

Why Are Emerging Markets Investors Removing Their China Exposure?

Emerging markets (EM) equities have gone through cycles of performance (*Exhibit 1*) throughout time, creating varied investor sentiment towards the asset class. Recently, discussions around excluding China from investment portfolios have become more common, spurring the growth of active EM ex-China strategies. This newsletter explores the current landscape of EM investing, examines the drivers of the EM ex-China trend, and analyzes the performance impact of removing China from an EM allocation.

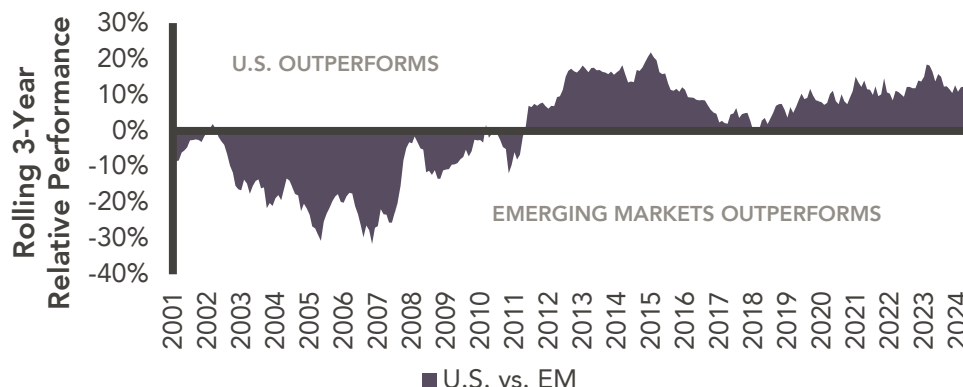


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Exhibit 1: U.S. versus emerging markets equities performance



Source: eVestment as of March 31, 2025; U.S. represented by S&P 500; EM by MSCI EM Index.

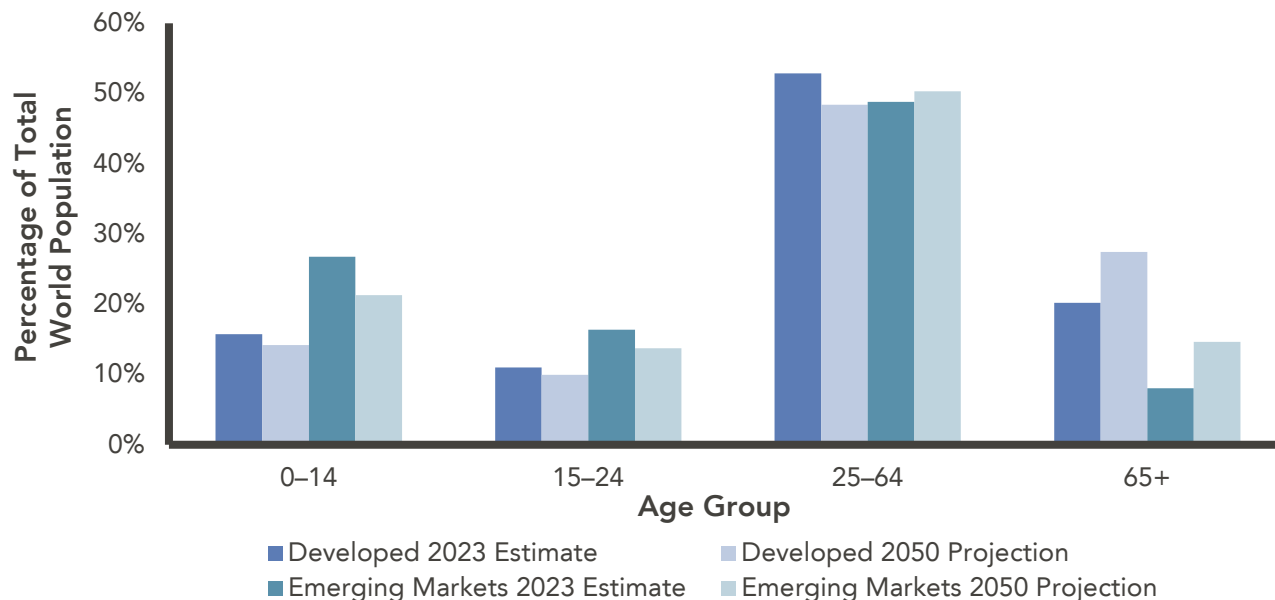
THE CURRENT EMERGING MARKETS LANDSCAPE

Within emerging markets, opportunities abound for equity investors. In 2024, emerging markets accounted for 50% of global GDP growth.¹ Additionally, demographics are more attractive in emerging markets with a larger percentage of young people and thus a growing workforce for the future. A larger workforce

¹ World Economics, May 2025

necessitates investment in work-related infrastructure such as transportation, factory equipment, and office space. Trends also show a shift within emerging markets towards more consumer spending and a growing middle class. According to one study,² the emerging markets middle class is anticipated to double in size by 2034 to 687 million households, making emerging markets consumers a larger part of global consumption.

▾ **Exhibit 2:** Population trends in developed versus emerging countries



Source: United Nations Department of Economic and Social Affairs Population Division, World Population Prospects 2023

Specific countries within emerging markets offer unique opportunities. India has seen significant investment in infrastructure, growing entrepreneurship and IPO offerings, and an increase in digitalization. India also houses over 1,000 global capability centers for companies such as Deloitte, Microsoft, and Amazon. These centers support multinational companies with talent, innovation, and additional resources. Taiwan and Korea play an integral part in the artificial intelligence (AI) technology supply chain, and companies such as Taiwan Semiconductor and SK Hynix stand to benefit from ongoing investment in AI capabilities.³ Latin America, despite political uncertainty within specific countries, offers opportunities with nearshoring trends, natural resources, and a trend toward digital transformation.

One would be remiss to ignore China, home to the second largest economy and equity market in the world. In 2024, the Chinese equity market was over \$10 trillion in market capitalization, making it larger than Japan and the United Kingdom’s combined. Despite recent weakness from the Chinese consumer, the country’s long-term economic prospects remain positive. Policymakers are focused on boosting consumption in 2025 with consumer subsidy programs and maintaining a lofty growth target of 5%, suggesting the potential for future government stimulus. Additionally, China is one of the world’s leading manufacturers.

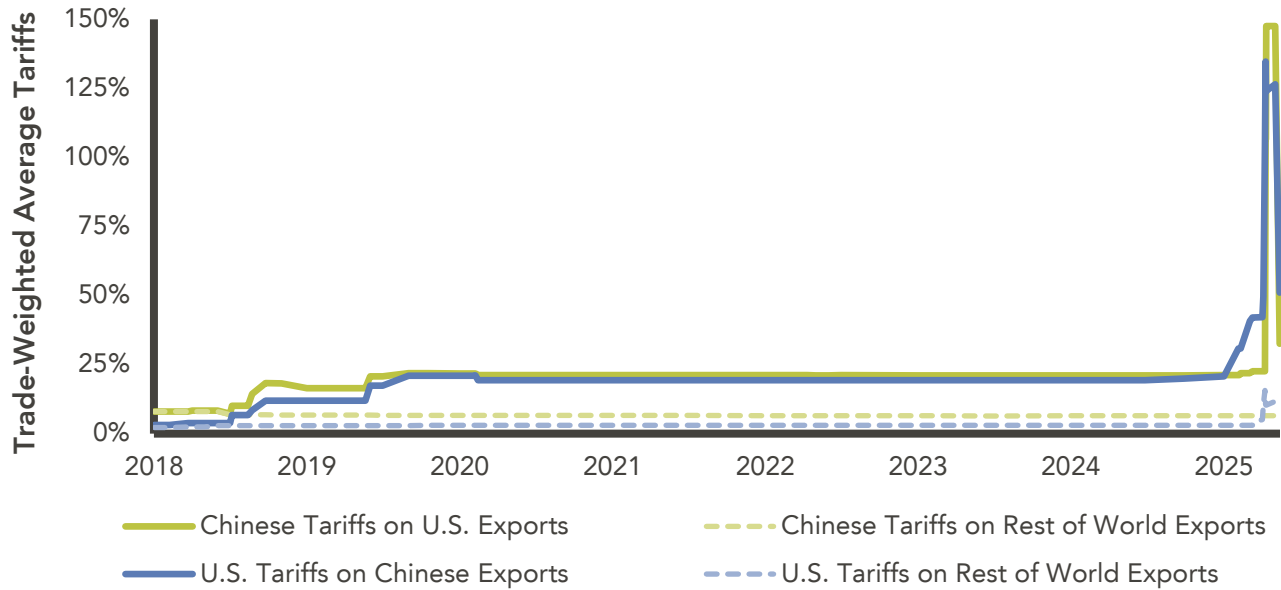
WHY HAS THIS EM EX-CHINA PHENOMENON TAKEN OFF IN RECENT YEARS?

However, recent geopolitical tensions, economic weakness, and regulatory concerns are leading investors to reconsider Chinese equities. Ongoing U.S.–China trade negotiations highlight geopolitical strain, with fluctuating tariffs fueling uncertainty around future policies.

² Oxford Economics, October 2024

³ This includes investments from large cloud providers like Amazon and Google.

Exhibit 3: The United States' and China's trade-weighted average tariffs



Source: Peterson Institute for International Economics as of May 14, 2025

The two countries' relations have also been strained due to other political differences, notably China's relationship with Taiwan. China views Taiwan as a Chinese territory, while Taiwan, an unofficial American ally, has expressed the desire to be an independent, self-governing democracy.

Economists' opinions vary widely on what, if any, action the Chinese government may take with regards to Taiwan. It remains uncertain whether the Chinese government would consider a form of military action against Taiwan, but such an extreme decision could result in economic sanctions, loss of profits from a Chinese equity market sell-off, or even forced divestment from China. This concern is not without precedent, given the financial impact for portfolios that held Russian securities at the onset of the Russia-Ukraine War. When Russian equity markets closed in 2022, investors were forced to liquidate positions or write them off as losses.⁴

The deteriorating relationship between the United States and China has led to both state and federal legislative proposals to limit investors' ability to invest in China. For example, states such as Missouri have introduced bills to restrict public fund investments in China. These bills have only been proposed in certain states, but they have heightened investors' awareness of the potential for investment restrictions. At the federal level, measures such as the Outbound Investment Security Program⁵ may limit investments in certain Chinese firms.

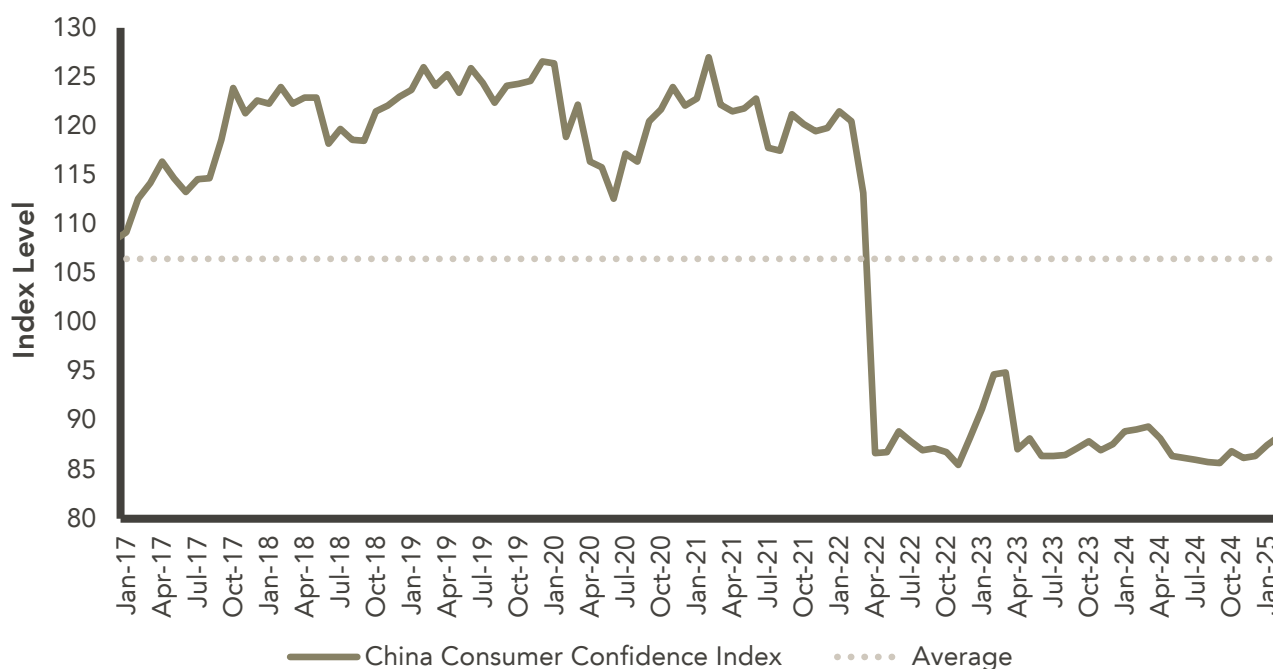
There are also investment-related concerns surrounding China's domestic woes, both economic and political. The Chinese economy has yet to fully recover from COVID-19, given the severe lockdowns imposed by the government during the pandemic and the lack of fiscal stimulus provided to its citizens throughout. This weakness has led Chinese consumer confidence to remain well below long-term averages, as illustrated in Exhibit 4 on the following page. This lack of confidence is reinforced by structural factors such as high youth unemployment and pervasive weakness in the country's property sector. Roughly 70% of household wealth

⁴ Russia's stock market closed in February 2022 after the country's invasion of Ukraine. Historically, governments have closed stock markets in times of crisis or war.

⁵The Outbound Investment Security Program restricts investments in technologies and products that are deemed detrimental to the United States' national security. This includes semiconductors, microelectronics, quantum information technologies, and artificial intelligence.

in China is held in real estate accounts,⁶ which means Chinese households have been significantly impacted by the over construction and subsequent vacancies contributing to the country's real estate collapse.

▾ **Exhibit 4: Chinese consumer confidence**



Source: Bloomberg as of February 28, 2025

Given that China operates under a socialist market economy, the government can enact swift regulatory crackdowns against private sector companies. The suspension of Ant Group's initial public offering (IPO) in 2020 and the regulatory onslaught faced by Didi Group in 2021 after the company went public on the New York Stock Exchange serve as two examples. Investors faced losses in both cases; participants in the Ant Group IPO couldn't realize their investments and Didi Group's share price declined significantly after going public. Related Chinese equities, especially other large technology companies, sold off in tandem due to market concerns around the Chinese government's involvement in private enterprise.⁷ While government regulation is common in all countries, the Chinese government's proclivity to enforce regulations in a near-immediate manner poses unique risks to Chinese businesses and investors.

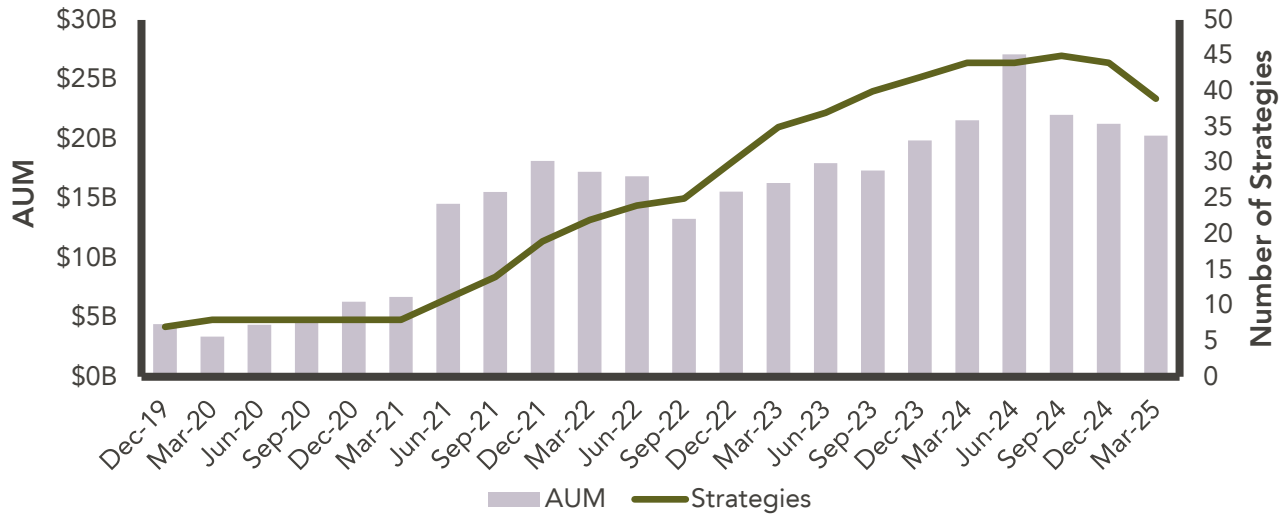
HOW HAS THE EX-CHINA TREND SHAPED THE INVESTMENT MANAGER UNIVERSE?

Investor concerns about China and legislative recommendations to invest ex-China have driven an uptick in the number of asset managers offering EM ex-China investment strategies. In 2019, there were seven actively managed EM ex-China strategies with a total of \$4.4B in AUM; by March 2025, that number had grown to 39 funded strategies with \$20.3B in AUM (*Exhibit 5, next page*). Despite this growing trend, the number and size of ex-China strategies pale in comparison to that of full EM allocation strategies. Additionally, the average track record for EM ex-China strategies has an inception date of 2021. The post-COVID environment in China is anomalous given the country's slow economic recovery, meaning recently incepted EM ex-China strategies capture a particularly challenged period for the Chinese equity market. Thus, the ability to analyze these strategies' performance is limited due to the length and nature of the time frame.

⁶ JPMorgan, July 2024

⁷ Examples include Alibaba, Tencent, Meituan, Prosus

Exhibit 5: Number of EM ex-China strategies and AUM growth



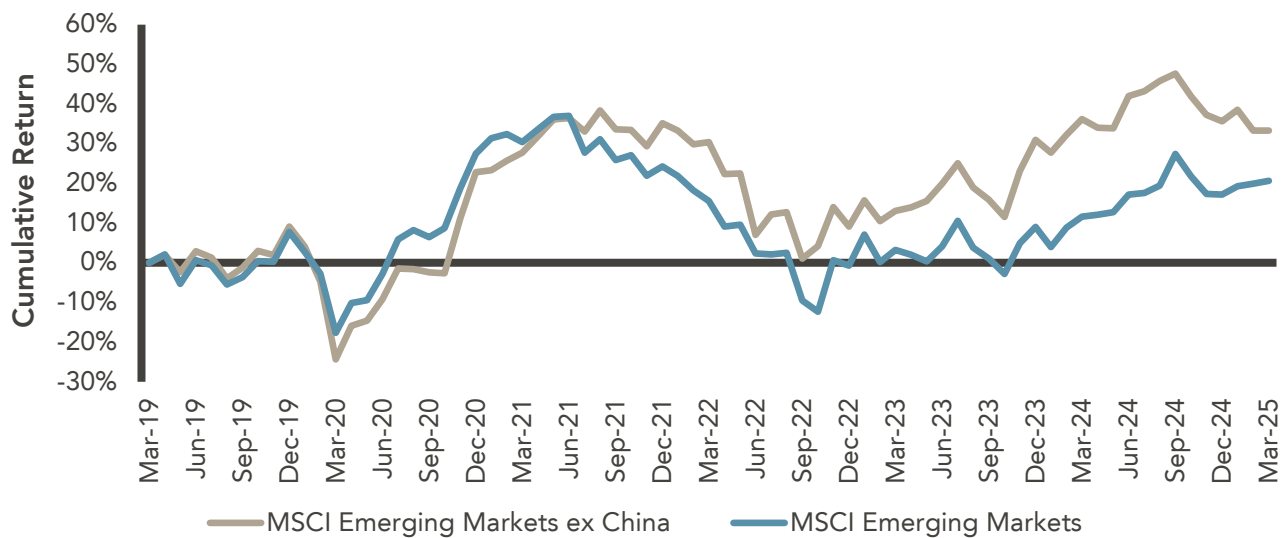
Source: eVestment as of March 31, 2025

UNDERSTANDING THE RISK/RETURN TRADEOFF OF EM VS. EM EX-CHINA

That said, since 2021 the EM index has lagged the EM ex-China index for a variety of reasons (*Exhibit 6*):

- China’s regulatory crackdowns, economic weakness, and a collapsing real estate sector have weighed on Chinese equity returns.
- The EM ex-China index features more technology exposure. Specifically, Taiwanese semiconductor-related stocks have benefited from global demand for chips amid AI and technology adoption.
- The EM ex-China index also carries more exposure to India. India has seen a consumer boom fueled by a growing middle class, infrastructure investing, and digitalization.
- More exposure in the EM ex-China index to South Korea, Brazil, and Saudi Arabia. South Korea’s financial hubs added stability, while Brazil and Saudi Arabia’s commodity exposure capitalized on energy price surges in 2022–2023.

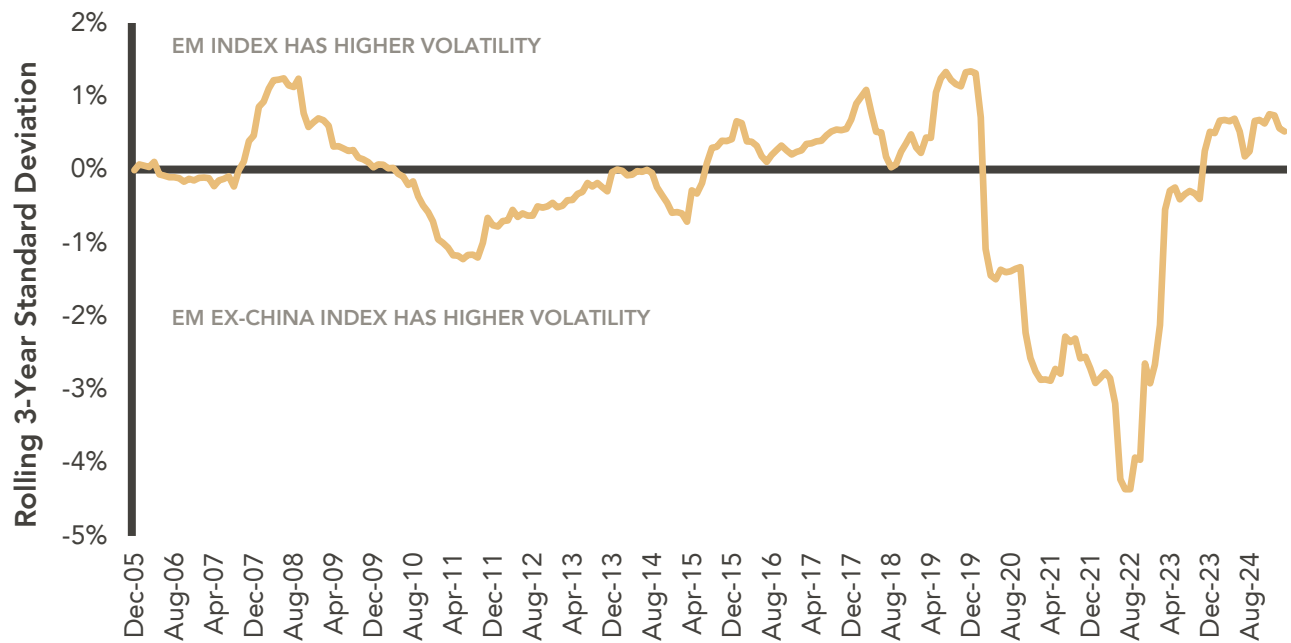
Exhibit 6: MSCI EM vs. EM ex-China cumulative returns



Source: Bloomberg as of March 31, 2025

While EM ex-China performance has been more attractive over recent years, the outperformance has come with increased volatility, exacerbated by the greater concentration of the EM ex-China index in more growth-oriented, cyclical industries like semiconductor manufacturing. Furthermore, this outperformance has come over a relatively short time span within the context of institutional investment horizons, not to mention the particularly difficult market environment in China over this same time period. These are factors worth remembering as investors think about reducing or eliminating their China exposures on the basis of recent performance.

Exhibit 7: Rolling 3-year standard deviation difference (EM – EM ex-China)



Source: Bloomberg as of March 31, 2025

CONCLUSION

Market dynamics, investor sentiment, and growth opportunities have fueled periods of outperformance and risk levels for the EM versus EM ex-China indices over time. Opting for EM ex-China may moderate the geopolitical and economic risks associated with investing in China, though it also drastically reduces the investable market, given China comprises 32% of the EM index. Additionally, removing China from the index increases concentration in sectors such as Taiwan’s semiconductor industry, India’s consumer market, and South Korea’s stable financial sector. This may lead to periods of outperformance when those industries are thriving, but the greater concentration can also result in heightened volatility. Furthermore, an investor’s peer rankings may be negatively impacted when China outperforms; benchmark selection is critical. We encourage investors to consider the benefits and risks of an EM ex-China allocation as they relate to organizational goals and risk/return targets. Ultimately, performance and risk will vary in specific time frames based on economic circumstances, so a focus on the long term is crucial. ■

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