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Navigating US China Tensions with Dynamic Portfolio Levers

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Institutional investors with exposure to China are facing a challenging macro-economic and demographic outlook. Real estate investment, which has been a major driver of economic growth in China, is now facing a crisis due to excessive debt and speculation. In addition, China's demographic policies have affected the availability and quality of its labor force and consumption demand, while the aging population could place an additional strain on growth.

These would be challenges enough, but China's strident and proudly Marxist President, Xi Jinping, is actively expanding his power and control over the economy through the Chinese Communist Party ("CCP").[1] The expanded authority of the CCP into publicly traded companies, banks, and brokerages has been accompanied by crackdowns on foreign audit and ratings companies in China. Progress toward financial and corporate reform and transparency appears to be moving backward.[2]

Sifting through economic, financial, and political factors is proving to be increasingly challenging for institutional investors as sentiment toward China continues to turn negative in western governments. While some US investors have decided to actively underweight or even exit China altogether, others are seeking dynamic portfolio and manager solutions.[3]

[1] Source: Asia Society, K. Rudd, "Xi Jingping, The Rise of Ideological Man, and the Acceleration of Radical Change in China," October 2022. Former Australian Prime Minister Kevin Rudd is fluent in mandarin and has met personally with President Xi on numerous occasions.

[2] Source: Peterson Institute for International Economics, N. Lardy, "The State Strikes Back: The End of Economic Reform in China," 2019. State owned enterprises now account for 61% of the largest 100 listed companies in China as of June 2023.

[3] Source: Bloomberg I. Mookerjee, "Why Global Investors Keep Unloading Chinese Stocks," October 23, 2023. See also Wall Street Journal, J. Douglass et al., "Foreign Firms Pull Billions in Earnings Out of China," November 6, 2023.

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Biden-Xi Meeting

Since the meeting of Presidents Biden and Xi in the fall of 2022, tensions between the US and China appeared to be getting worse, and governments, corporations, and markets around the world reassessed the geopolitical risks. Many have been reducing or eliminating their investments in China. In the third quarter of 2023, China recorded its first decline in direct investments since 1998 (-$11.8B), and foreign company earnings retained in China likewise turned negative.[4] Foreign exchange outflows were up sharply in September with $75 billion US dollars leaving China in a single month, putting downward pressure on the Chinese yuan which has weakened considerably.[5] China's real estate sector, which accounts for over twenty-five percent of the country's GDP, is in free fall, and piecemeal efforts by the CCP to stabilize the sector appear to have had a limited effect.[6]

[4] Source: Reuters, "China's First Deficit in Foreign Investment Signals West's De-Risking Pressure," November 6, 2023. Article based on preliminary balance of payment data as of September 30, 2023.

[5] Source: Ibid.

[6] Source: Financial Times, Chen Leng, "China Pushes State Banks to Accelerate Funding for Private Property Developers," November 20, 2023.

Against this stagnant economic backdrop, President Xi's speech to US businessmen at the APEC meeting in November could best be characterized as a charm initiative designed to entice US businesses back to China. The CCP message to the Chinese people was that China was extending the hand of friendship to the US. For example, the title of President Xi's speech in one media outlet was "Don't Squander Chance to Restore China-US Ties."[7]

[7] Source: Xinhua, "Don't Squander Chance to Restore China-US Ties," November 14, 2023.

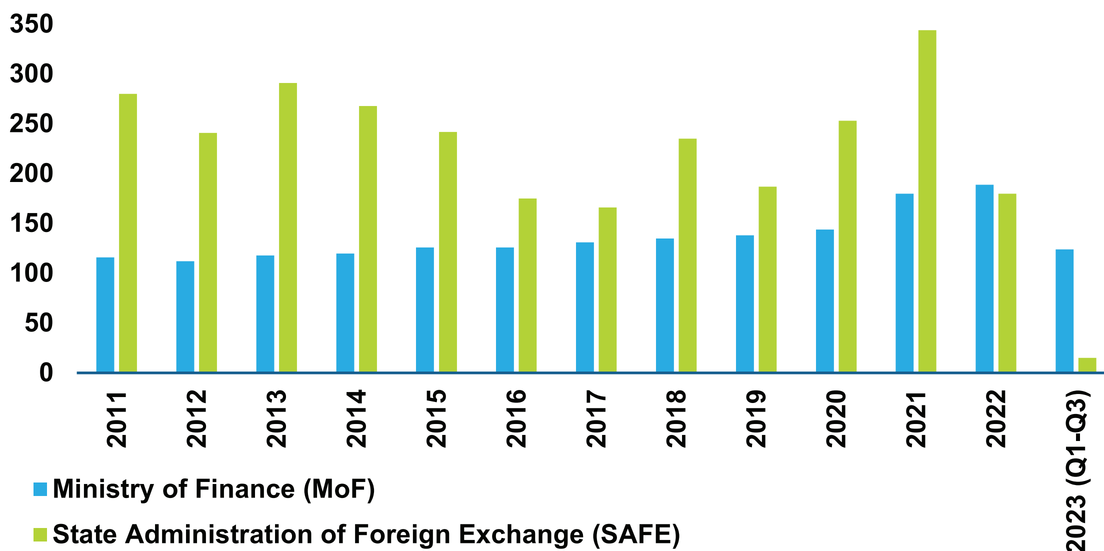

FIGURE 1

Foreign Direct Investment Inflows 2011-2023 (USD in Billions)

Source: Peterson Institute for International Economics, N. Lardy "Foreign direct investment is exiting China, new data show," November 17 2023. SAFE tracks net FDI while the Ministry of Finance tracks gross inflows.

The official White House recounting of the meeting between Presidents Biden and Xi could not have been more different in tone and substance. President Xi and President Biden have met many times over the years, but the White House seemed focused on conveying how frank and tough Biden was during the meeting.[8] "President Biden emphasized that the United States and China are in competition, noting that the United States would continue to invest in the sources of American strength at home and align with allies and partners around the world."[9]

[8] Source: White House, "Read Out of President Joe Biden's Meeting with President Xi Jinping of the People's Republic of China." November 2023.

[9] Source: Ibid.

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It remains to be seen if President Xi was able to restore foreign investor confidence sufficiently to reverse capital outflows. Right before the summit, the $771 billion-dollar Federal Retirement Thrift Investment Board announced that it would change its benchmark for its international fund so as to eliminate exposure to Chinese and Hong Kong stocks.[10] Some other institutions have recently chosen to stay the course.[11]

Allocating to China

Investing in China has never been simple, but the allure of robust economic growth and the second largest market in the world helped justify allocations to Chinese assets. The predominant exposure to China for many institutional investors was through emerging market equity allocations. Some of these investors are now considering options for strategically reducing or eliminating this exposure.

Given the rising likelihood that the economic and geopolitical complexities will persist, a flexible approach to China exposure may be more suitable for investors who are not prepared to exit China altogether but are unwilling to passively follow benchmark country weights. Ways to enhance portfolio flexibility may include bifurcating emerging markets to include an "ex-China" allocation or customizing emerging market strategic policy benchmarking to exclude China. In navigating the ever-evolving landscape of global markets, embracing adaptable strategies tailored to manage China exposure could prove pivotal in achieving a balanced and resilient investment portfolio.

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.

[10] Source: Financial Times, " J. Hughes, "US Federal Pension Fund to Exclude Hong Kong and China Investments," November 14, 2023.Political uncertainty was cited by FRTIB advisor Aon.

[11] Source: Missouri Independent, R. Keller, "Missouri Pension Board Rejects Push by Vivek Malek for China Divestment," November 20, 2023.

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