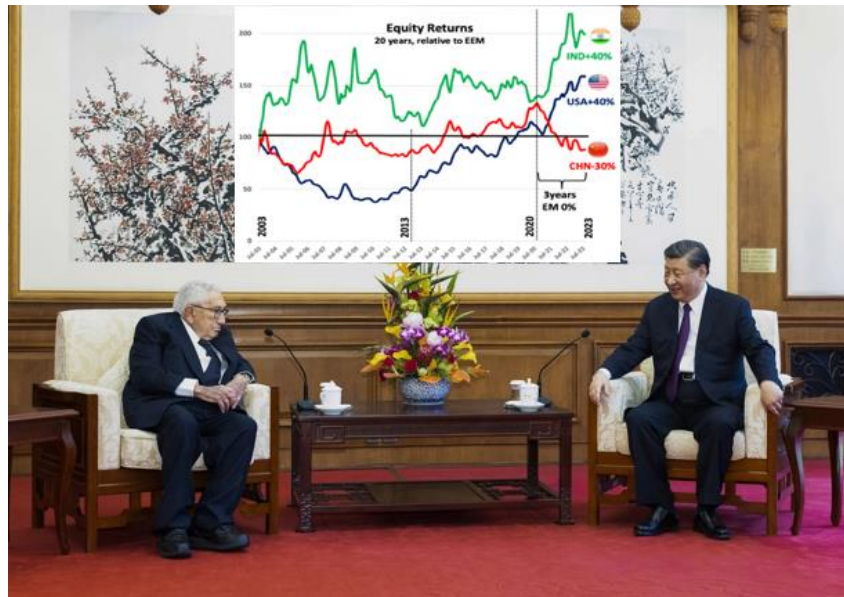




## RAPPROCHEMENT AFTER RED-SCARE



## EMERGING MARKETS GEOPOLITICS

## Rapprochement after Red-Scare

*"Leaders must invoke an alchemy of great vision."* Henry Kissinger

Henry Kissinger's secret trip to China in July 1971 was instrumental for opening a new chapter with geopolitical realism. Last week, 52 years later, the former Republican Secretary of State was [back in Beijing](#) to meet with President Xi to prevent further decoupling amidst a [new red-scare](#). Indeed, only [14% of Americans](#) now view China favorably, the [lowest recording in 50 years](#), worse than during Tiananmen Square.

America simply cannot alienate China, boxing it in the corner with Russia, especially as India and South Africa also abstained from condemning the Russian war. [American](#) and [European CEOs](#) have been actively reaching out to re-establish collaboration with China, which they argue is critical for fighting [climate change](#) and building guardrails on [artificial intelligence](#). Most investors prefer realistic collaboration over decoupling.

*What implications could arise from the Xi-Kissinger meeting? Who is benefiting from the red-scare and who stands to win from a potential rapprochement? How are investors currently valuing Chinese and Indian markets? And what is the likelihood for the long-term investment cycle to swing back in favor of emerging markets?*

At age 100, Henry Kissinger has seen some Realpolitik and some power-broking. He probably could not imagine that US public opinion on China is hitting a 50-year low. He may have mentioned three **geopolitical concerns** to President Xi: Taiwan, Russia, and North Korea. All three are dead-serious and carry massive risks for China, which he may have spelled out as long-time "[friend of China](#)". He probably was keen to explain that the current US administration has been working hard to defuse these concerns, even as he was visiting as a private citizen rather than a [backchannel](#).

On **Taiwan**, any military conflict could spiral out of control and undermine China's international standing for at least one generation, while [massive sanctions](#) would be triggered. In contrast, pragmatist Kissinger may have added that the peaceful process in Hong Kong, despite lots of soul-searching, has been successful from the Chinese perspective, but last year's escalation on Taiwan seriously harmed China's reputation. What sense is there to create rubble, eliminate public support, and destroy the IT jewels? And what sense to have waited for the porcupine to be armed to its teeth? There seems to be a win-win situation from mutual de-escalation of Taiwan tensions, especially in the preparation for Taiwanese [presidential elections](#) in January 2024.

On **Russia**, visiting European leaders have been unequivocal that any Chinese military help offered to Russia would cross the European Rubicon. Despite [Chinese diplomatic](#) and [US military talk](#), there was so far little success in brokering peace negotiations, but lots of concern about Russian chaos and [disintegration](#) on all sides remain. Chinese trade with Russia has expanded by 40%. China benefits from undermining trade sanctions against Russia, just as China's network helps to evade US sanctions. But there may be a win-win situation linking trade concessions to peace negotiations, and China may generate plenty of European good-will from a more constructive role.

On **North Korea**, there appears to be substantial risk of [escalation](#), and China holds a critical position to mediate. While China may like to pre-occupy US policymakers with risks of nuclear proliferation and rabble-raising in North Korea, it cannot be in the interest of China, or anyone in the region, to further increase nuclear risks. In fact, Japan and South Korea are feeling pushed to increase [collaboration with NATO](#). However, China may demand US concessions in return for calming down North Korean threats, and China does not want to be seen as part of the Russia-North Korea axis.

President Xi does no longer need to convey his hardline image for a domestic audience after his new term and power have been consolidated. In fact, he is currently facing lots of domestic pressure to [promote economic growth](#) rather than geopolitical goals. The potential power-broking deal would combine US concessions on respecting the Taiwan status-quo with Chinese concessions on constraining Russia and North Korea.

On **India**, the two statesmen may not have found agreement, as many companies have diversified their investments [from China into India](#), and China's decline has boosted [FDI flows into India, Indonesia, and Vietnam](#). China has also suffered at least six months of portfolio outflows, about \$100 bn exited Chinese debt markets, reflecting negative sentiment, against modestly positive portfolio inflows in emerging markets. Over the past three years, Chinese equity markets declined by over 30% in aggregate, the worst performing emerging market, while Indian equity markets soared by 40%.

Public opinion data from Pew Research (chart 1) confirm the deteriorating political relationship between China and India, as positive attitudes are barely at 22% and 30%, respectively. However, US policy makers have been heavily [courting India](#), although they have been concerned about democratic deficits and India abstaining at the UN on the Russian war. Today, **India** appears to have a record 87% favorable attitude to the US, versus 53% in the other direction, as India stands to benefit massively from US trade and investments. India clearly is the main beneficiary from US-Chinese tensions.

While the US has tried hard to [repair damaged relations with Europe](#), China has tried even harder to [drive a wedge between Europe and the US](#), but without much success. [Public opinion research](#) illustrates a major freeze in US and EU attitudes towards China, standing at 14% and 20%, whereas the Chinese have 60% positive attitudes towards Germany and France, which is also reflecting the spin of Chinese media. China could substantially improve [relations with Europe](#) by backing off from Russia while many European companies are desperately looking to rebuild exports to China.

After all, what [“alchemy of great vision”](#) do these two statesmen convey? Both realize that the US and China will compete economically but must collaborate on common issues such as climate-change. While trade sanctions may remain in areas considered critical for national security, they may be scaled back in less sensitive areas. And the Kissinger visit may start a new [geo-political rapprochement](#) as both China and the US stand to benefit from reducing tensions on Taiwan, on Russia, and on North Korea.

**Markets do reflect geopolitics**, in fact they may overshoot during wars, pandemics, and extreme geopolitical swings. Current [equity market flows](#) are telling us that India looks attractive while China looks deserted. [Investors](#) value Chinese stocks at fire-sale levels, with long-term CAPE ratios near 10, whereas Indian CAPE ratios rise above 30. China is currently struggling not only with a poor geopolitical perception but also with a poorly executed reopening from the pandemic and a structural adjustment to the real estate crisis. Markets are now pricing these three factors at worst possible levels.

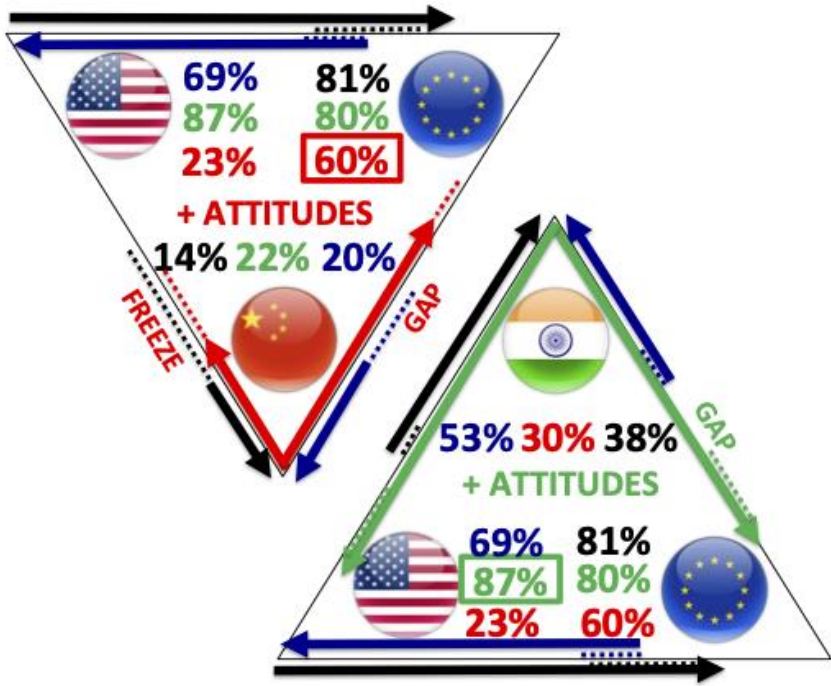
Assuming the status quo in China continues, it is likely that **leadership in emerging markets** will further shift towards India, Asean, and Latin America, which all recorded exceptionally strong performances last year. In fact, the majority of EM public equity markets have broken to the upside compared both to the EM universe and to the ACWI universe, which indicates that a new investment cycle could soon start. On the other hand, US equity markets appear to reach extended valuations with a CAPE above 30.

Investors may wish to look back twenty years to the aftermath of the dot-com bubble when US investors started flocking into emerging markets and the dollar started to decline. During that **ten-year cycle** between 2003-2012, US equities gained modestly but lost 50% as compared to emerging markets (chart 2) while the [dollar](#) declined by 25% (dotted line DXY, chart 2). The reverse happened during the next decade from 2013 to 2023, where US equities now trade at a 50% premium to emerging markets (chart 2, blue line), India even at a 100% premium (chart 2, green line). Meanwhile, the US dollar rose back to previous peaks and is currently 15% overvalued.

What could be potential **catalysts** for the ten-year investment-cycle to turn back in favor of emerging markets? It could be a peaking of US rates and a peaking dollar in a US slowdown, it could be a stronger Chinese reopening and a rebound of global trade, it could be a negotiated settlement and subsequent rebuilding of Ukraine, or it could well be a geo-political rapprochement with China. None of that is currently priced in. Mr. Kissinger may yet land a final surprise and cement his legacy on China.

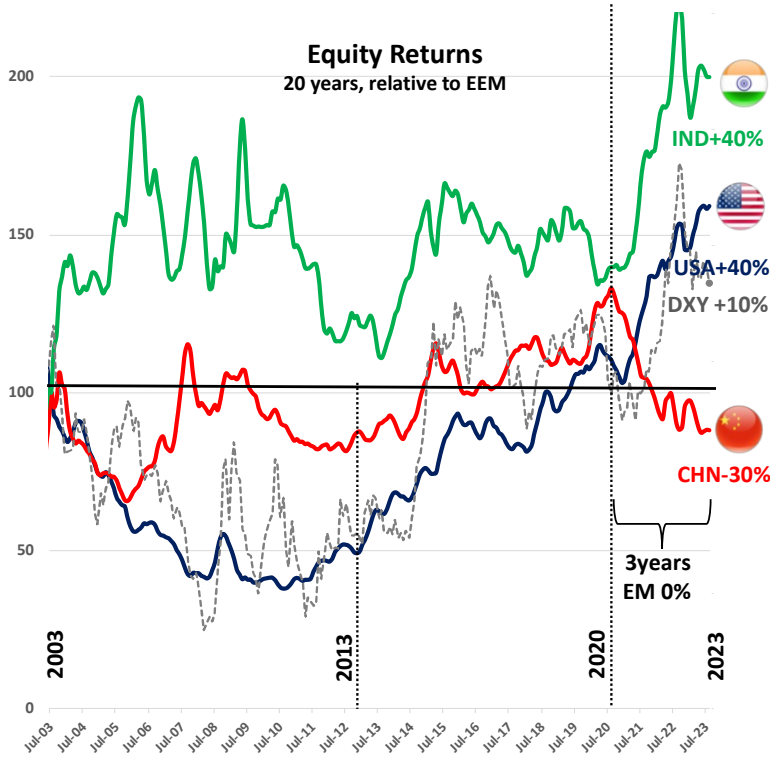
[www.emleaders.com/pdf/em-rapprochement.pdf](http://www.emleaders.com/pdf/em-rapprochement.pdf)

**China Chasing EU - India Chasing US** Chart 1



Sources: Pew Research, European Council ECFR, Global Affairs, Asia Society (2023)

**China Decline helps India Advance** Chart 2



Sources: Bloomberg, i-Shares, EM Leaders (2023)