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China: Business as usual or a game changer?

The ongoing regulatory changes in China do not fundamentally alter the long-term attractiveness of investments in the region. These regulatory changes are generally consistent with the government's stated aims of rebalancing the economy away from reliance on exports and investment, towards "higher quality" growth supported by domestic consumption and productivity.

Tighter regulation will cause growth to slow, but China will remain one of the largest contributors to global GDP growth. The future medium-term growth rate is likely to average c. 5% p.a., down from the recent average of 7%. This is still materially higher than forecasts of roughly 2% for developed markets. In addition, China's GDP per capita at c. $10K is less than a fifth of that of the US at $63K, leaving a long runway for growth. Future gains will come from improvement in domestic consumption and services, rather than investment spending.

International relations will remain fractious. China is sensitive to the perceived efforts of the US to interfere in the internal affairs aimed at changing the country's political system. Washington is primarily motivated by preserving domestic security and retaining its status as the country most responsible for maintaining world order. The West will continue to spar with China over important matters such as Taiwan's sovereignty, alleged human rights abuses and the perception that China has sided with Russia over the Ukraine situation.

High per capita growth amidst a backdrop of stricter but still pragmatic regulation and ongoing geopolitical uncertainty has us focusing on actively managed domestic opportunities within China. The investment opportunities are abundant.

For example, the China A-share index is composed of over 4,000 listed companies, captures 15% of global IPO deals annually and yet accounts for only 0.6% allocation in the MSCI All Country Index. Foreign ownership accounts for just 4.5% of the market. China's economy is equivalent in scale to that of the US or EU and provides investment opportunities distinct from those in the west. This provides helpful portfolio construction benefits. Over the last 5-years, the China A-share index has had a correlation of just 0.4 to the S&P 500.

Growth outlook: A long runway for growth outperformance despite regulatory interventions

Longer-term forecasts of China's growth are in the region of roughly 5% per annum going forward, as shown in Exhibit 1 below. This is down from a recent average rate of growth of closer to 7%. Much of this decline reflects the expectation of a protracted slowdown in the property sector. As shown in Exhibit 2, the property sector is expected to swing from contributing roughly +2% p.a. to annual GDP growth to being a detractor of c. 1-1.5% p.a. over the coming decade.

Exhibit 1

China's GDP growth is expected to remain around 5% over the coming years, materially higher than developed market economies

Region	Source	2022	2023	2024	2025
China	IMF	4.8%	5.2%	5.2%	5.1%
	OECD	5.1%	5.1%		
	Bloomberg Consensus	5.2%	5.1%	5.0%	
	Goldman Sachs	4.5%	5.0%	4.4%	4.2%
	Deutsche Bank	5.1%	5.5%	5.2%	5.0%
	JP Morgan	4.9%	5.3%		
	Average	4.9%	5.2%	5.0%	4.8%
US	IMF	4.0%	2.6%	1.7%	1.7%
	OECD	3.7%	2.4%		
	Bloomberg Consensus	3.7%	2.5%	2.1%	
	Goldman Sachs	3.2%	2.2%	2.2%	2.3%
	Deutsche Bank	3.6%	2.3%	1.9%	1.8%
	JP Morgan	3.7%	2.5%		
	Average	3.7%	2.4%	2.0%	1.9%

Note: *Forecasts as of January 2022*
Source: *As detailed above*

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Despite a notable slowdown in the second half of last year, China's economy is estimated to have grown at a healthy +8.1% in 2021. It is likely that the rapid growth in the first half of the year is what gave China's policymakers the confidence to enact their long-stated goal of tightening regulatory and monetary policy to deleverage and de-risk the economy, targeting property developers, various technology companies, environmental issues and pointing the economy in the direction of "common prosperity".

China's economic growth is projected to slow to c. 5% over the next few years as the economy continues to feel the negative impact of this deleveraging in the property sector and generally tighter regulation. There are near-term downside risks to these forecasts, most notably due to China's COVID-19 policy. Although China's stance has moved away from "zero tolerance" to "dynamic clearing", this still implies occasional localised lockdowns to stop outbreaks. With over 85% of the population fully inoculated and 23% having received a booster shot, the country should have a high degree of resistance to the more severe consequences of the virus. In addition, China is expected to roll out its own mRNA vaccine within the first quarter of 2022, but it remains to be seen if it has similar efficacy offered by the Pfizer/ Moderna vaccines.

Further supporting growth is a shift towards a loosening of monetary and fiscal policy in response to the recent growth slowdown. Virtually all restrictions which weighed on growth in 2021 have been eased in 2022.

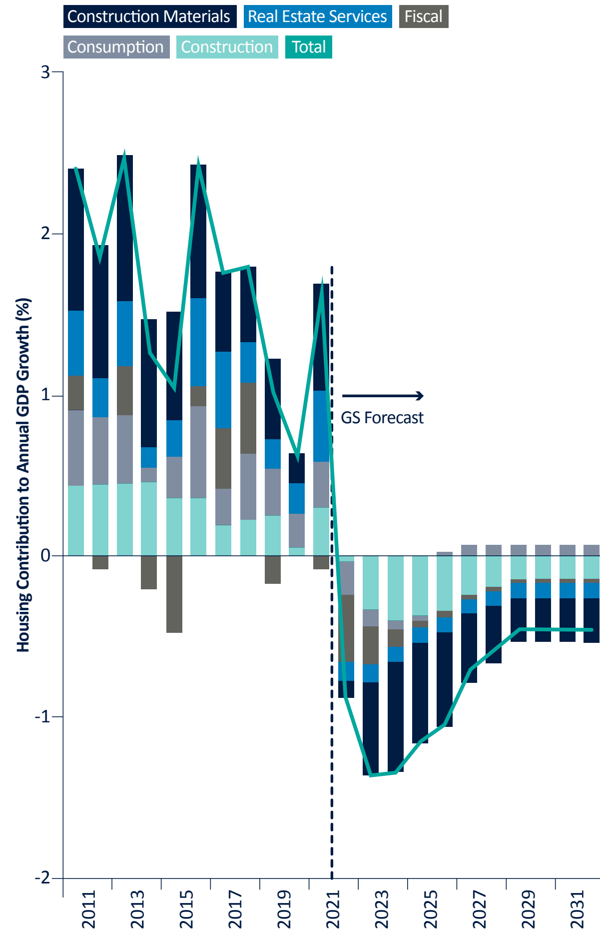
The People's Bank of China (PBoC) recently cut the one-year and five-year Loan Prime Rates for the first time since April 2020 and reduced the Required Reserve Ratio. The quantum of these cuts has so far been small, but the direction of travel is clear. We expect further easing in early 2022, particularly as this year sees the 100th anniversary of the ruling party and government officials will be keen to project an economy on the rise.

In addition, China faced an energy crunch toward the end of last year, due partly to Beijing's environmental campaign, which led to a sharp contraction of some energy-intensive sectors such as cement, steel, and other base metals. Loans to coal producers were also sharply curtailed. Many of these restrictions have since been relaxed, allowing these sectors to bounce back.

We expect the source of China's growth to continue to transition away from investment-led spending (e.g., property development – Exhibit 2) towards consumption-led growth.

Exhibit 2

China's property sector will cease to be a positive contributor to annual growth



Source: *Haver Analytics, Goldman Sachs Global Investment Research*

Although some suggest China's converging economic output with the US, estimated to reach equivalent levels by 2030, will limit the scope for continued outperformance, this framework neglects the large gap remaining in per capita income. China's GDP per capita is currently just over $10K per year, which is what US output per capita was in the early 1980s. For reference, it is estimated that US output per capita will be $70K in 2022 (Exhibit 3). There is ample scope for China to continue to grow rapidly as it builds out its domestic service industries and moves higher up the value chain in terms of the products manufactured in the region.

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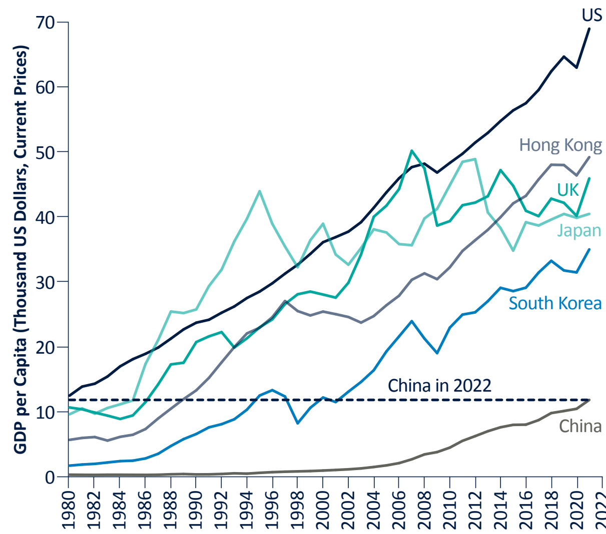
Exhibit 3

GDP per capita in China is equivalent to the US in 1980



Source: IMF

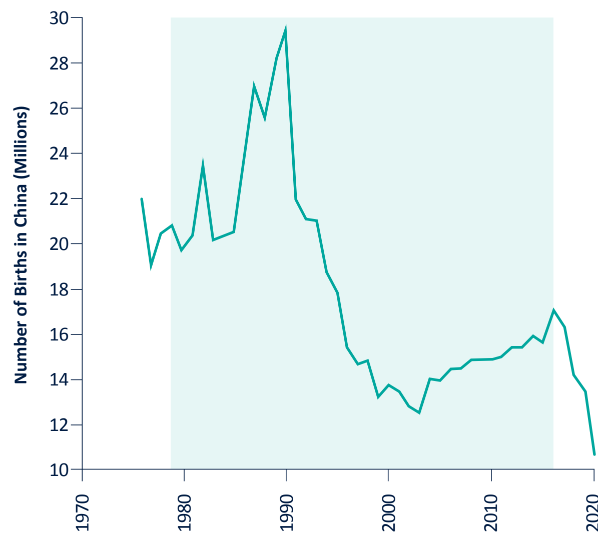
Regulatory moves in 2021 were intended to promote sustainable and equitable economic growth. Reforms in China remain subject to the ultimate constraint of maintaining overall economic stability.

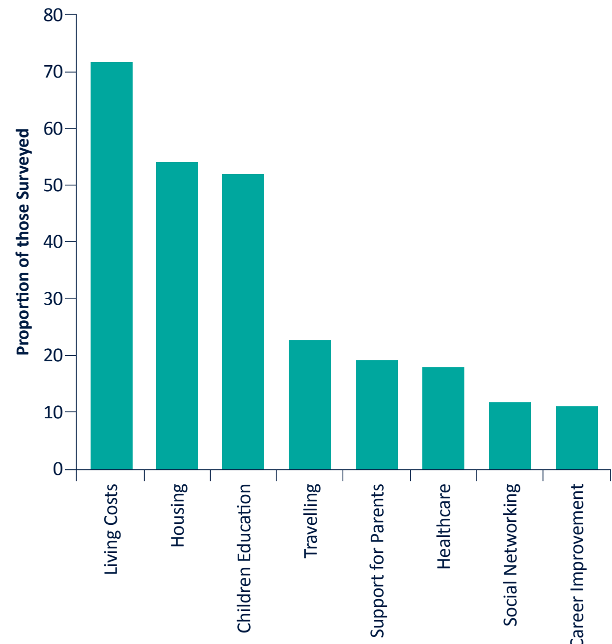
Few experts believe that China is trying to kill the golden goose of capitalist-style innovation incentivisation. The policy decisions in China in 2021 appear broadly consistent with the government's stated aims of rebalancing the economy away from reliance on exports and investment, towards "higher quality" growth supported by domestic consumption and productivity. In doing so, China's policymakers hope to avoid the "middle-income trap"- a phrase coined by the World Bank to highlight the difficulties countries face in moving from middle to high-income economies.

Avoiding the middle-income trap ultimately requires a policy backdrop that fosters entrepreneurial talent development. An often-quoted academic paper in the Quarterly Journal of Economics (Vol. CCXXIV, Issue 4, November 2009) "Misallocation and Manufacturing TFP in China and India" (Hsieh, Klenow) highlighted that a misallocation of resources, engendered in an economy where

Exhibit 4

China's population growth continues to decline, in part because of the cost of raising children in terms of housing and education





Note:
1. Grey area indicates period in which the "one-child policy" was in place
2. Middle class is defined as household annual income above RMB200k
***Source:** Alpine Macro*

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capital is allocated to inefficient state-owned companies, could have a 50% positive impact on total factor productivity growth in China if removed. China's policymakers are aware of the limits of state-controlled development.

Also required to escape the middle-income trap is a confident middle-class that saves less and spends more. In this regard, China faces additional demographic challenges, as the population is expected to start declining from 2022 onwards (Exhibit 4). The birth rate in China fell for the fifth year in a row in 2020 as the natural population growth rate declined to just 0.03%. China only has to look to the debt-ladened economies of Europe and Japan to assess the economic handicap of a rising dependency ratio created by an ageing population and declining workforce.

Attempting to overcome these demographic problems partly explains the regulatory focus on housing and education last year, as the high costs in these sectors are seen as impediments to having larger families. Both sectors are two of the largest expenses for the middle class, limiting consumers' spending power and reducing the affordability of children. More specifically:

Education: Education services were targeted for reform because upwards of 25% of urban family income was being spent on after-school tuition, and 50% of households surveyed listed children's education as the largest household expenditure. After-school tuition companies are no longer allowed to do so on a for-profit basis. TAL Education's stock price, one of the largest tuition companies, fell 95% from its peak as a result.

Housing: In the top 30 cities, the ratio between the price of a 100-square- metre house and annual household income is 11.5x, higher than the national average of 8.4x, based on data from the China National Bureau of Statistics. The ratio is even higher in tier-one cities, at 21x. Reform in the housing sector has been introduced to reduce exuberant use of leverage reduce the systemic risk of the property sector on the rest of the economy.

While these measures were clearly implemented in an overbearing fashion causing short-term volatility, these occurred in an otherwise record growth year where the central government may have estimated it could make regulatory 'investments' which would yield benefits over the longer term. However, while the pace of new regulation is likely to slow, it is unlikely to stop. Regulatory risk is particularly elevated in areas relating to data security, monopolistic behaviour and financial lending. As such, a detailed understanding of the regulatory framework and policy objectives is now mandatory for investment in China. It is for this reason that we have no passive exposure to China in our portfolios, only investing through active managers with "boots on the ground" and reliable networks.

"Chimerica" is long gone: China's political relationship with the US will remain strained

Nixon and Kissinger started the 47 year-long period of US "engagement" with China in 1972 and more recently the US began its process of "disengagement" in 2017. There is much debate on the shape and extent of any decoupling that may eventually take place, but what is clear is that the threats to each country's long-term goals had become too great to allow unfettered transfer of technology and economic power.

For its part, China's leadership has clear incentives to thwart the perceived efforts of the US to interfere in its internal affairs. It does not matter whether this is truly the US objective, but Beijing believes this to be a risk. For their part, Washington is primarily motivated by preserving domestic and global security by retaining its status as the country most responsible for maintaining world order.

These dynamics are not going away soon and there is likely to be continued erosion of trust. A recent example has been China's reluctance to condemn Russia's invasion of Ukraine. Russia and China signed a "no limits" partnership at the Winter Olympics shortly before Russia's invasion. In this pact, the two nations agreed to work together on space, climate change, artificial intelligence and control of the internet. It was an assertive statement of Russian and Chinese resolve to work together to build a new international order in stark contrast to the US/China alliance of the post-Nixon era that was designed to split the then communist powers and isolate the Soviet Union.

However, China has not completely abandoned its commitment to the US-led world order. Immediately after Russia's military invasion of Ukraine, President Xi recently cautioned Putin to pursue diplomatic negotiations. China's State-owned banks have begun to restrict US Dollar financing for the purchases of Russian commodities, in line with US sanctions, but Yuan-denominated letters of credit are still available. Critics suggest this is a ploy by

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China to be seen to be supporting US sanctions, while simultaneously using it as an opportunity for the Yuan to gain ground as a potential alternative reserve currency.

Since the US National Defense Strategy reclassified China as a strategic competitor in 2018, the external politics tightrope has become tougher for China, facing export restrictions on strategically important technologies and a more aggressive assertion of stance on political issues, internally (e.g., treatment of Uyghur Muslims) and externally (e.g., continued Taiwan flyovers and territorial creep in the South China Sea). This dynamic is likely to continue, as western governments to try block in China. As shown in Exhibit 5, the public perception of China in western democracies has deteriorated, suggesting that anti-China politicking will garner votes. For their part, China will continue to seek the means to reduce any reliance on Western countries, while continuing to use its growing political clout to influence regional affairs.

Exhibit 5

Surveys show a marked deterioration in public opinion of China over time in Western countries, likely exacerbated by COVID-19

% of respondents who have an unfavourable view of China

	2002	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
US	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	73	76
Canada	–	27	–	37	–	36	–	–	–	45	–	48	40	40	45	67	73	73
Sweden	–	–	–	40	–	–	–	–	–	–	–	–	59	49	52	70	85	80
Netherlands	–	34	–	–	–	–	–	–	–	–	–	–	43	42	45	58	73	72
Germany	–	37	33	54	68	63	61	59	67	64	64	60	60	53	54	56	71	71
Belgium	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	71	67
France	–	42	41	51	72	60	59	49	60	58	53	49	61	52	54	62	70	66
UK	–	16	14	27	36	29	35	26	35	31	38	37	44	37	35	55	74	63
Italy	–	–	–	61	–	–	–	–	64	62	70	57	61	59	60	57	62	60
Spain	–	21	38	43	56	41	38	39	46	47	55	50	56	43	48	53	63	57
Greece	–	–	–	–	–	–	–	–	38	37	46	–	37	40	48	32	–	42
Japan	42	–	71	67	84	69	69	61	84	93	91	89	86	83	78	85	86	88
Australia	–	–	–	–	40	–	–	–	–	35	–	33	39	32	47	57	81	78
South Korea	31	–	–	42	49	54	56	–	–	50	42	37	–	61	60	63	75	77
Taiwan	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	69

Source: *Spring 2021 Global Attitudes Survey, Pew Research Center*

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Investment Implications

We suggest a c. 6% allocation to Chinese equities, coming from 3.5% long equities, 1.5% hedged equities, and a c.1% lookthrough from Private Equity holdings.

In light of the above economic growth opportunities and political risks, a key question is whether China is still a compelling investment opportunity. In the view of many experts, the answer is a qualified 'yes'. It is qualified, because it will be increasingly important to avoid those companies and sectors that are either too closely linked to the government in terms of receiving state support, but also those areas which are vulnerable to state intervention and tightening regulation, particularly the tech platforms. Hence, a high degree of localised active management expertise is required. For those managers who can navigate through the state constraints, however, the opportunity set is compelling for three main reasons.

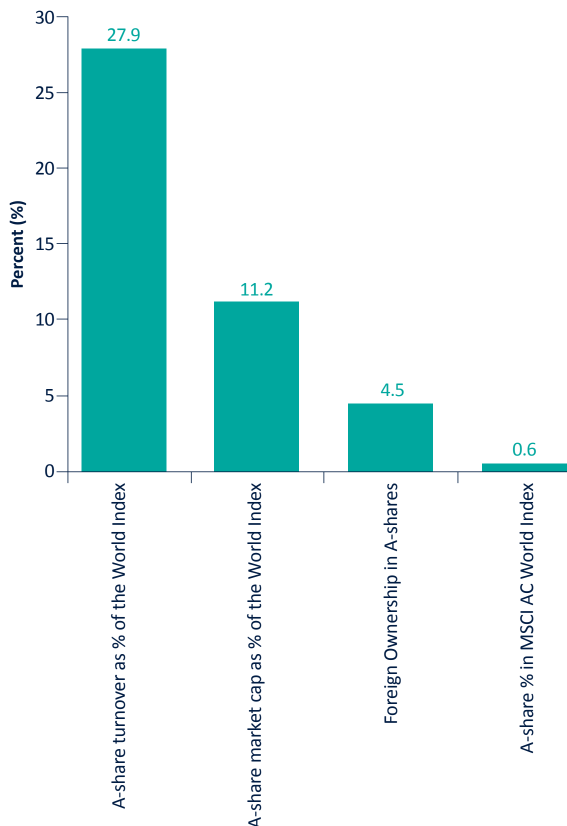
First, the scale of the opportunity set is massive. The China A-share market has a market cap of $14T and an average daily trading volume of c.$200B. This makes it the second largest in the world and the most actively traded. It covers over 4,000 listed companies and captures 15% of global IPO deals annually. Yet despite this, China A-shares accounts for only 0.6% allocation in the MSCI All Country Index and foreign ownership accounts for just 4.5% of the market.

These domestic-focused Chinese companies have a large, growing and addressable market which is increasing in terms of efficiency and interconnectivity (e.g., 1.3B monthly active WeChat users). A-Shares firms generate over 80% of their revenues within China. McKinsey highlights that one of the biggest consumer trends shaping the next decade of growth in China will be a pivot towards buying Chinese produced goods. A survey of 5,000 consumers in 15 Chinese cities found that the share of respondents who say they would buy a local Chinese brand over a foreign brand has increased from 15% in 2011 to 85% in 2020.

The companies also have a rapidly growing pool of talent to pick from. In 2019, Chinese universities produced 49,498 PhDs in STEM fields (science, technology, engineering and mathematics). Based on current enrollment patterns, Georgetown University's Center for Security and Emerging Technology (CSET) estimates that by 2025, China's yearly STEM PhD graduates (77,179) will nearly double those in the US (39,959).

Exhibit 6

China is underrepresented in global markets relative to China's economic influence



Source: *Goldman Sachs*

Second, there are also positive portfolio diversification benefits for international investors. As noted above, China operates on a different monetary policy cycle from most of developed markets. The China A-share index has a correlation of only 0.4 to the S&P 500 and 0.5 to the MSCI World over the last five years.

Third, high dispersion in returns suggests the scope for manager alpha is also significant. Of the over 4,000 listed companies, less than half are covered by sell-side research (based on data from IBES and Wind), leaving a long tail of stocks for diligent active managers to assess. Domestic retail investors account for over 70% of the average trading volume, yet the average Chinese household has only 11% of their wealth in equities, compared to 62% in property. In the US, the comparative figures are 36% of household wealth in equities and 23% in property.

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