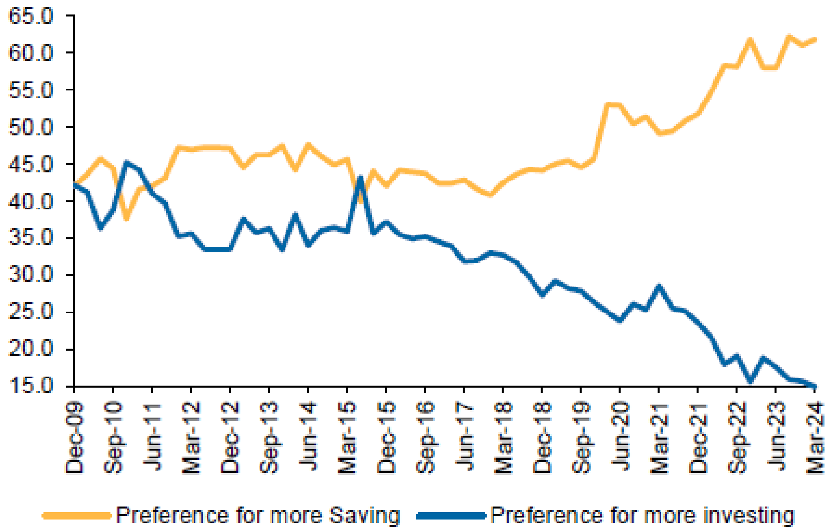
While China was the epicenter of the pandemic in 2020, policymakers responded swiftly to the initial wave, and the centrally planned nature of the economy facilitated a rapid resumption of activity. With the global consumption basket shifting rapidly from services to goods, China's export prowess created economic resilience and an enlarged trade surplus. Moreover, as much of the world embraced targets for decarbonization, China's strength in the EV and renewable energy supply chains contributed to strong equity market returns.

However, toward the end of 2020, China introduced a policy known as Three Red Lines, which sought to contain the leverage of private sector property developers. This represented a precursor to rising financial stress in the industry, carrying numerous spillover effects, as real estate contributes to approximately 20% of China's GDP. Relative to 2021 levels, property investment in 2023 was 25% lower, while property sales were 38% lower.

China's National Bureau of Statistics stopped releasing official data on developers' land purchases, but the last datapoint showed a 53% decline in 2022. According to the CREIS (China Real Estate Index System) land sales value across the top 300 cities fell 40% year-over-year during the first seven months of 2024. Land sales are an important revenue component of local governments, representing roughly 30% of local government revenue. A key multiplier effect associated with China's real estate sector is the use of the proceeds from land sales in infrastructure investment. As land sales dried up, so too did infrastructure spending, further exacerbating the effect of the property downturn on the broader economy.

The ramifications of this policy have been rising financial stress across the property sector, a deep slowdown in economic activity, and a significant impairment to consumer confidence, with consumer preferences for saving over investment rising significantly since 2020 (Exhibit 1).

Exhibit 1. China Consumer Preferences



Source: CEIC; Macquarie Global Strategy

This comes at a time when China already faces structural headwinds. The country's working age population peaked in the early 2010s, and China's overall population is now in outright decline. Barclays estimates that by 2030, more than 20% of the population will be over 65.

Further, China's relationship with the US continues to deteriorate, and in fact is seemingly the sole issue uniting US voters across all political parties, age groups, and education levels (Exhibit 2).

Exhibit 2. US View of China

	Unfavorable	Favorable
Rep/Lean Rep	90%	9%
-Conservative	95%	5%
-Mod/Lib	82%	17%
Dem/Lean Dem	77%	21%
-Conservative/Moderate	74%	24%
-Lib	82%	17%
Age Groups		
-18-29	72%	25%
-30-49	76%	20%
-50-64	86%	11%
65+	90%	8%
College Graduates	88%	11%
No College	78%	19%
Overall	81%	16%

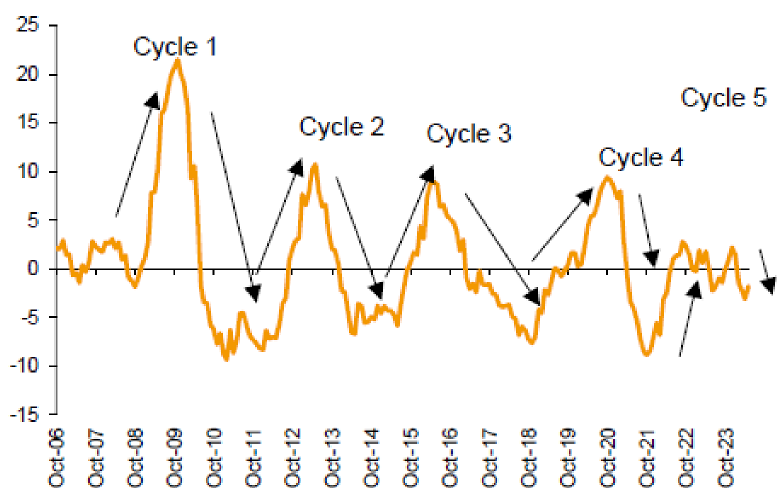
Source: Pew; Macquarie Global Strategy

Hawkish policy toward China in the US has already been characterized by a trade war during the first Trump administration, and if re-elected, Trump has proposed 60% tariffs on all Chinese goods, a policy that inevitably will result in a further hit to China's GDP growth.

While Chinese policymakers have not ignored the economic deterioration, they have been hesitant to repeat sins of the past, where China unleashed a gargantuan fiscal stimulus to rescue global growth in the wake of the failure of Lehman Brothers in 2008. In retrospect, this policy is viewed as reinforcing the overinvestment in certain segments of the economy, while bringing little economic benefit to China itself.

That said, China's strict adherence to Three Red Lines marks a meaningful about-face from the approach of the 2010s, which saw a series of cyclical downturns in the economy that were met with aggressive easing of financial conditions, fueling sharp increases in credit impulse, while further perpetuating the overreliance on fixed asset investment (Exhibit 3). China's economic model shifted following the introduction of Three Red Lines to one that is no longer credit driven, but as Macquarie economist Larry Hu notes, is "a 2-speed growth model, under which policymakers rely on manufacturing/exports to deflate property."

Exhibit 3. China Credit Impulse



Source: Bloomberg; Macquarie Global Strategy

Despite navigating the initial wave of Covid relatively better than most countries, China subsequently resorted to draconian lockdowns during subsequent waves. Thus, by 2022, when most of the rest of the world had resumed activity and was on a clear path toward recovery, China remained locked down for much of the year. The lifting of lockdowns toward the end of 2022 brought a sharp burst of economic activity, which quickly rolled over by May of 2023. With the economy hitting another air pocket, the authorities began to enact stimulus measures in July of 2023, albeit in piecemeal fashion.

Early in 2024, Chinese authorities reiterated their lack of appetite for large scale economic stimulus. However, local equities began to show selective signs of improvement, driven largely by an increasing focus on shareholder returns through buybacks and dividends. This primarily occurred in state-affiliated companies and select highly cash flow generative internet stocks, and also reflected the lack of appetite for growth capex. While investors welcomed improvements in shareholder returns, enthusiasm has proven short-lived, and this is unlikely to serve as a sustainable source of outperformance for Chinese equities.

Throughout the year, China has introduced policies designed to improve economic activity or address overhangs, but with little success. In May, a policy was rolled out to purchase and repurpose excess housing inventory. At face value, this could be an effective way to simultaneously reduce the inventory overhang and inject money into the economy. However, the size of the program was too small at 0.4% of GDP, whereas large scale rescue packages during times of economic crisis in 2008 and 2020 were on the order of 5-8% of GDP. Further, local governments' funding costs are in excess of rental yields, and unsurprisingly, the take-up of the funding has been very low.

The government is also reportedly considering interest rate cuts on existing mortgages to lower borrowing costs for households and boost consumption. Again, the boost to retail sales looks to be minimal, due to a low marginal propensity to consume, again a function of the hit to consumer confidence that has transpired in recent years.

In August, Chinese authorities provided funding to support equipment upgrades and promote the replacement of consumer goods, potentially providing a boost for demand for trucks, agricultural machinery, passenger vehicles and home appliances. That said, similar to the housing policy, the size of the stimulus was too small to have a meaningful impact, and following an initial rally, equities in these industries quickly rolled back over.

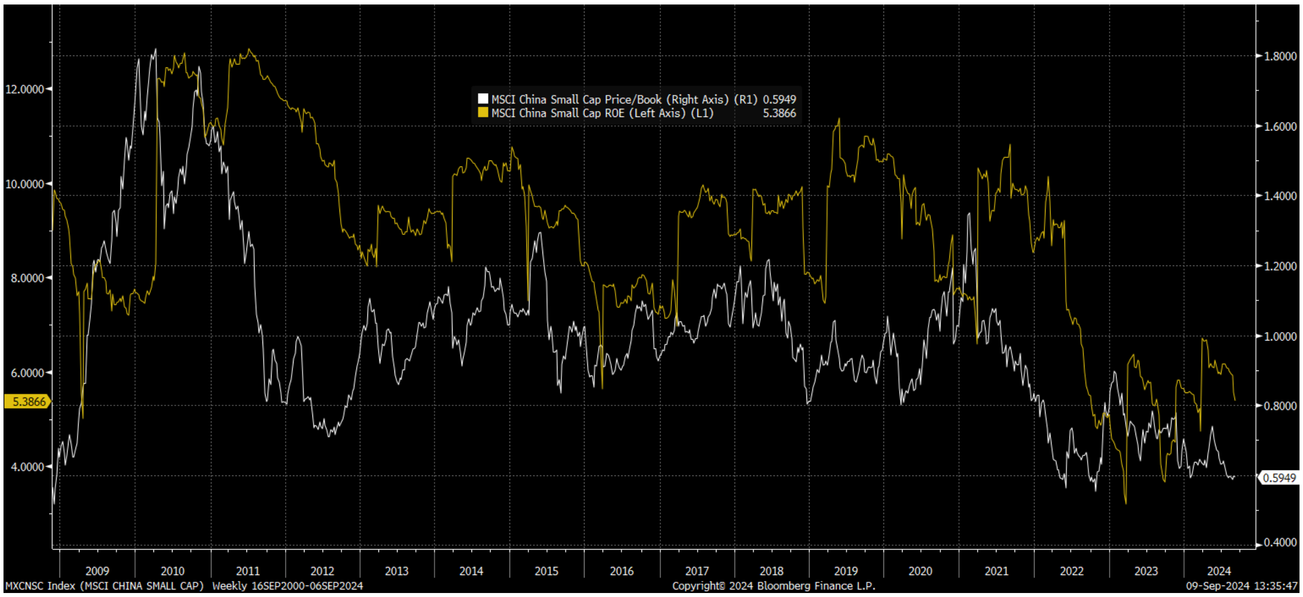
One question we frequently receive from clients is, "what could China do to arrest the deterioration in its economy and equity market?" Given the continuation of negative economic data, Chinese policymakers have a choice to make – will they simply aspire to meet the stated GDP growth target of "around 5%," or will they act more aggressively to stem the deflationary pressure in the economy? Through the second quarter of 2024, China experienced 5 consecutive quarters of GDP deflation, the longest streak since 1999. 23 months of Producer Price Index (PPI) deflation, alongside continued contractions in property and auto sales, a worsening labor market, and falling home prices and stock markets point to continued further weakness in consumption.

Recent data releases point to an increasing likelihood of China missing its growth target at the current trajectory. This would be a rare feat, as this has only happened once since 2000, as a result of the extreme lockdown measures taken during 2022. The recently held 3rd Plenum featured a promise by policymakers to achieve the growth target. Should that remain the central goal, this points to a continuation of the piecemeal approach to stimulus, rather than a meaningful cyclical inflection point.

If this remains the base case, then policymakers may resort to their typical playbook of cutting interest rates, loosening home purchase restrictions, and accelerating local government special bonds to provide funding for infrastructure spending. Aside from the consumer goods trade-in program outlined above, the government has shown little appetite to stimulate consumption. Overall, we would expect something more along the lines of defensive stimulus designed to meet growth targets, as opposed to a "big bang" like the 2008 stimulus.

Should that assumption hold, what does this imply for Chinese equities going forward? In recent years, the valuation of Chinese small caps has de-rated in tandem with an erosion in growth and profitability (Exhibit 4). Periodic trading opportunities have resulted from periods of major sentiment swings and improvements to "second derivative" earnings drivers. However, the lack of a meaningful cyclical impulse has precluded a more sustained rally from unfolding.

Exhibit 4. MSCI China Small Cap Price/Book and ROE



Source: Bloomberg

Until a more aggressive policy mix unfolds, particularly around clearing overhangs related to the property sector, we will continue to emphasize stock-specific differentiation, positive second derivative change, and improving shareholder returns. Current positions that fit these themes include a biotech company, which recently released compelling data exceeding that of large global peers, a producer of power management integrated circuits that is exhibiting an earnings recovery following a cyclical downturn, and a shipping company with a high degree of earnings visibility, leading to a double-digit dividend yield.

In aggregate, the strategy maintains an underweight position to China. We continue to emphasize the diversification benefits to allocators stemming from an allocation to EM Small Cap as an asset class. One such benefit in recent years has been the lower weighting in China within the MSCI EM Small Cap Index, relative to the broad MSCI EM Index. As a result of this, investors have benefited from the positive growth unfolding in other EM countries, including India, Mexico, Saudi Arabia, and Taiwan, while reducing the exposure to the drawdowns that have occurred in China.

Until next month,

Chad Cleaver, Lead Portfolio Manager
Driehaus Emerging Markets Small Cap Equity Strategy

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