Invesco

Approaching Investing in China

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Executive Summary

- Despite regulation in 2021 that negatively surprised as well as a multi-year period of COVID-19-related restrictions that just ended, in our view China represents a compelling investment opportunity.
- China can be treated as a separate portfolio allocation:
    - China's economy and financial markets are now on par with major developed markets (DMs) but are still in emerging markets (EM) indices, in which China represents a substantial and growing portion of the asset class.
    - As a result, EM performance metrics are often driven by China and equity indices can under-represent the rest of the EM asset class.
    - We understand why an increasing number of investors choose to invest in China on a standalone basis, which enables them to focus on emerging markets through EM ex-China allocations.

Is China investible?

In 2021, a series of unexpected regulatory actions caused many market observers and participants to question whether investors can confidently and predictably invest in China's markets. We believe China remains a key investment market for several reasons.

China's economy is too large to avoid. China accounted for 18.4% of global GDP in 2021 (in USD terms)[1] and we expect that share to continue rising. Further, World Bank data indicates that China accounts for 13.0% of global equity market capitalisation. China's share of the global economy and capital markets suggests that excluding it from portfolios risk incurring missed opportunities.

The growth potential of China is substantial. China has rapidly grown its middle class in the course of just a few decades, driving an increase in domestic consumption. And China has become a manufacturing powerhouse, capable of increasingly sophisticated production, which has driven substantial export growth. While China's economic growth has moderated in recent years, we expect it to continue to be significantly stronger than that of developed countries. In fact, the Communist Party's goal is to double the size of the Chinese economy from 2020 levels within 15 years. This is a critical objective that will be supported by fiscal and monetary policy. (source: China Likely to Make 5% Growth Its Bottom Line for 2022 - Bloomberg)

In terms of the regulations that caused such apprehension about investing in China, it is important to understand these are part of China's Common Prosperity Campaign to address economic inequality and increase financial well-being.

Largely unheard of just a year ago, "common prosperity" was the 2021 buzzword for China markets. The term was mentioned by over 70 major Chinese companies in their earnings announcements and by President Xi Jinping in over 60 speeches during the year, up from 30 in 2020 and just six in 2019.

"Common prosperity" is the latest of a series of political priorities articulated by President Xi – dual circulation, environmental protection and family values among others – driving major shifts in Chinese markets. But the market had trouble digesting this latest priority, which contributed to a deep lull in performance.

It has been a struggle to find a reliable framework to understand and predict these latest regulatory moves – now, common prosperity looks like the best conceptual lens through which to understand policy direction last year.

We may remember that "common prosperity" is not a new concept for modern China. The term came up in the Mao era and was repurposed by Deng Xiaoping 40 years ago, who famously proposed to let "some people to get rich first" while also asserting that "to get rich in a socialist society means prosperity for the entire people."

1. Source: IMF World Economic Outlook, October 2021

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Deng's policy pivot towards decentralization and privatization allowed Chinese household wealth to grow astonishingly over the past few decades – with China's GDP per capita[2] rapidly converging towards advanced economy levels[3].

Over the years, policymakers have prioritized growth at any cost with the belief that a rising tide lifts all boats, which is why China's breakneck growth has been so lopsided. Today, the urban household income is 2.5x greater than rural household income, and the country's Gini coefficient – a measure of income inequality – puts China among the most unequal major economies in the world.

In hindsight, China scholars would argue that common prosperity's return to the top of the CCP's political agenda was only a matter of time, especially with policymakers loathe to allow inequality and the cost of living to become such serious social issues as they have in developed markets. Even in China's modern market economy, the socialist spirit remains foundational to the whole of the political system.

President Xi unveiled what is undoubtably his most ambitious campaign to promulgate traditional socialist values at the CCP's centenary celebration in July 2021, where he proclaimed the country's success in ending 'absolute poverty' while outlining an all-encompassing effort to redistribute extreme wealth and reduce inequalities through a repackaged common prosperity slogan. While light on the details, the new policy has broad redistribution implications.

For example, while China has rapidly lifted much of its population out of extreme poverty, there remain approximately 600 million 'working poor' Chinese who have a monthly income of $154 or less while there is a rapidly growing number of millionaires and billionaires (source: The Brookings Institution, "Assessing China's "Common Prosperity" Campaign", September 2021). China recognizes the need to address this growing socioeconomic chasm – and that could ultimately be positive for the sustainability of economic growth.

The key objectives of China's regulations thus far can be grouped as follows:

- Financial stability: China wants to ensure adequate risk controls for financial services companies, including sufficient capitalization.
- Data protection: Data security is an important issue for all companies and consumers, but countries have done little to protect data. Chinese policymakers believe data security is a national security issue, and as such do not want foreign entities to have access to Chinese companies' data.
- Break-up of tech monopolies: Authorities are concerned that some companies may gain an unfair ability to set higher prices because they control an industry. They also want to ensure that smaller businesses are not at a disadvantage when competing.
- Better conditions for workers: China wants to ensure "gig workers" receive adequate treatment from employers, including earning a living wage and receiving health benefits.
- Combating climate change: The government wants to support a "greening" of the economy.

China's regulatory agenda has clearly given some investors pause. Yet the objective of China's regulatory actions has not been to drive foreign investors from China – or for China to undermine its market economy. Rather, it is intended to ultimately improve China's economic underpinnings by focusing on 'quality of growth' as opposed to 'quantity of growth', although it has created some significant short-term headwinds.

The truth is that many of the underlying concerns and challenges are the same issues faced by governments, investors and individuals worldwide. China's approach may have been more direct and top-down than many would like to see. But China's is a different political system from most others, and therefore the political-economy, the relationship between the state, the economy and the markets is going to be different than in a Western democracy. A different approach – with Chinese characteristics, you might say -- to the same challenges could be an important diversifier in a portfolio of many countries.

2. Purchasing Power Parity basis

3. Between 1993 to 2019, China's GDP per capita (PPP) has grown from 5% to over 30% of an advanced economy's GDP per capita (PPP)

Indeed, part of the point of diversifying country exposure is to achieve differentiated macro and portfolio outcomes, driven by differences in economic structure and sometimes cyclical positions. As the state, the economy and firms adjust to the new rules and recalibrations now underway, valuations are also realigning and performance is picking up.

We think this makes China an attractive investment opportunity for longer-term investors. What's more, Chinese policymakers have recently reassured foreign investors. At the World Economic Forum in Davos in January 2023, Chinese Vice Premier Liu He pronounced, "China's national reality dictates that opening up to the world is a must, not an expediency. We must open up wider and make it work better." (source: Vice Premier Liu He's Speech at the World Economic Forum Annual Meeting – Chinadaily.com.cn) Further, he insisted that "enterpreneurs, including foreign investors, will play a critical role as they are the key elements of social wealth creation", suggesting a supportive stance towards innovation going forward.

Finally, China has shown a real commitment to economic growth and sustainability with the dramatic changes it has made to its COVID-19 policy. By rolling back restrictions, Chinese policymakers have created an environment that is supportive of far stronger economic growth in 2023. In fact, International Monetary Fund Managing Director Kristalina Georgieva remarked at Davos that China's successful economic re-opening "is very likely the single most important factor for global growth in 2023. It matters tremendously." (source: Transcript of International Monetary Fund Managing Director Kristalina Georgieva Media Roundtable (imf.org)

China is in a class of its own

China's economy and markets are not only too large to ignore, but they are now so large that there is a small but growing group of investors who approach China as a specific investment allocation.

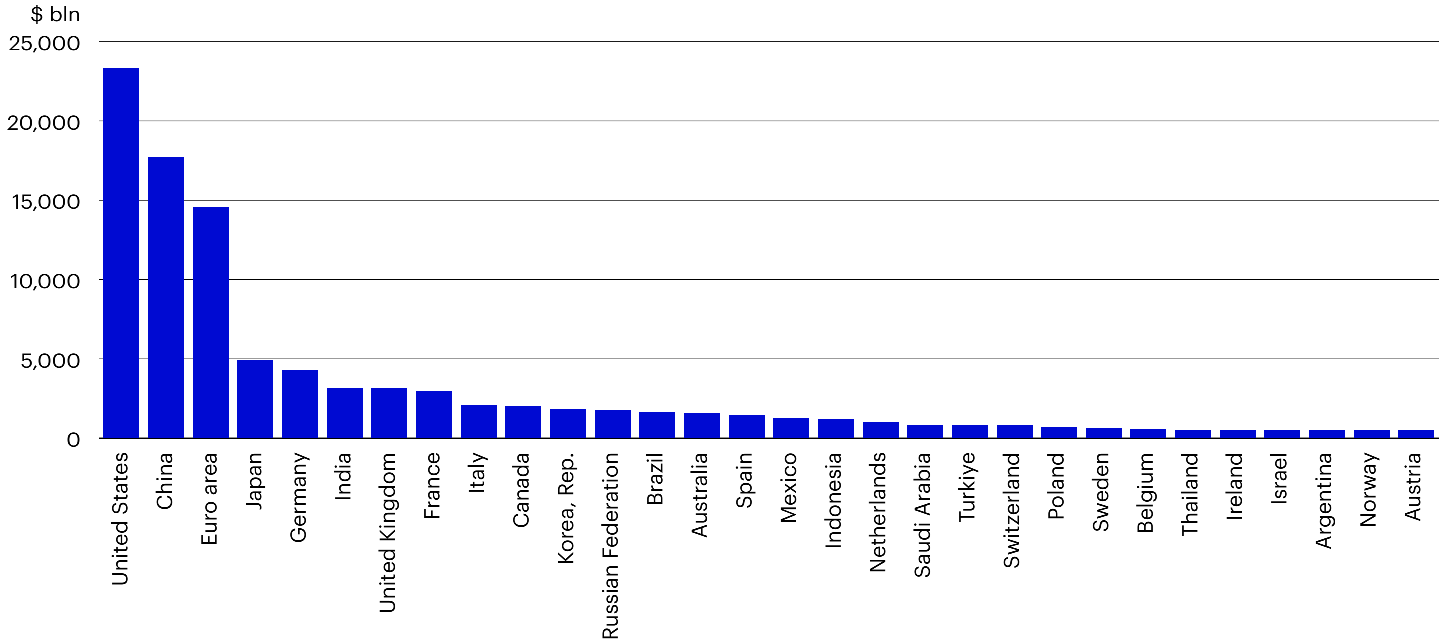
As Figure 1 shows, China's nominal GDP at market exchange rates is the second largest in the world, already significantly larger than the Eurozone (EZ). With higher growth rates than the US, EZ, UK or Japan, China is poised to become the largest economy within this decade. Indeed, on a purchasing power parity basis, which adjusts for different price levels for the same types of economic activity in different countries, China's economy is already the largest in the world. With many restrictions to investing in China lifted and the inclusion of the country in commonly used global benchmarks, we suspect China will form an increasing share of investor portfolios over the coming years and decades. In short, China has grown so large that we think it merits the same consideration as the US and other large developed markets (DM) and that it should certainly be separated from the usual basket of emerging markets (EM) economies.

In other words, investors are increasingly viewing China as being in a class by itself, in the same way that investors treat the major DM economies like the US, EZ, Japan and the UK, dedicating substantial analytical and investment resources to their economies and financial markets.

Indeed, we see both private and official institutional investors thinking about standalone country mandates for China. This rethink was flagged in investor interviews for the 2020 edition of the Invesco Global Sovereign Asset Management Study, which surveys sovereign wealth funds and central banks around the world annually.

At Invesco, we already take this approach in many of our own research and investment processes. We formulate our Invesco annual global outlook on a foundation of our assessment of the three major global growth poles – China, the EZ and the US. We also regularly discuss the global economy and markets with many clients by focusing on these three economies as a basis for thinking about how most other national economies and global asset classes will evolve, with a few exceptions in both DM and EM categories (notably the UK, Japan and India where domestic dynamics are often more important).

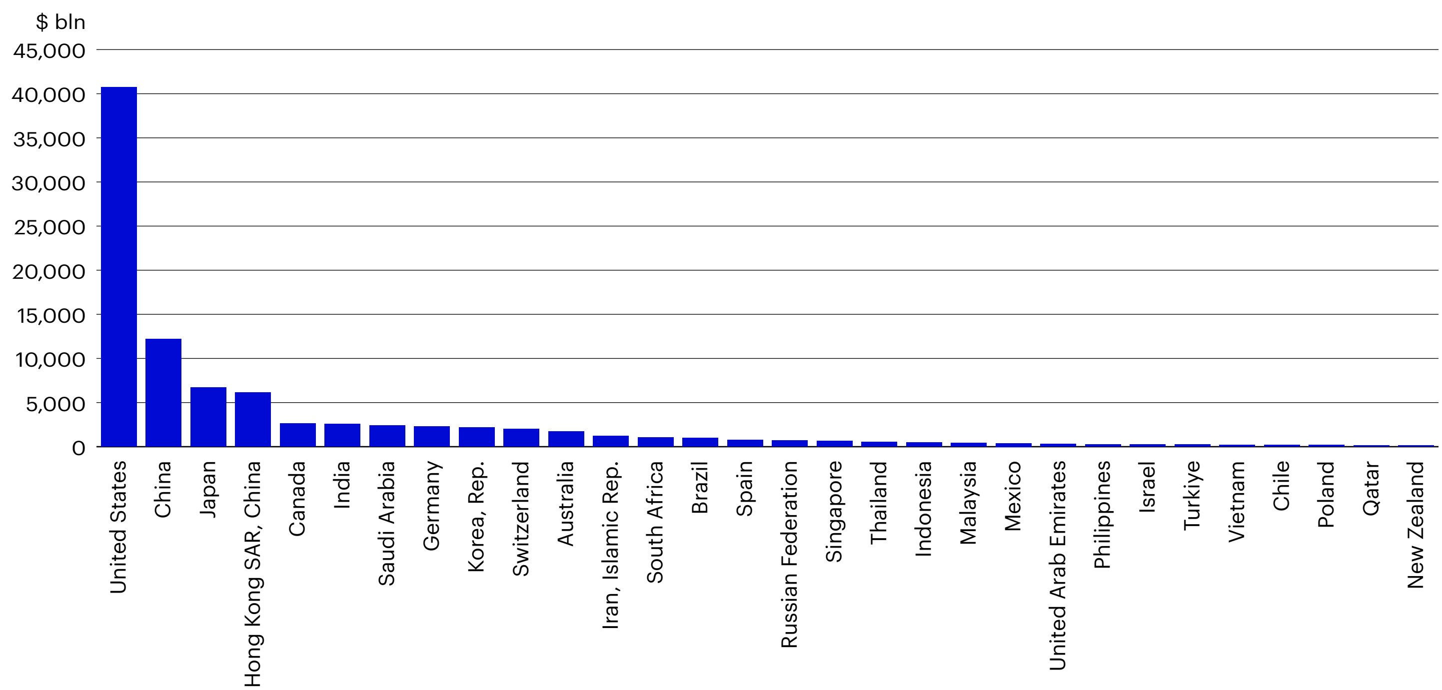
Figure 1: China's economy is far larger than most EMs and DMs



Note: 2021 GDP of the 30 largest economies in billions of USD. Source: World Bank, Invesco

Of course, it remains true that China does not have a high per capita income in line with the US, EZ, UK or Japan. It is also true that restrictions on capital account convertibility – the right of residents and non-residents to freely trade currencies and assets at will with each other – remain in China. It is understandable that such restrictions may be a reason for some index providers to restrict China's entry into the same indices as major DMs. However, China's uniqueness as now the world's largest trading nation, third largest bond market and second largest national equity market – yet with resident capital controls and other unique features not found in other major economies – is viewed by some investors as another reason for considering a standalone allocation to China.

Figure 2: China's stock market cap also far exceeds most DMs as well as EMs (billions of US$, 2020)



Note: 2020 national stock market caps. 30 largest equity markets, billions of US$. Eurostoxx market cap was US$3.7tn as at April 2021; UK stock market cap as at end-2021. Source: World Bank, Invesco

Figure 3: Share of China and other regions in global GDP and capital markets (%)

	World GDP[1]	World GDP (PPP)[1]	Global govt. debt[2]	Bloomberg[3]	FTSE Russell[4]	Global equity market cap.[5]	MSCI World[6]	FTSE World[7]	MSCI ACWI[6]	FTSE All-World[7]
China	18.4	18.6	16.5	9.3	3.2	13.0	—	—	3.6	3.7
Eurozone	15.1	11.9	15.8	17.8	28.7	5.9	10.0	8.8	9.0	8.1
Japan	5.1	3.7	11.7	12.7	14.6	7.2	6.3	6.8	5.5	6.4
UK	3.2	2.3	3.7	4.2	4.1	3.8	4.4	4.5	4.0	4.2
US	24.2	15.7	34.8	39.6	42.9	43.5	68.0	63.1	58.7	58.8

Notes:

1. GDP data as of 2021, provided by World Bank (PPP uses purchasing power parity exchange rates to convert all national GDPs to US dollars, rather than market exchange rates)
2. Share in credit to global government sector (in 2022 Q2, BIS data and global is based on BIS all-country aggregate)
3. Bloomberg Global Aggregate Treasuries Index, as of 31 December 2022
4. FTSE Russell World Government Bond Index, as of 31 December 2022. China was introduced to the FTSE Russell World Government Bond Index in October 2021 with the intention of bringing it to full weighting over a three year period. Separate research by FTSE Russell suggests that full weighting will be above 5%
5. Share in global equity market capitalisation, according to World Bank data. As of 2020, except UK and Eurozone, which show their share in the global total as of 2014 and 2019, respectively (more recent data is not available)
6. Based on MSCI World Index and MSCI ACWI Index (All Country World Index), as of 31 December 2022 (China is not included in MSCI World)
7. Based on FTSE World and FTSE All-World Indices, as of 31 December 2022 (China is not included in FTSE World)

Source: BIS, Bloomberg, FTSE Russell, MSCI, World Banks, Refinitiv Datastream and Invesco.

Re-defining the EM asset class as EM ex China

We think there are several good reasons beyond size for treating China upon its own merits, rather than as part of a broader global or emerging market portfolio.

As shown in Figure 3, even popular index providers are currently understating the importance of China within global asset markets. For example, World Bank data suggests that China accounts for 13.0% of global equity market capitalisation, whereas it only accounts for 3.5%-4.0% of MSCI and FTSE world benchmark indices (the US is at the other extreme). China is also under- represented in government debt market indices. Adherence to strategies based on those benchmarks may deprive investors of opportunities in China from which they could otherwise benefit.

The opposite appears to hold for those indices focused on emerging markets, with China dominating certain benchmarks. As of 31 December 2022, China accounted for 32.3% of the MSCI Emerging Markets Index and 35.0% of the FTSE Emerging Index. This naturally biases EM portfolios towards China, which may not suit those who consider its economy and corporate sector to be relatively advanced. Such investors may prefer to separate China from EM mandates. We note that fixed income benchmarks are less dominated (for example, the JP Morgan Government Bond Index Emerging Markets gives China a weighting of 10%).

It is important to note that EM has always been a wide-ranging asset class, lumping together countries with very different economic profiles – commodity exporters like Brazil or Russia as well as importers like some Asian countries; countries with very tight trade/investment links to DMs, like Mexico, Turkey or South Korea as well as more domestically-focused economies like India. Despite these major differences, most EMs do share several crucial macro characteristics. With a few exceptions, such as South Korea, they are not as productive as DMs, and their per capita incomes are significantly lower. With the exception of China, EM economies and financial markets tend to be smaller in market cap, not as deep in terms of liquidity and turnover, nor as broad in terms of the numbers and types of issuers of stocks or bonds as the major DMs.

EMs, with a very few exceptions, also share a crucial financial feature: All are significantly driven by the global economic or financial cycle, no matter how domestically focused their economies tend to be – like Brazil or India – and even if they run external trade surpluses like Russia. As a result, they tend to benefit when global growth is rising and the US dollar is softening; but suffer when global financial conditions tighten, global growth slows and the dollar strengthens.

For EMs, this mix of features has long enabled investors to dial up and down exposures to the overall asset class depending on views regarding the direction of the global economy, monetary policies and currencies. Equally, investors have been able to vary intra-EM exposures according to views and valuations reflecting both the global cycle and views about longer-term trends in specific EMs.

China is a critical exception. China has repeatedly shown that it is in a very strong position to chart its own course given the scale and diversity of its economy, the depth and size of its markets and its relatively tight and effective resident capital controls. In contrast, most EMs continue to be small economies that are very open and exposed to changes in the global economic cycle, in commodity export or import prices or global financial conditions, driven mainly by the Fed's monetary policies and the dollar. As such, EM economies respond to the global economy and their place in it, reflecting the structure of their economies – unlike the major economies that jointly drive the global economy – especially China, the EZ and the US.

The unique and independent nature of China's economy means it is often counter-cyclical. That means Chinese assets can often perform quite differently than US, Eurozone or other emerging markets assets. The diversification benefits of exposure to China make it important that investors are able to gain stand-alone access to Chinese markets.

Conclusion

In conclusion, we believe that the case for investing in China has not changed, despite recent regulatory actions. We moreover see the current and anticipated future importance of China and its financial markets justifying dedicated investment processes and teams. Further, many commonly used benchmarks understate the importance of China within global financial markets, which may cause structural underexposure.

China is almost the world's largest economy and among its largest, deepest, most liquid and diverse financial markets, we therefore believe in approaching China as a separate allocation from broader global/EM portfolios, leaving the investor free to decide the appropriate structural allocation.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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