For marketing purposes
For professional / qualified /
Institutional clients and investors only

Emerging markets

What's the impact from the US-China trade conflict?

By UBS Asset Management Emerging Markets and EquitiesTeam

While some of the risks impacting emerging markets (EM) in 2018 have receded, the recent escalation of the trade conflict has clouded the near-term outlook for EM.

- US export bans on Huawei could have wide-ranging first- and second-order impacts on Chinese, other Asian, and US companies;
- While the Huawei episode does cast a shadow over the IT hardware supply chain, we still like the sector from a medium- to long term perspective;
- The revenues of companies in the MSCI EM and China indices are overwhelmingly from domestic sources – over 70% for MSCI EM and over 90% for MSCI China – with only 7% and 2% respectively directly from the US[1];
- EM valuations look attractive and a number of long-term trends like premiumization, China's rebalancing to services industries, R&D-driven innovation and under penetration of credit in EM regions, offer opportunities for growth in the future.

[1] Factset, MSCI June 2019

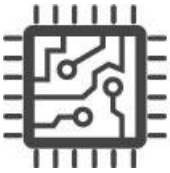
US export ban will have impacts beyond Huawei
The US export ban effectively barring US companies from doing business with Huawei could have wide-ranging first and second order impacts well beyond Huawei - on Chinese, other Asian and US companies which form part of the IT value chain.

We have reduced our weight in China by lowering our exposure to China banks that had held up relatively well in 2018 during the market rout, and spread this weight across other stocks that had underperformed in the rally in early 2019.

We are also carefully watching out for potential opportunities as stocks may get sold down well beyond what their fundamentals may warrant.

EM companies less reliant on US demand, intra-EM trade much more important
It is worth noting that the revenues of companies in the MSCI EM and China indices are overwhelmingly from domestic sources – over 70% for MSCI EM and over 90% for MSCI China – with only 7% and 2% respectively directly from the US. In addition, intra-EM trade continues to gain an increasing share of EM exports.

And the predominant exposure in our portfolios is to domestic themes with a preference for stocks exposed to rising consumer affluence in the emerging economies - with the middle income bulge likely to remain a large opportunity for growth for several years.



Semiconductor sector – medium-to-long term prospects remain attractive
While the Huawei episode does cast a shadow over the IT hardware supply chain, we still like the sector from a medium-to long term perspective. The semiconductor memory sector has consolidated significantly over the past decade with only three major players remaining now.

And unless we see end-demand destruction, Huawei's loss should be others' gain, and utilize the same supply chain. In addition, the continued growth of IoT (Internet of things), Cloud Computing, AI (artificial intelligence) etc. are expected to provide long-term demand drivers for semiconductors.

China has room to support with policy, most EM countries fundamentally healthy
China has both the ability and willingness to partly offset the impact of the trade conflict through fiscal, monetary and regulatory measures, as it has done since Q4 2018. On the average, EM countries have high real rates, fiscal balance has improved and inflation is in check. While there are some small vulnerable spots in EM, most EM countries are fundamentally healthy.

EM valuations look attractive
MSCI EM valuation at 1.5x P/B is well below its historic average of 1.8. And this is an asset class wherein the MSCI EM index has returned ~10% p.a. over the past ~20 years, meaningfully above the ~7.3% p.a. of the MSCI World index.

MSCI EM P/B (31 January 1997 – 31 May 2019)

Source: FactSet, MSCI, Mar 2019

Long-term opportunities

We would also like to point out a few long-term trends in EM and China, which provide selected good opportunities.

– Long-term trends driving growth for selected companies and industries;
– Increasing share of discretionary spending and premiumization;
– China's rebalancing into services and consumption;
– Increasing spending on R&D and technology leading to innovations;
– Under-penetration of credit across many EM countries.

In summary, while we are cautious near term, we continue to believe in a meaningful active allocation to this asset class from a long-term return perspective

Source for all data and charts (if not indicated otherwise): UBS Asset Management

www.ubs.com/chinaforesight

UBS