Ninety One

Previously Investec Asset Management

Building supremacy

China continues its path to supremacy, pushed on by its ongoing rivalry with the US. Given the uncertainty of this relationship, how can investors position themselves and benefit?

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China strengthens its 'soft power'

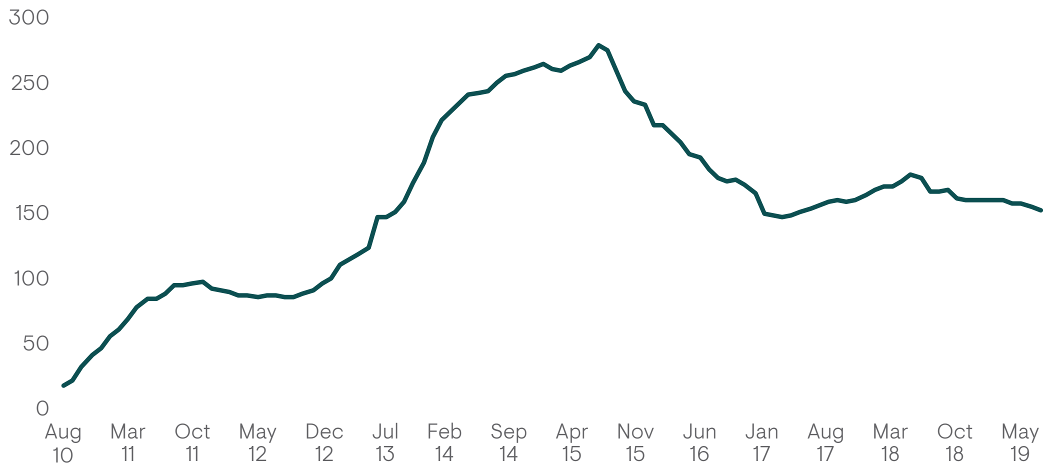
America's willingness to deploy its deep extraterritorial reach through sanctions and tariffs poses some difficult questions for Chinese policymakers. For China, its economic policy has hitherto emphasised control, but a closed approach to support its ultimate goal of achieving supremacy does not brandish an adept weapon in this rivalry. Addressing America is clearly influencing China to reshape its approach in order to build up the 'soft power' necessary to tackle its muscular rival.

Increasing China's financial power requires continued progress on the opening up of its financial markets, alongside the crucial internationalisation of the renminbi. China has already made significant steps towards achieving this. By way of an example, the US has achieved financial dominance through its control of US dollar transactions; most depository and custodian banks alongside settlement networks; and technology given US-domiciled corporations own many basic technologies.

China's efforts to internationalise the renminbi, as discussed in a paper[1], involve the full liberalisation of China's capital account, including measures to promote capital account inflows. One example is setting up offshore renminbi centres in global financial markets and the birth of the offshore dim sum bond market, which greatly increased the appeal of holding the Chinese currency overseas. There is a significant opportunity to increase the status of the renminbi as a global reserve currency, particularly as there is debate on the US dollar's leading position given America's large current account and fiscal deficits.

1. Ninety One, 'Globalising the renminbi', 18 May 2018.

Figure 1: Offshore renminbi deposits (US$ billion)



Source: Bloomberg, Ninety One calculations. Offshore RMB deposits held in Hong Kong, Singapore, Taiwan, South Korea and United Kingdom. As at 30 June 2019.

> Increasing China's financial power requires continued progress on the opening up of its financial markets

Renminbi deposits in the various offshore financial hubs grew steadily from zero at the start of the decade and a sizeable drawdown followed a peak in 2015. In recent years, we have seen fairly flat accumulation of offshore renminbi deposits.

To continue to internationalise the renminbi, this relies on domestic financial market reform and increased investment into China's onshore bond and equity markets. The stock and bond connect schemes are examples of such initiatives, with the most recent example being the Shanghai launch of the Science and Technology Innovation Board, or the 'STAR' market, that has similar rules to the US Nasdaq market to attract international investors. In September 2019, China's State Administration of Foreign Exchange decided to remove quota restrictions on two major inbound investment schemes, namely its dollar-dominated qualified foreign institutional investor (QFII) scheme and its yuan-denominated equivalent, the Renminbi Qualified Foreign Institutional Investor (RQFII). It said that the easing of restrictions would "make it much more convenient for overseas investors to participate in China's domestic financial markets."

Currency can also be used as a 'soft power' negotiating tool

By increasing its financial power like its adversary, China's financial markets will become less insulated from world events, and more determined by the disciplines of the market. However, it's clear that currency can also be used as a 'soft power' negotiating tool given it is a key determinant of international competitiveness, particularly in exports. In August 2019, the US announced it would add a 10% tariff on an additional US$300 billion of China's exports to the US. Following this, the onshore renminbi exchange rate fell past Rmb7 per US dollar for the first time since May 2008. This led to a rapid labelling of China as a 'currency manipulator' by the US.

Building technological supremacy

China has looked to address one hinderance to international competitiveness, namely letting much of its dynamic technology industry list offshore. Many of China's leading technology firms have historically eschewed Chinese exchanges, given the volatility of its domestic equity market. It seems highly likely that China's new policy on listing China depository receipts domestically could encourage many of its technology companies to obtain either primary or secondary listings on domestic exchanges. This will allow China-based investors to benefit from exposure to the most dynamic area of its economy, while also placing these firms further away from the reach of potential geopolitical rivals. The launch of the mainland 'STAR' board encourages technology companies to list at home, with significant potential for new listings. It is expected there will be a shortened time for the listing process, with a registration-based listing system, as opposed to a government regulatory approval model applicable to the main boards.

Figure 2: Greater China IPOs in 2018 by stock exchange Building technological supremacy

	Hong Kong main board	**Hong Kong GEM**	**Shanghai A-share**	**Shenzhen SME board**	**Shenzhen ChiNext**	**Taiwan**	**Total**
No. of IPOs	143*	75	57	19	29	31	**354**
% of total	40.4	21.2	16.1	5.4	8.2	8.7	**100**
Funds raised (US$ billion)	36.1	0.7	12.7	3.3	4.2	0.5	**57.5**
% of total	**62.8**	**1.2**	**22.1**	**5.7**	**7.3**	**0.9**	**100**

Source: PwC research. *including listing by introduction and switch from GEM to main board without raising funds in Hong Kong: 13 in 2018.

The tools wielded against ZTE and Huawei will also be of concern to China's leaders

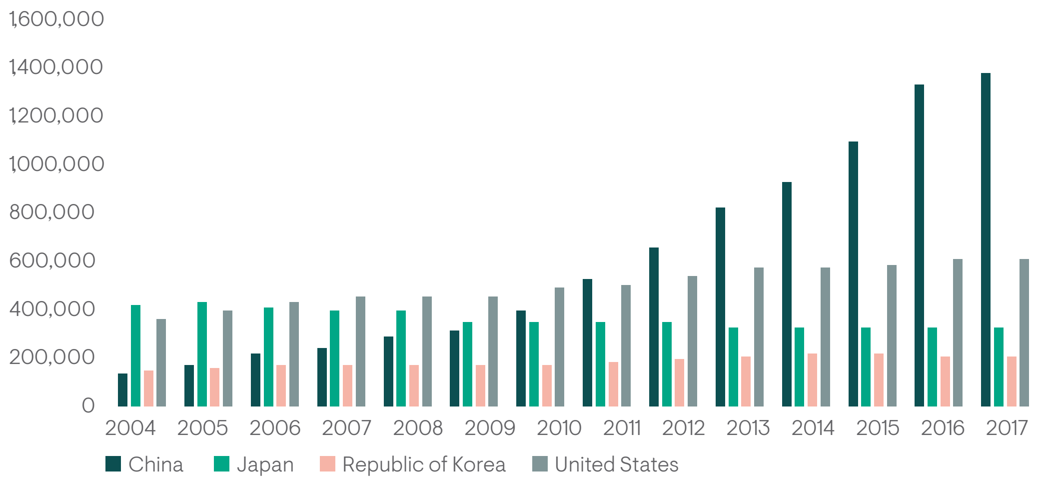
The tools wielded against technology companies ZTE and Huawei will also be of concern to China's leaders. The policy prescription for this would be to re-double its efforts to grow its indigenous technology industries. An unwelcome consequence could be that it could further raise the ire of the Americans. It is also likely to increase capital and operating costs, and potentially lead to the balkanisation of technology, between competing Chinese and American standards. For the Chinese, all this would likely feel unfortunate, but they may believe they have no alternative if they want to avoid periodic power struggles with the US. This could cause significant disruption across technology supply chains in Asia, America and globally.

China unlikely to cede its culture

Aside from mounting rivalry, tensions between China and the US are exacerbated by a high degree of mutual incomprehension. The Chinese have never dealt with someone like Donald Trump before, and are clearly struggling to respond. It is also clear, however, that the US does not understand China either. It can be difficult to comprehend how distinct China's culture is from that of the west and the sheer scale of China's history. For example, crews maintaining the Sichuan Dujiangyan flood defence projects can probably still read maintenance protocols written by their predecessors going back to circa 256 BC, which would be akin to the British still speaking Latin from Roman times. Chinese politicians often mention ancient philosophers in their speeches (such as Confucius who died 2,500 years ago), but these philosophers are arguably still relevant given that Chinese civilisation has remained recognisably intact for at least as long.

It would be realistic to expect China to abide by recognisable rules of good conduct, such as those on intellectual property. Its focus on innovation and the push towards intellectual property protections is reflected in the double-digit growth in patent applications (figure 3). However, it is naïve to expect China to transform into a clone of Europe or the US. It will retain its unique identity and culture. In one respect, this makes China difficult to deal with from a western perspective, but we believe this is a characteristic to be celebrated in our diverse world.

Figure 3: Total China patent applications continue to soar



Source: WIPO Statistics Database, May 2019.

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Lastly, there is a darker school of thought around China and US rivalry, and this is the idea of 'Thucydides's Trap', popularised by American scholar Graham Allison. This is an argument, dating back to Ancient Greek times, that when a rising power causes fear in an established power, the result will be an escalation towards war. While this is a possibility, in our view it is highly unlikely, given a war would not further either superpower's interests.

Reaching a new equilibrium

It is clear that US-China trade tensions are likely to persist, waxing and waning in their intensity. China's economic success has created a new strategic competitor to the US, and one that the US is now forcefully responding to with its 'soft power' arsenal. A continuation of the extended run of trade conflicts could prove debilitating for the global economy.

The long-running nature of this conflict is likely to create stock-picking opportunities and there is likely to be winners and losers from the developments. It is possible to have a neutral positioning on the China and US trade negotiations outcome by accessing global companies and the Association of Southeast Asian Nations (ASEAN) economies as an alternative manufacturing base to China. In technology, these are multinational companies such as Samsung Electronics and Taiwan Semiconductor, and manufacturers from Vietnam, Indonesia, Philippines, Malaysia and Thailand. Chinese mainland electronics companies, for example, are relocating facilities to Taiwan to circumvent the rules on China exports. Japanese companies such as Nintendo and Sharp are planning to move production to Vietnam.

We are likely to see a prolonged period of adjustment, as China finds its new place in the world and the US gradually adjusts to the fact that it is no longer the only 'game in town'. This is likely to prove an uncomfortable time for investment markets, which continue to be roiled by the ongoing unprecedented repercussions from the global financial crisis and the unorthodox economic policies instituted in its aftermath. As the Ancient Romans, or perhaps the Ancient Chinese, might have said: "Caveat Emptor".

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