

China

The economic context to investing in Chinese growth

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CFA Society VBA Netherlands



Start 

Chinese catchup growth

Graph:

GDP / population
relative to the US (= 1).

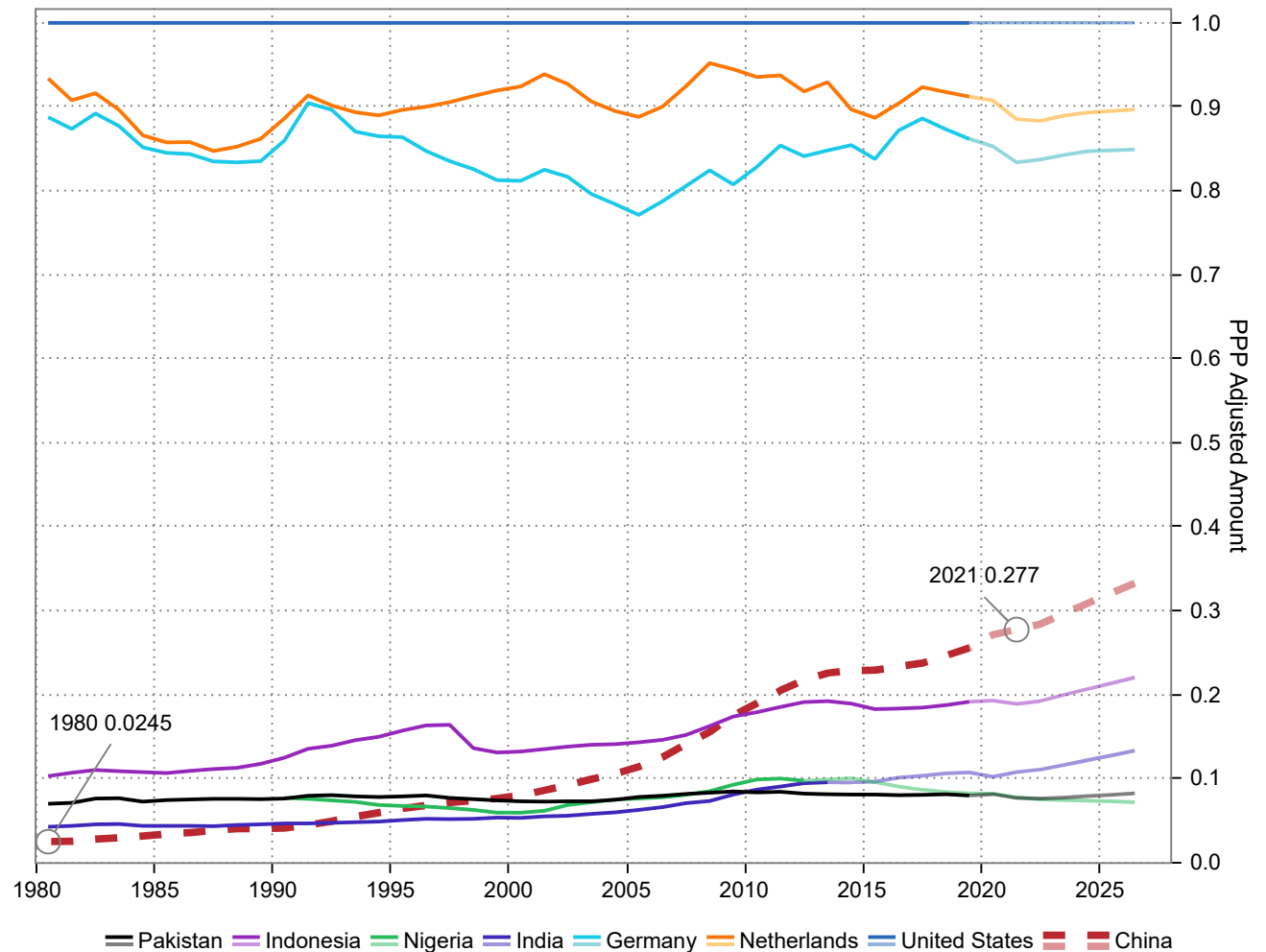
Growth theory

Countries should be able to converge to technological leaders, adding labor and capital.

Growth practice

Not always.

What happened in China since 1980?



Data: IMF, Macrobond, APG

How did China grow so fast?

East-Asian growth model (like Japan, South Korea, Taiwan)

- Industrialize to export
- Labor from rural areas to coastal cities
- Keep financial capital inside to reinvest

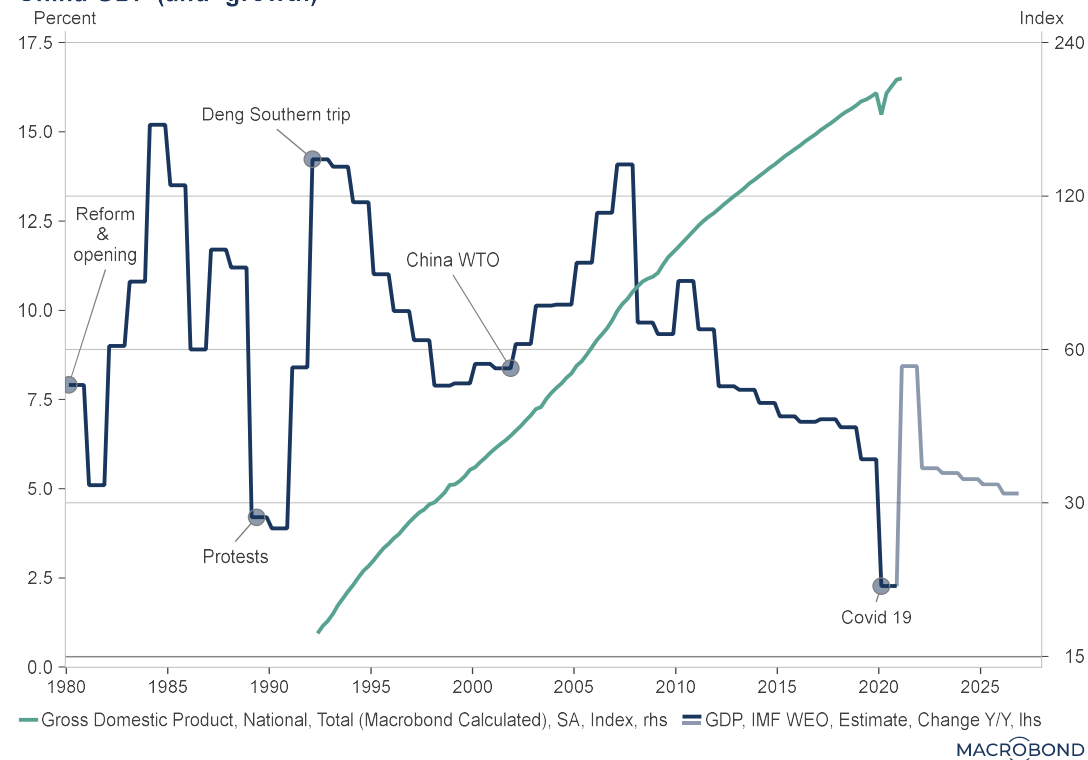
With a twist:

- Foreign investments (and technology)
- Import role for state-owned enterprises; no post-communist shock therapy
- Central control in theory, local experiments in practice

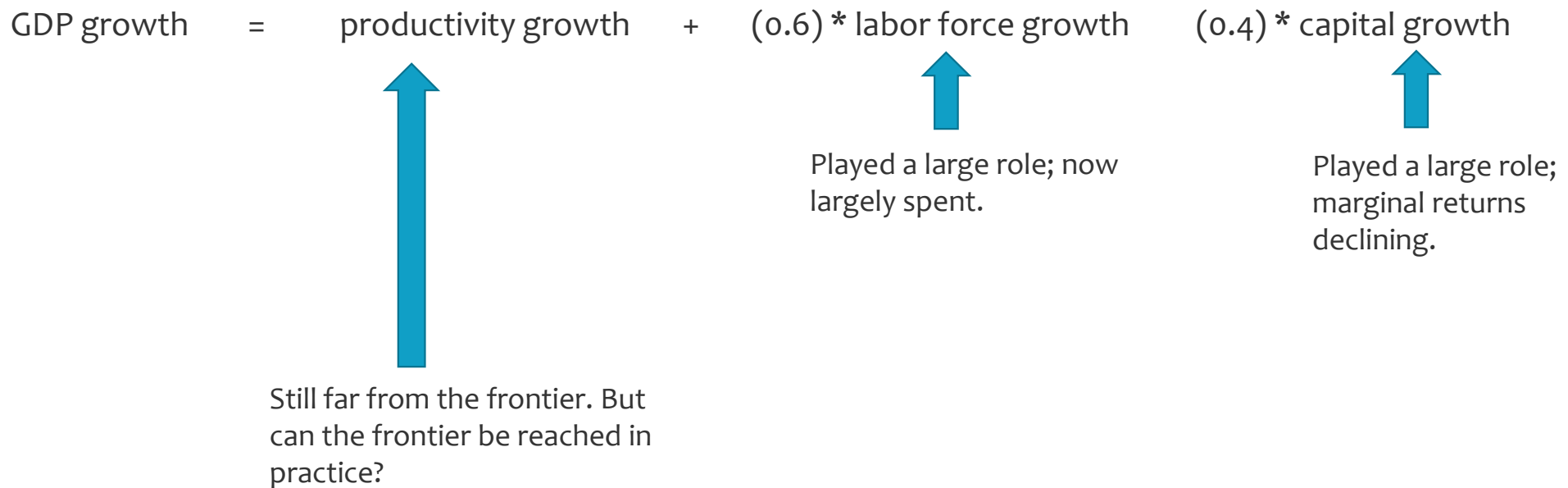
Luck:

- Demographic tailwind, healthy and literate population
- Opening at a fortunate moment
 - Containers, low transport costs
 - Examples and gateways close by (Taiwan, Hongkong)
 - US welcomes China into the fold during cold war with USSR

China GDP (and -growth)

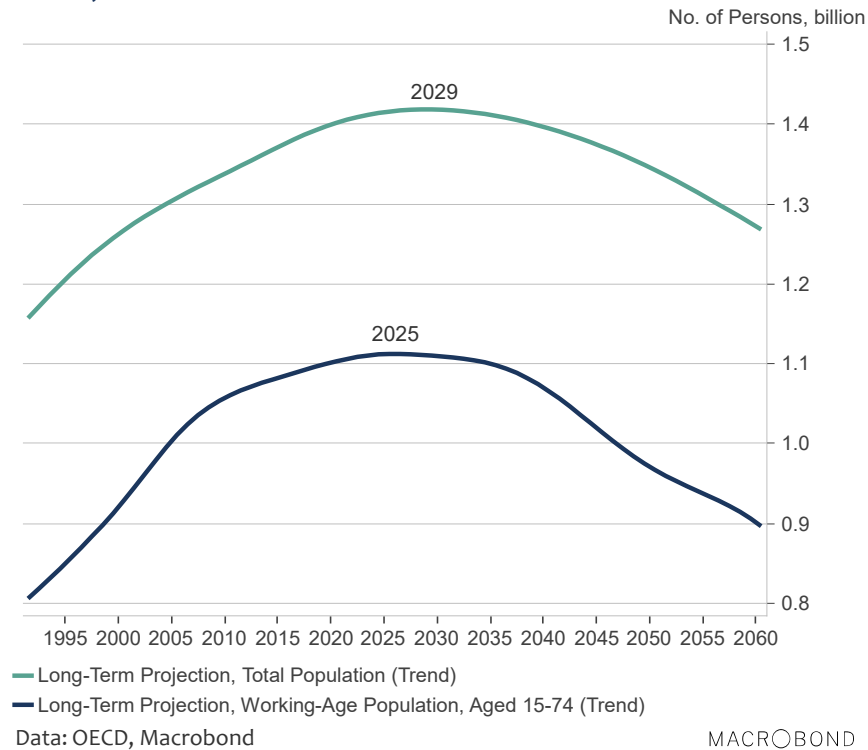


How much further can this growth go?

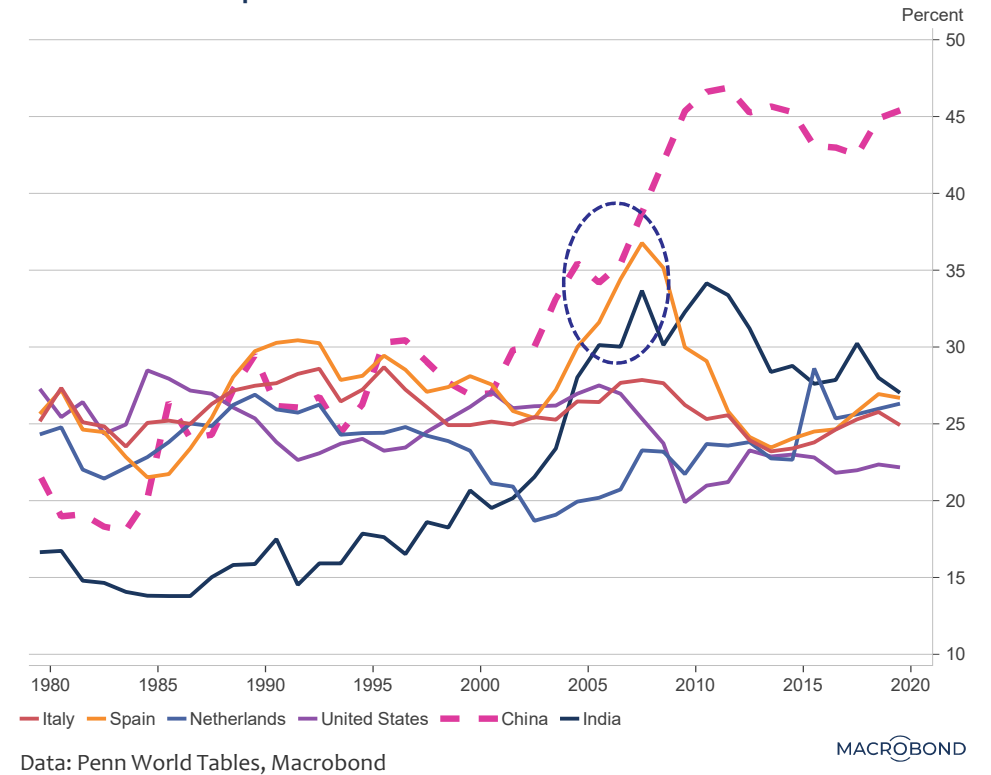


The limits of labor and capital

China, OECD Economic Outlook



Share of Gross Capital Formation in GDP

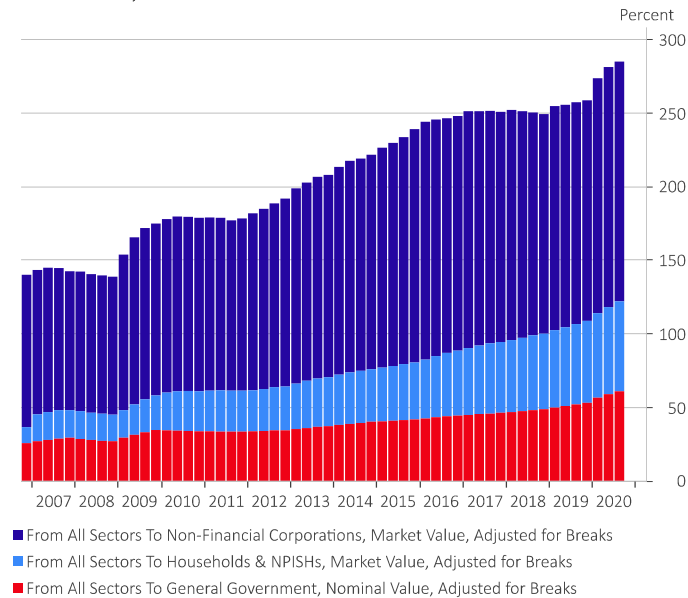


The debt issue

Capital growth mostly financed through debt, 284% GDP. Comparable to US, EU; relatively large for an emerging market.

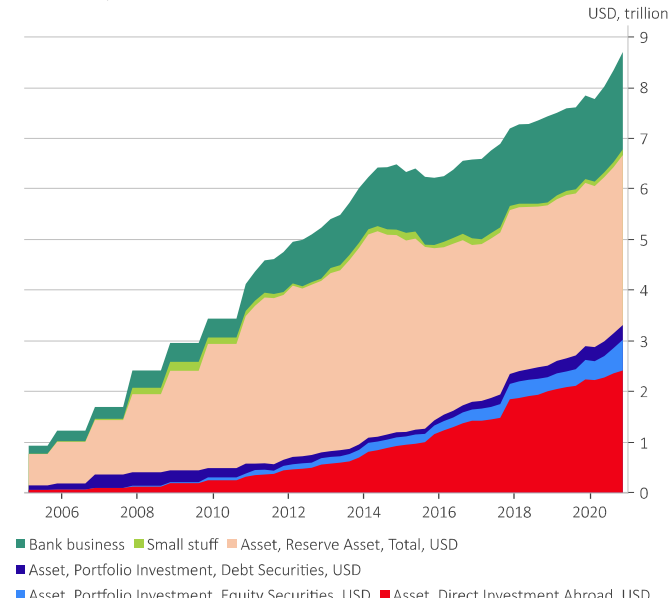
Debt is mostly internal, financed with deposits in state banks: financial crisis is unlikely. Drawback: capital allocation.

China, BIS Credit to Non-Financial Sectors, Percent of GDP



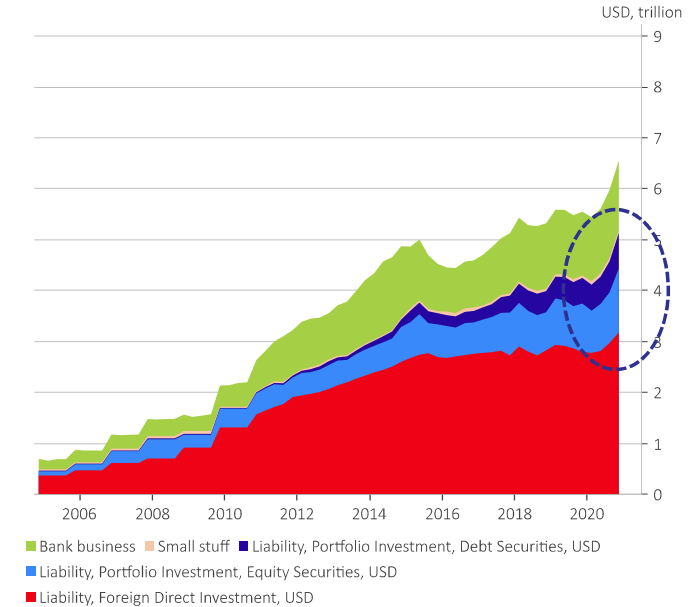
MACROBOND

China, International assets



MACROBOND

China, International liabilities



MACROBOND

From factory to market

China as the low-wage assembly line for developed countries – this model is ending.

China, Total export value, in % of GDP



The end of factory China

- Declining cost advantage
- Change in the attitude of the US, others
 - Access to technology, parts, reduced
 - Market access reduced

The start of market China

With growth comes spending power, allowing companies to develop for the home market

The questions

- Is the institutional setup fit for innovation?
- Can China deal with the external constraints?
 - Geopolitics
 - Environment

Economic structure: SOEs

State owned enterprises	Private enterprise
Key sectors: networks, finance, fuels, heavy industry, infra, aviation, military	The rest: retail, restaurants, medium- and small companies
Mostly large companies, capital intensive	Most of GDP, labor, investment, bank loans, trade surplus
30% GDP	70% GDP
9% RoE	15% RoE

2020 Fortune Global 500 List – companies with the most revenue

	Company	Sector	Ownership	Equity listed
1	Sinopec Group	Petroleum	State-owned	yes
2	State Grid Corporation of China	Electric utility	State-owned	no
3	China National Petroleum	Petroleum	State-owned	no
4	China State Construction Engineering	Construction	State-owned	yes
5	Ping An Insurance	Insurance	Public	yes
6	Industrial and Commercial Bank of China	Commercial bank	State-owned	yes
7	China Construction Bank	Commercial bank	State-owned	yes
8	Agricultural Bank of China	Commercial bank	State-owned	yes
9	Bank of China	Commercial bank	State-owned	yes
10	China Life Insurance	Insurance	State-owned	yes
11	Huawei	Telecommunications equipment	Limited (Private)	no

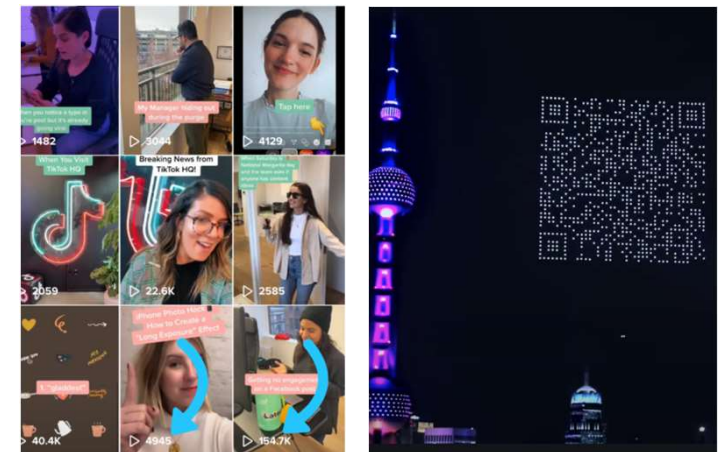
Chinese innovation politics

Centrally guided strategy:

- Large role for SOEs, state banks
- Industrial politics
 - Made in China 2025
 - Military-Civil fusion
 - Party cells inside private companies
- Belt and Road initiative
 - Continuing the accumulation growth model outside China

Private sector:

- From assembling to developing
- Large, protected market with growing purchasing power
- “Leapfrogging”: strong in online services. Possibly world leading in AI



From a legal to a geopolitical world

Multilateral world since ca. 1990:

- Driven by rules, contracts / not by military power
- WTO, WHO, G7, IMF, VN, ICC – problems solved in court
- Ultimately guaranteed by US power / not abused
- Great world for investors!
- Allowed Chinese growth

Since ca. 2016:

- US: China sabotaging the legal world order
- China: US a threatened hegemon
- Trade war: tariffs, licenses
- Tech war: reducing access to technology
- Battle for allies
- Not yet: actual war
- Less pleasant world for investors.



60 Minutes ✓
@60Minutes

"I want to be very clear about something," says Secretary of State Antony Blinken. "Our purpose is not to contain China, to hold it back, to keep it down. It is to uphold this rules-based order that China is posing a challenge to." [cbsn.ws/2So1ucj](https://www.cbsn.ws/2So1ucj)



Secretary of State says he's never seen China so aggressive militarily

Dual circulation

Internal loop

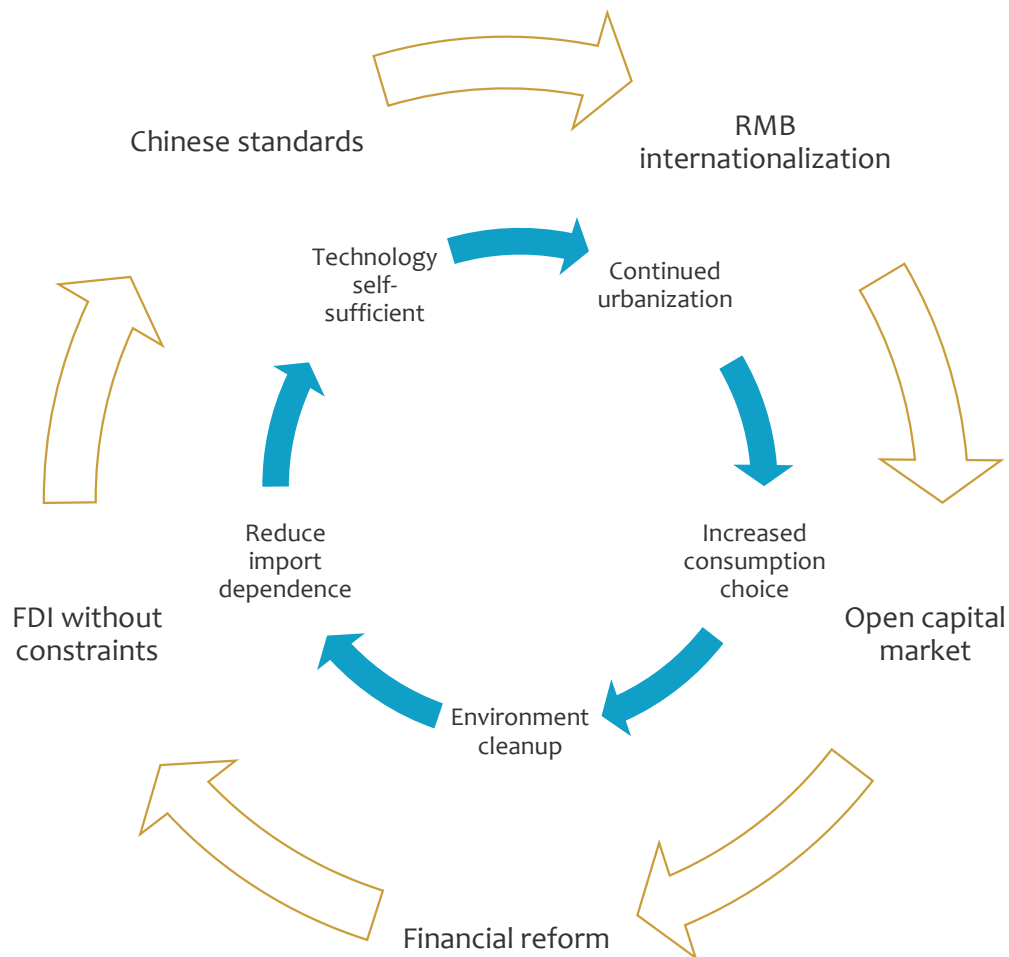
- Domestic demand can drive Chinese growth
- Free from dependence on foreign technology, parts

External loop

- Continue integration with the outside world
- Adoption of Chinese standards
- Increase monetary sovereignty by enhancing the role of the RMB

Counts on strength of Chinese economy to drive developments.

Sees China continuing to engage outside world, but on its own terms.



Investing in Chinese growth

1. China on its way to be the world's **largest economy** ✗
2. Economic growth gives rise to **profit growth** ✓ (onshore)
3. Inclusion in **investment indices** will increase valuation ✗ (maybe temporary)
4. Chinese markets have **low correlation** with developed markets ✓ (But beware when they open up)
5. Higher Chinese volatility translates into **high risk premia** ✓ (Sharpe ratio comparable to DM)
6. Dominance of **retail investors** gives relatively good alpha in equities ✓ (With the right local knowledge)

From: Hsu et al, Journal of Index Investing, Winter 2020, pp. 48-61

APG's approach

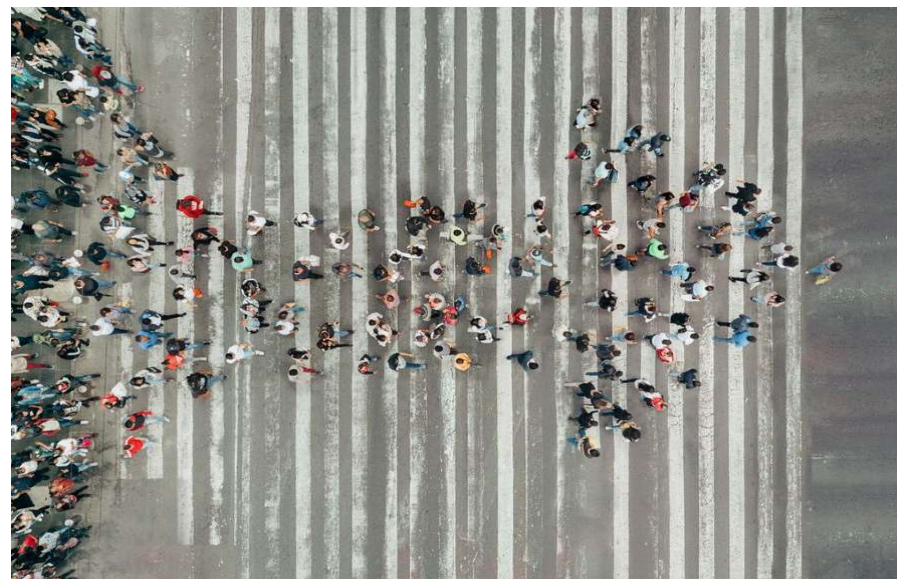
- Local presence, local partner; skip learning phase, discern credit quality
- Apply GRIG standards as everywhere, tailor engagements
- Focus investments, build relationships

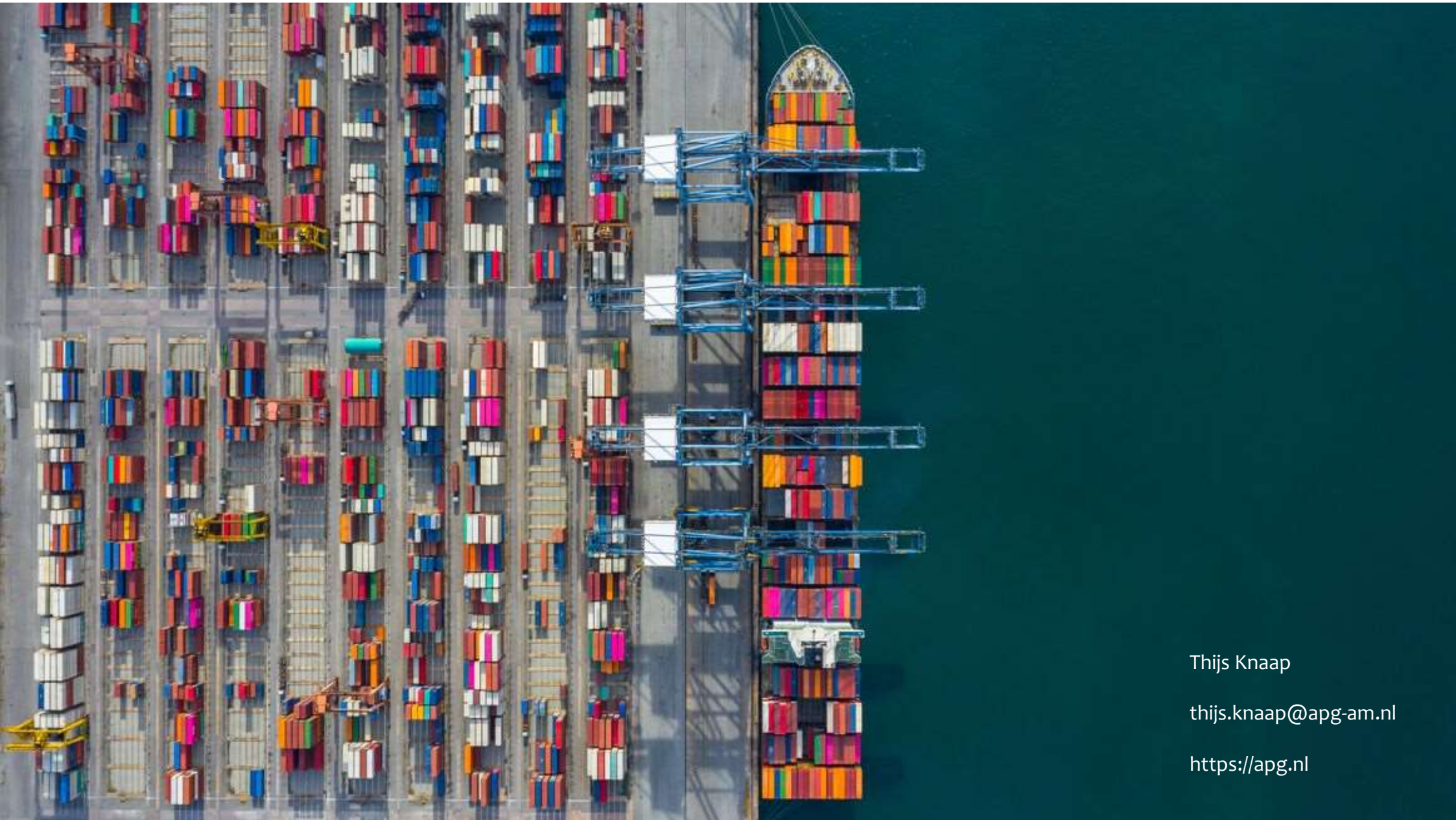
Conclusions

- Chinese growth is **unusual**, but not **too good to be true**
- But there are **new challenges**:
 - Outside constraints
 - Geopolitical
 - Environmental
 - Domestic innovation

For investors this means

- **The effects of Chinese growth** are everywhere:
 - Production and trade
 - Commodity markets
 - More and more: financial markets
 - And the world order in which investors operateEven if you do not invest in China, these things will affect you
- **Investing in China** brings opportunities and challenges
 - Large market with yield, diversification
 - Need a solid investment process to deal with uncertainties





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