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China and the Investor's Dilemma

Why a white paper about China? As we speak with investors in the US and around the world, we find that many are perplexed about the advantages and disadvantages of investing capital in China. On the one hand, China is the second largest economy in the world (after the US) and the country is growing much faster than the more developed economies. On the other hand, the ethical, geopolitical, and even potential legal issues associated with investing in China can be daunting.

In this paper we have tried to lay out in as objective a manner as possible the pros and cons of investing in China. We have intentionally avoided expressing our own opinion because ethical and geopolitical issues are best assessed by investors themselves, not by us. We hope, however, that this paper will help investors make well informed decisions for their families.

ARGUMENTS FOR INVESTING IN CHINA

The vast majority of investors in the West view China as just another investment opportunity, no different (or not much different) than investing in any market anywhere in the world. Hence, we summarize briefly the reasons investors allocate capital to China.

Size and growth rate. As noted above, China is the world's second largest economy and, while its exact rate of growth is difficult to pin down, it is certainly growing faster than the developed world and faster than many emerging economies. If that's all we knew about China, these factors alone would suggest that the country should be significantly represented in most globally diversified portfolios. As of June 2020, China's share of global GDP was 17.3%, second only to the United States at 25.9%. Contrast these GDP weights to China's current share of global equity market capitalization - currently at 13% - while the US share stands at 57%. By this metric, China's GDP-to-market capitalization ratio suggests it is meaningfully undervalued relative to the US.

A profitable innovation engine. Many years ago, China merely exploited its relatively low-cost labor force to cheaply produce low-margin goods and services for Western consumers. But China has increasingly moved into higher value-added goods and services. The country has become a dominant force in developing, selling, and marketing technologies that are critical to alternative energy production and transportation, biotechnology, telecommunications, and other industrial segments. While some of these innovations have been borne from coercive

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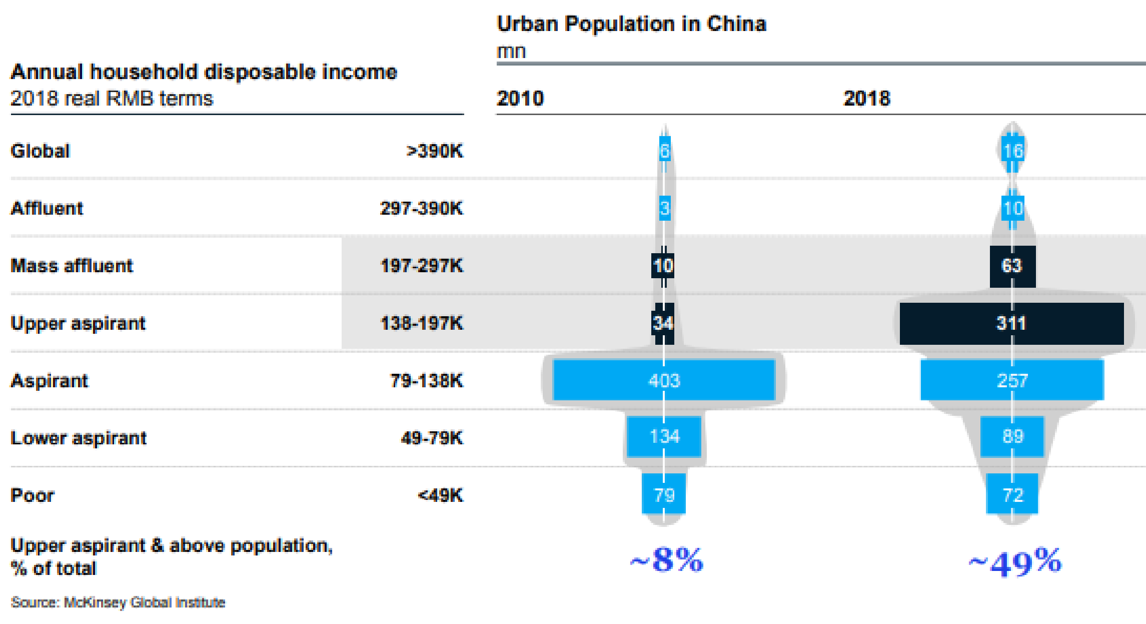
relationships with Western "partners," the country's home-grown capabilities are growing rapidly. As importantly, these developments are powering investable profit growth: as of March 2020, China's 8.97% profit margin is fat relative to companies elsewhere in the world, where the average profit margin clocks in at 6.3%.



The retreat of poverty. Whatever complaints investors and others may have about China today, it's important not to forget that the rapid economic growth in China since Deng Xiaoping has raised hundreds of millions of people out of deep poverty. It's not an exaggeration to say that this may count as one of the most important positive developments in the world since the collapse of the USSR. Despite its current size as the world's second largest economy, China is still in the process of industrializing, and as it does its productivity growth rate of 6.3% far eclipses that of the US, where productivity is currently growing at 1.9%.

Increasing self-reliance. Much of China's post-revolution growth was driven by foreign investment-fueled manufacturing and exports. While growth in that activity has been slowing for years, China's domestic consumers have gained sufficient critical mass to support much of the country's economy. As any economy matures, consumer spending becomes an ever-more important driver of GDP growth. In the US for example, nearly 70% of annual GDP arises from

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consumer spending. With almost 1.5 billion people, China boasts 18% of the global population. By comparison, the US population is 331 million, the EU population is 513 million, and Japan's population is 126 million. Beyond raw population measures, it is a country's middle and upper classes that account for the majority of its consumer spending and China's middle income population is now larger than the entire US population and is growing rapidly. Despite its much larger population, China's consumers spent $5.3 trillion in 2018, versus $13.6 trillion in the United States, suggesting substantial room for continued domestic consumption growth in China. China's domestic consumption has been growing at an 8% compound annual rate since 2000, versus 2% or less for the US, UK, Germany and Japan. In addition to providing an investment opportunity, China's increasing reliance on domestic consumption as a performance driver should produce diversification benefits for clients invested primarily in developed markets.

Thinking Post-Xi. Before President Xi came to power, China was both far less aggressive internationally and at least a bit less oppressive to its citizens. President Xi's approach is more aggressive and challenging for the West and his impact will likely be long lasting. Yet long lasting doesn't necessarily mean forever. For thousands of years the Chinese people have been one of the most dynamic and productive in the world and patient investors may find a post-Xi China much more to their liking – although they should remember that Xi has had himself named "President-for-Life."

Convergence. For decades, politicians, diplomats and economists have believed that if the West treated China with kid gloves and abetted Chinese economic growth, the Chinese would eventually "converge" with the West politically and culturally. So far that argument has proven to be wrong, but perhaps the time frame is just too short.

Keeping your enemies close. Michael Corleone wasn't speaking of China when he said, "keep your friends close and your enemies closer," but he may as well have been. One argument for continuing to invest in China is that the flow of Western dollars into the Chinese economy acts to some extent as a deterrent to any extreme behavior by the Chinese.

CONCERNS ABOUT INVESTING IN CHINA

In recent years more investors have expressed concerns about investing in China. While still a relatively small (but vocal) minority, some investors will consider the concerns described below to be cause for underweighting China or avoiding the country altogether.

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Slowing growth. Most projections about the glorious future of the Chinese economy simply take its existing growth rate and project it forward for many decades. So far, these projections have mostly been wrong because they failed to anticipate how quickly Chinese growth would slow. As this paper was being written, China announced that its growth rate in 1Q20 was 3.2%. Given COVID and the geopolitical pressures on China (see the discussion below) it's entirely possible that economic growth in China could slow even more in the future. After all, every rapidly growing economy in history has gradually slowed down over time. But in China, where the government's legitimacy is dependent on rapid economic growth, slowing growth could not merely derail China's hopes of becoming the world's largest economy, it could bring on significant civil unrest.

The resurrection of the SOEs. After many decades in which state-owned enterprises (SOEs) were deemphasized in favor of private companies following China's entry into the World Trade Organization, President Xi has resurrected the SOEs and they are now taking a growing slice of the Chinese economy and of the Communist Party's favor. In recent years, for example, SOEs have represented only about 25% of China's GDP (although growing), but they consume 80% of available bank credit. A continued deemphasis on private industry won't bode well for investment returns.

Massive state and private debt. Since the Global Financial Crisis, China's economic growth has been principally fueled by debt, with the result that China is now in a more precarious situation than Japan was before it entered its "lost decades." Like most other countries, China's debt to GDP has exploded since 2009: households from 100% to 260%; corporates from 110% to 150%; credit/financials from, 170% to 250%. The country has a $52 trillion property bubble (Wall Street Journal, "The $52 trillion bubble: China grapples with epic property boom," 7/16/20). No one knows how far China can carry its investment-driven growth before the economy flattens or collapses, but certainly the answer isn't "forever."

Population decline. Although most emerging market countries have populations that are growing rapidly, China – due in part to its One-Child Policy – has a population that is growing at less than ½ of 1% per annum. Worse, China's *working age* population will soon begin to decline. Since there is no immigration to China, its population bust will likely have a significant negative effect on its economic growth. Of course, China is not unique in facing this demographic problem; the same could be said for the US, Europe, Japan and virtually every other developed nation.

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Poor investment data. Because data about the Chinese economy is widely believed to be manipulated by the government, it's difficult to know how well the overall economy is doing, or how well individual segments of the economy may be faring. At the micro level, the SEC recently warned investors about the poor quality of reporting by China-based companies and reiterated that the SEC's accounting oversight arm, the Public Company Accounting Oversight Board, has been unable to inspect audits of US-listed Chinese companies (Reuters, "U.S. securities regulator warns investors over Chinese company disclosures," 4/22/20). More recently, Congress passed bipartisan legislation requiring Chinese firms traded on US exchanges to meet US audit standards or face delisting (Eversheds Sutherland, 12/3/2020).

Geopolitical issues. There are several geopolitical issues that investors might find to be of concern:

- Americans are increasingly mistrustful of China. A Pew poll in early 2020 showed that 68% of Republicans and 62% of Democrats considered China's power to be a major threat to the US (Pew Research Center, "U.S. Views of China Increasingly Negative Amid Coronavirus Outbreak," 4/21/20). This suggests that whether Republicans or Democrats are in power, the trade war with China is likely to get worse. As the US presses China and China retaliates, the risk of having capital stranded in China rises.
- Most of the world's large democracies are increasingly joining the US in opposition to a more aggressive China (Bloomberg, "Lawmakers from eight countries form new alliance to counter China," 6/5/20).
- For all the complaints about American hegemony, most people around the world would far rather live in an America-centric world than in a China-centric world (see "Ethical concerns," below).
- China's recent aggressive actions in Hong Kong, abrogating a decades-old treaty with the UK, have alarmed many investors.

Ethical concerns. The list of potential ethical concerns about China is unfortunately long, although of course individual investors feel very differently about these issues and how seriously they should affect how capital is allocated. Here, briefly, are some of the concerns:

- There are suspicions that China may be committing genocide among its ethnic Uighurs, the Muslim group in Xinjiang Province. In any event it is clear that the Chinese have forced more than a million Uighurs into vast "reeducation" camps (Foreign Policy, "Atrocities of

scale," 7/15/20).

- China recently violated its legal obligations to maintain Hong Kong in a "one state, two systems" status and is cracking down on all forms of democracy and political expression in Hong Kong.
- Many Western scientists believe that the coronavirus began to circulate in China long before the Chinese notified Western health authorities. Whether or not the virus might have been contained if China had been more forthright may never be known, but it is clear that China's suppression of information about the virus allowed it to circulate more rapidly.
- The Chinese military has been officially charged in the huge Equifax hacking, which resulted in the personal data of 145 million Americans being compromised. US authorities know full well that many other hacking incidents were conducted at the direction of the Chinese government (New York Times, "The US charged four members of China's military in the 2017 Equifax hacking," 2/10/20).
- China's efforts to crush free speech and freedom of the press internally are well-known. But earlier this year China expanded its efforts to the West by expelling reporters from the *New York Times*, the *Wall Street Journal*, and the *Washington Post* (ABC News, "China to expel American reporters," 3/18/20).
- China has used homegrown and foreign-sourced technology to aggressively surveil the country's citizens (The Atlantic, "The Panopticon is Already Here," 9/2020).

WHAT DOES LIMITING CHINA EXPOSURE MEAN IN PRACTICE?

Most clients who view China as an investment challenge—whether due to ethical reservations or economic/geopolitical concerns (or both)—also consider it a *dilemma* because eliminating or greatly reducing investment exposure to China is not without significant complications and costs.

Just for starters, China is, for all intents and purposes, the emerging markets (EM) asset class. As of September 30th, 2020 China represented more than 40% of the MSCI Emerging Markets Index.[*] To the extent that a thoughtfully constructed investment portfolio calls for even very modest exposure to EM, due to its higher expected returns on investment in exchange for higher volatility, it's worth pointing out that there is no easy way to "get here from there"

[*] https://www.msci.com/emerging-markets.

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without material exposure to China. EM as an asset class depends on growing middle class consumers and export-driven economies to power above-average returns on capital and China is the exemplar of those sources of return.

In our view, it is difficult to achieve optimal prospective risk-adjusted returns without some long-term, strategic allocation to emerging markets. While the specific costs can only be accurately estimated when taking into account client-specific characteristics, they are not immaterial. As a *very rough* guide, we estimate that stripping all emerging markets equity (public and private) from a taxable portfolio means that after-tax prospective returns could decline by about one percent and that correlation risks would become more elevated.

To put it mildly—in the face of even modest inflation and stable taxes—a lost percentage point of return is a serious cost and helps quantify the cost of eliminating direct China exposure. It also helps dimensionalize what might be required from compensating strategies—e.g., leaning very heavily on non-China EM or having to seek out more esoteric sources of non-correlated or faster growing returns.

Another element worth considering is the increasing difficulty of completely eliminating China exposure. Even if an investor is willing to accept somewhat lower returns by eliminating China from their portfolio, how far is that investor willing to go? What about significant China linkages in other, non-EM asset classes? While direct-to-China revenue exposure in the S&P 500 is modest (less than 5%), the look-through impact to key companies in the semi-conductor and technology space is significant, often well in excess of 15%.

In addition, US supply chains are sensitive to and highly reliant on the import and export of partially-finished goods and to some raw materials produced in China. The globally-connected nature of China is not limited solely to commodities and equities—while China's holdings of US Treasury obligations is not at peak levels, it is nonetheless extremely significant and, at $1.1 trillion, second only to Japan.* As the US Treasury sells huge additional amounts of bonds to fund the Fed's pandemic-related monetary activities, China's holdings of US debt will likely increase significantly.

Of course, most investors who want to reduce or eliminate *direct* exposure to China will be able to live with the cognitive dissonance that arises from having *indirect* exposure to China via their US large cap holdings. A bigger issue for investors who worry about slowing growth in China

* US Department of Treasury, Federal Reserve Board as of May 2020

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and/or increasing geopolitical tensions is the possibility that their capital could get stranded. While that is not Greycourt's base case, it is not a zero probability.

Given China's importance to other asset classes, it's worth considering how far an investor can or should go to reduce the knock-on effects: go too far and your portfolio will likely face unappealing tail risk outcomes. Consider, for example, that China likely controls the supply of more than 70% of pharmaceutical ingredients sold in the US, including 90% of antibiotics, 70% of acetaminophen / Tylenol, and 50%+ of the anti-coagulant heparin. China also produces more than 80% of all smartphone components globally and nearly all the athletic shoes and toys sold in the US.

Finally, it's worth noting that disinvesting in China is unlikely to drive meaningful change in that country. Unlike South Africa in the 1960s, China is simply too big and too interconnected to the rest of the world for a divestment movement to have much impact. The US represents only 19% of China's exports and 7% of China's imports. Hence, investors may face a real opportunity loss that affects their future spending and philanthropy without driving lasting change in China.

SUMMARY

At least for the foreseeable future, most investors will continue to put capital to work in China, even if they worry about the robustness of the capital markets, increasing geopolitical tensions, or have ethical concerns. For investors who wish to avoid China, however, there are alternatives, albeit increasingly imperfect ones as the degree of avoidance becomes more extreme.

This paper was written by Greg Curtis, Greg Friedman, Matt Litwin and David Morris of Greycourt & Co, Inc. Please note that this presentation is intended to provide interested persons with insights on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.