The Insight: Conversations – Defying Gravity with Robert O'Leary, Armen Panossian, Jean-Pierre Latrille, and Janet Wang

Anna Szymanski

Hello and welcome to the *Insight by Oaktree Capital*. I'm Anna Szymanski, Oaktree's senior financial writer. Today I'll be having three conversations with contributors from Oaktree's recent quarterly letter *Roundup*. We're going to be talking about the most surprising trends of the first quarter, the outlook for global convertibles, and why we believe Chinese equities look more attractive today than they did a year ago.

For today's first discussion, I'll be speaking with Oaktree's recently appointed co-CEOs, Bob O'Leary and Armen Panossian. Bob is also portfolio manager for Oaktree's Global Opportunities strategy and Armen is Oaktree's Head of Performing Credit. Bob, Armen, thanks so much for joining me.

Bob O'Leary

Thank you.

Armen Panossian

Thank you.

Anna

So we spoke in mid-December at a client event and at that time, you were talking about your outlook for 2024. We're now recording towards the end of the first quarter of 2024. So from both of you, I'm curious, what would you say are some of the most significant changes in the credit markets over the last few months?

Bob

Yeah, maybe I can jump in. So mid-December was really the height of the euphoria around the potential rate cuts. Rates peaked back in October, and you had a slow slide that picked up speed as you got into December. Since then, I think everybody's tapped the brakes a little bit. We've seen several data points that have challenged the notion that inflation is in retreat. I think that's thrown some uncertainty into the timing and size of the rate cuts for 2024 and beyond.

Spreads have generally gone tighter with that, but I think it's also fair to say that dispersion has increased. You see a lot of activity in the tails of the market. But I think the market is assessing right now, and I think it's a point of some uncertainty.

Armen

Yeah, I wouldn't add too much. I would just say that November and December of 2023, huge rally in the credit markets on a combined basis. High yield rallied over 8% in those two months alone. There was a little bit of a lull in January, and I think there was a perception that some of the return of early 2024 or in the first half of 2024 had been pulled forward into 2023.

On Bob's point around the macro indicators, specifically around inflation being a little bit more persistent than expected, I think there was a moment there, especially in January, where I think, the market was trying to assess, are we headed down from here? Is there going to be a reason to keep rates higher for longer? Is that going to trip us into a recession, or is there some other positive news that we could attach ourselves to help continue this rally?

That positive news hasn't been there, but I think what's been surprising has been how much capital has been sitting on the sidelines and just waiting for some opportunity to invest, and that capital is slowly leaking off of the sidelines and pushing spreads tighter. We're now in the low 300s spread in high yield. We typically don't see high-yield spreads under 300 basis points for a prolonged period of time, but we're around 310, 320 right now.

I think it's more because there's too much cash that's been sloshing around in the system. There's been a lot of COVID-related stimulus that has now made its way into the hands of savers, family offices, pension funds, insurance companies, savings accounts, and that is now getting deployed even with spreads at historical tights, but with absolute yields still being relatively attractive.

Anna

Bob, Armen mentioned something that he said surprised him about what we've seen in the first quarter. Is there anything that has surprised you about what we've seen in the last few months?

Bob

Yeah. So for me, it's just the resilience of the markets, both credit and equity, that you've thrown a lot at the market. You've thrown a very substantial rate increase. You've thrown some incredible and very tragic geopolitical events, and you have a very divisive election cycle coming up. Those are just three things, and there's several more. The market's taken all of that, shrugged it off, and gone higher.

So part of me thinks that's just the market defying gravity for a period of time and you'll get some correction. Part of that may be, again, as Armen was saying, just cash on the sidelines deciding that it wants to move in and participate in the rally. But I can tell you that the fundamentals are starting to show some ware.

Anna

Now, Armen, this resilience that Bob is talking about that we've certainly been seeing in the public markets, how has that impacted what you're seeing in the private credit landscape?

Armen

Private credit has also tightened in terms of spreads. It still has a very attractive absolute return because base rates are high. But over the last six to nine months, I would say private credit spreads for new transactions have tightened by about 75 or 100 basis points. Over the last 12 months, they've tightened probably 100 to 125 basis points. Part of it is because deal flow has declined. M&A or LBO deal volumes are down materially in 2023 versus 2022. When you're borrowing a 12 or 13%, the ROE or the return on equity for an LBO may not look quite as attractive across all industries. So LBOs were fewer and far between in 2023 versus 2022.

So declining deal flow, but at the same time, there has been inflows into private credit funds, specifically corporate direct lending funds focused on sponsored activity. Some of those were retail accounts consistent with this theme of a surprising amount of liquidity amongst savers. There have been material inflows into high-net worth or semi-liquid BDCs, business development corporations, that have seen pretty material month-to-month inflows, and those inflows have been chasing fewer and fewer deals. As a result, spreads have tightened.

As we look at the performance of companies, that's been, I think, a surprise. I don't think companies are performing well, but I do think that they're not rolling over as early as I thought they would've. Typically, when you see a rate hiking cycle, 18 months later, you start seeing some cracks in performance because companies start underinvesting in their business. And while we are seeing that happening in the tails, and those tails are pretty meaningful in size, I just would've expected to see more by now. I would've expected to see bigger cracks. I would've expected to see a broader swath of them.

And so, bigger businesses, which are the ones that we actually like investing in more, I would say, on balance, they've actually been surprisingly resilient and able to pass through cost increases and tread water for longer than I would've expected.

Anna

And consumers have continued to spend?

Armen

I think the consumer has not rolled over. The consumer has been working down their savings for sure, but they haven't rolled over to the extent that I would've expected at this point. But rates, I think, are likely to stay higher for a while just given the inflationary picture and given that this is an election year. I think as we approach the election, the likelihood of a meaningful rate cut declines.

So I think the backdrop is rates stay higher for longer and impact the consumer over time more and more, and this might take just a little bit longer to work out, but I don't see how we don't avoid some level of stress or distress along those tails, especially in the below investment grade credit markets.

Anna

Speaking of that stress and distress, Bob, I'm curious what you're seeing in terms of rescue financings. I know that was one thing when we spoke in December that you said that was an opportunity that had really been growing. So could you speak more about that?

Bob

Yeah, and it has only grown. So I'd say a couple things here. As we discussed back then, the need for rescue capital really arises from a financial obligation a company has, usually maturity, that can't be financed through regular ways in syndicated markets. Companies then have to turn to an alternative source of capital to avoid a restructuring.

Demand for rescue capital has risen recently, usually in conjunction with the move in interest rates and the ramp of the maturity schedule that a lot of these companies' face. Demand for rescue capital was very strong last year in spite of the fact that the maturity schedule was at its earliest stages, and the rate move had only begun to be felt by a lot of these companies.

Maturities are now ramping up, the rate move is in full effect, and demand for rescue capital is predictably high, and yet you have pretty strong market conditions. You're seeing it most in situations, first of all, in variable rate capital structure. That's pretty straightforward. Those are the companies that are feeling the full effect of the rate move. You're seeing it from an industry perspective in early cyclicals, where they may have had a rough landing coming out of the pandemic and their results don't really merit a syndicated financing. You're seeing it in situations where you have sponsors that have already shown that they will be aggressive, and you're seeing it in situations where companies have eaten through their liquidity needs. So it is increasing.

What we really are excited by in this area is the fact that, maybe for the first time in my career, you almost have arbitrage. You can observe the pricing of the risk on these companies in the market, in the secondary trading of the bank debt, and high yield bonds of these companies. You can look at how the credit agreement stacks up. You can look at the covenants that that credit agreement has, and then you can construct something superior because the documents that were put in place over the last several years are so deficient and full of holes that it allows for a newly constructed instrument to grab a lot of the value that wasn't taken by the existing credit agreement. Then you can price it usually at a premium to where the existing credit is in the secondary market.

So if you can construct a superior instrument with more assets pledged to it and better downside protection and price it at a premium, that's pretty good business. That's what's exciting here. Again, we think it's only going to grow over the course of the next year. It's still ramping as we speak in spite of very good market conditions, and we think that it has legs.

Anna

Especially as the maturity wall obviously becomes a lot larger as we move forward.

Bob

Correct.

Anna

From listening to both of you, it seems like we are in this kind of environment where, Armen, as you say, on the one hand, we maybe aren't seeing quite as much distress across the market as you would've anticipated. But because the debt markets have just grown so substantially over the last 10, 15 years, there still are tremendous opportunities for more opportunistic-focused investors.

Armen

I would agree. I think that there's both risk and opportunity in that statement. The risk is with the rally that's been shocking over the last several months in the credit markets with such a tightening of spreads, that has resulted in risk assets rallying, too. So in the case of CCC-rated high-yield bonds in 2023, the spread tightened 330 basis points, of which roughly half of that spread tightening was in the fourth quarter alone, and it's continued to tighten this year. I think spreads in CCCs have tightened nearly 60 basis points this year.

So when risk assets rally, those are the tails. That's the tails we're talking about that are probably showing the cracks sooner than the average issuer. But when risk assets rally despite the fundamental picture not really supporting such a rally, I think that creates a risk, which is if these macro indicators do worsen or if the economy does slow or inflation remains persistent, I think, or the market will have shown that it went too far too fast. And that's a risk factor we watch. It creates opportunities for obviously a lot of our business units at Oaktree, which is fantastic. But I think being cognizant of rallying, outpacing the fundamentals is a major risk factor at this point in the market that we see.

Anna

And Bob, would you say there are any other risks that have become maybe more pronounced over the last few months?

Bob

Yeah. One thing I think the market is sleeping on, and I think I mentioned this back in December, is liability management exercises.

Anna

Bob, could you just remind our listeners exactly what a liability management exercise is?

Bob

So liability management is where a company sometimes in conjunction with a sponsor, sometimes not engages in a transaction that plays creditors off against each other with the goal of either reducing debt or managing some term of the debt, whether it be the amount, the maturity, the interest, often in conjunction with raising additional capital, but it's a transaction designed to pit creditors against each other to lessen the liability schedule that the company faces and make it so that the sponsor has to either kick in no capital or very minimal amount to keep the equity that it has in that company alive.

Every restructuring advisor out there is working on multiple liability management exercises for sponsors that they have been engaged with. Any company that is close to having an issue and some of them there aren't even close where the sponsor just wants to do something proactively is considering this. You've seen in the last month, three or four of these transactions announced where if you were kind of a tourist in that particular credit, you woke up and found that a couple of the lenders had banded together and engaged in a transaction that seriously diminished the value of the instrument that you hold.

That's going to be an increased feature of the market, and I don't know that it's priced into spreads. You look at where loans are versus high yield and loans are obviously where most of this activity is going to occur when you get about 200 basis points of incremental spread to be in loans at the median or the average credit level, but that doesn't feel adequate.

When it's all said and done, when we get through the other side of this credit cycle, which probably is a couple years out, you're going to find that every sponsor of any significance has engaged if they haven't already has engaged in some liability management. And that will have worked out to the detriment of a big part of the creditors that hold the debt of these companies.

So that's going to ramp up as companies start to face more stress. What you'll see is you won't see defaults immediately. You'll see more of this liability management. In our experience, that doesn't really save a company. In fact, most of the time they end up defaulting anyhow. So that may stave off around the defaults, but you will see a lot of this activity and you'll see the defaults probably pushed out by a year or so. But it'll be an indication of the stress that's in the market. And again, it doesn't feel like people are paying adequate attention to that.

Anna

So both Bob and Armen, as we look forward, what would you say are some of the indicators or trends that you're really watching closely?

Bob

I go back to the consumer and a lot of the trends. The forward-looking trends for me are performance of various asset classes in the securitization market. Look at auto loans, look at mortgages, look at credit cards, look at personal loans. I would say the message is a little mixed at this point. Certainly auto loans are at a level on a 60-day delinquent level. They haven't seen since the financial crisis. That may be because of some of the unusual things that happened to the auto market back during COVID. But they are definitely high and still rising.

You also have credit cards, especially subprime lower rated credit card issuance, starting to see heightened defaults and charge-offs. It hasn't hit mortgages, but mortgages I think have their own unique phenomenon, which is if you got a 3% mortgage two or three years back, you're doing everything in your power to hold onto that. But I do think there is fatigue setting in particularly with the lower income consumer. You've seen that on a couple company earnings reports, and I think that's going to increase over time. It will be, I think just a matter of time where it starts to seep into some of the higher-level income consumers out there.

Armen

Yeah. Bob mentioned some really good forward-looking indicators. This isn't necessarily forward-looking, but the most valuable asset people own are their homes. The second and third quarter every year is really when you see home sales, both new home sales and existing home sales really take off or not. Existing home sales last year were down fairly materially because of the phenomenon that Bob mentioned, which is if you have a really low-rate mortgage, you're going to just stay in your home because you can't afford the next mortgage. So volumes decline.

The stability in the markets and home pricing was aided by the fact that there really wasn't much unemployment. But the employment picture is a little bit more mixed these days. I wouldn't say it's weak, but it's not as strong as it was six months ago. And if we do see some job losses and some forced selling of homes, even if it's a small number, even if it's 5% of the total existing home supply in the US because the buyers cannot afford next mortgage, especially in the first time home buyer category or the first move up buyer category, you may see some pretty material reductions in home prices, which is caused by a mixture of higher rates and some mixed job numbers.

If that happens, I think the impact on the consumer could be quite devastating. Again, because it's the most valuable asset people own, and when they look at their neighbor's house selling for 15% lower than what they thought their house was worth, they might not spend money for the home improvement that they had been doing over the last few years, or they just might not want to go on vacation anymore or buy that new car.

There's a huge correlation between consumer confidence and the value of homes. I watch that very closely, which means that the derivative factors I also watch very closely, which are inflation and how that impacts rates. Rates obviously impact the cost of mortgages, and then employment is their job creation or job destruction.

While I was looking at indicators that are even in advance of that, are people actually spending money and paying their bills on time? And if they're not, that means either they're losing their jobs or they just kind of went too far and they over-extended, and all of those are kind of intertwined.

Anna

To end our conversation today, do you have any final thoughts about where we stand at the end of the first quarter for both of you?

Bob

So for me, most of the factors we've touched on in this conversation are macro factors. There are things that affect all companies, whether it's rates or maturities, things like that. I also think it's very interesting at the individual industry level, there are a lot of trends going on independent of what's happening in the economy that have given rise to volatility, have given rise to stress. It's been talked about for a long time, but commercial real estate, you're starting to see real defaults. You're starting to see stress pick up in the CRE/CLO market. And it's not just office.

I think what you're seeing is that it's other areas where the market got very well over its skis and is now retrenching, and you're seeing situations that I think are going to require a fair amount, if not a restructuring, a fair amount of additional capital applied, and it's not clear where that capital comes from.

Armen

We talked about the macro indicators, and I think investors should ask themselves, how do I feel about my portfolio if rates stay here for another 12 to 18 months? I would just remind folks that at the end of 2022, the market consensus was that we would be in a recession in 2023 and there would be several rate cuts in 2023. And obviously that didn't play out. I think to some extent we have kicked the can down the road because of the liquidity in the markets and all that stimulus that was plowed into the markets in 2020 and 2021 is in the trillions of dollars. We've never seen that before.

So when you see trillions of dollars of helicopter cash and other stimulus packages, it causes inflation and that kind of masks some fundamental issues. I don't think those issues have gone away and those cracks are still developing, and there's still a little bit of a hangover from having all of that stimulus, cash sitting in these bank accounts and looking for a place to invest and casting aside the fundamentals.

So if you think that an extended period of high rates will at some point slow the economy down to a point where it becomes uncontrollable to the downside, I think one should ask themselves, do I have the right portfolio? Because I'm not going to be able to make that shift at the right time. I'm not going to be able to go to cash quickly if things do go badly.

So it's hard to predict are we going up from here or down from here, but certainly feels like we've come a long way to the upside and without really the fundamental indicators to support it and even the micro performance indicators to support it, just a chase to buy assets right now, including risk assets. But I guess my parting thought would be look at your portfolio and ask yourself whether it's positioned the right way for period of rates staying here for a while.

Anna Szymanski

For our next conversation, I'll be speaking with Jean-Pierre Latrille, co-portfolio manager of Oaktree's Global Convertible Strategy. JP, thanks so much for joining me.

JP Latrille

Thanks for having me.

Anna

To begin, can you just explain exactly what are convertible bonds?

JP

Sure. So a convertible bond is like any regular bond. It has a coupon, and it has a maturity date. The thing that makes convertible bonds special is the fact that they are convertible into a fixed amount of shares when they're issued. So the stock price goes down. The convertible bond will basically hold at its theoretical value as a fixed income instrument. But on the other side, when the stock price goes up, the convertible bond will participate with the rise in the equity price.

Anna

Can you now describe the global convertibles market? So roughly the size, what type of issuers make up this market?

JP

Sure. Maybe I'll start with the size of the market. Currently, it's over $350 billion in size. And it's made up by roughly 750 companies. If we look at the regional breakdown, the biggest region is the United States, which is approximately two thirds of the universe. Europe represents roughly a quarter while Asia is 10%, which also includes Japan. Now, if we look at the sector composition, it's pretty well diversified. Historically, technology and healthcare have been two of the larger sectors. We have a well-established, industrial conglomerates, global consumer brands, and utilities, among others. So the market's pretty diverse.

Now, if we look at the credit quality, we think that the global average is roughly BB plus with 40% being investment grade. So the quality in the convertible universe is actually quite good. And finally, the vast majority of issuers in our space are mid- to large-cap companies. These are mostly well-known, well-established firms.

Anna

So that last point brings me to my next question, because I think often when people think about convertibles, they think about smaller companies. And as you said, that's in fact not really the case. So what are some of the other misconceptions about the global convertibles market?

JP

In terms of misconceptions, I think some investors may think that the convertible market is made up of mostly speculative issuers that may be in early stages of development or they can't access other forms of financing, but actually, the opposite is true. The vast majority of issuers in our market are well-known companies that, as I mentioned, a good portion of them are investment grade rated. So while there will always be some speculative pockets in our market, most of the issuers are high quality, which provides investors with good downside protection by owning the convertible versus the equity.

Maybe another misconception is that convertibles are less liquid and difficult to price. And again, I think the opposite is true. The asset class is probably among the most liquid compared to other credit markets. Pricing is actually pretty transparent.

Anna

Now, let's just zoom in on today's market. What are some of the trends that we've seen in the global convertibles market over the last year?

JP

Last year, we had a solid year in terms of new issuance. Quality is up. Pricing has improved in the last two years, and we saw also many first-time issuers come to our market for financing. And on the demand side, investor appetite is quite strong, with most new deals being well oversubscribed and trading above their issue price. I think the better pricing that we're seeing has also materially improved the convexity of the asset class, which we're very happy with.

Anna

And what do you mean when you say the convexity?

JP

When you look at the payoff graph or the price path of convertible bond, the sweet spot is where the bond has the most curvature. So with higher coupons and lower premiums, the bonds will provide you better protection on the downside because of the higher coupon, but also the lower premium will provide you with more upside capture versus the stock. So that convexity has definitely improved. M&A is also a positive theme that is benefiting our market. So I would characterize the current state of our market as healthy, and it has ample room to grow.

Anna

Looking at that room to grow, in the piece in the quarterly letter *Roundup*, you're specifically talking about why the outlook seems pretty strong for convertibles right now. What are some of the reasons for that?

JP

Sure. So we think the market is attractive right now because the two main drivers of performance, which are, number one, the underlying equities of the convertible issuers, and number two, the terms the bonds are offering you. So if we start by looking at the underlying equities in our market, they've undergone a meaningful correction since their peak at the end of 2021, and they have underperformed the rally in broader equity markets since then. We think that they're now sensibly priced both on an absolute basis and also relative to their growth prospects. To give you some context, Anna, we estimate that the median forward p/e is roughly 15 times currently for companies that we expect are going to grow earnings in the mid teens. So if you look at the PEG ratio, it's now close to one. The PEG ratio is just the price earnings to growth ratio.

So when it's around one times, that's typically a sign that a company's equity is reasonably valued, vis-a-vis its growth prospects. Now, when we look at the bond terms, which is the second key driver of performance, global convertibles are offering investors better economics now. If you look at the average coupon, they've more than doubled to 2.8%, which is 140 basis points higher than the average at the end of 2021. Meanwhile, the premiums or the distance to that strike price is now close to 600 basis points below the pre-pandemic average, meaning investors aren't paying as much for the conversion option.

So when you marry sensible stock valuations and better bond pricing, we're constructive on the outlook and think that we are potentially in the early innings of a sustained recovery, which started in November of last year.

Anna

Earlier, you were talking about some shifts in issuance. So can you discuss some of the trends in the primary market over the last year?

JP

Sure. Overall, issuance in the asset class has been pretty healthy, totaling, I think it was roughly 80 billion last year, which was double the amount of the prior year. Also, the quality has been above average with more than 25% of issuers being investment grade rated. And also importantly, 70% of the new issuance that we've been seeing is coming from companies with large market caps, which is the highest level we've seen in over a decade. So we're also encouraged by the diversity of issuers. It's not only tech and healthcare. Our hope is that more companies that are seeking new capital or looking to refinance straight, that will turn to the convertibles market because the potential interest rate savings are quite substantial now that we're in a different interest rate regime.

Anna

This reminds me of an earlier piece that you and your team wrote about issuance following the global financial crisis, and you noted how issuance in the global convertibles market really hasn't kept up with issuance in the high yield bond market. Could you discuss this a little bit?

JP

As you mentioned, Anna, after the Global Financial Crisis and rates went basically to zero, the size of the global high yield market basically grew, I think it was four or five times versus the size of the convertible market basically remained stable. We think one of the reasons for that is, as companies look to finance in the fixed income market, they just preferred to pay relatively low absolute coupons, and that really cannibalize the issuance in the convertible market. We think that, obviously, that has changed quite dramatically in the last two years because, again, what you're paying in the straight debt market now is roughly, call it 8% for an average high yield issuer versus 3% for convertibles.

That's the substantial savings in interest. And obviously, you are sacrificing the potential for dilution, but many companies may have to make that choice. We are a lot more constructive on the relative market share of new issuance in our market, vis-a-vis the global high yield market. There's just a lot of room to recoup versus what we saw maybe 10 or 15 years ago.

Anna

So to end, any final thoughts on today's convertible market, what you expect moving forward?

JP

Everybody asks us, what's the right time to buy convertibles? I always like to use a quote from Howard to answer that question, which I hope I don't mess up, but it goes something like this. And I quote, "There is no right time to invest in convertibles." If the markets are going to go up, you want to be in stocks. If the markets are going to go down, you want to be in cash. So the only time that's right to be in convertibles is when you don't know what the markets are going to do. But of course, that's all the time.

We don't know what the markets are going to do. But as we discussed today, we think that the outlook has improved all the reasons that I mentioned, given the better pricing and the exposure to interesting and dynamic companies that are in our market.

Anna Szymanski

So for my final conversation, I'll be speaking with Janet Wang, co-portfolio manager of Oaktree's emerging markets equity strategy. Janet, thanks so much for joining me.

Janet Wang

Thank you for having me, Anna.

Anna

So for this conversation, we're going to be talking about the Chinese equity market. To begin, could you just explain what's been happening in this market over the last year?

Janet

Sure. It's definitely been a very challenging market, as I think many of our investors know. We would say there are two notable observations over the last year. First is really on investor positioning and sentiment. We could see that obviously everybody has been very pessimistic. And as a result, the positioning of investors have been very light. We would say that many of our peers are either underweight or very underweight relative to the benchmark.

The second thing that we would say is when we look at the market last year, companies came into the market feeling pretty optimistic about recovery and what the government was going to do with regards to stimulus. And of course, it didn't pan out and they had to revise markets down, which is what we saw at the end of last year. So coming into this year, they are pretty conservative and have been guiding in such a way.

Anna

In the *Roundup* piece that you wrote, you include a paraphrase of a quote from our co-chairman, Howard Marks, that speaks to what you're talking about here. So I just wanted to read this quote and have you unpack it a little bit and explain why this is so relevant to this market. The quote is, "If you have two piles of assets, one with things that everyone loves that are priced well and performing well, and the other with assets that everyone dislikes that have poor price performance and are believed to be troubled, you have to ask yourself, where will you find the best opportunities?"

Janet

So as Howard and Bruce would tell everybody that they really made their career in investing in markets and assets that are "uninvestible." So as we think about that, how do we describe uninvestible? Uninvestible really are assets that are unloved. So when we think about that, why is it unloved, it's unloved because of a variety of issues that have caused people to set expectations very low. But, the potential of this is that because they are unloved and expectations are very low, therefore the upside potential is much higher. Whereas if assets are very well-loved, expectations are very high, and therefore your risk reward for investing in these assets aren't as favorable because potentially the companies can actually surprise you on the downside.

Anna

Right, and you use that term uninvestible. So I'd like you to explain why you think that narrative about China being uninvestible is flawed.

Janet

Sure, yeah. As we think about that, when we look at China, of course there are several things. First is people were complaining about China not growing. Secondly, we think a lot of people complain to us about China having much higher leverage than they really should. Third is we hear about reshoring, nearshoring. So a diversification away from China, that's something that we get a lot of pushback on. And of course, lastly the geopolitical tensions around the world, specifically between U.S. and China. There are several different factors. Let's unpack that a little bit. So first thing about China and growth. Don't forget, China is a much bigger economy these days. Number two in the world with U.S. dollar 18 trillion in GDP.

So growth is going to be a little bit tougher, and they are going through an adjustment period. They are certainly doing what investors have been asking them to do, which is shifting away from infrastructure and property and doing a much more consumption driven economy. So there will be teething pains, it's going to be uneven. As we think about that, growth will be a little bit slower, but they are still growing. And what we do see on the ground is that actually revenues are growing. We see whether with travel or leisure spending or low-end consumption spending, revenues are actually higher than what they were pre-COVID. So again, China is growing.

The second issue about leverage, I think that's been the biggest debate over the last 20 years, but if we look at China's debt-to-GDP on the overall, especially within central government China, it's actually quite low. So where we are seeing pockets of stress is local government debt, and that's something that the central government is aware of and they are helping manage. So again, we don't think it's really that big of an issue.

On the third point where people talk about the diversification away from China manufacturing, look, China has built a very efficient ecosystem over the last 20 years. So it's very difficult to supplant that entire ecosystem. Is reshoring happening? Sure, it is. We see that happening, but we think it's very difficult to entirely replace China. And more importantly, this is something that we think will continue to drive inflation higher because to build out the ecosystem, you are putting pockets of areas around the world, which means you cannot create the same cost efficiency and therefore, consumers are the ones that will have to pay for this, right? So again, we don't think that China will be replaced completely, but reshoring is surely happening and that probably will continue to happen. The other part of it is what we hear and see is that exports to the G7 are down.

Anna

The Group of Seven countries.

Janet

Right. Group of Seven. Certainly, that is true, but what people don't talk about as much is that China has replaced that export capacity to Global South. So Brazil, Africa, basically other emerging markets, Southeast Asia, Middle East. So for us, the differentiation between the G7 capacity is basically being absorbed everywhere else. So China really has found other areas to export, and we would say that actually higher growth areas than the G7.

So we're not too concerned about that, and in fact, these other places are actually benefiting from it. And lastly, just on the Taiwan-China issue that we do hear a lot about. I think as we see the media certainly talks about it, but investors are voting the other way with their wallets. Taiwan has actually been one of the best performing markets since COVID up over a hundred percent over the four years. And investors love Taiwan. We see that in both the data in terms of fund flows as well as performance. So again, I think for all the stress that people are saying about Taiwan, they're certainly voting the other way with their wallets.

Anna

Jumping off there in terms of investor behavior, one of the other things that you note in the piece is that when we look at investor behavior regarding China, it's been somewhat counterintuitive over the last year. What exactly do you mean by that?

Janet

Yeah, I think in one of our letters we had talked about back in 2020, at the peak of China market, which was 2020 third quarter with the IPO of Ant Financial or the supposed IPO of Ant Financial, everyone at that point had asked us, "Hey, would you guys like to launch an A-share fund or a China only fund?" And we thought that was a bit counterintuitive. At that point, China was not only at its peak, valuations were extremely expensive. China was over 40% of the emerging market index benchmark. Companies like Alibaba and Tencent were over 8% each in the benchmark and valuations were in the thirties and forties. At that point, we were not as excited about China because valuations were expensive. So we were reluctant, and I think that at that point that was pretty counter-consensus. Everybody loved China.

Now, fast-forward to today, as China has made their adjustments that we had talked about, investors decided they don't love China anymore. Nobody wants an A-share fund, nobody wants a China only fund. But in fact, we're actually finding a lot of opportunities because these are still very good quality companies and valuations are now very attractive, we would say possibly even deep value. So for us, we're actually finding very good opportunities. And again, that's pretty counter-consensus.

Anna

Howard has a quote where he talks about wanting to buy things when they're on sale, not after they've been marked up.

Janet

Exactly.

Anna

The downturn that we have seen in the Chinese equity market over the last year or so, how does that compare to some of the downturns we've seen in previous Chinese equity markets?

Janet

Sure. It's a little bit different. We would say China is obviously much bigger these days, so it is a bigger ship to turn, but more importantly, the geopolitical environment is different. We see a lot of tensions not only with China and U.S., but globally. But again, a lot of this bad news is priced in and therefore we are seeing opportunities. But overall, look, we're not macro investors as you well know. So we're really focused on the fundamentals.

Anna

Speaking of fundamentals, as now we look forward, what would you say are some of the trends or indicators that investors should monitor regarding China?

Janet

Most people have been really focused on top line growth. I think that's out of habit because people expected China to see this rapid growth. As we talked about, China is different at this point with the slower growth projection. However, fundamentally, we're seeing very good attributes out of our companies, whether it's balance sheet, cashflow generation, and return to shareholders in both forms of dividend as well as buybacks. I think these are the metrics that you really want to focus and a little bit moving away from that top line growth. We're really more focused on the return of equity as well as the return to minority shareholders.

Anna

To finish up, any thoughts that you have about where we stand right now, where you think we may be going in terms of the Chinese equity market?

Janet

We are finding a lot of opportunities for exactly what we had talked about before, things being a little bit counter-consensus. So we're finding a lot of good companies at very attractive valuation. We think the challenge really is to narrow that list down into our investible universe. We think China is still a place that people would want to be. The risk reward is great exactly for the fact that investors have been very pessimistic and very light on their positioning. We think that that's a great opportunity for a lot of the Chinese equities to outperform and see re-rating.

Anna

Well, on that note, I think it's a great place to end. So thanks so much for joining me.

Janet

Thank you, Anna.