China: the “sleeping giant” of the equity markets

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Summary

Despite the coronavirus pandemic and ensuing global slowdown, 2020 was a watershed year for China in many ways. William Russell, Global Head of Product Specialists Equity, explains how China is delivering on its long-term strategy and what opportunities this can provide for investors.

Key takeaways

- China should no longer be considered an emerging market – rather, it’s on the way to becoming a global powerhouse
- China aims to be the world’s high-tech standard-bearer, thanks to major investments in 5G infrastructure, digitisation, semiconductors and artificial intelligence
- US-China trade tensions are likely to continue, which is one reason China is increasingly focusing on establishing its autonomy, strengthening supply chains and forging new alliances
- China is underrepresented in many benchmark indices considering the size of its economy and markets, so investors focusing exclusively on benchmarks may be investing too little in China

China is taking off while the West is still dealing with the coronavirus crisis. Why is China’s economy so strong?

William Russell: Without a doubt, Covid-19 has been the main risk to economic growth worldwide – and that applies to China as well. During the first quarter of 2020, the country was hit hard by the pandemic and growth suffered a lot. But while most Western countries, including the United States and the European Union, are still struggling to end the pandemic, China and many other Asian countries appear to be in a better position. China has made significant progress containing the virus, which has helped lay the foundation for robust growth. And the long-term success story is very likely to continue as well.

What makes you so sure of that?

William Russell: There are several factors driving China’s success. One is that China has enviable structural conditions – including positive demographic trends, healthy consumer behaviour and rising incomes. For example, the spending power of millennials in China is very different today as a result of their growing wealth. Another success factor is that China is focusing on economic issues with enormous growth potential – such as intensively promoting robotics and improving its renewable-energy supply. In addition, China is striving to be the world’s high-tech standard-bearer and the government is pursuing major investments in areas such as 5G infrastructure, digitisation, semiconductors and artificial intelligence. These will be the backbone of the country’s future growth model. And it is these sorts of developments that mean China should no longer be considered an emerging market – rather, it’s on the way to becoming a global powerhouse.

So government investment programmes continue to be a major force behind the recovery?

William Russell: China's economic policy and investment projects will naturally continue to be heavily influenced by the government. But one very noticeable feature last year was that China's economic policy was a lot more conventional than that of many Western countries. This is because of the experience back in 2009 after the global financial crisis, when China launched a huge fiscal programme that resulted in high levels of debt. In China, this is now widely recognised as a mistake. So as we look ahead, it is very likely that as the Chinese economy gathers momentum, the government will take prudent steps to reduce the level of policy support and investment spending in order to prevent a further build-up of leverage.

Good trade relations with other countries are an important condition for further growth. Do you think there are positive signs on this front?

William Russell: In recent years, China's relationship with the United States has been problematic. We think it is unlikely these tensions will ease significantly, even if the tone of the rhetoric becomes less confrontational. After all, being tough on China was one of the few things US politicians could agree on in the recent election. This is one reason why China is increasingly focusing on establishing its autonomy, strengthening supply chains, developing modern manufacturing facilities and forging new alliances. For example, the new Regional Comprehensive Economic Partnership (RCEP) is creating an economic bloc of Asia-Pacific countries that is home to around one-third of the world's population. In addition, after seven years of negotiations, the EU and China recently announced a comprehensive investment treaty: the Comprehensive Investment Agreement (CAI). This represents a strategic breakthrough for China and could also help China enter into new international partnerships.

The trend towards greater sustainability is playing a bigger and bigger role internationally. What does that mean to China?

William Russell: Interest in sustainability is growing fast in China. The country recently announced a pledge to be carbon-neutral by 2060. Although this sounds like a long way away, in practice there is immediate pressure on many companies – especially the largest carbon emitters – to accelerate plans towards reducing their carbon footprints. For example, substantial investments are being made in renewable energy sources, electric vehicles, hydrogen technology and other "clean technologies". China is already the largest market for electric vehicles globally and has also taken the lead in solar installations. More broadly, China is significantly upping its game in areas such as corporate governance and reporting. Many companies now have employee share-option schemes, which provide a stronger alignment with their shareholders. Of course, there is still a long way to go – and above all, there needs to be greater transparency for investors. But the direction of travel is very encouraging.

So how can investors benefit from China's continued rise?

William Russell: The most direct way is through investing in China's equity markets. Over the last 20 years (to 31 Dec 2020), the benchmark MSCI China Index has returned 521% compared with MSCI Europe's 98%. Historically most global investors have had relatively little direct exposure to China equities, and especially the mainland China A-share markets. One reason for this is that China has been – and continues to be – underrepresented in many indices considering the size and scale of its economy and financial markets. As a result, investors focusing exclusively on the benchmark may be investing too little in China, relatively speaking. For example, according to estimates by the International Monetary Fund, China accounted for more than 16% of global GDP in 2019, surpassing the EU's 15.4%. Yet China currently only makes up around 5% of the MSCI All Country World Index (MSCI ACWI) – the main benchmark for global stocks.

Does this mean China is still the "sleeping giant" of the equity market?

William Russell: Absolutely. There are good reasons why China has been underrepresented in global indices. For example, it was only quite recently that mainland China's stockmarkets – the so-called A-shares – became easily accessible to foreign investors. However, with the continued opening up of these markets, China's weighting in these indices should increase. Realistically, for example, China's share of the MSCI ACWI can be expected to double – getting it closer to the euro-zone's share. Indeed, over time, we think investors will come to think of China as a standalone asset class like the US or Japan. In addition, China's citizens have been investing more of their assets in their domestic equity markets, a trend that should also continue as the country's saving culture evolves.

What risks do you see?

William Russell: In the short term, we would not be surprised to see a period of consolidation in China's equity markets. They have rallied strongly over the last year and some profit-taking would be entirely natural. In addition, as China takes prudent steps to normalise monetary policy, the very strong liquidity environment may become more moderate. In fact we think some pullback would be a healthy development and help to set a more solid foundation for the future. Over the longer term, we continue to see compelling reasons to invest into China. It is, of course, a relatively volatile asset class, so it's important for investors to have a long-term perspective and consider their comfort level with drawdowns.

What are you hoping for from China in 2021?

William Russell: We have seen some incredible innovation in China in recent years – including the use of artificial intelligence in medical diagnosis to overcome an acute shortage of doctors. There have also been major steps forward in genetics and research into cancer-drug development. And we've seen technological developments in solar energy that push some production costs below those of fossil fuels. My hope is that we see further progress in these and other areas, and that these can be shared to benefit the rest of the world – rather than kept in silos as part of the overall shift towards deglobalisation.

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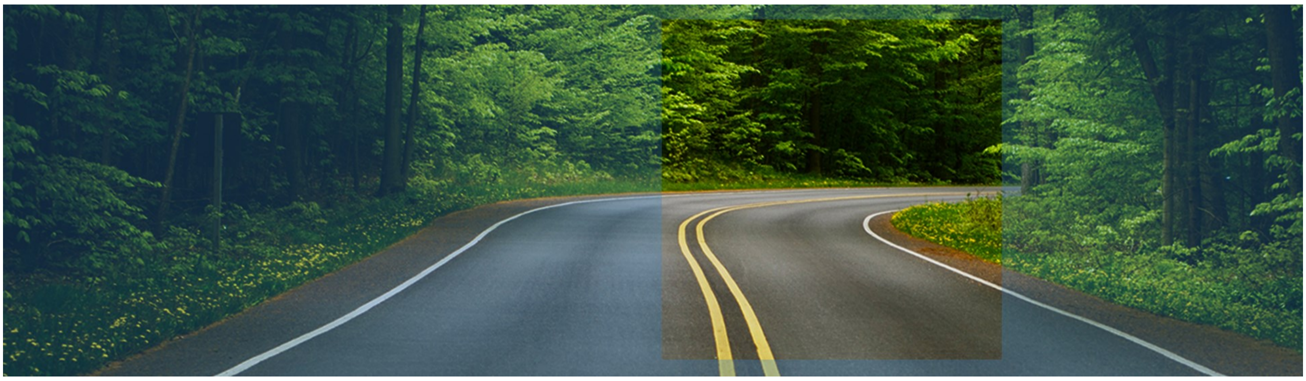

Summary

To help investors navigate today's drastically different world, we've identified three overarching themes: a resurgent China, persistently low yields, and the drive to live and invest more sustainably. We're using our expertise and insights to explain why these themes represent some of the biggest opportunities and risks for portfolios – and what investors can do.

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