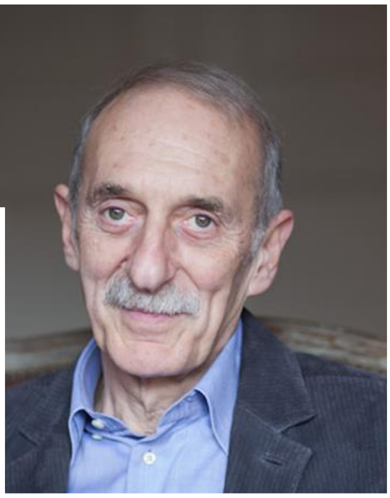
Emerging markets

'Investing in China is a question of stock picking rather than index picking'



- The relationship between China and the West has changed radically
- China faces many challenges and may not overtake the US by 2030
- Finding expert managers is key for investors to make the right choices

In just a decade, Chinese financial markets have gone from exotic category status to that of must for global investors. This calls for a much better understanding.

What is the China-US 'trade war' really about? Will China inevitably overtake the US as the dominant power? How should investors approach Chinese equity markets? Here are some of the questions we discussed with George Magnus, former chief economist at UBS and author of *Red Flags: why Xi Jinping's China is in Jeopardy*, published by Yale University Press in 2018.

Over the past couple of years, global financial markets have been swinging to the tune of US-China trade dispute. What's your take on the nature of this confrontation?

"This conflict is obviously about trade because we know that the high-profile part of the coverage is about tariffs. Products that the Americans export to China and obviously that the Chinese export to the United States. And it concerns things like soya beans and other agricultural produce, aircrafts, automobiles, pharmaceuticals, energy products and so on."

"So, self-evidently it's about trade. It started that way because when Donald Trump was campaigning to be elected, made a big issue about the US-China trade deficit and the loss of American manufacturing jobs. But since 2018, we have learned that what's really going on is a reset of the US-China relationship, in which trade is an important part but only the tip of the iceberg."

Interview
For professional investors
January 2020

George Magnus
Economist

Associate at the China Centre at Oxford University, research associate at the School of Oriental and African Studies and former chief economist at UBS.

"A number of other topics have been drawn into this dispute between not just China and the US, but also China and the EU as well, although things remain a little quieter as far as the EU is concerned. These topics include aspects that are closely related to trade, like foreign direct investment, but also other things, like the activities of technology companies, in particular telecommunications."

"It also involves many issues which Western companies complain about in China, like weak intellectual property protection, ownership limits on companies, access to markets and subsidies, or preferential treatment in procurement and the application of standards. All these elements speak to a much more existential conflict between China and the West."

"So, when I talk about the 'trade war', I usually refer to it as a 'so-called trade war' because although it's about trade, it's also about many other things."

'Western policymakers thought China would play by the rules of the international monetary system established after the Bretton Woods conference. I think it was very naive to believe that'

Then what is the most likely outcome? If this is really about the existence or the dominance of each block, a trade deal may not put an end to the dispute...

"Yes. This is about the struggle for supremacy, or at least the struggle for dominance. And it has become more sensitive because, although it's not formally part of the US government's agenda, some members of the administration talk a lot about a so-called decoupling. They envisage a world in which the US and China will go their separate ways when it comes to investment, technology and financial flows."

"Meanwhile, the Chinese are not innocent bystanders. Every time you hear Americans talk about decoupling, you can hear Chinese nationalists talk about self-reliance, meaning China doesn't need the US anymore and can go its own way when it comes to technology transfers in areas like digital technologies, electric vehicles, artificial intelligence, and so on."

"Both stances remain pretty rhetorical. I mean, they may not be achievable because, contrary to what happened with the former Soviet Union, there is a strong economic interdependence between the US and China that can't be undone very easily. Even in the unlikely case of a military conflict, I think many people in the US and in China would try to reestablish some sort of engagement."

"So, the relationship between China and the West will not be like it used to be going forward. It'll be more competitive, perhaps a little bit more edgy and there are certain things which we will never agree on. But I don't really want to believe that this is not a relationship that can be managed if there's goodwill on both sides."

The situation you describe looks very different from the one of the early 2000s, when China joined the WTO. At the time, there was more mutual understanding and less confrontational rhetoric. How do you explain this shift? Is it because China has changed? Or is it because the West has changed?

"Inevitably, as they say, it takes two to tango. The change has happened on both sides. At the time, many western policymakers thought that if they could bring China into the 'Western global system', it would become more open, more transparent and more liberal. They thought China would play by the rules of the international monetary system established after the Bretton Woods conference."

"I think it was very naive to believe that. But this has all changed now. During the 2000s, Western politicians talked about China as a strategic stakeholder and a partner. China is now seen as an adversary, even in the EU. This year, for instance, the EU-China Dialogue, which is a series of annual bilateral meetings at various levels, referred to China as a 'systemic rival' for the first time."

"So there's certainly been a radical shift in the way the West thinks about a more assertive China. Now, the real question is whether that would have happened without seeing President Xi Jinping coming to power in 2012. Obviously, it's a hypothetical question because we don't know what would have happened if somebody else had come to power."

"But the fact of the matter is that Xi Jinping has brought a very particular and repressive form of governance, which is a throwback to the kind of governance system that China had before 1978, when Deng Xiaoping came to power. It is much more ideological, much more autocratic and much more stifling of dissent."

"Naturally, Western politicians find Xi Jinping's China not just more competitive but also more politically threatening. This obviously has to do with the revelations about the fate of the Uighur people in Xinjiang, the treatment of Hong Kong, and the militarization of islands in the South China

Sea. So, yes, the West has changed, but China has changed as well."

Was this shift inevitable, given China's rise, or is there something else going on, in your view?

"I think there is a two-part response to your question. In a way, it may have been inevitable because China's extraordinary and rapid economic development was bound to make the country feel more confident in itself. Up until the global financial crisis of 2008, China had grown at double digit rates for about 20 years. It was unprecedented to grow so fast for so long."

"Obviously, if you're a big country and you reach a certain level of economic power, the way you see yourself and the way you see the world around you is going to change as well. And China now sees itself as being sufficiently big and important that it wants to see the rules of the world system change in a way in which it has a much stronger say and interest."

"Signs of such greater self-assertion and self-awareness became very clear after the global financial crisis. The Western world is on its knees while China manages to escape the worst aspects of the crisis and suddenly finds itself in a position where it is big, relied upon and capable of articulating a different model of development, which they actually think is superior to ours."

"So, part of the shift in the relationship between China and the West was probably inevitable. But the second part of the answer is that, when Xi Jinping comes to power in 2012, this is happening at a time of quite intense squabbling within the Chinese Communist Party (CCP) about China's direction and decision making."

'While the trends suggest that by 2030, China's GDP will be the largest in the world, this is not necessarily corroborated by an analysis of the things that have to happen in order to bring that about'

What do you mean exactly?

"At the time, Xi's supporters are very critical of the previous administration led by Hu Jintao and Wen Jiabao. They think these two have basically presided over a lost decade for China. They think Hu and Wen allowed corruption to fester and let the CCP to go into decline, almost decay. In their view, Hu and Wen were more interested in wealth accumulation for themselves and a few families."

"In the speeches Xi Jinping makes in 2012 and 2013, some even before he is chosen to be the leader, he talks a lot about restoring the 'purity of the party', which sounds like a very Leninist phrase. He also talks about Party discipline and Party loyalty, and about the criminality of using the Party for personal gain, and so on."

"And almost as soon as he becomes the leader of China, Xi Jinping marks out a totally different governance system, which is much more ideological and party-centric. Simultaneously, he launches an anti-corruption campaign that is still going on and that has imprisoned or punished over a million party members to date."

"So, my short answer to your question is that part of this apparent self-confidence – we can discuss whether that's a sign of strength or weakness – was inevitable, given the growth and size of the Chinese economy. But part of it is also definitely due to Xi Jinping's construction of what he calls the 'Chinese dream' and the 'great revitalization' of the Chinese nation."

"The idea is to correct what the Chinese call the 'century of humiliation': the period from 1839 to 1949, during which the country was overrun by foreigners and that is considered a historical anomaly. Achieving this means attaining the 'rich country' status and making the world much more China-centric, which conflicts with our Western ideas of the way the world should be structured."

Many people say China will indeed soon become the kind of superpower it aspires to and overtake the US. What do you think?

"Well, there are two different ways of thinking about this. On one hand, there's a mathematical way. People argue that, given present trends, China will become the biggest economy in the world by, say, 2030. But for this to happen, you need two things: China must carry on growing at a similar pace as it is now, and it must not experience any material depreciation in its exchange rate."

"And both premises are far from self-evident. The sustainable annual rate of growth of the Chinese economy for the coming decade is much closer to 3% or 4% than the current 6% or 7%. Moreover, I think the likelihood of large depreciation in the value of the renminbi's exchange rate over the next few years is quite high."

"So while current trends suggest that by 2030, China's GDP will be the largest in the world, this is not necessarily corroborated by an analysis of the things that have to happen in order to bring that about. China's GDP will likely be bigger than it is today in absolute terms, but it may not be much bigger relative to the US's GDP."

"On the other hand, the second way of looking at this issue is to think about whether you can take the past and extrapolate it into the future. I mean, we know that there are certain things that China has done very successfully in the past but cannot do again in the future. So, for example, they privatized industry, they privatized the housing market and they joined the WTO. They can't do any of those things again."

"Also, they put all of their children into primary school and they enrolled most of their children into secondary school. They shifted hundreds of millions of people out of low-productivity farming and agricultural activities into higher-productivity urban manufacturing. Many of the things that explain China's past success will not happen again in the future."

"And in many ways, China and the West now aspire to similar things, like increasing productivity growth or being a leader in technology. But while China is definitely succeeding in some areas, in some others, they are also finding it very difficult to compete, because their governance system is not necessarily conducive to economic success."

"Think, for example, about one key aspect of economic development: spreading new technologies into the boring bits of the economy. In the West, we tend to think that this has to be a bottom-up process and you can only succeed if you have the rule of law, good intellectual property regulation, a bankruptcy code, that allows entrepreneurs to learn from their mistakes, and so on and so forth."

"Meanwhile, the Chinese way of thinking about all this is very different. It's more a top-down process. So, I don't doubt that China will be a growing economy in the future. I don't doubt that it will have business opportunities that people will find attractive. But the idea that China will rule the economic world in a few years' time, I think, is definitely not proven."

'From a foreign investor's point of view, there are certainly good reasons to put money to work in China, particularly through the equity market'

Still, following a number of market reforms, some of the main index providers, such as MSCI, FTSE and Bloomberg Barclays, decided to include Chinese assets with a local listing in their flagship indices. In 2019, we have seen a noticeable increase in the weight of Chinese assets in these indices and further inclusion is likely. At the same time, MSCI recently warned that it would not include more Chinese stocks until concerns over access to hedging and derivatives instruments and other issues are addressed. Given the challenges we just talked about, what is your view on this?

"Well, as with most things when it comes to China, it is about nuance rather than black or white. I have no doubt that China is very welcoming of foreign capital. But we should also remember that this is a one-way street: China is very welcoming of foreign capital coming into China, but it is very hostile to the idea of relaxing controls on capital leaving China."

"So, in my view, investors should definitely not see China as an open and transparent country simply because it welcomes foreign capital. In fact, China needs US dollars. They like the idea of foreign investors putting money to work in China for very selfish reasons. It has nothing to do with governance principles. It's very much about national self-interest."

"From a foreign investor's point of view, there are certainly good reasons to put money to work in China, particularly through the equity market. Think about some the often-cited investment themes, like the country's rising middle class, for example. So, in a sense, you can see why global investors are interested, and even kind of excited to be part of this."

"But as the recent MSCI warning suggested, there should be no let-up in the transparency and openness of Chinese companies, when it comes to things like ownership caps in particular sectors, or the opening up of markets to foreign competitors in sectors where they were not allowed equal treatment compared to domestic firms."

"These are the kind of things that Western companies, in particular through the US and EU Chambers of Commerce in China, have been pitching and lobbying to Chinese authorities for a long time. The idea is to have a more open and transparent market which creates a more level playing field instead of depending on the way the wind is blowing at a certain point in time."

"There isn't the rule of law as we know it in the West. I mean, there are lots of laws. But of course, people must remember that there is no separation of powers, no independent courts. So, investors getting into Chinese financial markets must keep in mind that they are taking both an information and a governance risk."

"Obviously, if you simply follow an index and your money is by default invested in China, then you have no kind of say in any case. But if you invest in China on a discretionary basis, I think you are taking an information risk and a governance risk, because you don't have the same kind of recourse you might have in other countries. So, returns should be higher to compensate for that."

You mentioned earlier the risk of a potential adjustment of the renminbi's exchange rate? Is this a problem too?

"It wouldn't be an adjustment, but rather a significant depreciation. Although the People's Bank of China manages the exchange rate closely and within limited margins of fluctuation, I wouldn't draw much comfort from that. This may mean that day-to-day currency risk is quite small, but there is also a risk that at some point we will wake up on a Monday morning with a 20% lower exchange rate."

'The risk of a significant currency depreciation is not unique to China by any means. So, I don't necessarily think that's a powerful disincentive to invest in China'

"Having said that, this is something global investors are used to: if you invest outside your country, of course, you always take on board currency risk. The risk of a significant currency depreciation is not unique to China by any means. So, I don't necessarily think that's a powerful disincentive to invest in China."

To carry on with the currency topic, what do you think of Beijing's efforts to internationalize the renminbi?

"I'm a long-time skeptic of this. I understand why the Chinese government has been pushing this in the years immediately after the financial crisis. But in recent times the Chinese government has gone quite quiet about this. And I don't think it's a burning priority for them. And I think they are right to take that view."

"You can only have a truly international reserve-type currency if you allow foreigners to get access to your currency, and there's only two ways you can do that. One way is to have a continuous balance of payment deficits. The other way is to have open capital flows, in and out of the country. And Chinese authorities have no interest in either of these."

"Having said that, of course, they would like people to use the yuan more. So, they are trying. They've reached agreements with countries like Russia, to settle a certain proportion of their bilateral trade using the yuan as a means of payment. They are also involved in multilateral trade negotiations with some Asia-Pacific countries, whom they would like to see use the yuan more."

"From a national security point of view, they are also considering digital currencies as a way to avoid being closely aligned with the US dollar system. The Chinese are very sensitive to the power the dollar gives to the US and which enables them to take sanctions against certain countries. If they can find any means to insulate themselves from a dollar-based finance system, they'll be quite interested."

"But I think it's going to be an uphill struggle, to be honest. Ten years from now, the power of the renminbi may be not much bigger than the power in the Swiss franc or the Japanese yen."

We've been quite critical about China, so far. Still, there are positive aspects for investors. Which would you highlight?

"Well, what investors primarily want is interesting ideas that will make the value of their assets go up. Most of them care about politics only up to the point that they need China's economy to keep growing in the future. And from that perspective, even though China is not going to stop growing, there are certainly going to be some hiccups."

"But does that mean Chinese assets are poised for a downturn? Put differently, are the Chinese stock and bond markets strongly related to what happens in the underlying economy? The answer is: no, not really. And they are not very closely related to the rest of the world's economy either. So, what may unfold in the economy may not necessarily apply for Chinese listed companies."

"What I mean here is that financial markets could grow faster than the actual economy. Even if the economy goes through difficult years over the next decade, that doesn't mean all companies will be dogs. Also, one imagines that, overall, corporate income and profit growth in China will expand in line with GDP."

"The real issue will be to find the right investment ideas, the right themes and the right sectors. Those sectors may be less in manufacturing and more in service-producing areas, particularly if services are opened up to foreign companies. Those sectors will also be in areas such as electric vehicles, driverless cars, artificial intelligence and surveillance, pharmaceuticals and biotech."

"These are all areas in which China is putting a lot of money and a lot of effort. The issue for investors will be to find the companies that are going to perform in this environment and that may be able to perform regardless of the macroeconomic context. And for that, they will have to be pretty reliant on their financial services provider or their asset management company to make good choices."

'Investors will have to be pretty reliant on their financial services provider or their asset management company to make good choices'

"We've proven time and time again that in emerging markets – whether it's in Argentina, Brazil or Turkey, you name it – even though investors sometimes go through bad periods, they can still generate very decent returns on a 10 to 15-year horizon. But it is really a question of stock picking rather than index picking."

"There is an English saying that goes, 'It's horses for courses', meaning every situation is different and you need to be in the right companies. Therefore, you have to pick the asset managers that you're going to entrust your money to very carefully, because you have to be confident that they will make good choices more often than not."

"Five years ago, for example, it was very fashionable to look at Chinese electrical electric vehicle companies. Today, there are over 400 companies trying to compete in a market that will only be about two million units maximum next year. So, there aren't very many profitable companies at the moment, and what looked like a good idea five years ago does not seem that relevant anymore."

A bit like what happened with the solar panel industry over the last decade...

"Yes exactly. Now, the Chinese solar panel sector is in dire straits, after Beijing decided to reduce feed-in tariffs and limit subsidies for new solar generation projects. So, you have to be quite careful about how you allocate your money and beware of hype and potential policy U-turns."
"Having said that, there are two things that I think are definitely going to happen. First, there will be further urbanization. So, companies that are directly linked to the growth of cities will probably be finding good opportunities. Secondly, we also know that China is aging really quickly. So care for the elderly products and services will also be very much in demand."

What do the protests of the past few months in Hong Kong tell us about the younger generation in China, in your view? Are there any risks investors should watch for?

"As you know, I teach a bit at Oxford University and at the School of Oriental and African Studies in London. Doing so, I get to talk a lot to Chinese students coming to the UK. And when I go to Hong Kong and to Mainland China, I also always try to talk to younger people. And it's interesting because some of them are a little bit angsty about just what's going on."

"They don't like the idea that they may be falling out with America because actually they quite like America. They may not like Donald Trump, but they like America. At the same time, they tend to be very respectful of the CCP – in the urban areas, at least – because they have been conditioned into thinking that their prosperity and their living standards will keep rising year after year."

"So this is really important for China to keep this going. Were China to tumble into some kind of a recession, say maybe a meagre 2% GDP growth, that would be a big shock for them. And if jobs started to become scarcer – some trends are actually pointing in that direction – I think that would be quite dangerous for the CCP."

"In any case, the atmosphere has changed in recent years. I was in China last June, around the time the 30th anniversary of the Tiananmen Square protests. One event where I was supposed to speak in Shanghai was canceled at the last minute. The police had been there and wanted to know what was going on. The organizers decided it was better to stop it. I've never come across that before."

"So it's really a mixed bag of sentiments and emotions, you know. Some young people appear to be very optimistic about the future, others are quite concerned about the direction the country is travelling. And then there are lots of regional variations. People in Shanghai don't necessarily think the way people think in Yunnan province, and so on."

"As for the situation in Hong Kong, it is quite embarrassing, to say the least, for a government who preaches the sanctity of Communist Party control and harmonious development. At the moment, there's the perception that they cannot control it. So the longer the protest goes on, the riskier it is for Xi Jinping."

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Additional Information for investors with residence or seat in Spain

Robeco Institutional Asset Management BV, Branch in Spain is registered in Spain in the Commercial Registry of Madrid, in v.19.957, page 190, section 8, page M-351927 and in the Official Register of the National Securities Market Commission of branches of companies of services of investment of the European Economic Space, with the number 24. It has address in Street Serrano 47, Madrid and CIF W0032687F. The investment funds or SICAV mentioned in this document are regulated by the corresponding authorities of their country of origin and are registered in the Special Registry of the CNMV of Foreign Collective Investment Institutions marketed in Spain.

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Robeco Institutional Asset Management B.V is registered and regulated by the Financial Sector Conduct Authority in South Africa.

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This document is exclusively distributed in Switzerland to qualified investors as defined in the Swiss Collective Investment Schemes Act (CISA). This material is distributed by RobecoSAM AG, postal address: Josefstrasse 218, 8005 Zurich. ACOLIN Fund Services AG, postal address: Affolternstrasse 56, 8050 Zürich, acts as the Swiss representative of the Fund(s). UBS Switzerland AG, Bahnhofstrasse 45, 8001 Zurich, postal address: Europastrasse 2, P.O. Box, CH-8152 Opfikon, acts as the Swiss paying agent. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the Fund(s), as well as the list of the purchases and sales which the Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, at the office of the Swiss representative ACOLIN Fund Services AG. The prospectuses are also available via the website www.robeco.ch.

Additional Information for investors with residence or seat in the United Arab Emirates

Some Funds referred to in this marketing material have been registered with the UAE Securities and Commodities Authority (the Authority). Details of all Registered Funds can be found on the Authority's website. The Authority assumes no liability for the accuracy of the information set out in this material/document, nor for the failure of any persons engaged in the investment Fund in performing their duties and responsibilities.

Additional Information for investors with residence or seat in the United Kingdom

Robeco is subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

Additional Information for investors with residence or seat in Uruguay

The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

Additional Information concerning RobecoSAM Collective Investment Schemes

The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub-Funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website www.robecosam.com.