When Titans Tussle: Trade Wars and Market Shifts

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The reelection of President Donald Trump, coupled with Republican control of both the House and the Senate, has cast a spotlight on US-China relations, intensifying speculation that Washington's 'tough on China' approach is likely to deepen. In the first few days after the election, President-elect Trump reiterated his campaign pledge to levy substantial tariffs on Chinese exports to the US. Trump has proposed a 60% blanket tariff on all Chinese exports.[1]

For the Chinese Communist Party (CCP), the possible escalation of the trade war between the US and China threatens an already struggling domestic economy where manufacturing for export is one of few bright spots of economic activity. Should the 60% tariffs be enacted, China could see a 2.4% drop in its annual GDP.[2] Moreover, China is facing trade pressure from Europe as well. In October, the European Union levied tariffs on Chinese electric vehicles, signaling that trade partners are willing to protect their domestic manufacturing industries.[3]

Even before the election, some investors were re-evaluating their exposure to China due to geopolitical events, regulatory changes, and an economic slowdown, leading to interest in Emerging Market (EM) equities strategies that exclude China. Equity market performance has reflected pessimism about slowing growth and intrusive government policies in recent years. Emerging market equities have not kept pace with US or global equity returns over the past three years, and this was primarily due to China's recent underperformance. Chinese equities have produced negative returns in each of the last three calendar years (see Figure 1), declining 11.2% in 2023 when US equities were up 26%.[4]

[1] Source: Financial Times, "Asia Braces for Tough Tariffs in Trump Second Term," November 6, 2024.

[2] Ibid.

[3] Source: Reuters, "IMF Warns Asia Retaliatory Tariffs Could Undermine Growth," November 18, 2024.

[4] Source: MSCI and Russell for MSCI China and Russell 3000.

In late September, the CCP launched a stimulus plan to boost share prices for Chinese companies largely financed with targeted bank lending. One result of this action was a surge in stock prices in September and October, but enthusiasm has since waned, with Chinese stock prices falling in November.[5]

[5] Source: Financial Times, Hong Kong Stocks Fall AS China Stimulus Package Disappoints," November 11, 2024.

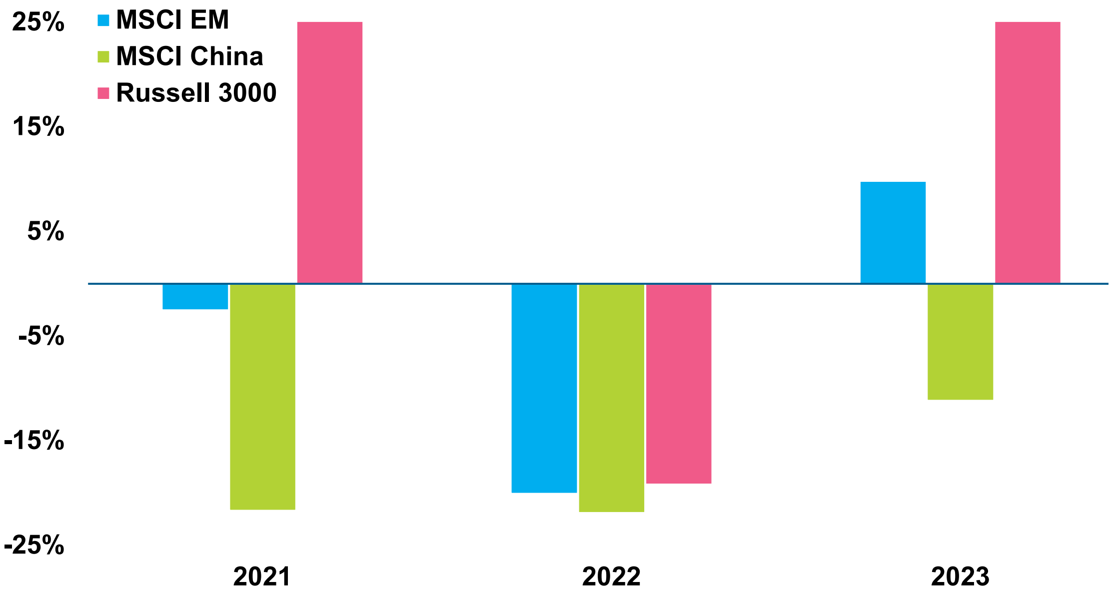

FIGURE 1
Calendar Year Returns

Source: Bloomberg, as of December 31, 2023. Indices used: MSCI EM Net, MSCI China Net, Russell 3000 Net. Returns are in USD.

China has long represented the largest country weight in the MSCI EM Index, peaking at 43% in October 2020. While it has since declined from its peak, it is still by far the largest country in the Index. Because of its significant size, China often has a larger influence on EM performance than most other countries. These factors have given rise to interest in splitting out China from emerging markets exposure, and the asset management industry has responded with an increasing number of options for doing so.

Removing China from the broader emerging markets group would affect many characteristics, the most obvious of which would be the weighting of countries in the Index. Notably, India would take China's position of largest country weight, with Taiwan very close behind, and Korea as the third largest country. This results in the MSCI EM ex-China Index being only slightly less regionally concentrated in the Asia-Pacific region (71%) compared to the MSCI EM Index (79%).[6]

[6] Data source: MSCI, as of March 29, 2024. MSCI's Asia/Pacific ex-Japan countries include China, Taiwan, Korea, India, Thailand, Malaysia, Indonesia, Philippines.

However, even if an investor were to go to the extreme and completely divest from China, it would not wholly eliminate the risk that China poses. This is because China represents a systemic risk, given its place in global supply chains and revenues for many companies. Hence disentangling a portfolio entirely from the systemic risk of China is not feasible for anyone invested in global capital markets. Investors for whom a primary concern is the level of systemic risk should consider building a defensive structure with risk mitigating strategies that hedge against systemic risks, including China.

The investment strategy landscape in emerging markets is characterized by a rapid proliferation of new strategies, a high level of responsiveness to client demands, and a cautious approach to financial commitments. Investors and fund managers alike may need to navigate these dynamics carefully, considering the implications of market volatility, regulatory environments, and the strategic allocation of assets. The interplay between investor interests, market readiness, and financial prudence will continue to shape the evolution of investment strategies in the foreseeable future.

As 2024 draws to a close, the Asian region continues to evolve as a dynamic and complex investment landscape. If you're seeking deeper insights to navigate these changes, explore the **Thought Leadership** section of our **website** or click the links here to learn more.

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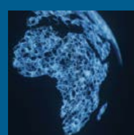

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