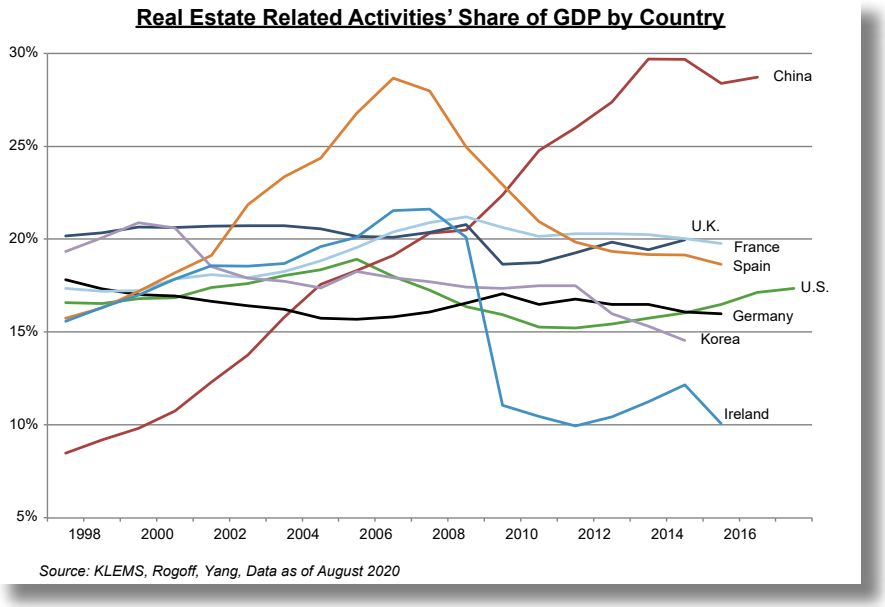
## Foreign Equities: China

***Quicktake:*** The leader out of the covid bottom has fallen towards the back of the pack and the prospects for a sustainable reversal have been slow to develop. China is facing threats of destabilization in the real estate market, its key positioning in the global supply chain, and government intervention in many of its fastest growing industries. Growth is likely to remain below target this year as China keeps its "covid zero" policies in place leading to reduced consumer activity and mobility in major metropolitan areas. The central bank shifted back to easing policies late last year to backstop growth, but any signs of additional financial instabilities like the Evergrande default will hinder their plans. Further default scenarios would lead to a reduction in credit growth which has been vital to China's recent expansion. China does enter the year as one of the most unloved investments, which typically means things won't be as bad as expected. This could lead to strong counter-rallies during risk-on periods. That said, in a global growth environment where the rest of the world is also moderating, any areas growing below trend will be easy candidates for an underweight recommendation.

China has struggled to maintain momentum after leading the world economy out of the covid trough. The world's second largest economy is facing issues in areas which had been key to the success of its markets in recent years. One of the most public issues has been the default of Evergrande, one of the largest real estate companies in China. The default has led to the air leaking out the red-hot property market and a debate on whether this is a temporary slowdown or a bubble popping. The initial fallout looked to be contained, but recent struggles for other developers have come to light and raised concerns that weakness may be more contagious than previously thought. This could lead to deeper structural problems as the real estate sector makes up a much larger part of the country's GDP compared to other global economies.

***Real estate makes up a disproportionate amount of China's GDP***




The next big threat has come from the government. China's ruling party has pulled back from its lassiez-faire support of the markets and is now taking a firm stance against the free market success of multiple industries. Their reasoning is utilitarian at heart. China's leaders are trying to build up the middle class in the country, and the majority of the new rules have focused on maximizing the economic benefits to lower- and middle-class populations. The attempt to keep the wealth gap with the upper class from rapidly widening is commendable, but it has also created significant uncertainty regarding how strong handed the government will be and which industries may be negatively affected in the future. Additionally, China's credit impulse has been rapidly declining. Credit growth is an important building block of economic expansion, and without it there will likely be less business spending, public spending, and infrastructure development. The People's Bank of China (PBOC), China's central bank, has been providing support by cutting reserve

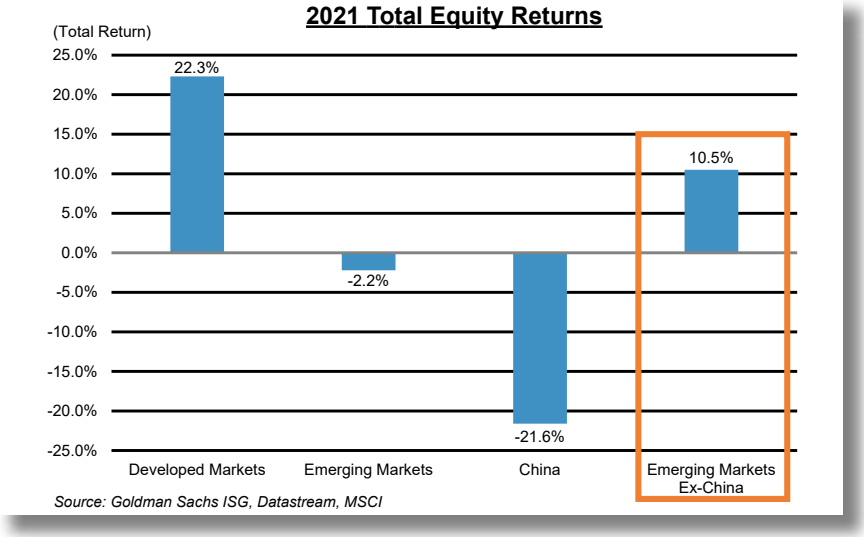
requirements to provide banks with more capital to lend, but so far there haven't been many new customers to lend to. A reversal in this trend would support a brighter outlook for 2022 growth.

Finally, manufacturing and consumer activity remain below trend. A primary reason for the decline is China's "zero covid" policy under which the government has vowed to eradicate covid within China. The policies may have led to less infections, but the cost has been weaker consumer activity and sentiment. Regulatory pressures may be fading, but instability in the consumer and manufacturing spaces will be harder to overcome. Ongoing supply chain issues have led many countries to turn inward and attempt to expand domestic manufacturing capacity. China is unlikely to lose its place as a global manufacturing hub, but the combination of a deglobalization ideology and an attempt to build wealth by shifting employment towards domestic services could weigh on manufacturing prospects.

***China's GDP growth is expected to remain below trend***


Slower growth in China drives our weak outlook for emerging markets as an asset class. China makes up more than one-third of major emerging market exchange traded funds (ETFs) on average. Additionally, weak growth China has historically been associated with weak relative returns for emerging markets. Since 1992, EM equities have trailed DM equity markets by around 10% on average when China's economy grows below target.

***China has a significant influence on EM asset class performance***




When all looks lost it benefits investors to review positions from a different perspective. China does enter the year as one of the most unloved investments, which typically means things won't be as bad as expected. We enter the year with an underweight rating for China, but we will be watching for signs that expectations are simply too low. To flip the script, we would need to see a rebound in credit growth, upward trending manufacturing and industrial production data, less restrictive covid protocols, and an ensuing pickup in consumer spending. Without this momentum, positive surges in Chinese equities are likely to be attractive but ultimately short-term in nature. We do think the markets are closer to putting in a bottom rather than churning lower, but a climb higher will go through many short-term peaks and troughs.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