Wealth Management International, Ltd.

Proactive Investment Management & Financial Planning

Global Perspectives, April 2018: Our Approach to Investing in China

China's economic reform program has been one of the most important developments in modern history. Beginning in 1979, the program has liberalized much of the Chinese economy by opening it up to private enterprise, free markets, and international trade. The result has been a surge of extraordinary, sustained growth. As shown in Figure 1, Chinese gross domestic product (GDP) is estimated to have expanded at an average annual rate of almost 10% from 1979 to 2017. That's several times faster than the average advanced country grew over the same period. Chinese corporate profits and asset prices have also risen strongly.

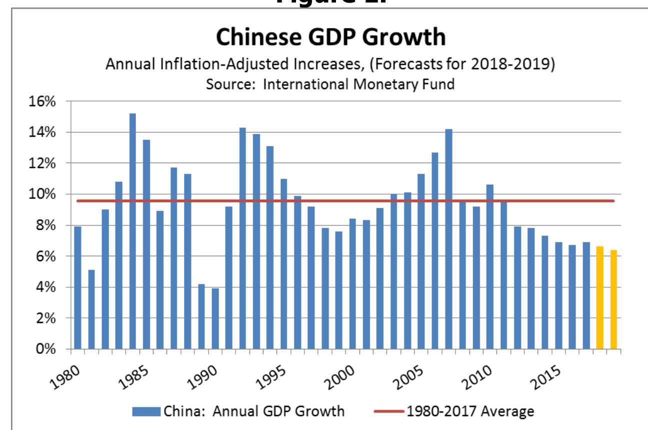
China's expansion and reconnection with the global economy have boosted living standards for hundreds of millions of its citizens and profoundly affected countries around the world. For example, demand from China has buoyed prices for globally-traded commodities like oil, even as its low wage rates and cheap manufactured exports have pushed down world inflation. The problem for investors is that the country's political, economic, and financial-market environment still presents serious hurdles to safely participating in that growth. Is there any good way to partake in Chinese opportunities without undue risk?

China's Political Background

The most important thing to remember about China is that it remains a Communist dictatorship, in spite of its partial economic liberalization. Political power is monopolized by the Chinese Communist Party, and even though top party leaders submitted to the restraints of collective leadership for decades after the disastrous dictatorship of Mao Zedong, the current leader is breaking free of those limits. President Xi Jinping (who is also the leader of the Communist Party) initially solidified his position using the run-of-the-mill methods of many strongmen before him: He eliminated all potential rivals under the guise of a sweeping anti-corruption program. More worrying, he has recently pushed through amendments to the Chinese constitution that could allow him to rule without restraint for decades. One such change elevated his philosophy, "*Xi Jinping Thought on Socialism With Chinese Characteristics*," to equal authority with that of Mao and Deng Xiaoping. He has also scrapped a rule that no one can serve more than two consecutive five-year terms as president. At the same time, Xi has pushed through rules giving party officials more power to influence private businesses, monitor Chinese citizens, and muzzle dissidents.

China's 1.3 billion people, armed forces, and massive economy are now falling under the sway of a single, authoritarian leader for the first time in decades, so it's imperative to understand what that leader believes and wants. Knowledgeable analysts stress that Xi's main goal is to once again make China the dominant power in Asia, and perhaps beyond. Scholars often point to the ancient Chinese view that their country is the "Middle Kingdom," occupying the most important position in the region while all other countries are merely peripheral (geographically, politically, economically, and culturally). We think it's more accurate to say Xi's goal is to re-establish China as the "Central Kingdom," which carries the more nuanced idea that China should not only dominate all others, but also serve as their guiding light and inspiration. Xi believes that the strength, stability, and economic growth that China has achieved gives it every right to present its system as equal – or even superior – to Western democratic capitalism.

Figure 1.



With his view that China is the life-giving sun around which all others should orbit, Xi's highest priority (other than his own self-preservation) is to build up China's national defense capabilities and its ability to project

© Wealth Management International, Ltd.
23131 North Lake Pleasant Parkway | Peoria, AZ 85383 | 623-875-5204 |1-888-91-ASSET
To find out how we use our research in an effort to build better investment strategies, see our website at www.wealthadv4u.com.
Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.

power. He is rapidly developing China's military forces (including sophisticated cyber-forces, stealth aircraft, and two aircraft carriers), and he is working to seize control over the South China Sea. In the economic sphere, Xi has launched a "Belt and Road Initiative" in which China will provide up to $1 trillion in grants and loans to build transportation and other infrastructure across Eurasia. The program also includes moves to enhance regional political cooperation, trade, financial flows, and cultural exchanges, but the key objective is to bind neighboring countries closer to China and ensure Chinese producers have ready markets for their goods and services. Another key initiative is Xi's "Made in China 2025" program, which aims to shift China away from its current focus on the final assembly of high-value components from abroad. The program identifies a large number of industries and technologies in which China is to become a leading global competitor, including robotics, artificial intelligence, semiconductors, telecommunications equipment, and electric vehicles. The program aims to achieve these goals not via the free market but through government intervention. As it already does elsewhere in the economy, the government aims to develop these industries and technologies using tactics like subsidies, protectionist trade barriers, government "guidance" for purchase and investment decisions, and extorting advanced technology from foreign firms wanting access to the Chinese market. The Chinese government often pays lip service to the free market, but the reality is that it generally only supports market principles when they serve the government's goals.

Figure 2.

China's first aircraft carrier, the Liaoning.

China's Economy Today

The problem for foreign investors is not just that the Chinese government interferes with market mechanisms and company-level decisions. The economy also remains dominated by state-owned enterprises (SOEs), even after decades of economic reform and privatizations. A recent study by the Congressional Research Service quoted China's State Council as saying the country currently has 150,000 or so SOEs operating at the central, regional, and local levels. Some analysts have estimated that SOEs make up 50% of China's manufacturing companies and 61% of the country's service firms. SOEs may produce half of China's total non-agricultural GDP. They also dominate China's stock markets, especially in sectors such as banking, energy, telecommunications, and transportation. These SOEs are often among the government's most important "national champions," which are charged with making China's presence felt in the global economy. The government usually remains the biggest shareholder of such SOEs, and it provides a wide range of support in the form of preferential financing and protection from competition. Even though these SOEs may generally operate like a private company, it is always an open question how much the government is influencing key business decisions for its own political purposes.

In spite of the Communist Party's continued monopolization of political power and the on-going dominance of SOEs, the Chinese government's slow, methodical, tightly controlled economic reforms since 1979 have produced nearly constant economic growth, as shown above in Figure 1. As might be expected in a maturing economy, growth is now moderating a bit. Chinese GDP growth in recent years has fallen below 7.0% per year. Because of problems with Chinese statistics, the true growth rate may be even weaker. Still, China's current economic growth is almost certainly stronger than the growth in most other large economies. The structure of Chinese growth has also become healthier. Data from China's National Bureau of Statistics show that from 2005 to 2007, the share of Chinese GDP growth coming from consumption spending was only 47.2%, far below the levels seen in most major developed countries. The share coming from net exports was a robust 12.7%, and the share of growth from gross fixed investment was an even stronger 40.0%. In contrast, during 2015 to 2017, the share of growth coming from consumption had ballooned to 61.7%. In those same three years, net exports detracted 0.6% from growth, and fixed investment contributed just 38.9%. The figures suggest the Chinese economy is still expanding and evolving fast enough to entice investors.

All the same, as we look forward, it's important to remember that China's economic growth and reforms have left it with dangerous imbalances. One big problem is that the government's economic and social policies have discouraged consumer spending and promoted excessive savings. Besides promoting excess investment in housing, the huge household savings volumes have left state-owned banks with an enormous overhang of

© Wealth Management International, Ltd.
23131 North Lake Pleasant Parkway | Peoria, AZ 85383 | 623-875-5204 |1-888-91-ASSET
To find out how we use our research in an effort to build better investment strategies, see our website at www.wealthadv4u.com.
Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.

deposit funds. The government has channeled those deposits into preferred industrial projects and waves of foreign investment. Loose lending by state-owned banks has produced a huge amount of excess production capacity among major industrial firms. That has led many such companies to cut prices and export heavily, contributing to trade tensions. It has also left Chinese companies with a very high level of debt, which they may eventually have trouble repaying. Political pressure to keep regional economic growth strong has even prompted local government leaders to take on too much debt, mostly for infrastructure investment.

The Problem With China's Financial Markets

Profligate bank lending and bad loans are not the only problem for China's financial markets. For U.S. investors, a big consideration is the state of the country's stock and bond markets.

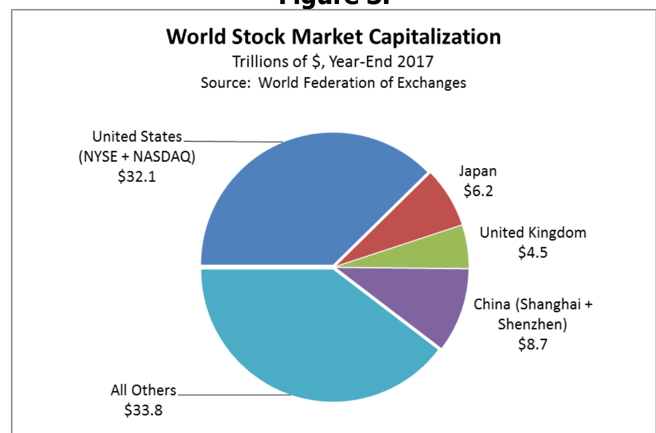
Stock Markets. China has two main stock exchanges: one on its eastern coast in Shanghai and one on its southern coast in Shenzhen (just opposite Hong Kong). According to the World Federation of Exchanges, the stocks listed on the Shanghai bourse had a total value (i.e., market capitalization) of $5.1 trillion at the end of 2017. Stocks in Shenzhen had a value of $3.6 trillion, bringing the total market capitalization of the two exchanges to 73.9% of Chinese GDP (see Figure 3). That means China now has one of the biggest stock markets in the world. However, compared with the United States, the country's stock market is still relatively small and plays a much more limited role in the economy. The total market capitalization of the New York Stock Exchange and NASDAQ stood at $32.1 trillion at year-end 2017, equal to 165.4% of U.S. GDP. In addition, the Shanghai and Shenzhen markets are subject to some unique, heavily distorting regulations that make stock trading treacherous. Important factors include:

- **Tight Limits on Entry and Exit.** The Chinese government tightly controls who can participate in the Shanghai and Shenzhen stock markets, and it limits how much money can flow into and out of them. To exercise these controls, the government uses a system of differentiated share classes. For example, class "A" shares can only be bought or sold by Chinese citizens using renminbi (the Chinese currency); class "B" shares can be traded by anyone, but only in foreign currencies like the U.S. dollar. The resulting price distortions are why many Chinese firms have listed at least some "H" shares on the much freer and more efficient Hong Kong stock exchange, or "N" shares in New York and "L" shares in London. Over time, the government has adopted various reforms to help address the price distortions in Shanghai and Shenzhen. In 2003, for example, it instituted the "Qualified Foreign Institutional Investor Program" (QFII) that lets large foreign financial firms apply for a quota of A shares, on the condition that any shares bought must be held for at least one year. A similar "Renminbi Qualified Foreign Institutional Investor Program" (RQFII) was subsequently established to let Chinese asset managers sell baskets of Chinese stocks in Hong Kong. Most recently, the government has established a "Hong Kong Stock Connect" program that allows foreigners to trade Shanghai and Shenzhen stocks via Hong Kong. The problem is that entry into and exit from the Chinese markets is still not free, in spite of these initiatives.

- **Active Government Interference.** The Chinese government also takes steps to actively interfere in the market in a sporadic, ad hoc way that is much more significant than in most other countries. For example, to arrest a mid-2015 market swoon, the government suddenly changed key trading rules to make it easier for small investors to borrow for stock purchases. It also suddenly ordered private companies and fund managers to buy up stocks. Such bald, heavy-handed actions make it hard for foreign investors to be sure their investments will be properly valued.

Bond Market. China's bond market has also become quite large in recent years. According to the Asian Development Bank, total outstanding principal on the market reached almost $9.0 trillion at the end of 2017, including instruments such as Chinese government bonds, intermediate-term corporate bonds, and short-term commercial paper. However, the market is generally closed to foreign investors other than those with QFII quotas. As with the stock markets, we believe Chinese bond markets also suffer from an unpalatable mix of structural problems and government manipulation.

Figure 3.



© Wealth Management International, Ltd.

Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.

Conclusion

At WMI, we generally prefer to invest in foreign stocks and bonds via products like mutual funds and exchange-traded funds (ETFs) that track foreign indexes. Therefore, we don't directly face many of the problems with Chinese stock and bond trading discussed above. All the same, we think Chinese market distortions could ultimately have a negative impact even on China-focused funds of the type that we prefer to use. We believe such funds would still suffer from problems like high government ownership, government manipulation of the markets, high valuations, volatile trading, limited information, high trading costs, and questionable corporate management.

Table 1.
Chinese Imports From Selected Countries
Billions of U.S. $; Asia-Pacific Countries Highlighted in Blue
Source: United Nations International Trade Centre

Import Source	Import Value 2007	Import Value 2017	Compound Annual Growth Rate
Korea	103.8	177.5	5.5%
Japan	134.0	165.5	2.1%
USA	69.5	154.8	8.3%
Taiwan	101.0	154.8	4.4%
Germany	45.4	96.9	7.9%
Australia	25.8	94.6	13.9%
Brazil	18.3	58.5	12.3%
Malaysia	28.7	54.0	6.5%
Viet Nam	3.2	50.4	31.6%
Thailand	22.7	41.8	6.3%
Russia	19.7	41.4	7.7%
Singapore	17.6	34.1	6.9%
Switzerland	5.9	33.0	18.9%
Saudi Arabia	17.6	31.8	6.1%
All Others	343.0	651.9	6.6%
Total	956.1	1,841.0	6.8%

Because of the risk involved even in indirectly holding Chinese shares, we think a better approach may be to invest in the broader Asia-Pacific region. After all, data from the Organization for Economic Cooperation and Development (OECD) show that while China's merchandise exports were growing at an average annual rate of 6.4% over the last ten years, its merchandise imports were growing at an even faster rate of 6.8%. Moreover, data from the United Nations International Trade Centre show that almost half of China's goods imports in 2017 came from the Asia-Pacific countries of Korea, Japan, Taiwan, Australia, Malaysia, Vietnam, Thailand, and Singapore (see Table 1). China was the largest or second-largest export market for each of those countries. In fact, China accounted for fully 29.6% of Australia's exports, 28.1% of Taiwan's exports, and 24.7% of Korea's exports. China's top import by far is electronic components such as integrated circuits and semiconductors, which come mostly from Taiwan, Korea, Malaysia, and Japan. Other important imports include industrial raw materials (such as crude oil and iron ore from Australia), telecommunications equipment (such as cell phones from Vietnam and Korea), and capital goods (such as data processing equipment from Thailand). Finally, many of China's trading partners in the region have much better stock market regulation and healthier, more competitive companies than China itself.

In sum, the economic growth and on-gong reforms in China may be attractive in theory, but they don't necessarily compensate for the country's continued political and structural problems. We believe direct investment in China still entails some unpalatable risks, from government control over the economy and businesses for the benefit of the Communist Party to economic imbalances like excessive debt and poor market regulations. Fortunately, many Asia-Pacific countries stand to see increased growth and rising profits from exporting into the expanding Chinese economy, and those countries often have much more attractive stock and bond markets. We therefore prefer to participate in the Chinese growth story by using an "indirect regional" approach that invests across the broad Asia-Pacific region. As with all of our foreign investing, we closely follow the political, economic, and financial market developments in countries across the region in an effort to identify those with the best prospects. Once we have made an investment in a country, we use the same disciplined monitoring and analysis to determine whether we should keep investing there. As always, we will regularly update our clients on the major shifts in our holdings and what is behind those shifts.

Patrick Fearon, CFA
Chief Investment Officer

© Wealth Management International, Ltd.
23131 North Lake Pleasant Parkway | Peoria, AZ 85383 | 623-875-5204 |1-888-91-ASSET
To find out how we use our research in an effort to build better investment strategies, see our website at www.wealthadv4u.com.
Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.