



Fundamental Equities Outlook Q4 2021

The earnings engine threatens to sputter as Fed tapering begins

- We downgrade our near-term outlook for emerging markets
- Fed tapering and less buoyant earnings likely to weigh on sentiment
- The drastic 'socialist' turn in China is bad news for 'capitalist' investors

As the end of the year approaches, investors are entering a traditionally auspicious season for equities. This time, though, we believe there is reason to be more cautious. For one, we've enjoyed an unusual summer party, given that summer months are typically a weak season for equity markets. The party peaked on US Labor Day, and we now think the usual fourth-quarter equity-market strength may fail to materialize.

Furthermore, the US Federal Reserve (Fed) has expressed its intention to start tapering its USD 120 billion monthly purchases from November this year, probably by USD 15 billion a month. This means that, although markets remain firmly supported through the generous provision of liquidity, it is inevitable that the huge pool of policy support will shrink. Guessing what this will mean for investors is difficult, but we expect somewhat higher interest rates to have a dampening effect on the current ebullient 'buy any dip' sentiment.

Also, we believe that the other engine that has driven stocks to all-time highs – namely, earnings – may well sputter in the fourth quarter. Input price pressure is hitting both industrial

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For professional investors
October 2021

Robeco Fundamental Equity Team

and consumer companies' profit margins. This is illustrated by the gap between producer price indices (PPIs), which reflect input prices, and consumer price indices (CPIs), which reflect output prices. Table 1 shows the latest statistics for selected countries.

Table 1 | Gauging the PPI-CPI gap

	PPI (Aug)	CPI (Aug)	PPI-CPI gap
US	8.3%	5.3%	3.0%
China	9.5%	0.8%	8.7%
Japan	5.5%	-0.4%	5.9%
Germany	12.0%	3.9%	8.1%

Source: Robeco, government statistics, Bloomberg, September 2021.

Meanwhile, the strong upward revisions to earnings forecasts seen over the past year seem bound to gradually fade. The upward momentum in earnings-outlook revisions has continued to be strong across the world, with only two downgrades for every three upgrades. We haven't seen such numbers since 2004. However, our view is that this trend is unlikely to be sustained, as we see slower economic growth and margin pressure ahead.

The inflation debate rages on

The inflation debate continues to rage, with expert views ranging from it being a 'transitory phenomenon' to 'stagflation'. Regardless of which view prevails, investors may soon find themselves stuck between a rock and a hard place. If inflation were to fall back in the coming months, companies would likely take the margin hit. But should inflationary pressures persist, investors would probably face headwinds from higher rates, to which growth stocks are especially vulnerable.

Growth stocks now account for a large portion of market capitalization-weighted indices, and this level of concentration worries us. The US generates about 20% of the world's gross domestic product, but accounts for 60% of the MSCI AC World Index. Within the US, about 25% of the S&P 500 Index is made up of six big tech stocks. Should your portfolio carry that much concentration risk, especially with many retail investors, robo-advisors and even pension funds charmed by cheap exchange-traded funds?

One really has to wonder whether these products still offer sufficient diversification. We're happy to point out that at Robeco we still run active portfolios based on fundamentals!

China on our minds

We are getting used to China, the world's second-biggest economy, making headlines. The China market has been weak so far this year, after the broad regulatory crackdown on some of its most popular segments. We are now confronted by the "common prosperity" mantra, a term first used by Mao Zedong in the 1950s, that may sound too 'socialist' to many 'capitalist' investors. Internet, media, and property, in particular, have been in regulators' crosshairs.

Internet has too much data, and property has too much debt. Both are seen as contributing to inequality and pose a risk to economic stability. However, we want to emphasize that this doesn't mean that private enterprises are no longer allowed to make a profit. It has always been an element of our investment process in China to invest with a government tailwind. From that perspective, it is encouraging to see the Chinese government's strong drive to cut the country's carbon emissions.

It is good to see China move from quantity to quality growth targets, and sectors that can contribute remain strong market favorites. Overall, however, we think this is likely to drive valuation multiples lower for Chinese stocks, as too much profit will not be seen as politically correct. Foreign investors, who have continued to accumulate positions over the last twelve months, may well reduce positions in the fourth quarter, with too much political noise a deterrent.

Feeling the (winter) heat

This quarter, we will be heading into the winter season again, and will therefore need some heating. And as much as we are trying to get away from fossil fuels, and as quickly as possible, we will burn a lot of oil and gas again. After having risen sharply for over a decade, US production levels have fallen by 20% since the onset of the Covid-19 pandemic. With demand rising again and supply constrained, gas prices have risen dramatically. Utilities will struggle to pass this on to consumers.

China's recent power crunch shows what can happen if rigid CO2 targets are set. Many provinces simply shut down coal-fired power plants to meet targets. More generally, firms in environmentally sensitive sectors are under pressure to contain investments, so supply is failing to follow demand in many areas. This is also the case, for example, for semiconductors, where it takes a long time for a new factory to get regulatory approvals.

Environmental inflation may become a new phenomenon. Will democratic governments succeed in getting their voters to accept this?

Monitoring Covid-19

As for the Covid-19 pandemic, the market has been moving from 'stay-at-home' plays to 'reopening' plays, with the ups and downs depending on infection numbers. The world is now divided between the countries that try to eradicate Covid-19 entirely and those that adapt to living with an endemic disease. The former are mostly located in Asia, China, and Australia, in particular, while most of us are living in the liberal latter.

In both cases, the evolution of vaccination rates will be crucial, though it is clear that even vaccinated people can fall sick and spread the virus, albeit in a milder form. However, in the specific case of China, which currently has very low natural immunity to the virus, Covid-19 remains a big risk and means borders will likely stay closed for longer. That said, the country's domestic economy is big enough now, and can afford to do that.

In conclusion, we have turned more cautious on the macroeconomic and the earnings front, as you will glean from our developed and emerging markets teams' assessments in the pages that follow. For now, this does have a large impact on our near-term outlook, especially for emerging markets, which have historically been more sensitive to tighter US monetary policy. That said, we will closely monitor corporate earnings outlook comments and the ongoing inflation debate over the coming weeks.

If your presents can be shipped on time, then I hope you will enjoy a peaceful Christmas to ponder over another remarkable year in equity markets.

Arnout van Rijn
CIO Asia-Pacific Equities

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Developed Markets Equities | Taper is coming

- Covid-19 pandemic abates as vaccinations progress
- Global earnings growth remains robust
- Inflation poses rising challenges for central banks
- Federal Reserve signals tapering will start in November

Five-factor summary

Factors	Score
Macro	= (from +)
Earnings	+
Valuation	=
Technical	+
Sentiment	=
Total	+

Source: Robeco Global Equities Team.

We maintain a long-term positive outlook for developed market (DM) equities. Nevertheless, we have lowered our macro factor from positive to neutral. We think that macro risks are increasing, as the US Federal Reserve (Fed) has indicated it wants to start tapering, i.e., reduce the pace of its balance sheet expansion, in November. The first rate hikes have been signaled for the second half of 2022 or the first half of 2023. Meanwhile, global earnings revisions are likely peaking out, after a very strong post-pandemic rebound.

In our view, the risk of a near-term correction has risen due to ongoing inflation concerns, China's unprecedented regulatory crackdown, the tapering announcement, and 'tax and spend' prospects in the US. Historically, a number of significant pullbacks have taken place in the US stock market in September and ended as early as October. It has been a while since we witnessed any meaningful market pullback. The last correction (a drop of over 10%) occurred in the MSCI World Index during the pandemic-induced market pullback of February/March 2020.

There has been global, consistent, and steady fiscal stimulus supporting the markets over the past 18 months, and the world's largest central banks are likely to remain accommodative overall. However, Norway's central bank became the first in the developed world to hike rates since the pandemic began, although only a small hike from 0.0% to 0.25%. The UK faces consumer price inflation at a nine-year high (August), and the Bank of England (BoE) may become the first to diverge from the common view that price pressures are transitory. Other central banks may also have to rethink their policy after continued strong inflation readings.

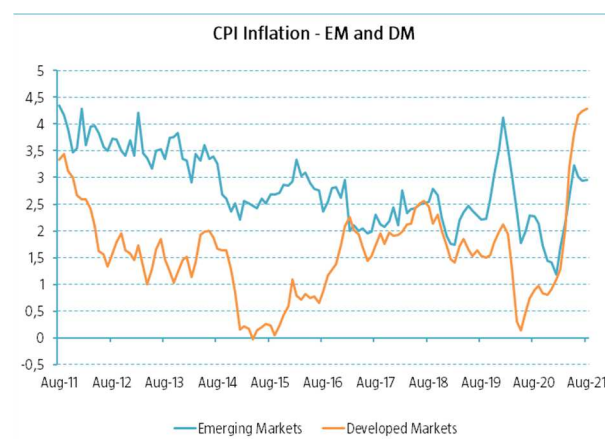
At a minimum, the Fed's asset purchase tapering will likely begin this quarter, most probably in November.

MSCI World Index actual and forecast earnings growth is still very strong. Financial analysts are finally catching up with corporate results and have been rewarding companies with positive earnings-per-share and sales revisions for 2021 and 2022.

There are some risks to these upgrades, notably from the rise in raw materials prices coupled with continued supply chain disruptions. Multiples have in fact retreated modestly, which is positive, as earnings growth has been outpacing price appreciation in recent months. The real story has been style rotation. This year has seen a shift toward cyclicals, then to growth, and now appears to be reversing again. We believe positioning ought to remain toward good fundamentals, particularly highly profitable companies with strong cashflows. Technical analysis is still supportive and market sentiment is not excessively bullish.

We do worry a little about the outlook for next year, as economic growth and earnings growth will probably moderate after a post-pandemic recovery. Tapering concerns are also likely to come to the fore, after a record-high services ISM report in the US, the fastest US nominal GDP growth since the 1950s, as well as increasingly hawkish comments from Fed officials. Going forward, inflation surprises and central bank policy will be more important than valuations and growth, in our view. Meanwhile, in the US, we also face a public spending environment that puts renewed pressure on the debt ceiling cap.

Figure 1 | CPI Inflation in emerging & developed markets



Source: DataStream, September 2021.

Global macro surprise turns negative while inflation pressure continues

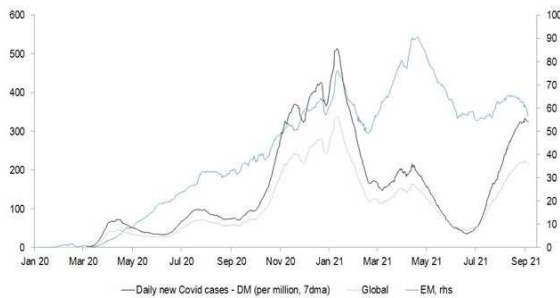
We wrote extensively about our inflation concerns in our previous Quarterly Outlook. US inflation may have peaked in August, as used motor vehicle prices tumbled, but persistent supply constraints will likely keep inflation high for longer. In Europe, where pricing contracts are often struck only once per year, we expect core goods inflation to

continue to rise. In addition to uncertainty about the path of inflation over the next few quarters (Figure 1), we note that following a full calendar year of robust and positive global macroeconomic surprises through August, global economic surprises have recently been deteriorating as noted in the Citi Economic Surprise Index. This combination of negative economic surprises and inflation uncertainty raises the risk of a near-term correction.

The Covid-19 wave looks ugly: but, policy appears focused towards re-opening

Daily Covid-19 cases in the US spiked again in late summer, but may peak along with the rest of developed markets (Figure 2). In any case, we see that most economies favor ‘re-opening’ policies. We see progress in a number of mobility indicators. For example, data from Apple shows that public transport searches are up in most developed countries including the US, the UK, Germany, Spain, and Japan. It is difficult to assess Covid-19 re-opening policies versus tightening measures, as we see rapid policy change across Europe and in portions of the US.

Figure 2 | The Covid situation is improving globally with new cases peaking in both EM and DM.



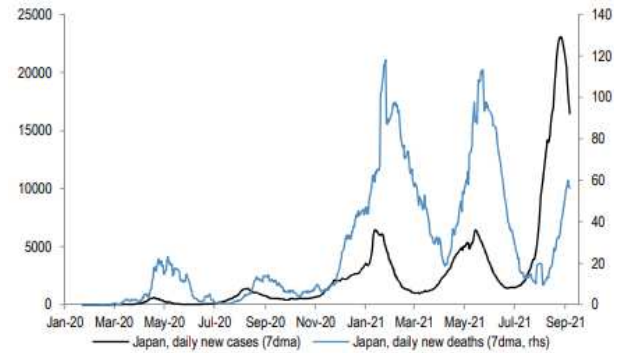
Source: J.P. Morgan, September 2021.

Japan’s Covid-19 rates, election uncertainty and poor economy weigh heavily

The MSCI Japan Index received a favorable boost when Prime Minister Yoshihide Suga announced his resignation effective at the end of September. The market initially responded favorably in the hope that his successor will be more successful at battling Covid-19 and the poor economic momentum. However, we believe this phenomenon will be a short-lived relative-alpha generator. Japan is recovering from its highest Covid-19 infection rates (Figure 3).

Yoshihide Suga’s successor, the newly elected Fumio Kishida, is expected to adopt a more proactive stance to tackle the pandemic and other economic and political challenges, as he faces an imminent national election within weeks. That said, with Japan leading the world economies in negative economic surprises, we find relatively little to be positive about regarding Japan’s domestic economy.

Figure 3 | Japan daily cases and new deaths



Source: J.P. Morgan, September 2021.

Earnings revisions for the MSCI World Index continue to rebound

Earnings revisions for the MSCI World Index continue to recover strongly. We think there is potential for earnings revisions to rise further, but would caution that we are lapping the worst impact from the Covid-19 pandemic. In the US, the estimated earnings growth rate for the third quarter of 2021 is 27.6%. If achieved, this will be the third-highest year-on-year earnings growth rate reported since 2010. We have some concerns that earnings revisions will start moderating, as companies may feel the continued pinch of higher inflation. A record 224 companies of the S&P 500 Index cited inflation concerns in their second quarter earnings conference calls. From a year-on-year perspective, earnings revisions are most likely to start moderating.

Figure 4 | Earnings revisions for the MSCI World continue to look strong



Source: DataStream, September 2021.

Valuations remain high from an absolute perspective

Equity valuations are high across the world, at least from a historical perspective, but neutral given the rate environment we are in. We see that the MSCI World Index is trading at close to 19.2 times 12-month forward earnings. Meanwhile, the US market, which is clearly more technology and services-oriented, is trading closer to 21.5 times forward earnings. This reflects the current inflationary

environment, as well as the record stimulus pumped into the global economy during the pandemic slowdown. Money keeps flowing into equities, and stocks remain relatively attractive versus credits and government bonds, as rates are expected to rise at some point, from historic low levels.

Figure 5 | Absolute valuations in the US and developed markets



Source: DataStream, September 2021.

Main risks to our outlook

Our outlook for developed markets equities is now more cautious than in prior quarters of 2021. The main risk to our outlook is implied by the inflation pressures highlighted in recent corporate results, which may force central banks to act. We think that most central banks are willing to let inflation overshoot their targets, as they do not want to harm the fragile economic recovery amid the ongoing spread of the delta variant of the Covid-19 virus. Uncertainty related to the timing and size of the Fed's tapering, as well as the current administration's willingness to tax and spend aggressively (a proposed USD 4-5 trillion in spending and tax increases), may weigh on global markets in the short term.

Implications for portfolio positioning

In the Global Equity portfolios, we have a slight underweight position in European equities and an overweight position in North America. We also maintain an overweight position in the Asia-Pacific region and are underweight in Japan. We continue to like defensive, high-quality sectors, such as Healthcare and Consumer Discretionary over more bond-like sectors, such as Utilities and Consumer Staples. We remain on the lookout for companies with a good or improving sustainability profile, that also have a good long-term track record of return on invested capital and that have a decent valuation on free cash flow. During the past quarter, we have taken some profits in high-flying Information Technology and Communication Services sectors and have added to the Financials, Consumer Discretionary, Materials and Industrials sectors, to broaden the portfolio and have less exposure to high-duration growth stocks.

Emerging Markets Equities | China and the Fed remain top of mind

- Vaccination programs are accelerating, inflation has started to decelerate in emerging markets
- Key milestones of Q4 2021 will be :
 - Chinese headwinds continue but should be more or less priced in
 - Risks relate to new variants of Covid-19 and inflation being less transitory than expected

Five-factor summary

Factors	Score
Macro	=
Earnings	= (from +)
Valuation	+
Technical	- (from =)
Sentiment	=
Total	= (from +)

Source: Robeco Emerging Markets Team

We downgrade our stance on emerging markets to a neutral one, on the back of less attractive earnings and technical profiles. The economic rebound of the last quarters has been translated into a strong earnings performance across emerging markets. This substantial tailwind has now largely worked its way through companies' top and bottom line. Earnings revisions in emerging markets have become weaker than in developed ones. The earnings-revision ratio for emerging markets has recently softened, but remains above 1.0. In conclusion, forward EPS estimates in emerging markets are both decelerating and underperforming those in developed ones. As a result, we have downgraded the earnings component in our five-factor analysis framework.

We have also downgraded the technical factor from neutral to negative. Emerging markets substantially lagged developed markets recently, causing a deterioration in their technical profile.

As the table above shows, the valuation factor remains positive. This was reinforced during the last quarter. The sentiment factor remains neutral, since there has been an unprecedented inflow of investment money into emerging markets, totaling more than USD 150 billion since October 2020. We expect continued inflows, but at a slower pace than in the previous quarters. The constructive sentiment should persist, since investors are increasingly looking for

value propositions that will benefit from a reopening of the global economy.

EM faces headwinds, but these are very well flagged

Concerns around China's property sector have triggered some volatility in emerging markets. Irrespective of the near-term outcome for property developer Evergrande coupon payments, working off the leverage incurred over a slowing property market is likely to take a long time. The risks of contagion and further slowing in the property sector are real. Having said this, what matters more for other emerging markets is the negative impact on Chinese growth, and by extension commodity prices, and whether policymakers will step in to offset those downside risks.

Any potential default or restructuring would need to be carefully managed to limit economic and market contagion effects. Chinese authorities need to provide a clear message soon to shore up confidence among homebuyers, suppliers, and contractors, as well as banks and other non-bank financial institutions, in order to prevent the realization of downside risks. Evergrande is a large and complex business, that encompasses many onshore and offshore subsidiaries, but it accounts for only 4% of China's total property sales, suggesting somewhat limited spillovers to the real economy in the event of an orderly default.

The bigger risk is that such a potential default would lead to a slowdown in the Chinese property sector, which dominates households' balance sheets (40% of household assets) and has strong linkages to the banking system (40% of loans are backed by properties), as a result of worsening sentiment and broad-based deleveraging. The increased regulatory actions from the Chinese government towards big technology companies has resulted in a further deterioration in sentiment towards Chinese equities and – because of the sheer size of the Chinese market – also emerging equities.

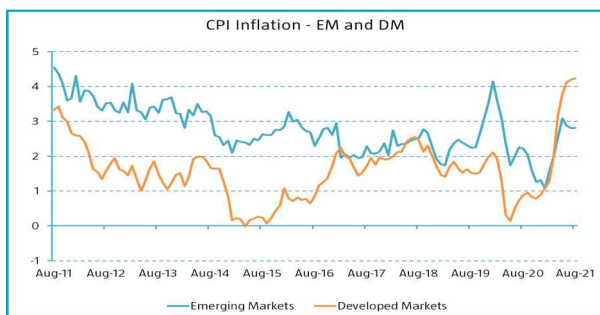
With regards to Covid-19 and its variants, vaccination rates in emerging markets are well on track to reach 70% by year end. This compares with an expected 80% share in developed countries. The widespread vaccination rollout should enable a sustained rise in mobility and economic activity. Covid-19 is thereby no longer a clear headwind, but merely a potential risk.

Regarding the upcoming tapering process in the US, more clarity was recently given on this by Fed chairman Jerome Powell. Tapering is expected to start towards the end of 2021. Depending on macroeconomic data, we might see the first rate hikes in 2023. Contrary to 2013, the upcoming tapering is very well flagged, so a repeat of the selloffs of the second half of 2013 might be avoided. So far this year, emerging markets have substantially lagged their developed counterparts in terms of equity returns. The US tapering process was the main reason behind this underperformance, in combination with the Chinese regulatory crackdown on domestic big tech companies.

Inflation environment still benign

Next to these headwinds, however, we identify various tailwinds, such as the much more favorable consumer price index (CPI) evolution in emerging markets relative to developed markets, as illustrated in Figure 6. The macroeconomic environment is strong across most emerging countries, while inflation has been moderating after a strong rebound.

Figure 6 | Inflation estimates



Source: Bloomberg, Robeco, September 2021.

Since the second half 2020, we have seen a spike in commodity-related inflation. Recently, however, CPIs have been decelerating in emerging markets, while they remained strongly on the rise in developed ones.

Monetary tightening in some EM

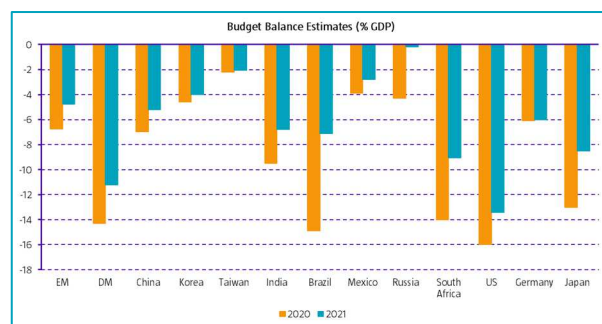
Despite the generally benign inflationary environment, some emerging market central banks have turned more hawkish. Latin America is expected to lead the pack in the remainder of 2021. Brazil, for one, is likely to hike rates further, as its central bank is expected to react more aggressively to tighter global financial conditions and uncertainty over fiscal developments. On the other side of the spectrum, Turkey recently surprised the market with a rate cut of 100 basis points, from 19% to 18%.

The central banks from most of the other large emerging markets are keeping rates steady at current low levels. The exception has been Bank of Korea, which started to hike cautiously in August, from 0.50% to 0.75%. It remains to be seen how hawkish emerging market central banks will eventually become, in relation to the Fed's tapering.

Tailwinds from budget and current account balances

We remain constructive regarding macroeconomics in emerging markets in general, and in North Asia in particular. Solid fundamentals support our stance, as this region could see GDP growth numbers in the low single digits in 2021, with large current account surpluses and relatively low fiscal deficits. On the other hand, South Asia, and most of Latin America and EMEA, could see high single-digit GDP growth, resilient current account balances and fiscal deficits close to all-time highs, although likely to come down substantially as economies recover. Figures 7 and 8 illustrate this backdrop.

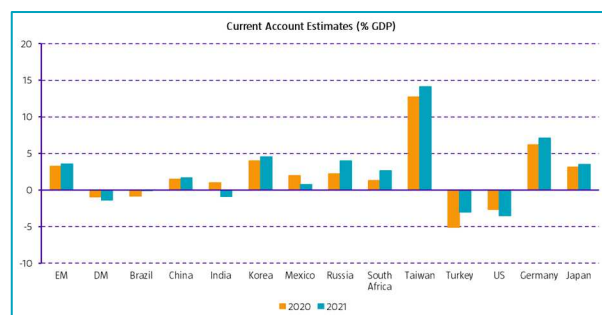
Figure 7 | Budget balance estimates



Source: Bloomberg, Robeco, September 2021.

On average, the current account balances of emerging markets look much better than those of developed markets. The same is true for fiscal balances.

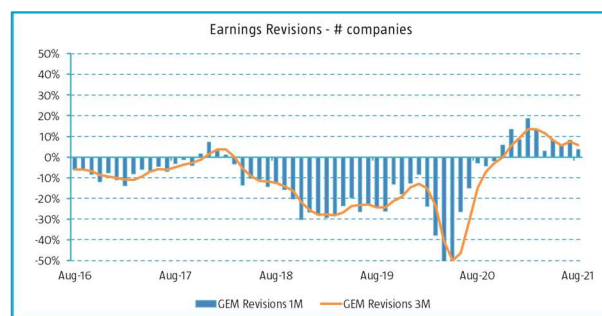
Figure 8 | Current account estimates



Source: Bloomberg, Robeco, September 2021.

Earnings expectations decelerating

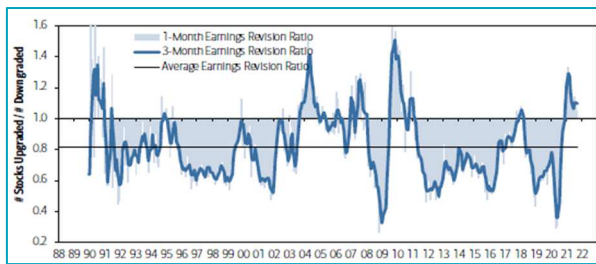
Figure 9 | Earnings revisions emerging markets



Source: IBES, Robeco, September 2021.

In September, the one-month earnings revisions ratio dropped in emerging markets, from 1.11 to 1.05, as Figure 10 shows. It remains above 1.0 and comfortably above the long-term average earnings revisions ratio. From an earnings point of view, these are positive signals.

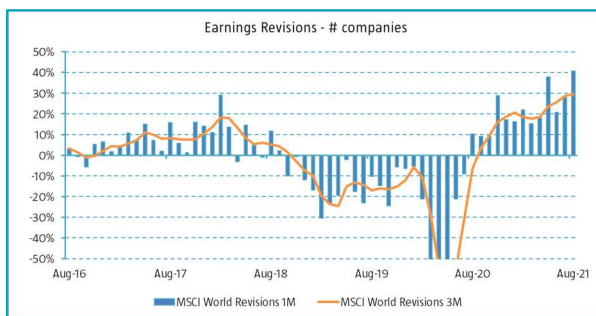
Figure 10 | Trends in earnings expectations EM



Source: Bank of America, September 2021.

Earnings revisions are lower in emerging markets than in developed markets. The gap widened over the last couple of months and explains why we downgraded the earnings factor, despite the fact that the absolute earnings growth expected for 2021 in emerging markets remains very strong (over +45%).

Figure 11 | Trends in earnings expectations MSCI World Index



Source: IBES, Robeco, September 2021.

Valuation a positive factor for emerging markets

Valuation remains a positive factor for emerging markets. The 12-month forward P/E ratio approached a 10-year low in early 2020, but bounced back to higher levels, as Figure 12 shows.

Figure 12 | Valuations remain attractive in emerging markets



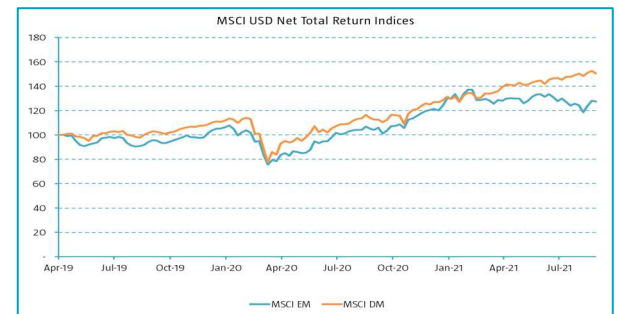
Source: MSCI, Robeco, September 2021.

The average P/E ratio in emerging markets is close to 13 times, compared to 20 times for the MSCI World Index. This translates into a 35% valuation discount for emerging markets, relative to developed ones. The average historical discount is close to 20%. From a price-to-book perspective (P/BV), emerging equities are trading at a 30% discount relative to their developed counterparts. The average historical discount is about 15%.

Technical picture downgraded to negative

Emerging markets have been lagging their developed counterparts over the last year. Over the last 12 months, emerging equity markets returned 21%, whereas the developed markets returned more than 34% in euro. Year to date, the total returns are 4% and 22% respectively. As a result, the technical factor has been downgraded from neutral to negative.

Figure 13 | Emerging markets' technical indicators are in line with those of developed ones



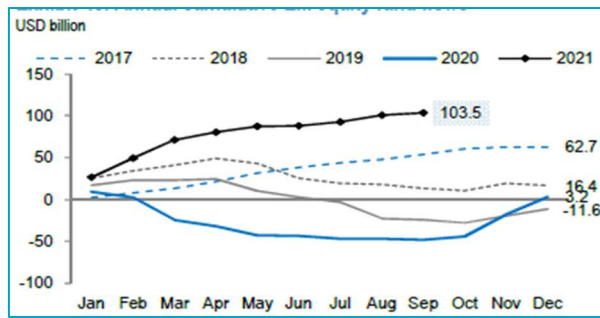
Source: MSCI, Robeco, September 2021

Sentiment remains neutral

We keep the sentiment factor at a neutral stance, following the more than USD 150 billion of cumulative inflows into emerging equity funds over the last year. The inflows are expected to continue, as investors look for attractively valued asset classes with high yields.

In an era of reopening economies and large-scale vaccination campaigns across the globe, global investors' appetite for risk might remain high. Simultaneously, investors might seek more 'value' for their portfolios. However, we do expect the current deceleration in inflows to continue as tapering signals are becoming more evident. So far in 2021, inflows into emerging equity funds have exceeded USD 100 billion, a level not seen over the last five years, as shown in Figure 14.

Figure 14 | EM Equity annual cumulative flows



Source: EPFR Global, September 2021.

Implications for portfolio positioning

We maintain the value tilt in our Emerging Markets Equity portfolios, which have a lower average P/E ratio than the MSCI Emerging Markets Index. Within emerging markets, we remain constructive on North Asia, on the back of stronger macroeconomic fundamentals. In the upcoming 'taper era', the focus will shift again towards macroeconomic vulnerabilities, such as current account balances. The largest current account surpluses are in North Asia (China, Taiwan, South Korea). These countries also seem to be more resilient from a currency perspective.

The portfolios remain close to maximum overweight in South Korea. We have maintained our overweight position in Taiwan. Within the rest of EM, we slightly increased our positions in Greece, and implemented our first position in Turkey in a while, as we believe there is a high chance of a strong rebound in their economies and in corporate profits. Current valuations in both countries do not reflect the expected earnings recovery.

From a sector perspective, we keep a comfortable overweight position in consumer discretionary and information technology. Meanwhile, we maintain a significant underweight position in the expensive consumer staples sector. We also have a slightly overweight position in financials. Valuations have corrected the most in this sector after the lockdowns, and in some countries the credit profile is better than initially expected.

In China, financial stability is still a top priority for the government, as stated repeatedly by senior government officials. With regards to Evergrande, policymakers would choose to wait before acting, to avoid moral hazard and deter excessive risk taking, and then to step in at a later stage to ensure an orderly debt restructuring, with the aim of safeguarding financial and social stability. There could be a segregation of project companies from the group to ensure the asset value is materialized and the cash flow is used for project construction only. Project delivery will be crucial from a social stability point of view, as home buyers and suppliers are most important among stakeholders. As a percentage of banks' total loan balance, the loan balances of individual developers like Evergrande are limited. Banks

have instead been focusing on collateralized project loans, which should lead to quite manageable losses.

A self-fulfilling liquidity crunch could arise for other developers, as banks, suppliers and homebuyers would all turn more cautious. But the spillover effect could be contained, if the government eases the existing controls on credit flows to the property sector. Unlike governments in the west, the Chinese government has much stronger influence on financial institutions, as they are mostly state-owned. The government can effectively isolate credit events and prevent a contagion to the rest of the economy.

China's macro policy will tilt more towards loosening, with expectation of an RRR cut to support the economy. Policymakers may push for faster local government bond issuance in the coming months to support growth, which could translate into stronger infrastructure investment.

Exports could stay resilient in the coming months, thanks to demand recovery in developed markets and some production reshuffling, but with increasing challenges. China's consumption recovery could still face disruption due to resurgences of Covid-19, given China's continued strict implementation of its 'zero Covid' strategy.

Investors in China were also taught a new term in August: 'common prosperity'. President Xi Jinping wants a more balanced wealth distribution in a country where inequality has grown rapidly over the past few decades. The idea is to ensure that China's growth is more sustainable and of a better quality. Common prosperity is aimed at facilitating growth in the middle class, and is an objective that will be achieved in multiple phases over time. Policies aimed at promoting common prosperity will likely aid China's economic rebalancing towards consumption, especially consumption by the lower- and middle-income population, and away from investment in some areas. We expect support for SMEs and services sectors, better labor protection, land-use-rights reform, and efforts to build a more robust capital market.

China's policy priority is shifting from speed of growth to promoting the quality and sustainability of growth, and from efficiency to equality. China's market still offers attractive investment opportunities. Themes and sectors that are likely to benefit from China's policies are: electric vehicles and electric vehicle batteries, new energy, new materials, and environmental protection sectors; technology hardware, semiconductors, agriculture-related sectors, important for China's food security.

Chinese equity valuations have come back to a level in line with the historical average. We expect further negative earnings revisions for the MSCI China Index, due to heavy exposure to the internet sector, which is under heavy regulatory scrutiny. A-shares earnings revisions have bottomed out and turned more positive. We are generally positioning ourselves to focus more on pricing power and earnings upside momentum for our portfolio construction.

The Chinese Equities portfolio is overweight in utilities, healthcare, and materials. and underweight in financials, information technology and the internet sectors.

The Chinese A shares equities portfolio is overweight in materials, consumer discretionary and utilities, and underweight in financials and consumer staples.

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