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Investment Perspectives

Spring 2022

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Welcome

Welcome to our 2022 Spring edition of Investment Perspectives

It has been a tumultuous period since our last edition. In the third week of February, the UK government lifted the last of its COVID-19 restrictions – but the relief was to be short-lived. Mere days later, Russia launched its invasion of Ukraine, triggering an exodus of refugees and a sharp fall in global equities. Markets have since recovered some ground, but commodity prices have proven stubbornly high, which has contributed to rising inflation from already heightened levels. Indeed, headline Consumer Price Index (CPI) touched a 30-year high in February, and has stayed well above the Bank of England's target ever since.

In this edition, Chris Arcari considers the future path of inflation and global growth, and the outlook for key asset classes in his Capital Markets Update. In addition:

- Philip Pearson and Linda McAleer profile infrastructure, asking if the investment case for the asset class continues to have merit
- Penny Cochrane discusses how real estate debt has evolved in recent years, the drivers shaping the investment opportunity, and the key considerations for investors
- Oriana Mezini explores the prospects for Chinese equities in the wake of significant structural change and capital market reforms.

As we progress through spring and into summer, we hope for a prosperous year ahead. Last but not least, we send our best wishes to those clients and readers who have been personally affected by the conflict in Ukraine.

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Capital markets update

Released: April 2022

The Russia-Ukraine conflict, and its impact on commodity prices, has exacerbated existing inflationary pressures, weighing on the growth outlook as input and living costs rise, and central banks turn less accommodative.

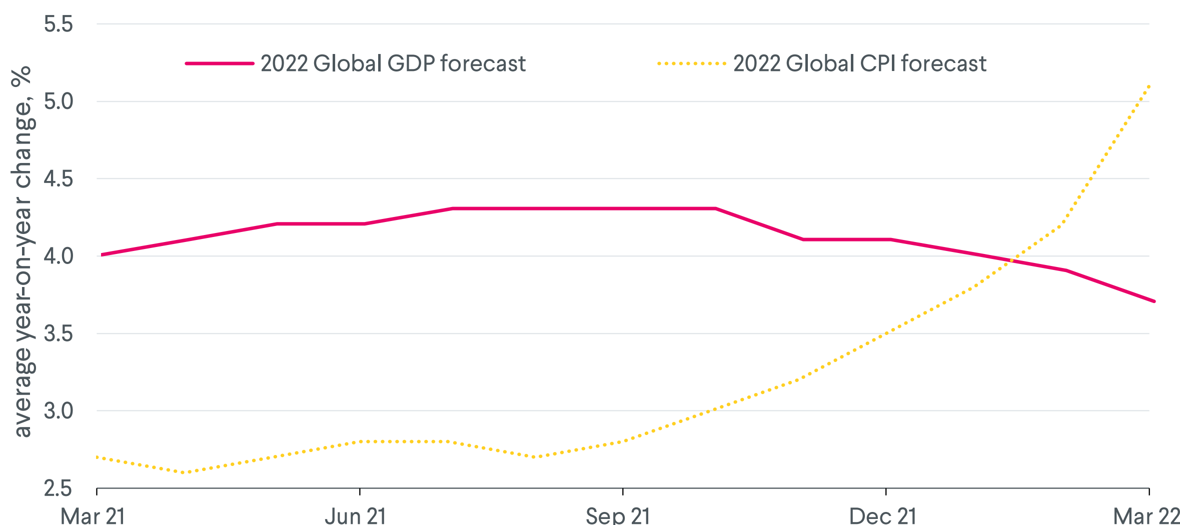
Sovereign bond yields rose significantly as interest-rate expectations increased, equity prices fell, and credit spreads widened as the outlook dimmed.

Global themes

Consensus forecasts for global growth have been revised downwards while global CPI forecasts have reached new highs as the Russia-Ukraine conflict has reinforced and intensified existing trends (Chart 1). Russia and Ukraine represent a small share of global GDP and trade, but produce a disproportionate share of key global commodity exports.

Physical disruptions and sanctions have triggered broad commodity price rises which, alongside existing inflationary pressures, are increasing input costs and weighing on real consumer incomes. The rapid spread of Omicron in China, which has led to large-scale lockdowns, has also been a factor, weighing on Chinese domestic demand and compounding existing supply chain issues.

Chart 1: War in Ukraine upends global growth and inflation forecasts [1]



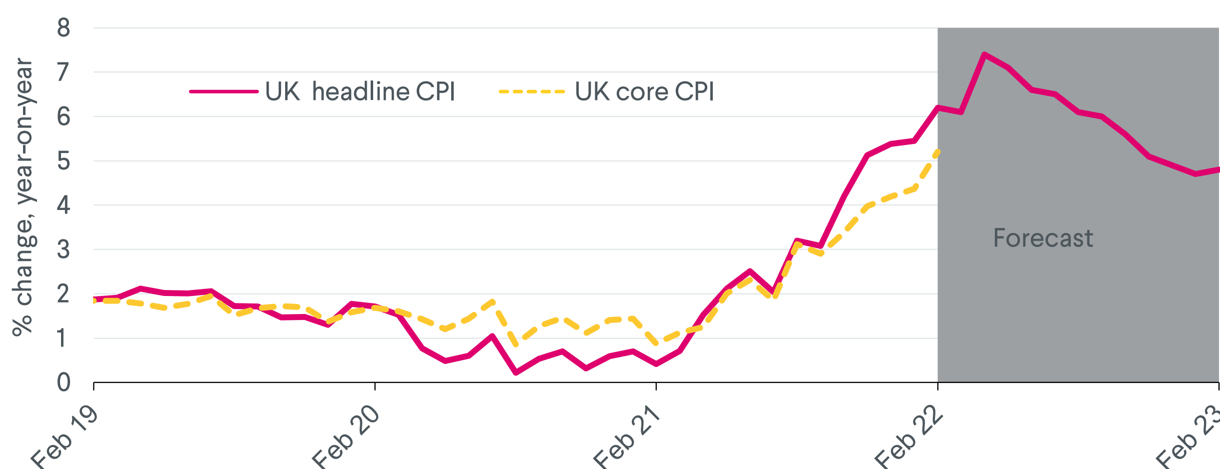
Source: Consensus Economics

[1] Consensus Economics

Global growth has been revised down from a relatively robust pace, but forecasts still point to relatively strong growth over the next couple of years, by the standards we've seen since the global financial crisis. Indeed, flash composite purchasing managers' indices for March remain consistent with economic expansion in both the service and manufacturing sectors in the major advanced economies. However, surveys continue to highlight severe labour and materials shortages, as well as input and output prices rising at survey-record highs.

We anticipate inflation peaking at higher levels in the near term and falling back more slowly than previously expected. UK CPI inflation in February once again exceeded expectations, with further rises expected over the coming months (Chart 2). Part of this is attributable to soaring energy costs, but policymakers will be more concerned that core inflation, which excludes volatile energy and food costs, is also running at 30-year highs.

Chart 2: UK CPI inflation reached a near 30-year high in February [2]

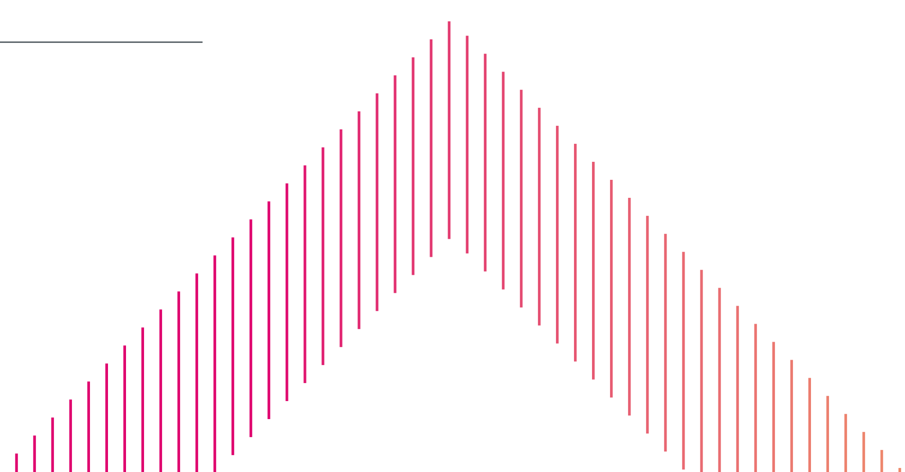


Source: Refinitiv Datastream and Consensus Economics

We expect the Bank of England and the Federal Reserve will feel that high current inflation and tight labour markets justify further interest-rate increases. However, the picture has become more complicated for central bankers: interest rates can do little to combat supply disruptions, while high energy prices can eventually help to suppress inflation pressure by weighing on demand. As a result, policymakers could slow down the pace of hikes if energy prices lead to further deterioration in the consumer outlook.

We still expect above-trend growth in the near term, but the balance of risks to both growth and inflation has shifted in the wrong direction. Although we expect interest rates to rise at a pace that does not necessarily disrupt the economic recovery, upside inflation risks leave scope for a much larger negative impact on growth and add substantial risk to the corporate earnings and default outlook.

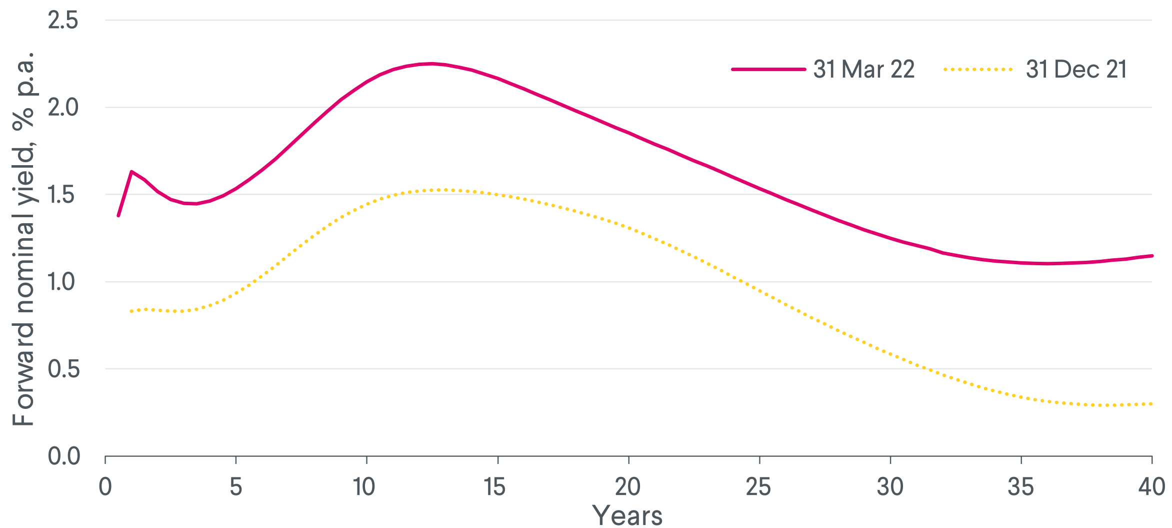
[2] Refinitiv Datastream



Government bonds

In the UK, market-implied expectations of interest rates have risen at all durations (see Chart 3). The current path out to 10 years or so does not, in our view, look unreasonable. Any new-found enthusiasm the Bank of England has for raising rates may be tempered by its own forecasts, which show a sharp fall in GDP growth, an excess of supply over demand, and below-target inflation in 2024. Longer-term yields, which imply that interest rates will begin to fall in 12 years' time, offer less compensation for inflation risks and the uncertain impact a reversal of central bank asset purchases could have on yields.

Chart 3: Front-end of the forward nominal curve continues to offer better value than the long-end



Source: Bank of England

Implied inflation has also risen at all durations. The rise at shorter terms has fundamental support from the expectation that near-term inflation will stay higher for longer and the premium reflects the risk of further increases in inflation. If a de-anchoring of longer-term inflation expectations is a concern, there is little evidence of this in longer-term forward implied inflation, where inflation risk premia are only slightly elevated relative to neutral expectations.

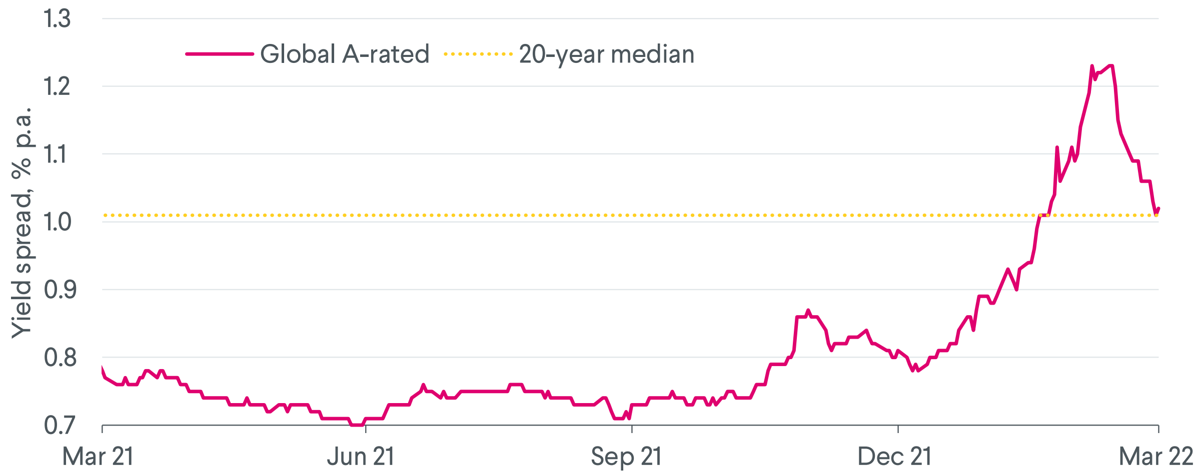
However, should inflation moderate as forecast, and move back towards target over the next three to five years, medium-term implied inflation looks more vulnerable to a re-pricing of inflation risk.

Credit

Despite snapping back sharply from levels reached in mid-March, credit spreads have risen significantly this year. Investment-grade spreads have returned to long-term median levels (Chart 4), but speculative-grade spreads remain below long-term averages.

Geographic dispersion increased as spreads in continental European markets rose more significantly than their US counterparts, consistent with the suggestion that the economic impact of the conflict will be more keenly felt in Europe.

Chart 4: Recent spread widening has restored a degree of value to credit markets



Source: ICE Index Platform

Slowing economic growth raises the risk of default and downgrades, but cash balances, income and capital leverage metrics are in robust shape, bolstered by the scale of refinancing in recent years at extremely low rates and a recovery in earnings. Because of our view on implied interest rates, we prefer shorter-dated and floating-rate credit.

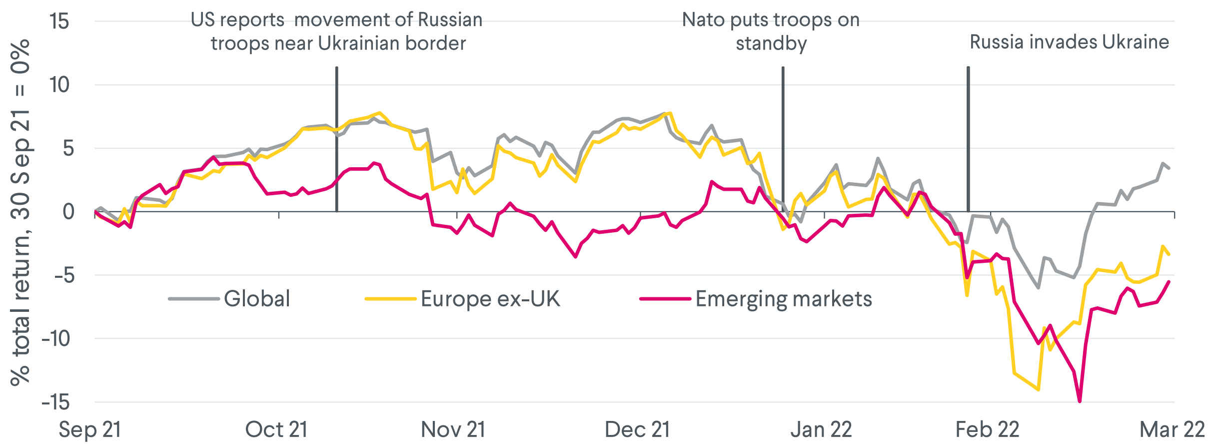
However, we retain a degree of caution: high current and forecast inflation, and its corrosive effect on nominal coupons, dims the appeal of fixed-income assets. Speculative-grade credit spreads, trading well below long-term medians, may not adequately compensate for the increased downside risks.

Equities

Global equities have largely rebounded from the initial sell-off following Russia's invasion of Ukraine, but high inflation, expectations of monetary tightening, geopolitical tensions, and slowing earnings momentum have all contributed to a -4.6% year-to-date global equity return (see Chart 5).

This, coupled with ongoing earnings growth, has taken a little heat out of valuations, but they are still stretched by historic levels.

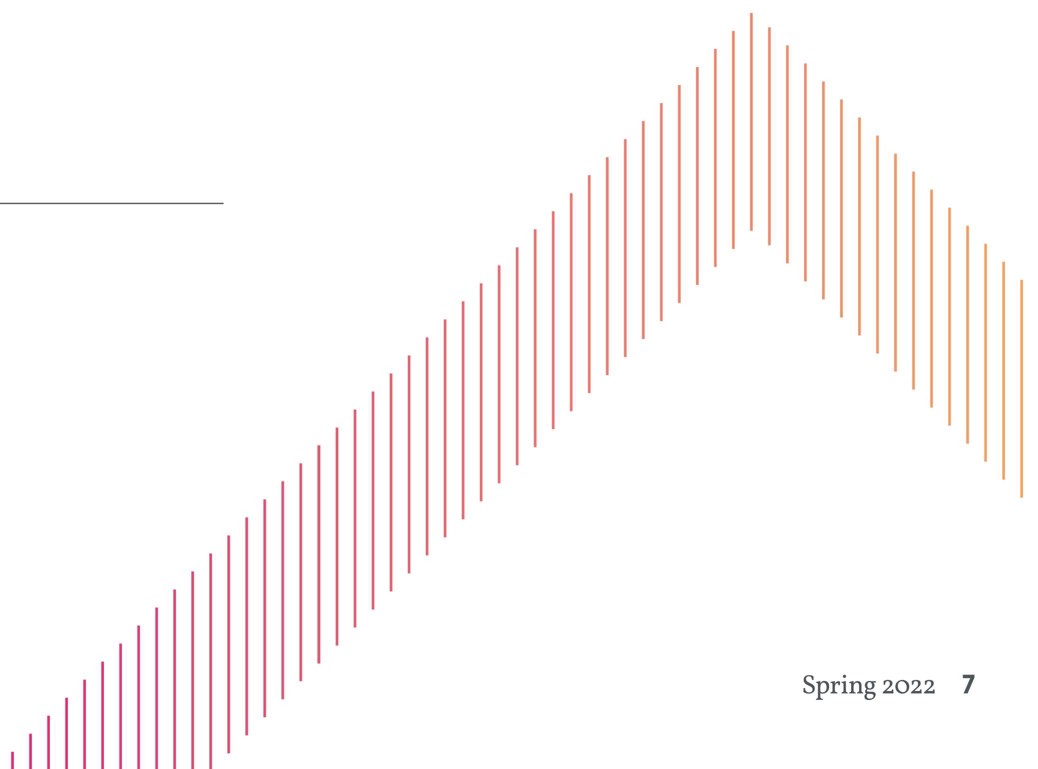
Chart 5: Equities have largely rebounded from the initial Russia-Ukraine sell-off while European and emerging markets have underperformed.



Source: Refinitiv Datastream

Earnings growth in 2022 will inevitably slow sharply from an expected 54% in 2021. But demand and revenue growth remain strong and there is evidence that businesses expect to be able to pass on most of their higher costs. Business surveys highlight the share of firms raising, or planning to raise, average selling prices to record highs [3].

Consensus forecasts show earnings growing by almost 10% this year, reflecting only a modest margin squeeze. Nevertheless, there are risks, and the inflationary backdrop may favour sectors that benefit from more inelastic demand and greater industry concentration, both of which are key in maintaining pricing power and margins.

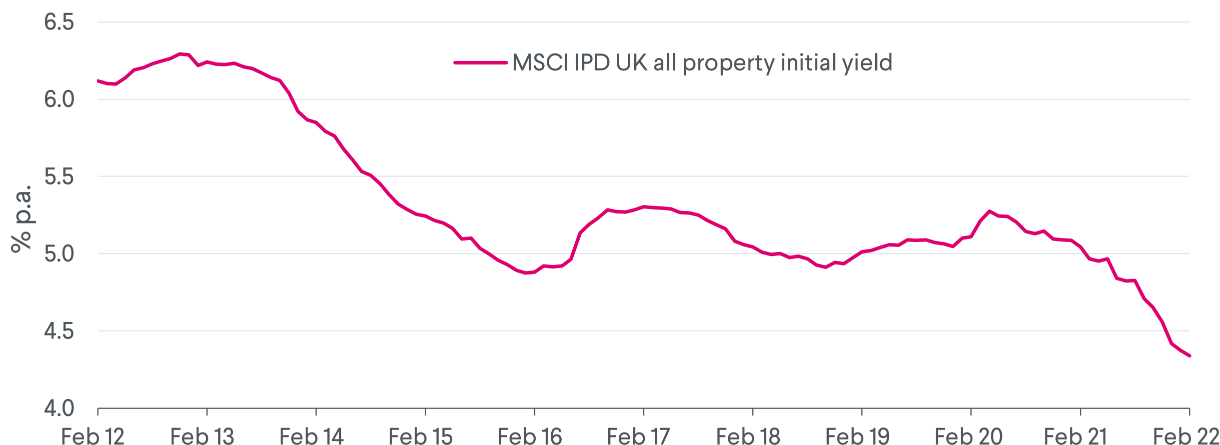


[3] NFIB Small Business Optimism Survey

Property

The property market appears to have reasonably strong fundamental and technical foundations to support further recovery. Nominal property rents, in aggregate, have been rising for the past year, though rental growth continues to fall short of inflation. The most recent Royal Institution of Chartered Surveyors Commercial Property Survey showed that respondents expect further rent increases as availability reduces. The investment market is in good health, supported by overseas demand and a resurgence in the number of domestic buyers – transaction volumes reached their highest quarterly volume since 2015 at the end of 2021. Within the market, there is still significant sectoral divergence, with strong industrial fundamentals masking weaker sectors, such as retail.

Chart 6: UK property yields are low, even relative to more recent history



Source: MSCI IPD

Initial (current) and reversionary (full) rental yields have continued to trend downwards and are very low versus their long- and even short-term history (Chart 6). However, as with equities, demanding valuations are offset, at least to some extent, by the current and projected low level of real government bond yields.

The prospect of some inflation protection from rental growth over the medium term, particularly within the long-lease market, is also attractive in current circumstances.

Conclusion

We still expect above-trend growth and though inflation is still not expected to be a long-term problem, even if exacerbated by the Russia-Ukraine conflict, it will be higher for longer. Nevertheless, central banks are likely to continue raising rates. The potential impact of inflation and energy prices on real consumer incomes increases the downside risks for growth.

Sovereign bond yields have risen to reflect a faster path of interest-rate rises, and we think the risk of higher inflation is increasingly balanced by the risk that a faster-than-expected slowdown eases current price pressures. This makes us more comfortable than we were previously with the path of future interest rates (implied by nominal gilts). Uncertainty and risk to the inflation outlook provide near-term support to index-linked gilts, but the very low level of real yields undermines their relative appeal on a longer-term view.

Spreads have also risen across credit markets and, given our views on yields, we are more agnostic between short-duration fixed- and floating-rate credit. Within credit markets, we see better value in investment-grade than in speculative-grade markets, where spreads may still not adequately reflect increased downside risk. Despite improved valuations in bond and credit markets, the potential impact of high and more persistent inflation on real returns means we retain a degree of caution.

Nevertheless, the combination of improved valuations and the view that markets have already moved to price in a lot of near-term inflation risk calls for a more neutral position between income and growth assets, given that equity and property valuations still look extremely stretched versus history. However, the prospect of inflation-linkage in earnings and rental growth, set against the high inflation backdrop, prevents us from taking an underweight position in growth assets, despite high valuations and increased downside risks.

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Infrastructure – future prospects

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Introduction

Infrastructure is a "natural" asset choice for long-term investors looking for a steady stream of cashflows, so it's not surprising that the asset class has attracted institutional capital for many years. The volume of capital deployed has increased over time, but not as quickly as many expected or hoped. The reality is that it takes a long time to originate new infrastructure assets: the bespoke nature of infrastructure assets, the complexity of infrastructure projects and the cumbersome nature of planning processes in many jurisdictions are three key reasons why this is the case. Originating suitable assets is likely to remain a challenge, leading some to fear that the capital currently being committed will take too long to be deployed or that investors will compete too aggressively for assets, driving returns down to unattractive levels.

This article provides an update on recent developments and future prospects for infrastructure and considers the continued strength of the investment case.

A diverse opportunity set

Infrastructure is commonly defined as the set of facilities and essential services required for the effective functioning of modern economies. Behind this simple definition lies an asset class of considerable diversity; this makes it challenging to evaluate infrastructure opportunities but also underpins the diversification potential of this asset class.

Infrastructure opportunities can be differentiated in several ways as shown in the graphic below:

Jurisdiction
Developing markets
Emerging markets

Sector
Transport
Energy generation, transmission and distribution
Telecommunications
Other utilities, eg water and waste
Social, eg education and health

Ownership
Public
Private operating business
Project company

Life-stage
Feasability/planning
Development
Operational

Risk Profile
Core
Core-plus
Value-add
Opportunistic

Cashflow profile
Nominal cashflow
Inflation-linked cashflow
Capital gain

ESG profile
Environmental impact
Social impact
Strength of governance

Worldwide, most infrastructure is in public ownership, although private companies are typically involved in developing and sometimes operating the assets. The UK is unusual in this respect – it began privatising existing infrastructure and developing new assets through public-private partnerships much earlier than most other countries. The UK now has a high proportion of privately owned and operated infrastructure, underpinned by robust regulatory and legal frameworks and a relatively deep secondary market.

The available market data focuses on transactions in private assets. Global transaction volumes were down in 2020/21 but fluctuated between $250–350bn of enterprise value in the preceding five years. Over the same period, the volume of capital raised globally increased from $80–120bn p.a. before flattening off during the pandemic.

Most countries do not invest enough in infrastructure, given the key role it plays in facilitating economic growth and in the equitable distribution of wealth. In many countries, key infrastructure is over-used, needs upgrading, or is simply not available. At the same time, there is strong demand from institutional investors to increase allocations to the asset class. So why has the market not grown more quickly, and what are the prospects for future growth?

The prospects for future growth

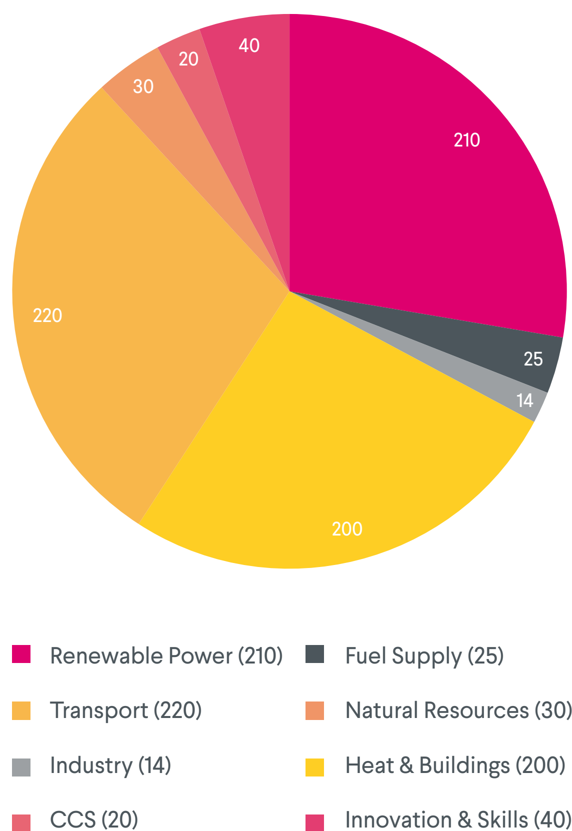
Infrastructure projects are challenging to deliver. They typically involve high capital expenditure, take years to develop, and decades to achieve the full return on investment. Consequently, the market has a slow and steady rate of natural growth – but there are a number of reasons to be optimistic about the prospects for the asset class.

1. Governments are showing greater awareness of the socio-economic costs of sluggish productivity growth and wealth inequalities, and the role high-quality infrastructure can play in addressing them.
2. The pandemic and heightened geopolitical risks have highlighted the need for more resilient supply chains, which also involve increased investment in infrastructure.
3. The single most important driver of growth will be decarbonisation - achieving 'net-zero' will require massive investment across all segments of the economy.

In the UK, for example, the government's net-zero strategy calls for £695–825bn of public and private sector capital to be mobilised from 2022 to 2035, which equates to £45–55bn per annum. Much of this will be invested in enabling infrastructure (see chart below). Investment will be required in many sectors, including renewable power generation (solar, wind, hydro/tidal, etc), energy storage (e.g. large-scale battery facilities), green fuels (e.g. hydrogen), transportation (e.g. electric vehicle charging networks), carbon capture and storage, and others. Opportunities will also arise to invest in companies that support the energy transition.

Similar projections were provided by the UK's National Infrastructure Commission in its first infrastructure assessment report. It is estimated that public investment of around 1.2% GDP (£27–29bn per annum), matched by a similar amount of private capital, would be required to fund national infrastructure requirements over the 2020s.

UK Net Zero Strategy, Capital Investment, 2022 - 2035, £bn



Have the key trends in infrastructure changed?

Institutional investment in infrastructure has been dominated by three key trends over the last decade:

- The increasing importance of renewable energy and digital infrastructure
- A greater understanding and tolerance of risk
- The development of new origination channels.

In 2010, renewable energy projects, such as offshore windfarms and biomass/energy from waste plants, were considered niche investments. Now they dominate deal pipelines alongside investments in digital infrastructure, including data centres, fibre broadband and 4G/5G mobile networks. Generous government subsidies played a key role in stimulating the supply of private capital and improving technologies. Such policies have been so successful that today renewable energy projects in developed markets are viable without government support and are generally considered to be low risk. As a result, investors have invested heavily in the sector and returns have come down. To achieve similar returns, investors have had to accept more risk.

Institutional investors now routinely invest in:

- Technologies, such as battery storage systems, that are technically mature but not commercially proven at scale
- Operating businesses, such as airports and train operating companies, rather than just the underlying infrastructure assets
- Jurisdictions with increased political, regulatory and legal risks
- Assets under development as well as those in operation.

At the same time, we have also seen a trend of infrastructure managers offering new funds focusing on lower-risk, core, or super-core assets.

Originating high-quality assets has been a perennial challenge in infrastructure. Over the last decade, institutions have increasingly taken two approaches to address this issue. The first is to develop new assets themselves or commit capital to third-party development platforms, and the second is to explore alternative sources of existing assets.

In the past, investors relied on privatisation programmes and thin secondary markets as the primary means of acquiring existing assets. Privatisation is less popular than it once was in many countries, but there has been a significant increase in the divestment of infrastructure assets by major utility companies and other corporations seeking to optimise their balance sheets over the last decade. Secondary market trading has increased dramatically, and we are also seeing a rise in take-private transactions of listed companies.

What does that mean for investors?

The investment case for infrastructure depends on six key elements, as illustrated below. The diagram also summarises our assessment of the continued validity of each element using the following scale: no major concerns (green), issues to be addressed (amber), major obstacles to successful investment (red).

Element	Assessment
1 Growing opportunity set	▲ (amber)
2 Attractive risk-adjusted returns	▲ (green)
3 Long-dated income streams	▲ (green)
4 Strong downside protection	▲ (amber)
5 Diversification	▲ (green)
6 Positive environmental and social impacts	▲ (green)

Headline returns in infrastructure have fallen since the global financial crisis as the asset class became more established and new investors entered the market. But the premium received by investors for taking infrastructure risk (measured by the difference between the yields on infrastructure assets and sovereign bonds) has remained remarkably stable, as shown in the chart on the next page.

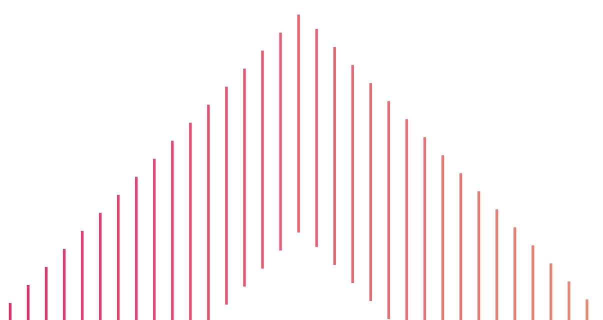
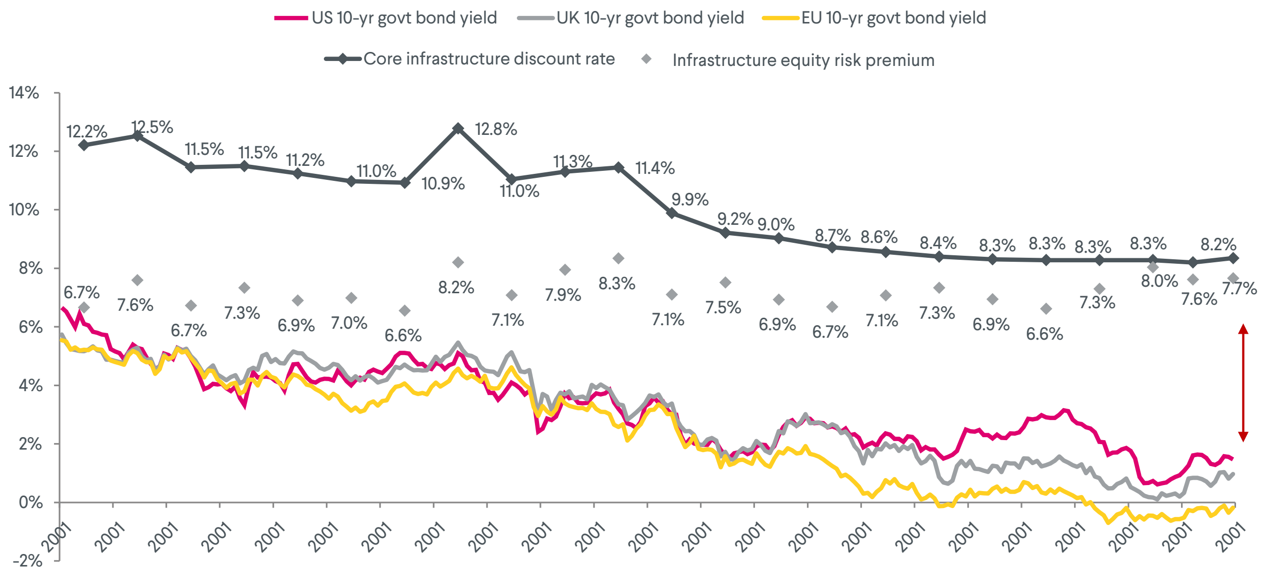


Chart 7: Estimates for core infrastructure discount rates vs. risk-free proxies



Source: JPMorgan Asset Management

Stabilised operational infrastructure assets (usually categorised as core/core-plus) continue to offer attractive income yields which often have an implicit and sometimes a contractual linkage to inflation.

As we've noted above, there is evidence that some sponsors are taking more risk to maintain headline returns. But even higher-risk infrastructure often benefits from strong downside protection, including: involvement in the provision of essential public services, regulated monopoly positions, contracted revenue and a focus on proven technologies.

Conclusion

Although the nature of the underlying assets has evolved over recent years, the investment case for infrastructure is strong. Capital deployment is still a challenge and effective risk management is more important than ever, but we believe infrastructure can still add value as a diversifier and long-term enhanced income asset within a wider investment portfolio. Given the large investment required to meet the UK's net-zero targets, an investment in infrastructure in the current market cycle could also have strong environmental and social impacts.

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The attractiveness of real estate debt

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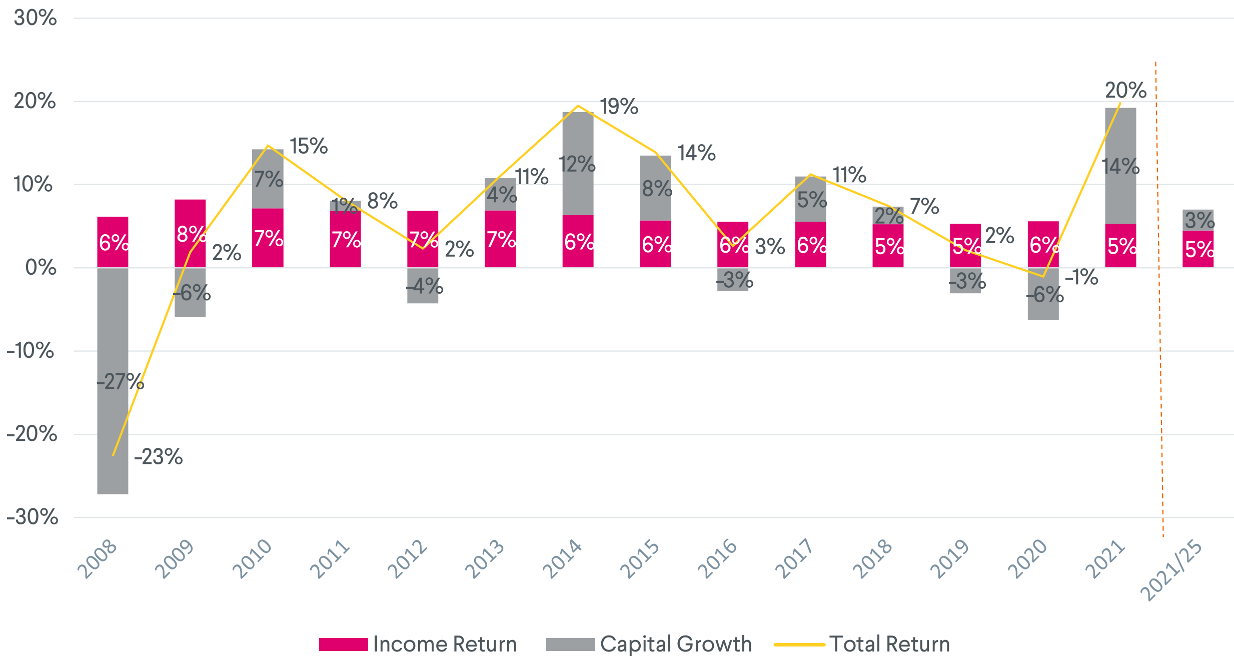
Commercial real estate debt refers to loans backed by real estate. A large proportion of investment in real estate is financed by a combination of equity and debt. Unlike equity owners, debt holders generally intend to be passive investors, earning an agreed interest rate throughout the life of the investment and repaid at maturity of the loan.

This article looks at why investors should consider an investment in real estate debt as part of a well-diversified portfolio, and how the asset class stacks up relative to equivalent rated corporate bonds and to equity investment in property. We also touch on how the market has evolved over recent years, what is driving the investment opportunity and potential considerations for investors.

Why consider real estate debt?

Core UK property is a long-established asset class for institutional pension fund investors. Investors are attracted to the asset class as it provides a relatively consistent income as well as potential capital appreciation and some inflation protection over the long term. The extent and direction of capital growth are variable, depending on the market cycle and on asset specifics, such as location and quality. After a strong 2021, with the Morgan Stanley Capital International (MSCI) UK Monthly Index returning 19.9%, the outlook for capital appreciation over the next three years has moderated considerably. Chart 8 below shows historic returns and the consensus capital appreciation forecast of 2.5% p.a. for the period 2021–2025, which is mostly attributed to the bounce-back last year in 2021.

Chart 8: Historic UK property (equity) returns and outlook



Source: MSCI UK Monthly Property Index to December 2021, IPF Research, UK Consensus Forecasts: Autumn 2021

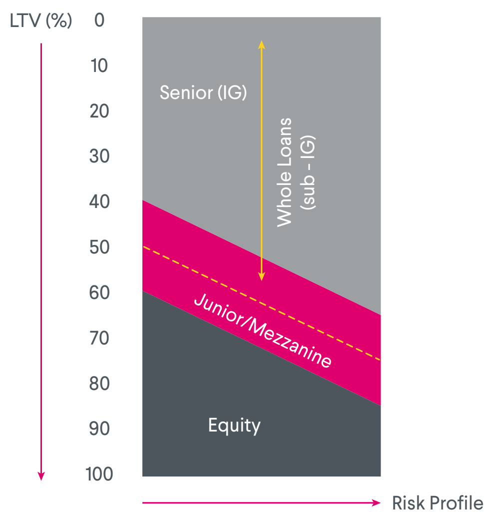
Real estate debt is a relatively new asset class to many institutional investors, but it can offer attractive risk-adjusted returns when compared to both real estate equity and corporate bonds.

Returns can vary considerably depending on a number of factors:

- Stability of income depending on whether refurbishment or development is required
- Where you are lending in the capital structure
- How deep a position you take.

Typically, whole loans (a combination of senior and junior debt) or subordinated loans generate a higher return from taking a higher level of risk than senior loans (Chart 9). The main measure of risk is typically loan to value (LTV), which is the ratio of the loan relative to the value of the property.

Chart 9: Example capital structure of an investment



Note: Illustrative only, not to scale

What is driving the investment opportunity?

There are several factors driving the investment opportunity for real estate debt, which we'll consider in turn. These are:

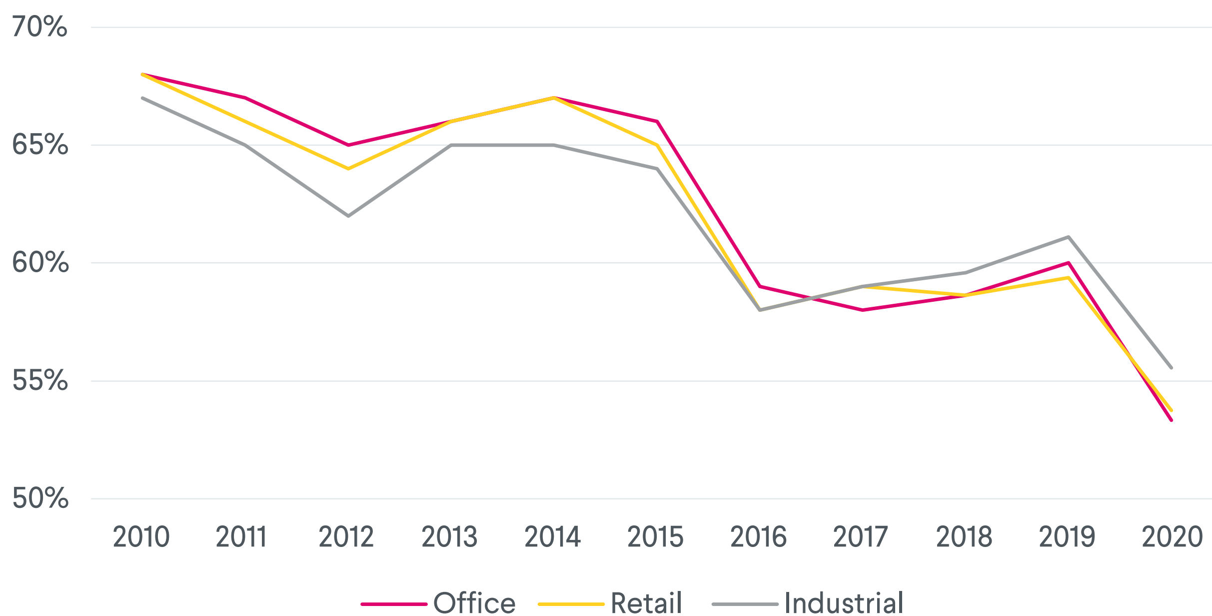
- Shortfall in debt capital
- Maturity profile of outstanding loan books
- Attractive yields in a low yielding environment.

Debt capital shortfall

In the years following the global financial crisis, banks significantly pared back lending due to changes in regulations, which forced them to hold more capital against their debt issuance. The resulting financing gap was particularly marked in the UK and European real estate markets.

Following the COVID-19 pandemic, banks have retrenched further, focusing solely on key relationships and on properties with low LTV ratios. The average LTV across bank lenders is now below 60%, a radical change from the LTVs of around that we saw before the financial crisis. This demonstrates the marked conservative nature of most bank lenders (Chart 10). This leaves an opportunity for alternative lenders to invest in higher LTV loans.

Chart 10: Average of maximum senior loan to value ratio (%) by property sector, 2010–2020



Source: Business School (formerly Cass) Commercial Real Estate (CRE) Lending Report YE 2020

Loan maturity profile

A large wave of loan maturities is due for refinancing in the next five years, which we expect to lead to high demand for real estate debt. According to Cass Business School's Commercial Real Estate (CRE) Lending Report 2020, approximately 80% of all outstanding loans in the UK are due for repayment between 2021 and 2025. With many banks unable to refinance the loans on their book at similar terms, their borrowers will seek alternative lenders.

Attractive yields

Real estate debt vs equity

Equity investors in real estate are exposed to variable capital appreciation/depreciation and accept the first loss (or all losses if there is no debt finance). While this can generate significant returns in certain market environments, e.g. returning close to 20% last year, forward-looking forecasts show more normalised expected returns.

With real estate debt, the LTV will be approximately 50–85% and investors can earn returns of 3–8%+ with the additional benefit of no stamp duty on transactions. This means that asset valuations need to drop by more than 15% before debtholders take a principal loss. This has only happened during the global financial crisis in 2008, and it's worth highlighting that income returns remained stable throughout.

Given the favourable position in the capital structure over equity, we believe that real estate debt offers an attractive risk-adjusted return for investors who can withstand the illiquidity.

Real estate debt vs corporate bonds

Real estate debt typically falls into the income-focused part of investors' asset allocations. Compared to corporate bonds, real estate debt provides a significant pick-up in yield (Chart 11) even given recent spread movements in public credit. This is due to the illiquidity premium, as loans tend to have 3–7 years' tenor and there is no established secondary market meaning the debt is held to maturity.

On a risk-adjusted basis, the case for real estate debt is further supported by typically higher recovery rates versus corporate credit since the debt is secured on a physical asset.

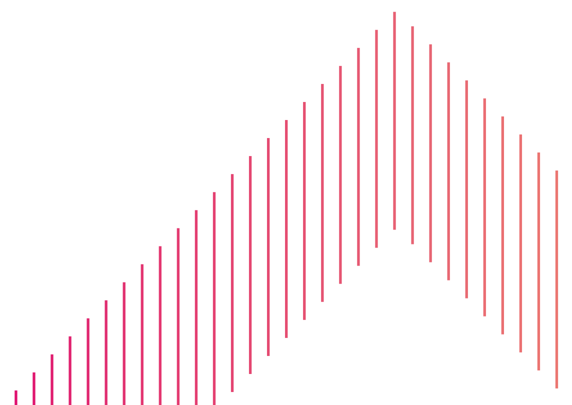
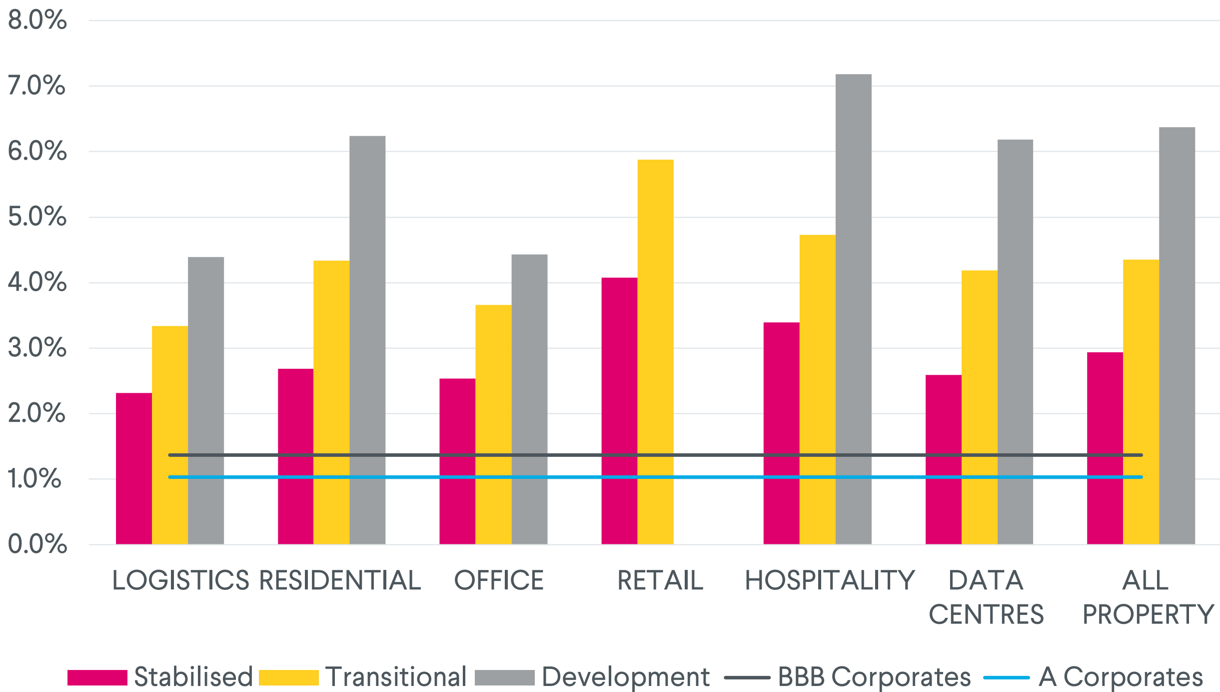


Chart 11: Real estate lending returns versus competing fixed income investments, low LTV and varied levels of asset maturity, September 2021



Source: CBRE Investment Management, Refinitiv, BofAML. CBRE Investment Management define low LTV lending as 50%.

Conclusion

An allocation to real estate debt has the potential to form an integral part of a well-diversified portfolio. It can serve as a good diversifier from other forms of private debt, such as direct lending, and also from real estate equity. Expected returns are lower than equity returns, but lenders are better protected as they are higher in the capital structure, earning more certain income from an asset that will repay its debt prior to paying equity owners. There are structural factors that should support debt pricing, namely bank retrenchment and a wave of upcoming loan maturities.

Real estate debt is an illiquid asset class with typical fund terms of around 10 years. More open-ended funds are being launched, which may allow a shorter lock-up period, but the underlying liquidity could still be challenging. A lock-up of capital may not be appropriate for some pension schemes with improved funding levels who are expecting to reach their end-game sooner.

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Is China still an attractive opportunity for investors?

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In the face of rising geopolitical risks, government regulatory interventions and the ever-growing importance of Environmental, Social and Governance (ESG) factors, this article discusses the opportunity and challenges of investing in Chinese equities.

The Chinese economy has experienced significant structural changes and capital market reforms. This is likely to continue and could lead to better risk-adjusted returns for Chinese equities. However, there is a lot of variability around these long-term expectations. This includes geopolitical risks, the pace of structural reforms, Chinese government policies to rebalance inequality in its economy, corporate governance, market liquidity and other ESG factors.

The opportunity

Chinese equities are growing and their weight in emerging markets and global indices is increasing, which cannot be ignored. However, many investors are underinvested. For many, exposure to China is primarily through offshore listed equities. This approach could potentially limit the ability to benefit from the future evolution of the Chinese economy, which will be increasingly reflected in its onshore equity market, China A-shares [4]. This part of the market captures many of the secular growth trends of China's economy, thus offering further diversification benefits. Below, we consider the opportunity from a sectoral perspective and highlight the dominance and growing size of the Chinese equity market in global indices.

The growing dominance of China's weight in the global indices

China accounts for around 34% of the MSCI Emerging Market Index, while the weight of onshore Chinese equities (China A-shares) is only about 5%. However, its onshore equity market is large and although it continues to be dominated by local and retail investors, as liquidity and access to foreign investors improve, the Chinese equity weight in global indices will likely increase.

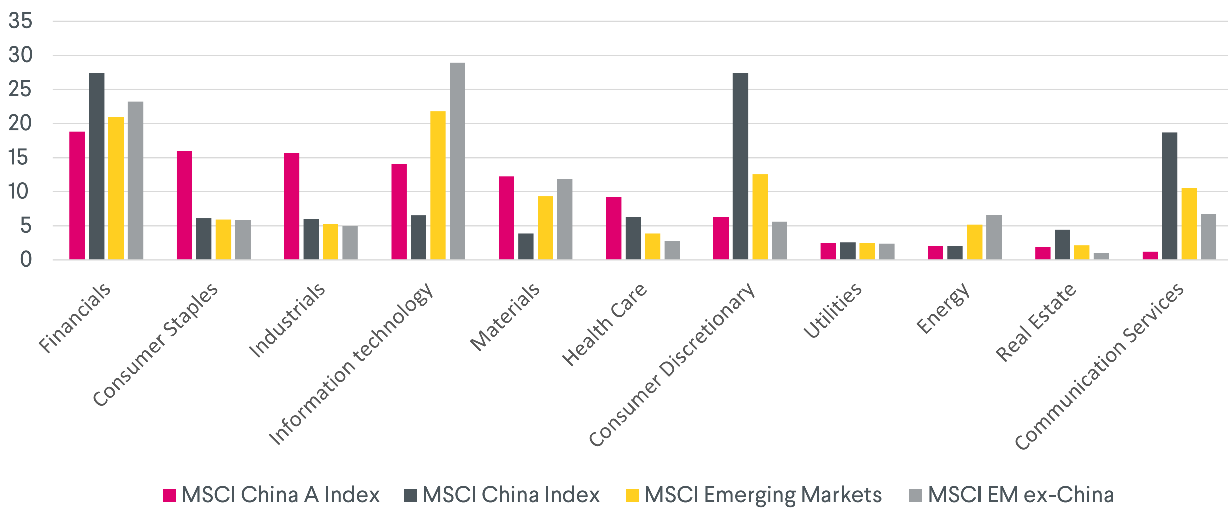
The composition of the China-A index offers more diversification

The MSCI China index is highly concentrated in certain stocks. For example, Tencent and Alibaba combined represent around 30% of the index while the top 10 stocks represent around 40% of the index. Consequently, the performance of the indices has been driven by a small group of companies. On the other hand, the onshore index (MSCI China A Onshore) is more diversified and the opportunity set is broader, both in terms of the number of stocks and market capitalisation. The MSCI China A-shares index includes around 500 stocks, including many mid-cap and small companies, and the performance drivers are wider.

There are also sectoral differences with the MSCI China index, which is skewed towards communication services, consumer discretionary and financials. The China A-shares index has higher allocations to information technology, consumer staples and healthcare, providing more exposure to a more consumption-oriented and innovation-led economy.

[4] A-shares are domestic Chinese company stocks listed onshore in Shenzen or Shanghai.

Chart 12: Sectoral differences – MSCI China A, MSCI China and MSCI Emerging Markets



Source: MSCI as at Feb 2022

Currently, the China A-shares domestic market is dominated by local retail investors compared with other emerging and developed equity markets. This makes the Chinese domestic listed equity market more inefficient and provides more opportunities for generating alpha through stock selection. That said, the China A-share equity market is highly volatile, but as access for foreign institutional investors improves and liquidity increases, this volatility should become more in line with the rest of the emerging and developed equity markets.

The challenges

Geopolitical risks remain, and these have intensified during the Russia-Ukraine war. This has led to some investors becoming more concerned about a similar situation arising with China and the likely sanctions and implications of such a scenario. However, although this is difficult to predict, China has established itself as one of the largest trade partners for most of the economies in the world and is highly integrated into the global supply chain. This can be viewed as a positive and sufficient to prevent any conflict. Another geopolitical risk is US-China relations. This is still a risk that continues to be real, although the issues are more centred on economic and technological superiority.

China, as with many other emerging market countries, lags developed markets on ESG standards and disclosures. The integration of ESG in investment decision-making also starts from a low base, especially for the local asset managers. On the other hand, the Chinese government has emphasised environmental and social responsibility as part of its five-year plan. Despite these being positive steps towards sustainable investing, some of the ways in which the Chinese government can be influential is by directly intervening through regulation in public listed equities. We have seen this more recently with companies in social media and education platforms (for example, Alibaba, Tencent and New Oriental), which led to their stock prices falling significantly. These regulatory interventions can have a material adverse impact on the long-term fundamental and business case for some of these companies, but they can also open up opportunities for long-term investors.

Given the complexity of these issues and associated risks, it is sensible to gain exposure to China through active managers who can distil and select the best set of listed equity opportunities from a risk-reward perspective, applying both bottom-up and top-down analysis to help navigate this market.

Summary

We believe China is an attractive opportunity for long-term investors for the following reasons:

- The expansion of stocks in indices will provide more diversification and represent companies that benefit from the future growth of the Chinese economy
- These companies support long-term structural growth characteristics such as innovation, technology, consumer growth and healthcare
- The market is expected to become more institutional over time, with improved liquidity and volatility.

However, there are many factors and risks to consider when investing in China such as geopolitical, government intervention and wider environmental, social and governance risks. Given all these complexities, our preferred approach for allocation to emerging market equities is through an active manager. There are many global asset managers with on-the ground resources in China, as well as local asset managers with dedicated expertise in this market.

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Market returns to 31 March 2022

	Yield *% p.a.*		Returns to 31 March 2022 *(sterling, % p.a.)*		
	31 - December	31 - March	1 Year	3 Years	5 Years
Equities					
Global	1.8	1.9	12.7	13.9	10.9
UK	3.1	3.1	13.0	5.3	4.7
Developed markets ex UK	1.6	1.8	14.8	15.4	12.0
Emerging markets	2.6	2.7	-3.3	5.8	5.6
Bonds					
Conventional gilts	1.0	1.7	-5.1	-0.5	0.5
Index-linked gilts	-2.4	-2.0	5.1	3.2	3.1
Sterling corporate bonds	2.2	3.2	-5.5	1.3	1.9
High yield (US) *	4.9	6.2	-0.3	4.4	4.6
Emerging market debt * +	5.7	6.2	-7.4	0.0	1.7
UK Property	-	-	23.9	8.4	8.4
Gold *	-	-	13.9	14.4	9.2
Oil *	-	-	69.2	16.2	15.4

* Return in $ + Hard currency

Source Datastream:

FTSE All Share
FTSE World Developed ex UK
FTSE All World

FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities

BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly

Credit Suisse Hedge Fund
Gold Bullion LBM

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