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INVESTMENT OPPORTUNITIES AS CHINA'S POLICIES EVOLVE

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Beyond Chimerica

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What next for China-U.S. economic ties?

A once-symbiotic relationship between the U.S. and Chinese economies — dubbed Chimerica — has frayed in recent years, prompting talk of a full-blown decoupling of the two. Some distancing has been inevitable, in view of China's development beyond its low-cost manufacturing center, geopolitical strains, and U.S. dissatisfaction with the loss of jobs and other economic costs from integration. Pressure to decouple has been compounded by China's economic shift from quasi-capitalist to one oriented increasingly under Communist Party control. Bipartisan support in the U.S. has added to economic-distancing pressure.

U.S. tariffs extend across 66.4% of imports from China, compared with Chinese tariffs on 58.3% of imports from the U.S.

Source: "U.S. Signals No Thaw in Trade Relations With China," The New York Times, November 16, 2021

Opposing game plans. President Biden is prepared to move beyond his embrace of the Trump administration's hawkish trade policy, keyed to tariff increases, by building on current trade restrictions. Pillars of the new strategy can be summarized in this way:

a) Direct talks beyond current Chinese import targets for U.S. goods to address more fundamental grievances over China's subsidies to local firms, intellectual property theft, and forced technology transfers

b) Establishing closer coordination on China policy with our allies

c) Creating new policy tools to address trade imbalances, national security issues, and subsidized foreign investment by China

U.S. trade initiatives have been met by China's desire to achieve technological self-reliance in the wake of crippling U.S. restrictions on Huawei and other Chinese communications companies. In foreign investment, China has countered U.S. regulatory threats against Chinese firms trading up to $2.1 trillion in shares on U.S. exchanges by embarking on a campaign to have them delist from the U.S. market.[1] The government also has begun banning variable interest entities (VIEs) as a financing loophole for Chinese companies. (A VIE allows foreign investors to own stock in a shell company without owning the underlying entity driving share prices.)

Nearly 60% of U.S. multinationals surveyed by the American Chamber of Commerce increased their China investments in 2021, and 72% had no plans to shift production from the country for at least the next three years.

Source: John Plender, "Didi's Delisting Revives U.S.-China Decoupling Fears," Financial Times, December 4, 2021

However, China's economic strategy is more nuanced than a simple decoupling of trade ties with the U.S. This is most apparent in its opening of the local financial market to Western firms, thereby maintaining the flow of foreign capital but under China's direct supervision. The allure of China investment is apparent both from the increased exposure of foreign banks and from the near doubling of local stock and bond holdings by foreigners in the past three years to $1.1 trillion,[2] despite the wave of government regulations and restrictions in recent years.

The stakes for investors. Investor expectations have swung from optimism over China's Western convergence to worries over a cold war estrangement,

1. "Asymmetric Decoupling," The Economist, December 11, 2021
2. Ibid

similar to that between the Soviet Union and the West. However, China's relationship with the West is far more complicated than that, not least because of the size and potential growth of demand for goods and financial and other services in a domestic market ranked second in the world. Moreover, the country enjoys special non-price advantages in its role as a global factory, including specialized labor, advanced logistics and infrastructure, and ample port capacity.

Domestic and foreign trade advantages help explain why a September 23, 2021 survey by the American Chamber of Commerce showed 72% of U.S. multinationals showing no intention of shifting production out of China in the next three years. So-called *dual players* are among the most reluctant to leave, according to a recent Harvard Business Review study,[3] because of both their large sales in the local market and their use of China as a major base for global production — in other words, their dual play. The country's economic advantages and its willingness to open its capital market should continue to create opportunities for foreign investors, particularly in industries favored by the government to support consumer-led economic growth.

Further U.S. efforts to untangle its bilateral relationship with China could have perceptible effect on U.S. growth and investment returns in the U.S., particularly those most exposed to China trade. For example, an economic study[4] done a year ago estimates a $190 billion loss of U.S. gross domestic product (GDP) annually by 2025 and the loss rising to $250 billion by 2030 — equivalent to a tax increase of 0.5% to 1.0% a year — if U.S. tariffs were raised to 25% across the board. Added losses could result from forgone capital gains and lost tourist revenues, if U.S. investments in China and Chinese travel to the U.S. were halved. Even that measure understates the full impact of increased tariffs, from retaliatory measures by China, lost opportunities for trade growth between the two countries, and the ripple effect of reduced GDP on other parts of the economy.

However, we view decoupling as likely to proceed slowly and selectively because of the degree to which the two countries are integrated and the costs of a more complete rupture of economic ties. That, we believe, will insulate large- and mid-cap U.S. industrial and technology sectors we favor from economic strains in the foreseeable future.

We also expect investment opportunities over the coming decade as China develops a private sector to serve its 1.4 billion consumers. Amid rising mutually targeted U.S.-China regulation, U.S. and European firms that operate successfully in China we believe often do so by competing effectively with local firms and are adept at mitigating risks — including exchange rate movements — as they do business in China. A conservative investor may prefer to let companies on the ground in China manage risks. Our recent report, "The Future of Globalization" discusses this and several potential alternatives for investing in the evolving U.S.-China relationship.[5]

Key takeaways

- President Biden's trade initiatives going forward likely will focus more on trade restrictions than on cost increases from higher tariffs, even as China focuses on gaining greater control over foreign trade and investment.
- We believe that future decoupling by the U.S. and China will be more nuanced than a simple split between the two economies, mindful of the potential economic costs — far greater than they were during the Cold War.
- A measured approach toward any future U.S.-China decoupling will keep our favorable view intact toward high-quality U.S. large-cap companies, several in sectors with high exposure to China.

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3. Allen J. Morrison, "The Strategic Challenges of Decoupling," Harvard Business Review, May – June 2021
4. "Understanding U.S.-China Decoupling: Macro Trends and Industry Impacts," Rhodium Group, February 17, 2021
5. "The Future of Globalization; Investing in an Interconnected World," Wells Fargo Investment Institute, September 2021

Chinese domestic policies in the Year of the Tiger

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Targeting the middle class

In November, leaders of China's Communist Party proclaimed President Xi Jinping's ideology the "essence of Chinese culture." Xi's "common prosperity" initiative comprises a set of domestic policies that seek to narrow China's wealth gap. Its key objectives include expanding the middle class, reducing income inequality, and strengthening the social safety net. This year will mark 10 years (two terms) of Xi's leadership. Elimination of term limits should keep him in power for a third term and potentially beyond. The timing of Xi's ambitious domestic agenda coincides with the run-up to the 2022 Party Congress where he is expected to be reconfirmed.

China's richest 20% earn more than 10 times the poorest 20%, a wider gap than the U.S. and many European countries.

Source: Bloomberg, September 3, 2021

China's economy slowed from 7.9% in the second quarter of 2021 to 4.9% in the third quarter of 2021 due to a number of factors: power shortages, COVID-19-related restrictions, property-sector debt, and regulatory crackdowns. Although factory production grew nominally in November, economic data revealed challenges in China's economy, particularly for consumers and the property sector, pointing to a need for fiscal and monetary support to avoid a further decline in 2022. As China continues its transition from an export-driven to a services-led economy, we believe Beijing will likely endorse policies that promote economic growth and grow the middle class.

600 million Chinese citizens live on an annual income of 12,000 yuan ($1,858).

Source: Bloomberg, September 3, 2021

Domestic priorities

As we look ahead to the Year of the Tiger, there are several components that comprise China's domestic policy focus. These include:

China's retail-sales growth tumbled from 4.9% year over year in October to 3.9% in November, largely due to COVID-19-related restrictions.

Source: The Wall Street Journal, December 15, 2021

Consumption: Consumer activity is a key ingredient of China's growth outlook. The Chinese economy faces headwinds from shrinking demand, supply shocks, and weaker expectations in the aftermath of the pandemic and a zero-COVID policy with more lockdowns. How Beijing responds to these challenges should impact growth.

Regulatory crackdowns: Chinese regulators have targeted the technology sector and successful entrepreneurs, real estate, and financial institutions. These moves aim to rein in monopolies and consolidate power toward a more state-led model. Expanded government is not a new objective. It is an extension of Beijing's 2000's industrial policies.

Temper social excesses: Alongside regulatory restrictions, Beijing seeks to limit "societal excesses," including celebrities, video gaming, and private-tutoring schools, while addressing income disparities and increasing earnings of low-income workers.

Housing and real estate: Debt troubles have roiled China's real estate sector. Speculation in real estate is driving housing prices to unaffordable levels, straining the middle class. Beijing has been cracking down on the real estate sector, including borrowing limits for developers. Reducing living costs (including housing) is an objective of common prosperity.

Stimulus: Beijing is targeting stimulus to stabilize growth but currently has no plans for massive government spending as in previous slowdowns. Beijing could follow Hong Kong's example of spending vouchers for specific businesses or other provisional measures.

Economic and investment implications

Beijing is expected to set around a 5% growth target for 2022. China's pivot away from an overreliance on housing and infrastructure investments toward an emphasis on domestic consumption will have near-term and longer-term implications for the economy and investors. This warrants caution for sectors exposed to crackdowns (real estate and technology) while emphasizing industries more aligned with Beijing's priorities (internet, consumer staples/local brands, and low-carbon energy).

Despite the focus of income and regulatory actions, Xi supports entrepreneurship, avowing that common prosperity depends on hard work, warning about the danger of government dependence. Beijing will cut 500 billion yuan (0.5% GDP) in taxes for small and medium-size companies to help stimulate the economy.[6] Policymakers also agreed to increase tax deductions for research and development expenditures to boost innovation.

Although regulatory crackdowns and slowdown in retail activity have raised near-term uncertainty, we believe policy actions that help balance growth and financial stability support our current Neutral outlooks on Asian emerging markets and Emerging Market Equities. Emerging markets should participate in the global equity bull market, near term, but not lead it. Broad exposure to emerging markets that includes China may help diversify some of the near-term risks.

Key takeaways

- Beijing's "common prosperity" initiative aims to narrow China's persistent wealth gap.
- As China transitions from an export-driven to a services-led economy, Beijing will likely endorse policies to promote economic growth and grow the middle class.
- We believe Beijing's policy actions to balance growth and financial stability support our current Neutral outlook on emerging Asia and Emerging Market Equities.

6. Cornerstone Macro, November 19, 2021

China's policies toward its neighbors

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We believe regional interdependence will continue to grow

For the bulk of at least the past 25 years, many of China's regional neighbors have benefited from the economic relationship they have forged with what has grown to become the second-largest economy in the world. Companies in high-income countries such as Japan, South Korea, and Taiwan have gathered components from their own factories or other producers and then sent these components to China for final assembly. The traditional low-wage nature of Chinese workers has allowed these companies to benefit by lowering their costs with the goal of increasing profit margins.

Eight of China's top 15 trading partners are also members of the Regional Comprehensive Economic Partnership (RCEP). This is an important Asia-Pacific free trade agreement that will further regional interdependence.

In the more recent decade, China has made efforts to move its economy toward a model that relies more on its own consumers being the primary driver rather than relying on exports to countries like the United States and the United Kingdom and in developed regional blocks like the European Union. China is encouraging its consumers, especially the younger generation, to buy goods that are made within the country.

The rise in Chinese wages during the past decade provides both the fuel for domestic spending and the incentive to look for lower-wage sources for goods. Consequently, we expect a list of China's top 15 trading partners, in terms of both exports and imports, includes regional neighbors Japan, Hong Kong, South Korea, Taiwan, Australia, Vietnam, Malaysia, India, Russia, Thailand, Singapore, and Indonesia. China and 14 other countries last November signed the Regional Comprehensive Economic Partnership (RCEP). Eight of the RCEP signatories are among China's top 15 trading partners. The signatories to the RCEP represent a wide range of high-wage to low-wage countries, many of which already had long-established trading relationships with China.

Most of China's relationships with its regional neighbors should continue to focus on goods, as most of these neighboring economies are not services based. However, as China opens up its market to trade in services, countries like India are likely to aggressively pursue inroads to this high-growth area of the Chinese economy. Companies in the United States and in a number of developed international countries such as the U.K., Germany, and Japan are also launching major efforts to boost their services (for example, financial, environmental protection, health care, and agricultural services) revenues in China.

It is likely that large economies such as China, over time, will migrate to an even greater extent toward more regionally interdependent relationships. The world's second-largest economy is the core that these neighboring countries depend on for the health and well-being of their domestic economies. China has the trade-based infrastructure in place, such as ports that allow for the transportation of goods to and from its regional neighbors.

When looking to invest in the growth of China and its regional neighbors, U.S. investors can directly purchase shares in Chinese companies on the Hong Kong exchange, but the more convenient vehicles for stock selection may be active equity funds that feature stock-picking managers familiar with individual companies based in China or one of its neighbors. Passive regional global funds also exist and may make sense for investors seeking broad exposure to China and its trading partners. Another way to invest includes American depositary receipts (ADRs), which give an investor partial ownership in Chinese equity shares. However, the U.S. has designated 35 of these issues as national security threats because of potential ties to the Chinese military.[7] We recommend caution when considering ADRs.

Key takeaways

- China's regional economic relationships with its neighbors are likely to grow further in coming decades.
- We recommend a more broad-based investment approach rather than focusing on individual companies in the region.

7. "The Future of Globalization; Investing in an Interconnected World," Wells Fargo Investment Institute, September 2021, p. 17

Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. The prices of **small and mid-cap** company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions. Investing in **foreign securities** including American Depositary Receipts, presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

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Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

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