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Emerging markets, sustainability and returns: China or India?

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Fiona Manning & Will Scholes | Fund managers

Which emerging market will deliver sustainable returns for UK pension funds? Fund managers Fiona Manning and Will Scholes examine the development paths of China and India.

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[How Emerging Markets can help pension schemes meet their sustainability objectives]

Pension fund allocations to emerging markets remain low in the UK and together make up less than 15% of global equity market capitalisation, even though these regions represent 85% of the world's population.

Emerging markets offer institutional investors the opportunity to access much faster growth than the UK – yet it is important to be selective and look at their growth profile through a sustainable lens and not just on a simple GDP basis.

It is also vital to look beyond simple narrative and dig into what is driving the long-term, sustainable growth that investors can harness for their portfolios.

Side by side

While India has been grabbing the attention of commentators, we believe in the short run China offers more value.

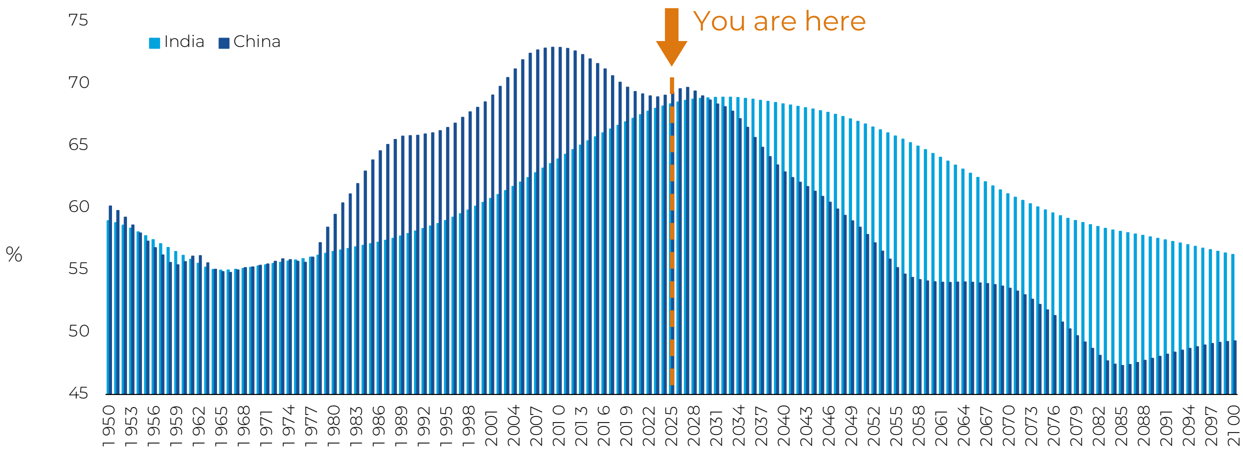
Despite recent sentiment that its extraordinary growth story has run its course, China is far from being a busted flush. The country is still investing heavily in the research & development and export opportunities to benefit its workforce, with a concerted focus on quality of economic growth over quantity.

Valuations are failing to reflect this, presenting an opportunity for investors to share in its growing wealth creation at discounted prices.

Viewing India through the same sustainable lens – the S of ESG – it lags in several social development areas which, for us, signals future issues. Most problematic, of course, is that despite being the world's fifth largest economy, it has the largest number of people living below the poverty line.

Population and performance

Riding the wave - Share of working age population (%) – China and India – 1950 to 2100



Source: United Nations, Department of Economic and Social Affairs, Population Division (2022) World Population Prospects 2022. Online Edition.

Each of these enormous emerging market economies is home to around 1.4 billion individuals, together making up about a third of the world's population.

China is on the cusp of decline in terms of working age population, while India's overall population is expected to continue to grow into 2050. Yet, the average education level of those entering China's workforce is an order of magnitude higher than those departing.

When we look at the different market performances, there are two vastly different dynamics that play a significant role in determining how portfolios should be positioned.

China has been delivering wealth creation (i.e. GDP-per-capita growth) faster than most developing economies since 1963, whereas the best we can say about India is that its population is not worse off in peer-relative terms. This point is a vital part of the forward-looking narrative around the two nations.

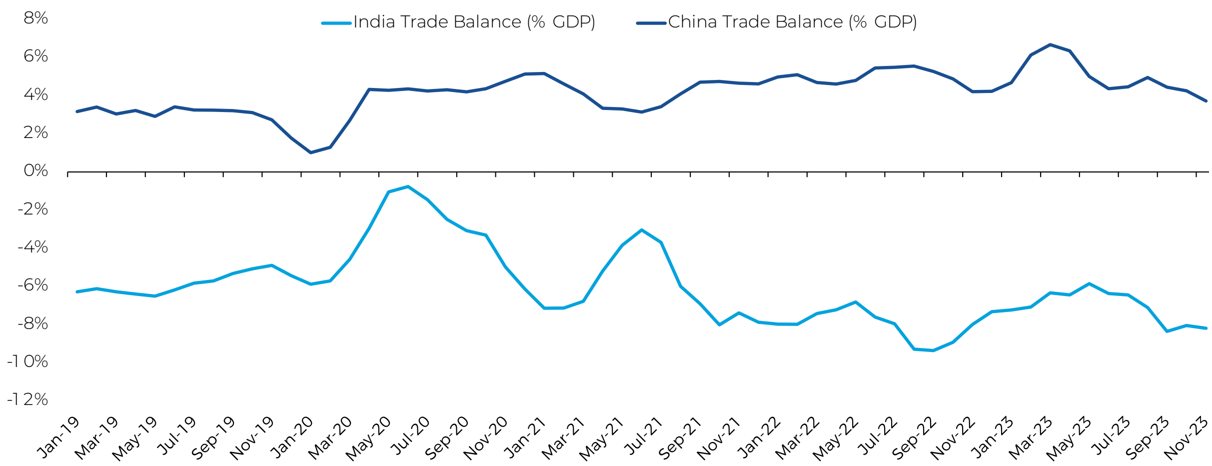
The importance of export success

Many investors know China is breaking into complex area exports, from electric vehicles to clean tech to semiconductors – and they are doing it at speed.

As fund managers, we need to see much more evidence from India that it is investing in these areas if we are to see rampant long-run growth in its share of world exports.

Export manufacturing is particularly important because it provides jobs at scale, and a chance to acquire skills and technological upgrading. In turn, this is correlated to savings rates and productivity. This is in contrast to commodity-driven export economies, where boom and bust cycles tend to kill off innovative companies at an early stage.

Trade and exports, a fine imbalance - Trade balance (3mma) as % of GDP – India and China



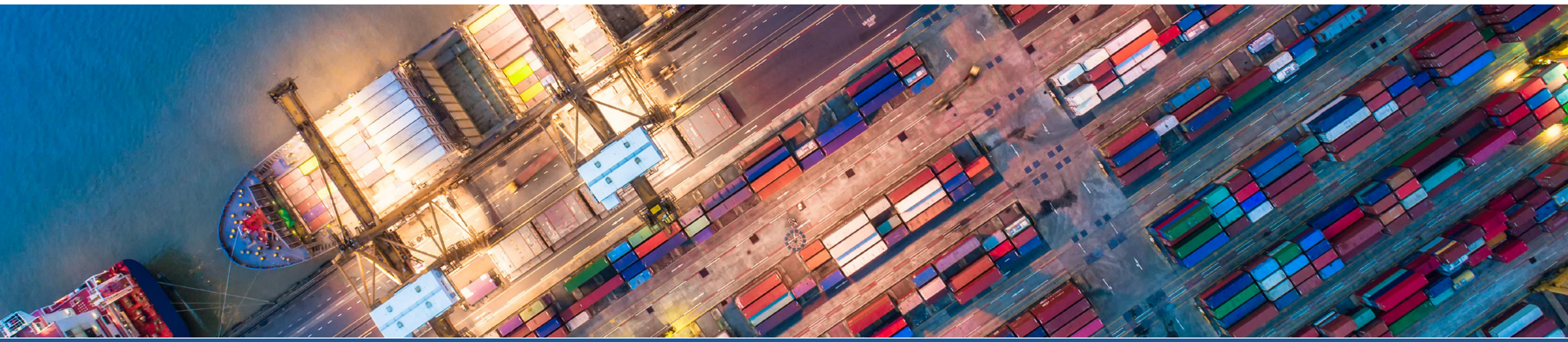
Source: EM Advisers.

India has a significant trade deficit, and that deficit has been expanding. Meanwhile China has a very steady structural trade surplus, so has few issues gathering capital for investment. Value-added exports don't just mean jobs and skills accumulation, they mean inflows of dollars. And it is access to hard currency funding that time and again proves a bottleneck for emerging market economic growth.

Inequality and female workforce participation

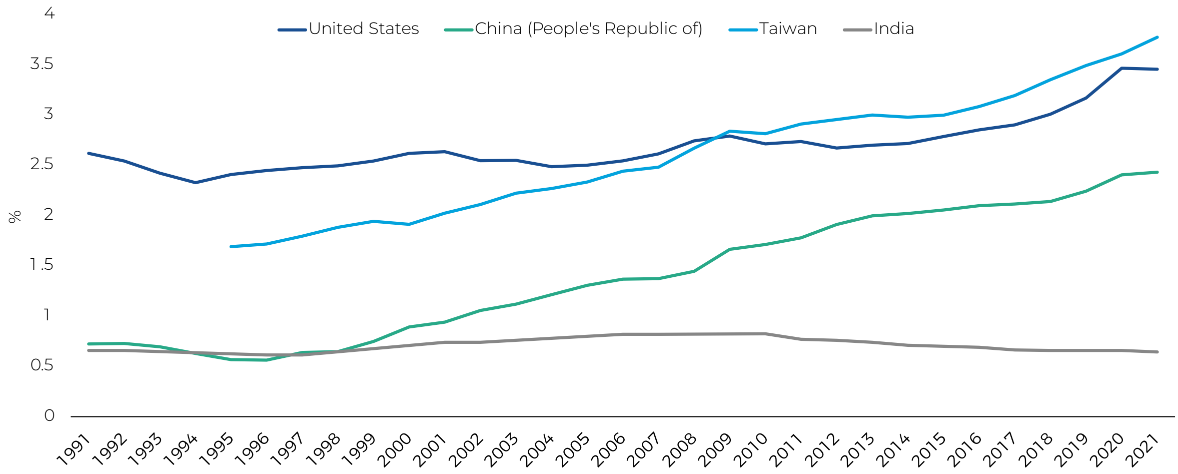
One of the key differences between China and India is the disparity in household savings. India has become one of the most unequal societies globally, where women are particularly disadvantaged. Female participation in the workforce is low by global standards, and although it has been increasing, it is still a step-change behind markets like China.

What we need to see from India is the harnessing of that domestic capital. Female participation in the workforce is key, as smaller family sizes that enable women to work allow for a much higher savings rate. At a macro level, this is important for providing a domestic pool of capital to support investment.



Investment in technological innovation

From the factory to the lab - Gross expenditure on R&D as % of GDP



Source: OECD, NSTMIS, Dept Science & Technology, Government of India.

China has been investing heavily in technological innovation as a percentage of GDP, supporting the wealth creation effect. It leads in more than 30 out of 44 technologies identified by the Australian Strategic Policy Institute as critical.

Interestingly, spending on research and development comes from a broad base of corporates, harnessing China Plc.

In contrast, Indian expenditure on R&D is growing no faster than the broader economy, and although government investment has been robust, what it has failed to do is really harness India Plc. Companies in India are not pulling their weight.

Conclusion

Demographics aren't deterministic. A young and growing population doesn't guarantee you rapid economic development any more than an ageing one assures your decline. The euphoria about demographics and long-term GDP growth opportunities in India overlooks some key challenges around human capital and equality.

Additionally -- and important for investors to note -- the market is pricing in perfect execution.

On the other hand, the market is completely discounting China's investment in broad wealth creation and technological innovation.

While we know GDP growth doesn't give a proxy for index growth, it provides the right environment for companies to thrive, develop, to invest and to grow -- and that is critical. Structural, sustainable growth stories don't crop up by accidents of birth, but rather by continuous reinvestment and constant innovation.