FEG INSIGHT

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CHINA

Risk or Reward?

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China is surrounded by a whirlwind of ongoing trade tensions, technology disputes with major players such as Huawei, and large-scale protests in Hong Kong, amid a backdrop of an aging population and slowing growth. These headlines appear at a time when China is not only the second largest economy in the world, but also playing a greater role in global stock markets through the inclusion of the Chinese A-share market in major indices.

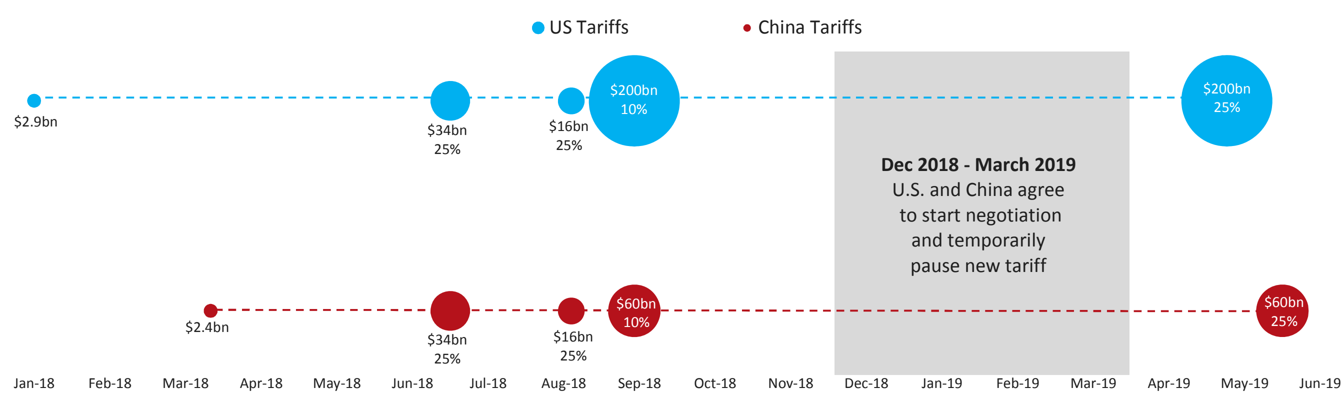
This report highlights recent events revolving around China and identifies the risks and opportunities facing investors. As stated in an earlier FEG publication on Brexit, one of the unfortunate aspects of investing is the uncertainty; however, that uncertainty is ultimately the very risk that can provide rewards. Given the vast opportunity China presents, FEG continuously focuses on separating signals from noise, and providing insight on implications of recent events surrounding China.

TRADE TENSIONS

U.S. stock and bond markets alike faced heightened volatility over the past few weeks, partly in response to U.S.-China trade war developments. The large market moves are representative of the sentiment surrounding the massive scale of the trade tensions between two of the world's largest economies, which have grown in their interdependence over the years. For context, in 2018, the U.S. imported about $540 billion in Chinese goods, up nearly 60% from 10 years ago.[1]

President Trump first laid out plans to counter what he called "unfair trade practices" from China at a presidential rally in Pennsylvania, prior to being elected. In 2018, the U.S. imposed tariffs on all washing machines and solar panels, followed by all steel and aluminum imports–not just those from China. The U.S. and China then began a tit-for-tat exchange of protectionist policies, with each country implementing tariffs on the exports of the other.

ESCALATION OF THE U.S.–CHINA TRADE WAR



Sources: https://www.bbc.com/news/business-48253002, Rabobank

Trade tensions seemed to settle modestly in late 2018 and into early 2019 before resurfacing months later. In early August of this year, the U.S. Treasury Department labeled China a "currency manipulator" after China devalued the yuan in response to fresh tariffs imposed by the U.S. earlier in the month, bringing the yuan's daily reference rate below 7 yuan to the dollar for the first time in over a decade, nearing 7.2 to a dollar earlier this month.[2]

CHINA LETS THE YUAN DEVALUE

Value of the Yuan—Yuan per U.S. Dollar

Data source: www.macrotrends.net; data as of 9/3/2019.

Such protectionism from both sides is broadly believed to be negative for global trade and economic growth. In fact, in November 2018, the head of the World Trade Organization (WTO) stated that global free trade was facing its "worst crisis" since the General Agreement on Tariffs and Trade (GATT) in 1947, which was put in place to reduce trade barriers. But who's bearing the brunt of this pain?[3]

While the initial impacts of the tariffs were largely felt by the manufacturing industry in the U.S., corporations at large are starting to incorporate potential tariff-related implications into their forward-looking earnings projections. Recent reports show that the trade conflicts have started to impact the supply chains of companies in the U.S.

The entire conflict, and those involved, remains largely unpredictable. Recently, President Trump asked U.S. companies to begin looking for alternatives to Chinese products. While reducing reliance on China would take time, there are a number of ways Trump could reinforce this goal that would not require congressional approval, such as hiking tariffs on Chinese goods to the point it is no longer profitable for U.S. companies to use Chinese inputs, declaring a "national emergency," or through federal procurement curbs targeted at specific sectors. Additionally, the most recent suggested rounds of tariffs could result in consumers beginning to feel more of a direct impact.

Interestingly, the U.S. and China are not the only ones feeling the impact of trade conflict; the European Union (EU) relies heavily on trade for economic growth, with exports comprising about 40% of the economic union's GDP. Within the EU, Germany—the largest economy and exporter of the union—has the most to lose due to the U.S.-China dispute. Decreased U.S. demand for German goods as a result of trade conflict and potential devaluation of the Chinese yuan could severely impact Germany's economy. South Korean and Japanese exports also have been negatively affected.

On the other hand, countries like Vietnam are benefiting from the conflict. Global supply chains continue to be disrupted, as U.S. companies seek relatively cheaper production in Vietnam over more expensive Chinese goods. Year-over-year, there already has been a 40% increase in U.S. imports from Vietnam.[4] Additionally, an International Monetary Fund (IMF) report released in July emphasized the ripple effect from the U.S.-China trade conflict, projecting lower global economic growth for 2019. According to the report, “risks to the forecast are mainly to the downside. They include further trade and technology tensions that dent sentiment and slow investment.”[5]

TECHNOLOGY WAR

Although major headlines mainly focus on the trade tensions, a separate “tech war” continues to rage quietly in the background. In an environment where data is becoming the new oil—an economically critical “commodity”—global superpowers remain engaged in a race to become the leader in artificial intelligence. With its intense focus on continuous innovation, the U.S. remains a leader in this space. However, the race continues, and others are quickly catching up. The U.S. has alleged China is engaged in intellectual property theft, claiming Chinese companies have stolen billions of dollars’ worth of intellectual property from the U.S. in recent years.

Tech-related tensions became more public in December 2018 when the Chief Financial Officer (CFO) of Huawei (pronounced “wah-way”), a Chinese technology giant, was arrested in Canada at the request of the U.S. government. U.S. authorities have since accused its CFO, Meng Wanzhou, and the company of violating sanctions on Iran. Huawei also has been accused of bank fraud for allegedly misleading financial institutions. The company also is being investigated for allegedly attempting to steal intellectual property from T-Mobile in the U.S. Huawei has denied any wrongdoing and their attorneys have called the case against Meng and the company “politically motivated.”

Earlier this year, Huawei was blacklisted by the U.S. government as a “national security risk,” which implies U.S. companies can no longer sell Huawei’s products and components without government approval. Recently, the U.S. Commerce Department extended the ban on doing business with Huawei for an additional 90 days to give smaller U.S. technology companies more time to transition away from reliance on Huawei’s products. While many allegations have been made by both sides, a resolution to this conflict remains elusive in the absence of clear facts. Germany and the UK also are encouraging global economies to reduce their relationships with Huawei, as companies and governments worldwide see large Chinese tech companies as security threats. Although Huawei is currently the most high-profile example of the brewing tech war, FEG anticipates there will be ongoing global tensions with China regarding the use and protection of intellectual property.

PROTESTS IN HONG KONG

Source: John YE / Shutterstock.com

In April, Hong Kong's government proposed plans to change legislation and allow Hong Kong citizens suspected of criminal activities to potentially be extradited to China. Essentially, those suspected of criminal activities in Hong Kong could be handed over to the Chinese government, which is not known for having a particularly favorable human rights record. Widespread protests began in June through a largely peaceful march, and nearly a million people participated. The second round of protests turned ugly as Hong Kong police fired tear gas and rubber bullets at protestors.

Following the second protests, Hong Kong leader Carrie Lam expressed "deep sorrow" at the controversy associated with the extradition bill and stated she would indefinitely delay its implementation. However, this did not appease protestors' concerns that the bill could be brought back. The following day it is estimated nearly two million people—in a region of seven million residents—protested, calling for a complete withdrawal of the bill, as well as Lam's resignation.[6]

Since then, protestors blockaded police headquarters; stormed the Legislative Council (LegCo) building; and marched through Kowloon, a popular tourist area, to voice their concern. Protests continued in an effort to pressure the government to withdraw the bill, with some civil servants joining the cause.

Protests are no longer focused simply on the withdrawal of the extradition bill, but on freedom and the extent of China's control over Hong Kong. Citizens of Hong Kong see China as eroding Hong Kong's autonomy. They also have expressed anger regarding law enforcement in Hong Kong turning what was intended to be peaceful demonstrations into violent clashes.

Until August 6, China was not actively involved in the conversations between Hong Kong leaders and citizens; however, in early August, China issued its strongest warning to date, telling protestors "not to play with fire" and not to "mistake restraint for weakness."

Protestors were undeterred, shutting down Hong Kong's airports in subsequent protests. Recently, China added military troops to the Hong Kong garrison, claiming the change was just a troop "rotation." However, the Hong Kong government has permission to use the troops to maintain public order.

Lam announced she would be open to using emergency powers if the violent protests continued, which would effectively give her the ability to pass new laws without legislative approval. Additionally, Hong Kong arrested several pro-democracy activists, some of whom earlier took part in the "umbrella protests" in September 2014.

Following months of protests, Lam ultimately withdrew the extradition bill on September 4. While it is likely these events—including the shutdown of the Hong Kong airport and its subsequent impact on tourism—will have economic and political implications, the degree of that impact, and the extent of further protests, remains unknown.

CHINA'S DEMOGRAPHIC CHALLENGE

China's geopolitical issues previously discussed are additional factors for an already demographically challenged region. China's famous "one-child policy," which successfully slowed the growth of the Chinese population, may be leading to a contraction of the country's population in the long term. China switched to a "two-child policy" in 2016 in an attempt to boost its slowing population growth amid concerns on maintaining an adequate workforce to support continued economic growth. In spite of governmental efforts, birth rates continued to fall in 2017, with some provinces in China reporting declines of local birth rates near 35%.[7] Continued low birth rates could ultimately result in an aging population requiring greater support and fewer workers to provide that support.

A recent article posted by the *Harvard Business Review* asserts that a slowdown in China is inevitable, highlighting parallels between China's current demographic issues with those of Japan years ago.[8] For example, China's productivity growth rate is decelerating, migration from rural to urban areas has decreased, and a wave of immigration to support the demographic picture is unlikely, given China is not known to be a particularly immigrant-friendly country.

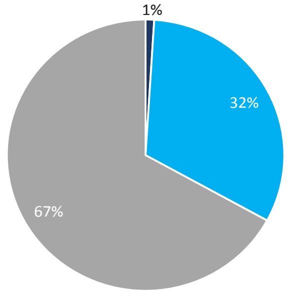
INVESTMENT IMPLICATIONS

U.S. equity markets continue to move almost daily on news of potential exacerbation or settlement of the trade tensions between the two largest economies in the world. The resultant flight-to-quality, evidenced by gold's steep climb and long-term U.S. Treasury yields touching fresh lows, echoes the uncertainty associated with trade conflicts. In his latest speech at the annual Jackson Hole Economic Policy Symposium, Federal Reserve Chair Jerome Powell noted the global outlook was deteriorating and voiced the Fed's limited ability to counteract the impacts of trade tensions through monetary policy. In spite of this, equity markets in the U.S. have been volatile yet resilient in the face of ongoing tensions.

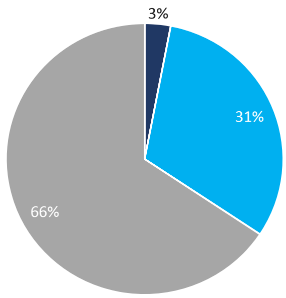
CHINA'S POTENTIAL IMPACT
MSCI EM INDEX

- China A Shares
- China Off Shore
- Non-China

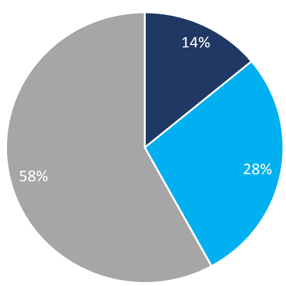
Current 5%
A-Share Inclusion



Proposed 20%
A-Share Inclusion



100%
A-Share Inclusion



Data source: MSCI.

The current geopolitical tensions surrounding China are especially important to consider as China becomes a larger part of global markets through the inclusion of A-shares in global indices. A-shares–or domestic shares–are equity shares traded in mainland China on one of the two Chinese stock exchanges (Shenzen and Shanghai).

In 2018, MSCI added China's mainland equity market to the MSCI Emerging Market Index (MSCI EM), which is expected to increase access to and investment in domestic Chinese markets and further strengthen the nation's relevance in the global equity markets. Historically, A-shares were hard to access for investors outside of mainland China, as a result of restrictions on foreign investments.

Over the long term, investors may find asset managers adding Chinese exposure to portfolios and potentially making more dedicated total China and A-share specific funds available to investors. The liquid market contains thousands of stocks and a market capitalization greater than many developed markets, but full integration will take several years. However, the opening of China's A-share market and inclusion in indices cannot be ignored due to the country's existing and ever-growing global importance. The broader macroeconomic issues could thus present an opportunity for active management—in this already inefficient market—to seek more attractive returns.

CONCLUSION

Many unknowns remain in China in terms of ongoing trade tensions, with additional tariffs implemented recently and more expected in coming months, and what appears to be a longer-term technology war. Unlike the U.S., which has general elections next year, China does not have any sense of political urgency and thus can maintain a patient approach.

Given the numerous opportunities becoming more accessible and the continued complexities surrounding China and the demographic headwind to growth, FEG believes investors are best served by maintaining a long-term perspective and balancing the risk and reward opportunities when selecting investment strategies targeting China. Additionally, we hope you can join us at our FEG 2019 Investment Forum September 23–25, as we help you separate signals from noise. FEG's Brian Hooper will be moderating a panel featuring Bo Meunier and Jason Hsu, from Wellington and Rayliant, respectively, who will provide different views on the opportunities and risks in China, as well as how to access Chinese markets.

Footnotes
[1] Office of the United States Trade Representative (USTR)
[2] Wall Street Journal
[3] BBC
[4] Atlantic Council
[5] International Monetary Fund https://www.imf.org/en/Publications/WEO/Issues/2019/07/18/WEOupdateJuly2019
[6] BBC
[7] New York Times
[8] https://hbr.org/2019/09/can-china-avoid-a-growth-crisis

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