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Understanding China: an economic and investment perspective, part III

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In our series "Understanding China," we have laid out the structures of China's political economy (Part I) and capital markets (Part II). This third installment in our China series will lay out how investors may want to consider their portfolio exposure to China, and how these allocations may be impacted by China's political and economic transitions.

Rising US-China trade tensions, recent military drills around Taiwan, and Xi's total control of the Chinese Communist Party (CCP) have some investors reconsidering their allocation to Chinese assets. This paper examines current political, policy, economic, and geopolitical headwinds that China is facing. The trade-offs between economic gains and policy risks are changing – former market-friendly pragmatism and openness is waning, while party ideology and nationalism are growing. These trends have been spearheaded by President Xi Jinping, who now dominates China's Communist Party, and hence, China. Not since Mao has China's party ethos and political & economic future been so dominated by a single person.

Portfolio exposure to China

Most institutional investors have their largest exposure to China in their equity allocation. Even though China is the second largest economy in the world, and the second most populous behind India, China is still a small country weight in global equity benchmarks,[1] and dedicated China equity allocations are still more of an exception than the norm in institutional portfolios. In 2021, China comprised approximately 40% of the MSCI Emerging Market (EM) equity index, roughly doubling since 2014. However, the 2022 bear market has taken its toll, and China's share of the index has fallen to around 31%.[2]

Many investors also have direct exposure to China through other asset classes, primarily emerging market debt, private equity, and hedge funds. Based on benchmark country weights and publicly available data, we estimate that a typical large US public plan's total exposure to China is approximately 3-5% of their total portfolio.[3] The most common reason for an allocation at the high end of or above this range is if an investor has an overweight position to emerging market equities.

[1] Source: MSCI ACWI index fact sheet as of September 2022. China is 3.5% of the MSCI ACWI index after the US (62%), Japan (5.4%) and the UK (3.7%).

[2] Source: MSCI as of September 2022.

[3] Source: Meketa calculations assuming market capitalization weighted regional exposures in the broad equity allocation. Individual portfolio weights may differ. Calculations are based on allocation data from 2021 Annual Comprehensive Financial Reports for large public pension funds.

9/30/2022	All Cap World Index	All Cap World ex-US	Developed Markets ex-US	Emerging Markets	Emerging Markets ex-China
Top 3 Countries	US (60.6%), Japan (5.5%), UK (3.7%)	Japan (14.1%), UK (9.7%), China (9.2%)	Japan (22.6%), UK (15.4%), France (11.3%)	China (31.5%), India (15.3%), Taiwan (13.8%)	India (22.3%), Taiwan (20.1%), S. Korea (15.5%)
Top 3 Countries Weight	70%	33%	49%	61%	58%
Top 3 Sectors	IT (20.9%), Financials (14.8%), Health Care (13.2%)	Financials (20.7%), Industrials (12.1%), Consumer Disc. (11.4%)	Financials (17.6%), Industrials (15.0%), Health Care (13.5%)	Financials (22.6%), IT (18.3%), Consumer Disc. (14%)	Financials (25.8), IT (24.2%), Materials (11.1%)
Top 3 Sectors Weight	49%	44%	46%	55%	61%
Market Capitalization (USD)	$54.6T	$19.6T	$12.2T	$5.7T	$3.9T

FIGURE 1
Exposure for Major MSCI Indices as of September 30, 2022

Sources: MSCI as September 2022 and Meketa Investment Group.

But market capitalization weights for Chinese equities are only one variable to consider. China is a major source of global corporate revenues and profits. When looking at global equity exposures to revenues derived from China, investors' exposure to China may be even more significant. China accounts for over 50% of the MSCI emerging market index's revenue and about 29% of the MSCI ACWI ex-US index's revenues. Even when Chinese equities are excluded from the MSCI emerging market index, China still accounts for 37% of emerging market corporate revenues.

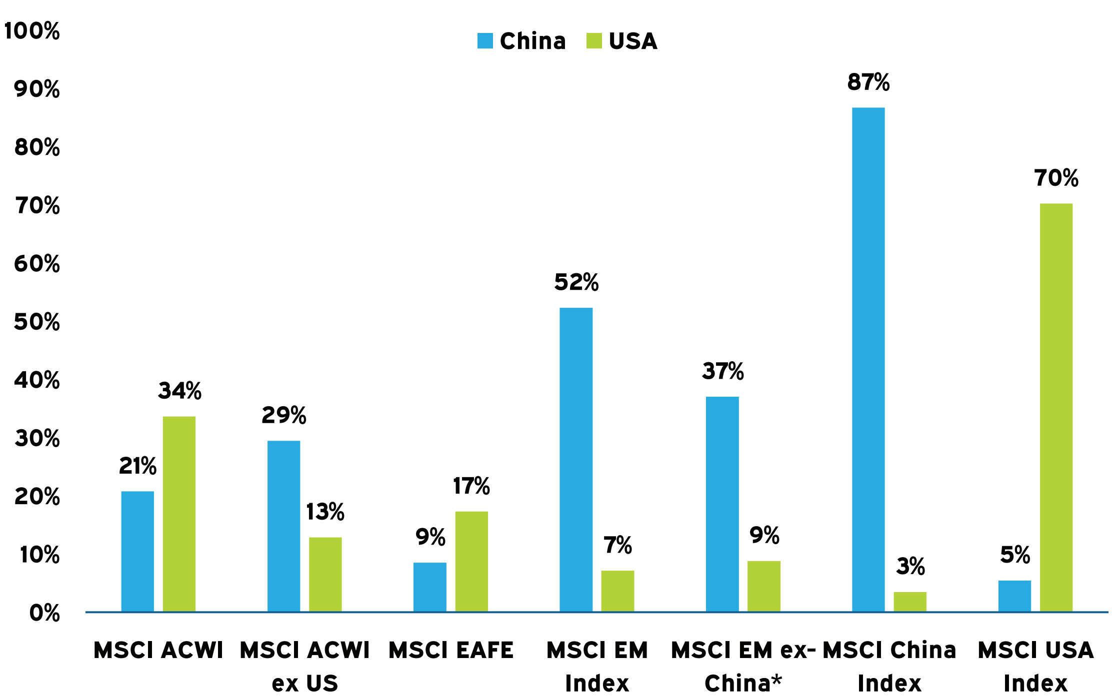

FIGURE 2
US & China Revenues by Regional Benchmark

Source: MSCI data as of October 2022. MSCI Emerging Markets ex-China revenue calculated by Meketa is based on MSCI EM and MSCI China data.

Another way to consider exposure to China is through its role in global supply chains. The lockdowns and supply-chain failures during the COVID pandemic highlighted the global dependency on China for consumer goods. China accounts for 30% of the value-added manufacturing of the world. Computers, semiconductors, communications technologies, home appliances, auto parts, solar panels and wind turbines, medical supplies, and pharmaceuticals all have links to Chinese manufacturing.

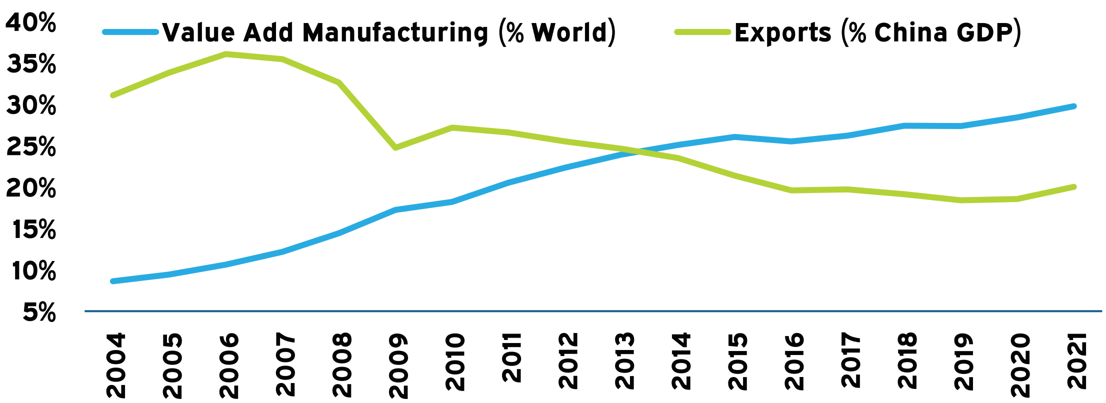

FIGURE 3
China Value-Add Manufacturing & Exports

Source: World Bank data as of October 2022.

Still, while China is very integrated in certain sectors of the global economy, there are many more where it is not. The linkage is significantly higher for goods than services. Further, reliance on China in many supply chains has been diminishing, partly as a result of COVID. However, this will take years, and just because manufacturers are diversifying their supply chain, it does not mean they are abandoning China altogether.

Framing China risks | pro-market pragmatism v party-first nationalism

The 20th Party Congress marked a major political milestone for the CCP and President Xi. But event risk is common in emerging markets, and China is not the first emerging market country to undergo a major political transition. And China's markets could, over time, prove to be resilient through the recent rise in nationalism and enthusiasm for party doctrine.

An optimistic view would see the current tensions between China and the west as transitory and focus instead on the economic potential of further investing in China. On balance, the sheer market value attached to global supply chains, investments, and economic interdependencies between China and the rest of the world are too important to jeopardize the progress made over the past thirty years.

On the other hand, the third term of President Xi and his vision for "fortress China" may mark the end of market-friendly socialism (that more closely resembled capitalism) and a return to ideological orthodoxy. This could have both short-term and long-term repercussions. Furthermore, the sheer size of China in the EM index and the global economy means that any event-risk involving China would likely dwarf the impact of previous events that entailed much smaller markets and economies.

Investors now find themselves at a crossroads where they must weigh the potential benefits of continued investing in China against the rising risks. This decision can be framed in the context of policies and behaviors that are likely to be market-friendly (e.g., pragmatism) versus those that are not (e.g., nationalism, ideology & ego).

CCP pragmatism, globalization & foreign investors

China's relationship with the west began to thaw near the end of Mao's life, and particularly under the premiership of Zhou Enlai. In the 1980s, Deng Xiaoping prioritized economic growth through market-based reforms while de-emphasizing the Marxist ideological underpinnings of the CCP. Deng's policies came to be described as "Socialism with Chinese Characteristics," a bridge from Mao's strict communism to a new economic model by "crossing the river by feeling the stones."[4] Subsequent leaders followed this path, and by 2001, China had made sufficient progress on market-based reforms to join the World Trade Organization (WTO). CCP policy still included planning goals and work plans, but it allowed for a practical approach of trial and error.[5] Over thirty years of progress toward establishing market-based reforms, investors came to align with the CCP process of trial programs and regional small scale rollouts of policy reforms.[6]

Among these reforms were the CCP's efforts to reform and restructure the State-Owned Enterprises (SOEs) that dominated almost every aspect of China's economy. The CCP kept control of strategic, large SOEs, but it allowed small SOEs to privatize, a process described as "Grasp the large, let go of the small".[7] The privatization and, in some cases, listing of former SOEs opened the economy to shareholder capitalism and allowed for domestic entrepreneurship. In the early 2000s, large SOEs dominated the economy in terms of revenue, but by 2020, the private sector accounted for nearly 50% of the top 100 largest listed companies in the A-share markets.[8] Stocks traded on mainland Chinese exchanges account for a total market capitalization of approximately $10.6 trillion dollars.[9] While this is far lower than the combined NYSE and Nasdaq market cap of $38.5 trillion in the US, it trails only the US in total market capitalization[10]. The China A shares market has existed since the 1990s, but China has only taken significant action to liberalize the A-shares market over the past decade.[11]

President Xi's 3rd term & China's communist party rejuvenation

President Xi first stepped into power as a reformer. Xi's corruption-busting activities were popular among many in the rank and file, as well as the people. Xi argued that the blind pursuit of money and economic growth had corrupted the CCP. Xi's anti-corruption campaign focused on high profile individuals, which had the effect of chilling some of the worst corruption in the party, but also helping to eliminate political rivals. A decade ago, Xi's passion for the CCP and for restoring China to greatness was thought to be political theater or rhetorical enthusiasm. But now, Xi is perceived as a true believer in these causes.

[4] Source: https://www.asianstudies.org/publications/eaa/archives/crossing-the-river-by-feeling-the-stones-deng-xiaoping-in-the-making-of-modern-china/

[5] World Bank as of December 2020. Illustration replicated from Yuen Yuen Ang, "CCP Decision Making and the 20th Party Congress," Testimony Before the US-China Economic and Security Review Committee, January 27, 2022.

[6] Source: Illustration replicated from Yuen Yuen Ang, "CCP Decision Making and the 20th Party Congress," Testimony Before the US-China Economic and Security Review Committee, January 27, 2022.

[7] Source: T. Huang and N. Véron, "The Private Sector Advances in China: The Evolving Ownership Structures of the Largest Companies in the Xi Jinping Era," Peterson Institute for International Economics working paper 22-3, March 2022.

[8] Source: Ibid.

[9] Source: CEIC as of September 2022.

[10] Source: FRED, Wilshire 5000 total US market capitalization as of September 2022.

[11] For example, a key development was the introduction in 2014 of Stock Connect, an access program between the Shanghai/Shenzhen and Hong Kong exchanges. See Meketa's "Understanding China: Part II" research paper.

Xi has consolidated power in a way that means he is going to be the final decision maker on all major policy issues. Like Mao and Deng before him, Xi's political ideology is being taught in all educational institutions. The new seven-person Standing Committee of the Politburo has been purged of party technocrats, closet capitalists, and political moderates, and filled instead with Xi loyalists. The public removal of former President Hu from the final day of meetings marked a very public signal that Xi is in complete power within the CCP and that the days of collaborative power sharing among party cliques has ended.[12] This is the first time since Mao's regime that the CCP has been so dominated by a single personality.[13]

President Xi is focused on restoring discipline within the CCP.[14] Party discipline is entirely founded on reinforcing loyalty to the party leadership and compliance with Marxist ideology. XI's political dominance depends on party discipline and adherence to his vision for fortress China. President Xi's vision does *not* include more market-based reforms or expansion of private enterprise. Rather, Xi's vision includes an expanded role for the CCP in strategic economic sectors. The Made in China 2025 initiative has set ambitious goals for next generation technology development in artificial intelligence, biotech, renewable energy, and semiconductor self-sufficiency.

Xi and the CCP want to achieve first world economic wealth by 2035, which would equate to 5% GDP growth per annum.[15] Xi wants high quality development in new technologies, accompanied by reduced dependency on real estate and infrastructure investment to deliver this economic growth. At the same time, Xi seeks to reduce income inequality through his "Common prosperity" initiative. There are increasing concerns that China may not be able to achieve such a high rate of growth, especially given its policies and actions in recent years (see Figure 4) that could stymie future growth. During the CCP Congress, the government delayed the GDP release until after the meeting concluded. Officially, China's economy grew at 3.9%, below its target of 5.5%, but some believe that the actual rate of growth could be even lower.[16] When President Xi took office in 2012, China's official GDP growth was 7.8%. Since Xi's ascendancy China's growth rate has slowed considerably even as its total debt to GDP rose from around 140% in 2008 to 292% in 2022.[17] Lower rates of economic growth will put pressure on the CCP's and Xi's legitimacy over time if plans for restructuring the economy go awry.[18]

The CCP's continued use of state-controlled ventures to implement and control economic policy is testament to their intention to keep free market capitalism on a very short leash. The CCP has tolerated the enriching engines of private property, limited shareholder capitalism, foreign investment, and trade, so long as they brought continued economic growth. But these western economic values have not infiltrated official CCP doctrine. The CCP wants to remain in power in perpetuity and does not plan to retreat from economic and financial control.[19] The party sees itself as the key agent for China to "reclaim" its place as a geopolitical and economic super-power[20].

Since the 1980s, the CCP has based its political legitimacy in China primarily on raising income, improving living standards, and economic growth. However, if economic growth continues to slow, President Xi and the CCP will need to find new ways to maintain legitimacy, control, and authority. Nationalism, autocracy, and wealth redistribution through common prosperity are emerging as galvanizing political ideals.[21]

[12] Source: Foreign Policy webinar, "Deciphering China's 20th Party Congress," October 24, 2022.

[13] Source: Ibid.

[14] Source: TS Lombard October 2022.

[15] Source: TS Lombard and Financial Times, October 2022. A range of professional economist estimates now question the ability of China to escape the middle-income trap and achieve sufficient per capita income gains to rival advanced economies by 2035. As of October 2022, the World Bank estimates that the United States has a per capita income around $66,000 a year while China's is nearly $11,000 a year. The current World Bank Gross National Income per capita threshold for a high-income country is $13,205 a year. https://datahelpdesk.worldbank.org/knowledgebase/articles/378834-how-does-the-world-bank-classify-countries.

[16] Source: Luis R. Martinez, https://bfi.uchicago.edu/insight/finding/how-much-should-we-trust-the-dictators-gdp-growth-estimates/. Based on nocturnal light emissions, Martinez finds that autocracies overstate their GDPs largely through overstating government spending and investment.

[17] Source: Bank for International Settlements as of October 2022. Note China's sovereign debt is far lower due to heavy borrowing at the provincial and SPVs for local and provincial governments.

[18] Source: TS Lombard, Xi to Build Fortress China, October 2022.

[19] For Xi in particular, this seems to be focused on reasserting the CCPs power and the revitalization of the Leninist party-state.

[20] This includes both soft power and hard power (in military terms).

[21] Source: Foreign Policy webinar, "Deciphering China's 20th Party Congress," October 24, 2022.

Initiated by CCP	Initiated by US/other
CCP intervention in private tutoring companies and gaming companies	OFAC prohibits ownership of Chinese companies with People's Liberation Army (PLA) ownership/interest
Didi IPO failure	Chinese companies removed from MSCI indices
Interference in IPO pricing on Chinese exchanges and listing of ADRs in the US	SEC audits Chinese ADR delisting/relisting in Hong Kong
Asking for forced donations from companies for social programs	OFAC limits sale of advanced semiconductors to China
Foreign investors shut out of bankruptcy and restructuring proceedings related to Evergrande	OFAC sanctions China over human rights abuses in Xinjiang on solar panels and wind turbines from region
Zero-COVID policies restricting international travel, ex-pats leave China, and supply chain issues	CHIPS Act limits sale of advanced US technologies to China
Extended military exercises around Taiwan	National Security Plan – China containment
Xi's expressed friendship without limits with Putin	

FIGURE 4
Recent Events

Source: Meketa Investment Group.

Note: The Office of Foreign Asset Control (OFAC) is part of the US Treasury Department.

US nationalism & containment of China

When considering China investment exposure, US foreign policy toward China warrants consideration. Over the past decade, the relationship between China and the US has grown strained. China benefitted from cooperative US behavior and a broad globalization trend. Many politicians in the west believed that trading with China would open it up to western ideas and make it more likely to adopt similar ideals. But as expectations for China to embrace these beliefs have faded, US diplomatic, trade, and military pragmatism has given way to increasing focus on limiting or blocking China's economic rise.

China has achieved economic and military prominence on the global stage, and its ambitions are no longer easily checked by the US. The US is increasingly acting in a way it deems to be protecting its national interests but may be perceived as hostile by China. Trump's trade war turned into Biden's extended tariffs. Repeated accusations of IP theft, unfair trade practices, censorship, religious persecution, and human rights abuses have complicated US-China relations. China's plans to acquire advanced technologies and dominate renewable energy manufacturing capacity has prompted retaliatory policies from the US government. The US government has been more and more interested in containing China's acquisition of cutting-edge technologies, protecting US intellectual property rights, and defending US businesses from Chinese anti-competitive trade behaviors. If this trend continues, the US government could make investment in China difficult, painful, or even illegal. And the odds for armed conflict appear to be growing more likely, perhaps even (worryingly) inevitable.[22]

[22] The "Thucydides Trap" refers to an apparent tendency towards war when an emerging power threatens to displace an existing great power as a regional or international hegemon and can be used to describe the current relationship between China and the US.

China's headwinds: internal & external

China's rise in recent decades benefited from an external set of tailwinds that offered support for rapid economic growth. The fall of the Soviet Union and the rise of the WTO coincided with increasing trade openness around the globe. Free flow of capital and multilateralism from the IMF and the World Bank supported the development of emerging countries like China. But these external tailwinds have largely run their course. The rate of globalization has stalled since the Global Financial Crisis, the world's population is aging rapidly, and governments are increasingly skeptical of multilateralism, favoring domestic issues over international cooperation.

China is facing its own set of external headwinds which may pose a challenge for President Xi's ambitions. External demand for Chinese exports has been slowing. According to the IMF, advanced economies are facing slow growth and high inflation, or even recession, in 2023.[23] The Chinese government has been allowing the yuan to depreciate against other currencies to support export competitiveness. But if the yuan weakens too much, the CCP risks importing inflation, as China remains a major importer of food and energy.

Until recently, China's Belt & Road Initiative (BRI) was a flagship for Chinese expansion in Asia, Africa, and the Middle East. However, slow economic growth, high food and energy prices, and a strong US dollar have forced BRI beneficiaries to renegotiate their debts to China. Nearly 60% of the countries that received BRI loans are now in serious financial difficulties,[24] and the CCP has recently tried to re-orient Xi's ambitious programs.[25] Independent research finds that at least fifty percent of the one trillion dollars of BRI loans are not reported to the World Bank or the IMF.[26]

President Xi and President Putin have repeatedly declared their friendship. But Russia's invasion of Ukraine in 2022 has reinvigorated NATO and western alliances, putting China and the CCP in a difficult position. China has been careful to observe formal neutrality while purchasing Russia natural gas and oil. But the timing of the economic fallout of the war could not have been more inconvenient for China.

The CCP continues to advance its autarkic goals of "dual circulation" whereby China intends to reduce its dependency on imports from other countries while upgrading China's exports.[27] The doctrine of dual circulation fosters domestic demand and self-sufficiency in technology, food, energy, and consumer goods. China has been seeking to reduce dependency on the US and Europe for trade, and thus to reduce exposure to political influence. Mixed into the promotion of economic restructuring is a growing nationalism which appears to have abandoned the former ethos of the peaceful rise of China. The US National Security Plan, the CHIPS Act, and on-going containment of Chinese military companies are substantial headwinds to China's plans to reduce dependency on foreign technology.

At the 20th Party Congress, most of the CCP attendees wore surgical masks in alignment with President Xi's Zero-COVID policies. The architect of the Shanghai COVID-19 lockdowns, Li Qiang, has been tapped to become the next premier of China, despite his unpopularity with the people. The persistence of rolling lockdowns in

[23] Source: International Monetary Fund, World Economic Outlook, October 2022.

[24] Source: Wall Street Journal, "China's Lending Strategy in Emerging Markets Risks Prolonging Borrowers' Pain," September 8, 2022.

[25] Source: https://www.wsj.com/articles/china-belt-road-debt-11663961638. Some experts believe that the majority of the BRI loans made since 2015 have been renegotiated with borrowers. President Xi expanded State-Owned Enterprise foreign expansion funding through Chinese banks in early 2012 to support higher rates of return for state-owned companies. The BRI program officially expanded in 2015. Some research indicates that China's BRI lending may exceed the total of all Paris Debt Club and IMF loans combined making China the largest single international creditor.

[26] Source: C. Reinhart, et al. "China's Overseas Lending," NBER working paper 2019. https://www.nber.org/system/files/working_papers/w26050/w26050.pdf

[27] The CCP has even added the policy to the Party's constitution. Source: Atlantic Council October 2002, H. Tran, "Dual circulation in China: A progress report." China's exports peaked in 2006 as a share of GDP and now about 34% of GDP in 2020. Both the IMF and the World Bank have recommended that China restructure its economy away from fixed asset investment and exports to domestic demand.

China has been one reason for weak consumer demand in 2022. Rolling lockdowns may be discontinued but a full re-opening of China's economy could be delayed due to an absence of an effective COVID-19 vaccine. Negotiations between the CCP and western pharmaceutical companies stalled when the companies declined to share their mRNA technology with Chinese pharmaceutical companies.[28]

[28] Source: Financial Times, "Moderna refused China request to reveal vaccine technology," October 1, 2022.

Common prosperity & wealth redistribution

Because President Xi has become so powerful, his ideology has become party doctrine. Xi's speeches and thoughts have been elevated into the CCP cannon. In 2018, a book was published entitled "Xi Jinping's Thought for a New Era of Socialism with Chinese Characteristics" and formally incorporated into China's Constitution. Xi's thoughts are now taught in all levels of public schooling, alongside the political cannons of Mao and Deng Xiaoping.

Key among Xi's principles is a belief in a redistributive state. In Xi's two-hour speech, the Political Report to the party, he reiterated the Party's commitment to high quality economic growth and common prosperity. "There are still many tough points to blocking reform in key areas; there are many challenges in the ideological field, and the gap between urban and rural development and income distribution is still large. The masses face many problems in employment, education, medical care, childcare, elderly care, housing, and other aspects."[29]

[29] Source: TS Lombard, Xi Build Fortress China. Direct quote from President Xi's speech given to the CCP at the 20th Party Congress.

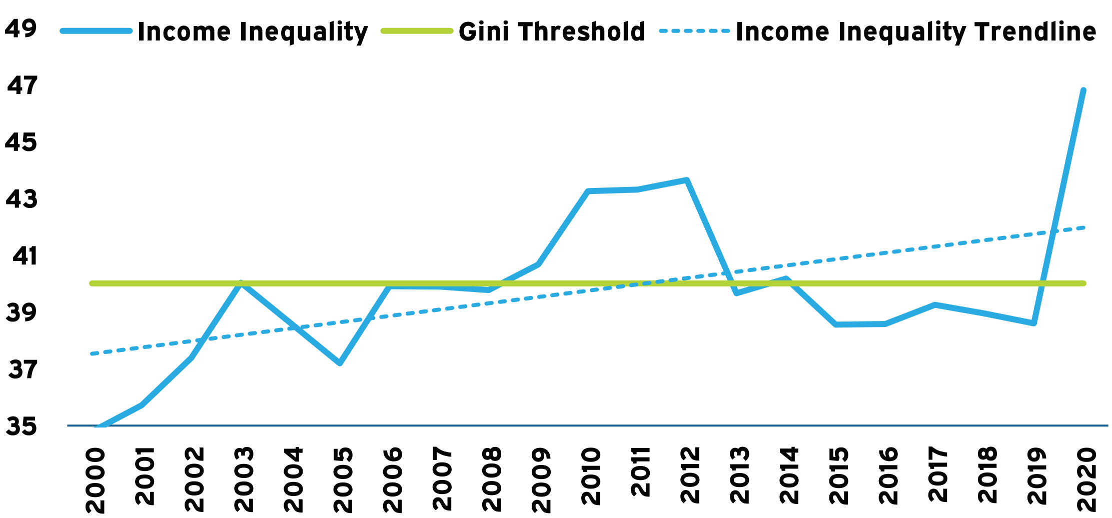

FIGURE 5
China Income Inequality

Source: Data UNU-WIDER Income Inequality Data as of August 2022. Measurement of income inequality may vary by country and methodology. Some years have multiple estimates; chart uses first estimate of the year.

In 2021, the World Bank estimated that China's income inequality was considerably higher than most European countries but only slightly less than that of the US.[30] Recent analysis from the IMF indicates that coastal urban populations have a much higher income than their rural counterparts. Despite over a decade of economic policies to boost wages and expand access to urban jobs and social services, China's own official metrics of income inequality have remained stubbornly high. The wealthiest twenty percent of China's population commands over forty-five percent of the nation's income, while the bottom quintile of earners account for less than ten percent of the nation's income.[31]

[30] Source: World Bank Gini Index. As of December 2021, China's self-reported Gini coefficient was 38.5, while France, German and the United Kingdom had Gini coefficient scores below 32, and the US's score was 41.

[31] Source: China National Bureau for Statistics as of August 2022. Other (academic and policy) estimates of China's income inequality are higher than the NBS' official metrics. Differences in methodology may account for the divergent estimates.

President Xi offers few concrete solutions to income inequality in his Common Prosperity writings and speeches. China watchers point to potential themes like income and property taxes, social safety nets, and other redistribution solutions. Many China experts argue that national redistribution and taxation schemes will take several years to develop and implement.[32] Instead of formal taxation schemes, large companies have been asked to make generous donations to charity.[33] For example, Alibaba and Tencent donated approximately $15 billion to social innovation programs in 2021.[34]

In 2021, the CCP launched a trial common prosperity program in the province of Zhejiang, which is the home of Alibaba's headquarters. The plan is focused on integrating rural and urban economic opportunities and social services by expanding the social safety net, providing low-cost housing, and providing financing for small and medium size enterprises.[35] The pilot program document includes specific mandatory income ranges, taxation, and redistribution through social programs.[36] If it proves successful, the pilot program is intended to serve as a template to be rolled out to the rest of the country over time.

China's rapid-aging challenge

China is aging rapidly, even as its attempts to promote larger families have failed to materialize. In 2016, China officially ended the mandatory one child policy, but there is little evidence that family size is increasing. In 2021, the CCP announced that the government would allow three children per family.[38] Meanwhile, there remains a significant gender gap in China with nearly 35 million more men than women.[39] When low fertility rates are added to the challenge of longer-lived retirees, China is looking more like Japan and Europe than a youthful emerging market economy. By 2025 China will have more people over the age of 65 than under the age of 24. The rapidly rising dependency ratio may improve wages for workers, but it will reduce China's competitiveness in export prices and likely act as a drag on economic growth.

Deflating the real estate bubble

Approximately two-thirds of Chinese household wealth is in real estate, and household debt is now at comparable levels to other advanced economies.[40] After years of ever-increasing home prices, the cycle of debt-fueled growth appears to have peaked. The high-profile bankruptcy of property developer Evergrande in 2021 has broken the long-held assumption that the CCP would bailout the highly leveraged real estate sector.

In China, it has been a customary business practice for real estate developers to engage in pre-sales[41] of properties to finance their construction. However, over the past five years, developers have been selling unbuilt properties much more quickly than they have been able to finish them (see Figure 6). Moreover, property developers issued ever larger amounts of debt to continue to acquire land and to fund the development of these properties. In 2017 and 2018, developers issued over $80 billion in offshore debt.[42] There remain questions regarding the true level of debt for some real estate developers, but it appears that developers face a combined bill of debts due totaling approximately $292 billion dollars in formal on-shore and off-shore markets in 2022 and 2023.[43]

[32] Source: Bloomberg News September 2, 2021 "Alibaba $15.5 billion for Common Prosperity Drive."

[33] Source: Michael Schuman, "China's Big New Idea," The Atlantic, December 14, 2021. It is worth noting that similar national donation schemes have been encouraged in Brazil, India, and Russia.

[34] Source: World Economic Forum and Bloomberg. https://www.weforum.org/agenda/2021/12/how-can-china-s-philanthropic-sector-advance-common-prosperity/

[35] Sources: Caixin and Bloomberg as of August 2022.

[36] Source: CSIS Implementation Plan for the Zhejiang High-Quality Development and Establishment of a Demonstration Zone for Common Prosperity (2021-2025).

[37] Source: https://www.brookings.edu/articles/the-end-of-chinas-one-child-policy/

[38] Source: https://www.bbc.com/news/world-asia-china-57303592

[39] Source: Ibid.

[40] Source: CEIC as of October 2022. China's household debt is 62.3% of nominal GDP compared to the EU's level of 51.1% and the United States 61.1%.

[41] Pre-sale means to sell a property before development has been completed (or even started), with the intention of the owner taking possession once development has been completed.

[42] Source: https://www.spglobal.com/en/research-insights/articles/for-china-s-developers-a-borrowing-boom-is-also-borrowed-time

[43] Source: Bloomberg as of October 31, 2022. https://www.bloomberg.com/news/articles/2022-10-31/china-builders-have-292-billion-of-debt-coming-due-through-2023?leadSource=uverify%20wall

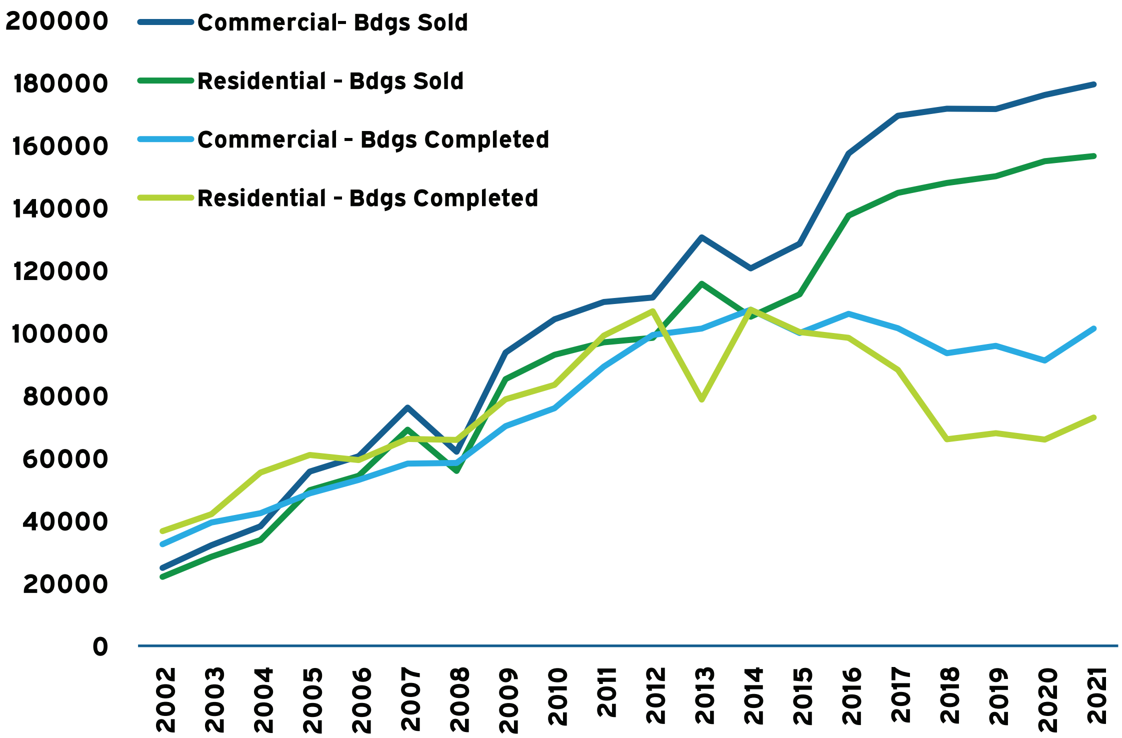

FIGURE 6

Residential and Commercial Real Estate Sold and Completed (10K Sq. Meters)

Source: FactSet as of August 2022.

In 2019, Beijing took steps to curtail excessive leverage on real estate developers' balance sheets and promulgated the "Three Red Lines" that established solvency minimums. A little more than a year later, rumors began that some large developers could not meet the new regulatory minimums.[44] The massive developer Evergrande, forbidden from raising more debt by the three-red lines rules, struggled to make debt service payments, and eventually its shares were suspended from trading in Hong Kong. Saddled with over $300 billion of debt, the company eventually defaulted on one of its payments in December 2021.[45]

One of Xi Jinping's most famous quotes came in 2017, when he stated, "houses are meant to be inhabited, not for speculation."[46] At the 2022 Party convention, Xi reiterated his economic vision that China's growth would no longer rely on real estate speculation. Perhaps unsurprisingly, Beijing has been reluctant to step in and bail out the property developers. Instead, Beijing has issued incremental policies through local governments, state-owned enterprises, and policy banks that focus on completing pre-sold properties rather than bailing out the developers.

As a result, China's highly leveraged real estate sector is undergoing a slow-motion crash that is impacting bank balance sheets, municipal government revenues, and consumer sentiment. Banks are suffering as developers are unable to service their debts. The purchase of land for development had been an important source of local government revenues, and that has dried up. And many consumers have refused to pay mortgages on unfinished properties that they do not believe will be completed.

[44] Source: Financial Times October 8, 2021. " Half of Beijing's Top Developers Crossed Three Red Lines," https://www.ft.com/content/d5803d64-5cc5-46f0-bed0-1bc207440f9c. The three red lines rules issued in 2020 curtailed real estate developers' ability to issue new debts based on cash flows and ability to service current debts. Rules established set ratios for cash, debt, and assets. Liabilities should be less than 70% of the company assets (assets could not include cash from pre-sales). Total net debt to be capped at 100% of the company's equity value. And cash reserves had to equal short-term debt by value.

[45] Rebecca Choong Wilkins. "Evergrande Declared in Default as Huge Restructuring Looms." Bloomberg. 12/9/2021. Web. Accessed 2/24/2022.

[46] "Housing Should Be for Living in, Not for Speculation, Xi Says. The three red lines are the three requirements designed for real estate developers to stave off runaway debt levels. Specifically, it requires the ratio of liabilities to assets to be under 70%, the ratio of net debt to equity to be below 100%, and the ratio of cash to short term debt to be at least 100%. If these requirements are not met, then developers can face down a ban from raising more debt.

One-China policy & the fate of Taiwan's independence

Taiwan has been a challenging diplomatic issue for US-China relations dating back to the flight of Chiang Kai-Shek's nationalist government to the island in 1949. Of late, the issue has escalated, as the US seeks to keep sea trade routes open and check China's military expansion. Nearly half of the world's shipping container traffic passes through the Strait of Taiwan.[47] For over twenty years, the possibility of China invading Taiwan appeared remote.

[47] Source: Bloomberg August 2, 2022. "Taiwan Tensions Raises Risks in One of the Busiest Shipping Lanes."

Russia's invasion of Ukraine changed geopolitical calculations for China, Taiwan, and the US. Whereas western leaders may have previously believed that pragmatism would prevail, President Putin demonstrated that a combination of nationalism and ego could override such concerns. Xi's recent consolidation of power naturally raises concern that he, too, may be guided by forces other than reason. For example, he might believe that reuniting Taiwan with China during his tenure will secure his place in CCP lore.

At the 20th Party Congress, President Xi underscored his vision for the Great Rejuvenation of the Chinese Nation that included the reunification of mainland China and Taiwan. Xi's description of integrating Taiwan along the same lines as the integration of Hong Kong appears to be focused on a creeping erosion of political independence. In 2020, China implemented a National Security Law which all-but ended Hong Kong's independence. In 2022, the People's Liberation Army has intensified its military excursions and monitoring to intimidate Taiwan's political leaders. In 2024, Taiwan will have national elections, and the increasing pressure from China may well amplify anti-China sentiments in Taiwan.

Aside from the geopolitical risks of a forced reunification of Taiwan, for multinational companies and investors, the loss of Taiwan from the global supply chain could have serious consequences. Taiwan accounts for about 50% of the world's semiconductor foundry capacity,[48] and produces around 90% of the world's semiconductors.[49] Taiwan's continued independence and security is of paramount importance for the world's technology and communications companies and global investors. The risks and challenges are not just geopolitical. The supply of critical technology inputs depends on Taiwan remaining a secure and independent nation.

[48] Source: https://www.semiconductor-digest.com/taiwan-to-control-48-of-global-foundry-capacity-in-2022-says-trendforce/

[49] Source: A. Varas et al, "Strengthening the semiconductor supply chain in an Uncertain Era," Boston Consulting Group Report, April 2021. Manufacturing capacity for chips below 10 nanometers. S. Korea produces about 8% of supply.

Taiwan is almost 14% of the MSCI Emerging Market equity index and over 20% of the MSCI Emerging Market ex-China index. Together, China and Taiwan account for over 45% of the MSCI emerging market index.[50] If armed conflict resulted in the kind of sanctions and seizure of foreign assets that have been recently witnessed with Russia's invasion of Ukraine, the losses for global equity investors could be enormous.

[50] Source: MSCI as of October 2022. Hong Kong accounts for another 2%.

Reassessing China outlook and exposure

Recent events have given investors reason to reconsider their outlook for China, as well as their exposure. We see two primary changes that investors should integrate into their calculations. The first is that economic growth in China is very likely to be much lower than what many investors had been expecting for the foreseeable future. The second is that there is an increasing (though hopefully still small) probability that China and the US engage in an armed conflict, with Taiwan being the most likely focal point of such a conflict. The first of these is a high probability, low-impact event, while the second is a low probability, high impact event.

Investing always involves taking on risk, and it could be argued that the markets have already adjusted their pricing to account for these risks. Through the end of October, EM equities were down nearly 30% year-to-date and Chinese equities were down more than 40%.[51] This included a steep sell-off in October after the new Politburo was announced. This leaves emerging market and China equity indices trading at a steep discount to their long-run average price-to-earnings ratios (see Figure 7).

[51] Source: MSCI. Returns are in USD terms.

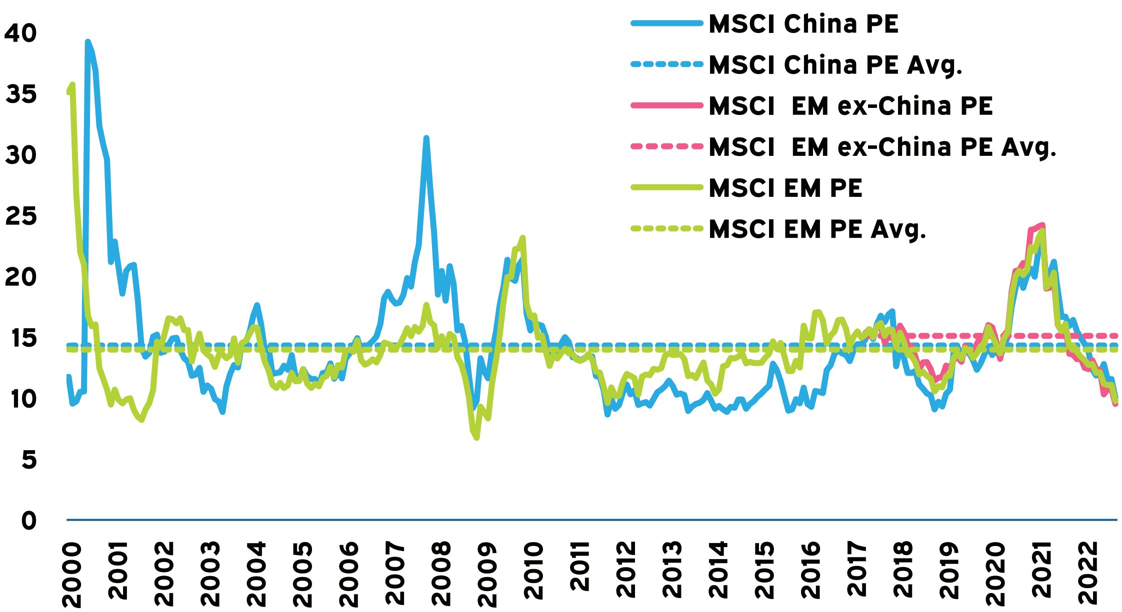

FIGURE 7

Emerging Market Price-Earnings Ratios

Source: Bloomberg and MSCI as of October 2022.

Any decision around shifting emerging market or China allocations should include consideration of the potential opportunity costs, such as the potential of foregone gains by selling at low valuations. In addition, shifting exposures may incur additional manager and transaction costs that should be taken into account. Further, if an investor continues to use a broad benchmark that includes China after making a shift, they will incur tracking error versus that benchmark. Moreover, emerging markets equities have historically been a fertile area for active managers to generate alpha, hence reducing exposure to emerging markets could diminish potential alpha. Finally, some investors may face headline risks, either by maintaining their China exposure or in implementing investment structures that seek to cap or reduce China exposure.

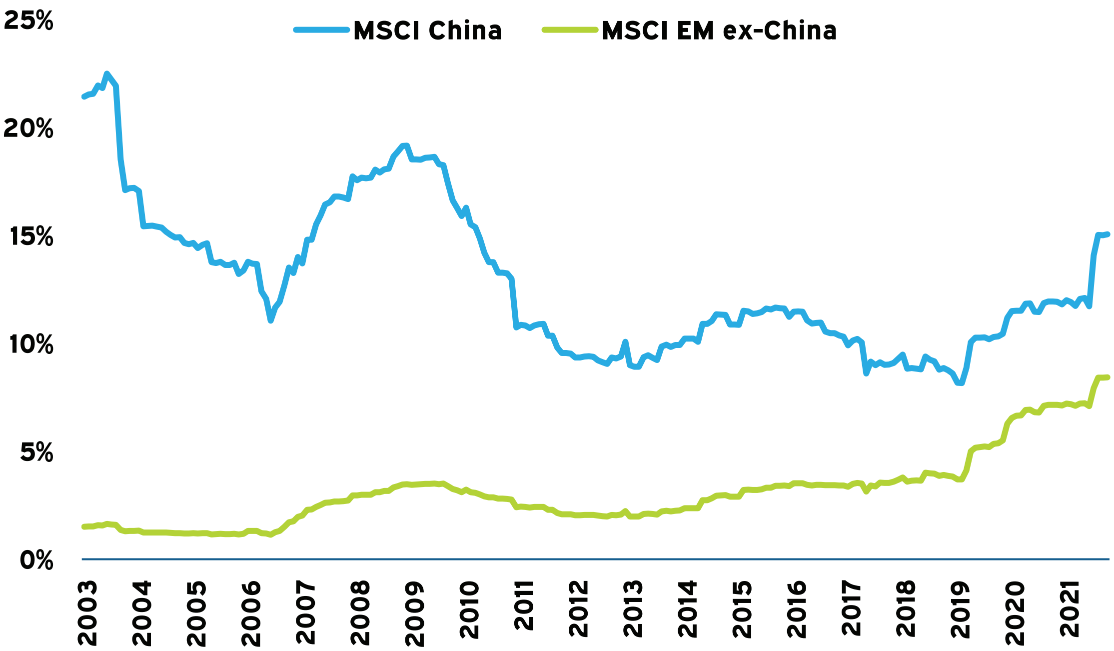

FIGURE 8

3-Year Annualized Tracking Error vs. MSCI Emerging Market Index

Source: MSCI data as of October 2022.

First and foremost, investors should determine what their exposure is to China. As noted earlier, the primary source of China exposure for many investors is through dedicated mandates such as emerging market equity and emerging market debt. But exposure can often also be found in global and foreign equity portfolios, foreign and high yield bond portfolios, private equity funds, infrastructure funds, non-core real estate funds, and hedge funds.

Once total exposure is determined, the next step for an investor is to decide if they are comfortable with it. This should include an evaluation of how well hedged their portfolio is against the systemic risk of a China-related event, as well as a prolonged but more subtle downturn in growth.

If an investor then decides that they want to reduce their exposure to China, they have myriad options. Perhaps the simplest way is to trim their emerging market equity and debt allocations. For investors that have global equity mandates, they could shift from an MSCI ACWI to an MSCI World benchmark. Similarly, investors that utilize the MSCI ACWI ex-US as the benchmark for their non-US equity investments could shift to the MSCI EAFE or MSCI World ex-US index.

Each of these options cuts emerging markets exposure broadly, not just China exposure. For investors who want to maintain their broader emerging markets equity allocation but desire a direct reduction in China exposure, they could shift some or all of their emerging market equity allocation to the MSCI Emerging Markets ex-China index. Similarly, investors with emerging market debt mandates could shift to a benchmark that caps China exposure.[52] Finally, investors with separate account structures may choose to work with investment managers to actively cap China exposures in their portfolios.

[52] For example, there are multiple versions of JP Morgan EM debt benchmarks that cap individual country weights at 10%.

Conclusions

President Xi Jinping now asserts complete control over the CCP and has arguably become the most powerful person on the planet. We suspect the top three motivating factors for Xi in order of importance are: 1) President Xi, as the embodiment of the CCP, wants to establish his historical legacy; 2) the CCP plans to remain in power forever through loyal adherence to Marxist-Leninist ideology, and 3) President Xi wants to make China a global superpower.

Investors should consider China's future within the context of these goals and what happens when these objectives conflict with each other. Moreover, these objectives may occasionally be in conflict with each other. For example, President Xi prioritizes reunification with Taiwan while the CCP may prefer to pursue relatively peaceful economic growth to stay in power. If Xi invades Taiwan, then China would likely become a pariah state, setting economic growth back by a decade, and worst case (from a CCP perspective), leading to mass discontent and overthrow of the CCP.

Investors who are bullish on China are betting (knowingly or not) on pragmatism prevailing over Xi's desire to bolster himself and his legacy in Chinese lore. While the path may be bumpy, pragmatism would likely prove beneficial for investors in the long run. A middle path, whereby the CCP pursues ideological & socialist purity will likely slow long-term economic growth in China, potentially making it less attractive to investors. Finally, should Xi choose to annex Taiwan by coercion or force, the outcome for investors could be painful if western (e.g., NATO) countries respond with financial sanctions and seizure of assets as happened when Russia invaded Ukraine.

Even if China refrains from outright military action in Taiwan, US actions could be perceived as provocative and hostile by the CCP. A decade of declining relations between the countries has fostered mutual suspicion. The US now has a stated policy of containment of China.[53] If policy decisions continue in this direction, there is a not insignificant risk that the US government could make investment in China extremely difficult, painful, or even illegal.

Exposure to China has grown for many investors over the past decade, often unintentionally. Outsized portfolio exposure to China may warrant renewed cost/benefit evaluation in light of growing ideological activism from China's CCP and the increasingly strident US policy of China containment.[54] China poses a systemic risk, and disentangling a portfolio entirely from this risk is not feasible for anyone invested in global capital markets.

Investors should engage in a thorough examination of their portfolio to determine what their exposure is to China. Some investors, upon considering their exposure and their overall portfolio structure, may decide they are appropriately positioned. Others may choose to reduce their EM and/or China exposure directly, and/or add a hedge against systemic risk. If investors want to reduce their direct portfolio exposure to China, they have multiple options, many of which include changing mandates or benchmarks for existing strategies. If investors want to add or increase a hedge, this could take the form of an indirect hedge (e.g., long US Treasuries), a direct China hedge (e.g., long options on certain Chinese or Taiwanese markets), or a broader systemic hedge (e.g., long volatility or tail risk strategies).

[53] Source: Department of Commerce US CHIPS Act guidance and Biden National Security Plan as of October 2022.

[54] Source: Biden administration's National Security Policy as of October 2022.

Appendix | state-owned enterprises

In 2015, the Chinese government directed SOEs and mixed ownership structures to step in and buy company shares during the sell-off. After stabilizing the markets between June and November, the SOEs owned significant stakes in over 1,000 companies.[55] Today, the CCP's strategic vision for the 4th industrial revolution may see more mixed ownership structures like hybrid venture capital funds such as China Integrated Circuit Industry Investment Fund (the Big Fund 2015) and Sino IC Capital.[56]

[55] Source: Goldman Sachs estimates quotes in T. Huang and N. Véron, "The Private Sector Advances in China: The Evolving Ownership Structures of the Largest Companies in the Xi Jinping Era," Peterson Institute for International Economics working paper 22-3, March 2022.

[56] Source: https://www.wsj.com/articles/venture-capital-becomes-a-tech-battleground-between-china-u-s-11643202001

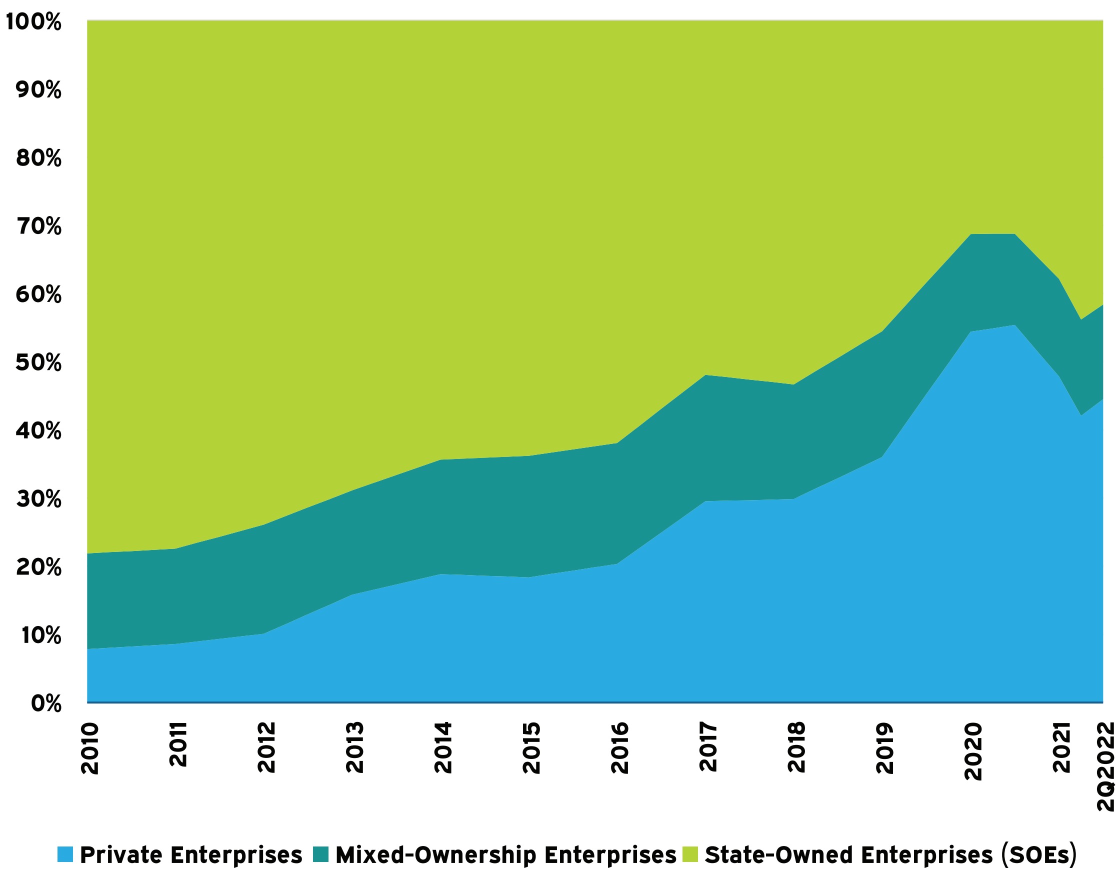

FIGURE 9

Enterprise Structure of Top 100 Companies by Revenue (% of Total by Count)

Source: Ibid.

Today the process of privatization has stalled, and government ownership of key assets and businesses remains the rule. China's SOEs constitute the majority of revenue share even today. New SOEs adopted mixed-ownership structures controlled by government interests through direct private investments and the purchase of company shares. These structures, as seen for the China Securities Finance Corporation (CSF), China Investment Corporation (CIC), and Central Huijin Company, function like asset managers for the state, holding significant number of shares in both listed and private companies.

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