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Five common concerns when allocating to China

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Capturing insulated exposure to China's domestic growth through the onshore market

- China is, quite simply, an opportunity too big to ignore; there is little doubt that the most populous country in the world is — and increasingly will be — a major force in directing global capital markets. Its economy has been a success story of the pandemic, but investors worry about whether it will continue to grow.
- They also want to know whether China A-shares offer insulated exposure to China's growth. We believe they do, which is why we launched a dedicated China A-shares strategy in January 2020 to capture the country's compelling domestic growth through its increasingly accessible onshore market.
- Geopolitical disputes, ranging from tensions with the US to disagreement with the Australian government, remain in the headlines and a concern for investors. However, we believe such incidents are to be expected as China evolves towards becoming the world's largest economy.
- Another common concern is the US executive order banning investment in Chinese companies it claims have military ties. In this Q&A we explain our firm's position and the potential implications.
- Rising superpower displacement is an issue that investors have had to consider throughout history. We argue that if investors considering whether to invest in rising economic superpowers over the last 500 years had put behavioural bias to one side and had invested based solely on fundamentals, in just about every instance, it would have been a profitable trade.
- We address these concerns in detail in the Q&A, and in doing so, explain why we believe the long-term reward of investing in China significantly outweighs the risks.

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Q1 Is China's growth engine stalling?

- Despite the pandemic, China still managed to deliver annual growth in 2020 – the only major economy globally to do so. The IMF expects stellar growth of 8.4% this year and 5.6% in 2022, comfortably among the strongest growth trajectories in the world[1].
- We believe that China still has a significant growth runway. Its urbanisation rate is similar to that of Japan in the 1970s, not the early 1990s[2]. Meanwhile, China's capital stock per worker is still substantially lower than Japan's or Korea's[3].
- China's economy has grown fourfold over the last 20 years, from the global number six to number two today, as measured by nominal size of the economy. If China can maintain its growth advantage, its economy would overtake the US by 2030.
- The outline of the Chinese government's 14th Five-Year Plan (covering 2021-2025) stressed that the quality and sustainability of further expansion is a priority, and this will be centred around domestic growth. Beijing has turned its gaze inward towards internal production and consumption that capitalises on the growing wealth of the Chinese consumer. By 2030, the number of China's affluent households is set to more than double[4], which should create new investment opportunities throughout the next decade and beyond.
- Reflecting this, services now make up over half of China's economy by sector, and industrial growth has been slowing. China is already the world's second largest domestic consumer market after the US and this is expected to double in the next decade[5].
- Meanwhile, Chinese manufacturers are moving gradually up the value chain, building on the advantage of the breadth and depth of China's supply chain and vast domestic market. New technologies have improved coordination and overall speed to market, and **we firmly believe the robust growth seen over the past decade is here to stay**.

Q2 Does investing in China A-shares offer insulated exposure to China?

- By virtue of being listed on the onshore market, A-shares are naturally tilted towards domestically-focused sectors, such as consumer staples, healthcare, materials and industrials, and so investing in these companies offers exposure biased to China's compelling domestic growth story. Rising affluence and the propensity to upgrade purchases are also supporting strong underlying growth in the healthcare and income protection insurance space.
- This helps explain why China's 'new economy' is growing faster than the traditional 'old economy' sectors (Figure 1). Among A-share issuers, the market capitalisation of 'new economy' sectors (technology, healthcare and consumer) now exceeds that of 'old economy' sectors (banks, utilities, real estate, energy, materials and industrials), underlining the opportunities in these growing markets.

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1. Source: IMF, World Economic Outlook Update, April 2021.
2. Source: The World Bank.
3. Source: University of Groningen, Penn World Tables.
4. Source: CEIC, Haver, UBS estimates, as at 30 September 2020. About 680 million people are expected to have annual disposable income of above US$10,000 by 2030, 2.4x the population of 2019.
5. Source: CEIC, Haver, UBS estimates, as at 30 September 2020. Global consumption markets as measured US dollars.

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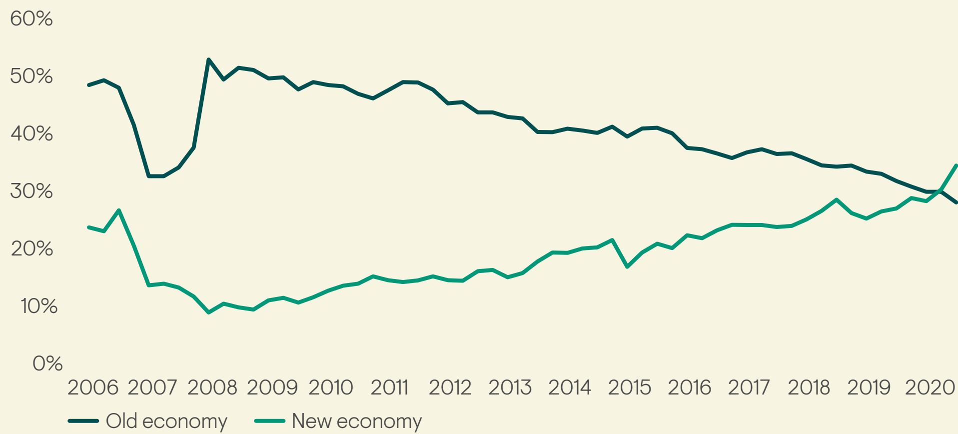
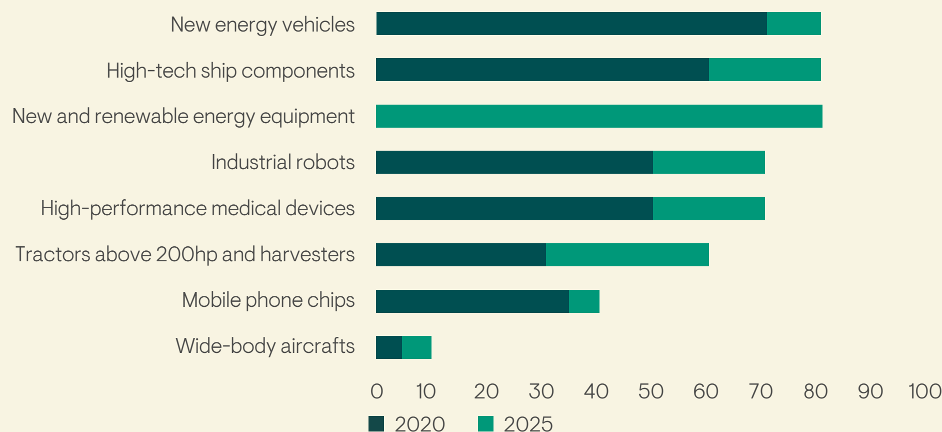
Figure 1: China's 'new economy' sectors are now bigger than their 'old economy' counterparts



Source: Bloomberg. Ninety One.

- China's transformation extends from its consumer to its manufacturing sector, which now contributes to over 28% of global manufacturing output[6], with rapidly increasing market share across sectors such as renewable energy equipment, machinery and electrical equipment. One of China's aspirations is global leadership in technology. To achieve this, it aims to increase its domestic market share across a number of value-add subsectors, including high-performance medical devices, electric vehicles and robotics by 2025 (Figure 2).
- In many cases, China's onshore market provides the only meaningful exposure to Chinese companies in these sectors, despite an increasing number of mainland companies seeking an offshore listing, notably in Hong Kong.
- Much of China's domestic priorities support its target to become carbon neutral by 2060, creating further opportunities for investors. Self-sufficiency in energy, for example, would be beneficial, given that around 70% of the oil refined in China is imported[7].

Figure 2: China aims to expand its domestic leadership across the manufacturing space



Source: Institute for Security & Development Policy, 'Made in China 2025', June 2018. hp = horsepower. This chart has been redrawn by Ninety One.

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6. Source: United Nations data, 'World Manufacturing Production: Statistics for Quarter IV 2020,' 8 March 2021.
7. Source: US Energy Information Administration, 'China's crude oil imports surpassed 10 million barrels per day in 2019,' 23 March 2020.

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- Access to onshore companies is also becoming more possible. Foreign ownership of the China A-share market has nearly doubled to 4% since the opening of the Stock Connect programme.[8] This should continue to rise as China further opens up its capital markets to international investors and increases their attractiveness, diversity and liquidity. One reform of note is Hong Kong Exchanges and Clearing's plan to roll out more A-share derivatives to help global investors hedge risks, which should allay some investor concerns.
- In addition, the Stock Connects have recently broadened the capitalisation range on their markets to include eligible A-shares listed on the Shanghai Stock Exchange's Sci-Tech Innovation Board (Star Market) as well as eligible pre-revenue biotech companies listed in Hong Kong, thereby increasing the richness and diversity of the platform. To expedite the IPO process, a registration-based IPO system has been applied to broader A-share markets[9], which should help to attract listings and fund innovative enterprises.
- Given the high retail investor participation in A-share markets, this creates a rich pool of alpha opportunities for investors to secure insulated exposure to China. There is an early window of opportunity for international investors, considering household wealth allocation to the stock market remains low in China, but it is growing.
- In the **Ninety One 4Factor China A-Shares Strategy, the vast majority of revenue from company holdings is domestically focused**, with **only low single-digit exposure to international revenues**. This enables the portfolio to be insulated from external international risks and well positioned to benefit from the continued growth of the domestic Chinese market and rising wealth of consumers.

Q3 How will the new US political leadership influence geopolitical risks associated with investing in China?

- The Trump era may be over, but it remains to be seen how US-China relations will develop. According to Ninety One's Co-Head of Multi-Asset Growth Philip Saunders, recurrent geopolitical flare-ups are likely to moderate somewhat, but will not completely disappear. However, President Biden's administration is likely to use more conventional diplomacy, with policy implemented in a more structured and internationally collaborative way. This may be less comfortable for China, which is likely to tone down its aggressive tone on diplomacy and concentrate on its own priorities.
- One critical priority — encouraged by the tensions in recent years – is achieving technological self-sufficiency. China's 14th Five-Year Plan suggests Beijing intends to accelerate technological decoupling from the US through domestic-led innovation that can deliver import substitution[10], helping China's continued march up the production value chain.

8. Source: PBoC, CSRC, Wind Info, CICC Research.
9. In 2020, this included the Shenzhen Stock Exchange's ChiNext board, joining the Star Market.
10. Import substitution is a strategy focused on domestically-produced goods to replace those that are imported.

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- Nevertheless, greater cooperation could be on the cards in some areas. Before Trump, the US Chamber of Commerce (representing the interests of the US corporate sector in China) was an active partner and an advocate of reform in China. Having been forced to be less vocal, the lobby appears to be finding its voice again. In February 2021, the Chamber said that American companies would lose as much as US$500 billion if they slashed investment in China or were subject to elevated tariffs, in a report highlighting the cost of a full decoupling of the world's largest economies.
- Despite these geopolitical issues, we believe **investors should take reassurance from China's consistency in its relentless pursuit to shore up its domestic capabilities**. Beijing has continued to open up the Chinese economy, liberalise its capital markets and reform state-owned enterprises (SOEs). Moreover, the Five-Year plan reiterates its focus on improving macroeconomic governance, promoting market-orientated reforms and accelerating the transformation of government functions, together with the liberalisation of trade and investment.
- Given the **breadth and depth of China's own supply chains and vast local market, we believe the strength of its domestic economy remains largely insulated from international pressures**. As investors, it is worth bearing in mind that what grabs the headlines and what is actually occurring on the ground - thanks to the abundance of reforms - can be markedly different from an investment perspective.

Q4 With the new US executive order banning investment in Chinese companies it claims have military ties, what is our firm's position and what are the potential implications?

- **Ninety One is fully complying with November's executive order** banning US investors from investing in companies that are on its defence blacklist. We have thoroughly reviewed our portfolios and **deemed the China A-Shares Strategy is not exposed to any companies on the blacklist**.
- Another area of uncertainty is on the prospect of Chinese American Depositary Receipts (ADRs) in the US being forced to delist, with newsflow around Alibaba and Tencent earlier in the year. However, the continued opening up of the A-share market and reforms on the Hong Kong market provides a backup for Chinese companies that seek either a primary or a secondary listing, creating further investment opportunities. Indeed, Alibaba and Tencent are already listed in Hong Kong.

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Q5 Will the next century belong to China?

> "Over the past five hundred years, in sixteen cases a major rising power has threatened to displace a ruling power. In twelve of those, the result was war. The four cases that avoided the outcome did so only because of huge painful adjustments in attitudes and actions on the part of challenger and challenged alike."

Graham Allison, 'Destined for War'.

Figure 3: Rising superpower displacement is a common theme across centuries

Case	Period	Ruling Power	Rising Power	Result
1	First half of 16th century	France	Hapsburgs	War
2	16th–17th centuries	Hapsburgs	Ottoman Empire	War
3	17th century	Hapsburgs	Sweden	War
4	17th century	Dutch Republic	England	War
5	Late 17th–early 18th centuries	France	Great Britain	War
6	Late 18th–early 19th centuries	United Kingdom	France	War
7	Mid–19th century	United Kingdom, France	Russia	War
8	19th century	France	Germany	War
9	Late 19th–early 20th centuries	Russia, China	Japan	War
10	Early 20th century	UK	USA	No war
11	Early 20th century	UK, France, Russia	Germany	War (WW1)
12	Mid–20th century	UK, France, Russia	Germany	War (WW2)
13	Mid–20th century	USA	Japan	War (WW2)
14	1970s–1980s	Soviet Union	Japan	No war
15	1940s–1980s	USA	Soviet Union	No war
16	1990s–present	UK, France	Germany	No war

Source: 'Destined for War', Graham Allison.

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- We would also stress that as China develops into a superpower, a brief look at the history books would tell us that conflict is inevitable. However, conflict can be peaceful. Historically, superpowers butting heads has been a regular occurrence, but since WW2, conflicts have not been settled by warfare, but by negotiation and treaties (Figure 3). Our view is that China's rise will continue this trend and play out without risk of a major war.
- **Superpower competition often does work out and if investors put emotions to one side** and **invest based on long-term fundamentals, this can prove a shrewd move** turning bouts of volatile headlines to their advantage.
- Given its **focus on self-sufficient growth and reform, we believe China and China A-shares will play an ever-increasing role in global investors' portfolios** in the decades to come.

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