Insight
Market Outlooks

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Why China Remains Attractive Despite Risks

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- China's growth story will continue, although that story is changing and becoming more complex.
- We believe that investment in China remains a unique and compelling opportunity to capture returns, even in light of slowing absolute growth and a unique set of risks.

After two decades of staggering economic growth in China, recent developments have understandably raised investor doubts about future investment prospects in the country. China's economy did recover relatively quickly from the pandemic — but Chinese equities are now trading well below their 20-year average, exhibiting a high valuation divergence compared to global markets. And a recent wave of regulatory intervention across a variety of sectors has created even more questions about China's growth prospects in coming years.

As China's share in the global economy continues to rise — albeit at a potentially slower pace — we believe investors should consider not just maintaining, but rather increasing, their allocation to China. Both from a macroeconomic and regulatory perspective, we believe that China is following a path that is quite distinct from other emerging markets. Understanding China's path, and the risk/return characteristics that define that path, are key to thinking through the inclusion of Chinese assets in an institutional portfolio, including the consideration of a dedicated allocation to China.

In this piece, we'll discuss the evolution of China's growth story from a macroeconomic and geopolitical perspective, including potential threats to economic growth and some of the broad risks that investors should consider when investing in China. In general, we believe that investment in China remains a unique and compelling opportunity to capture returns, even in light of slowing absolute growth. At the same time, China investment presents a unique set of risks that demand close attention.

China's Evolving Growth Story

The Chinese economic growth phenomenon is well known yet awe-inspiring nonetheless. As of mid-2021, China's economy was over five times larger than it was in 2000. The enormity of this statistic can only be fully appreciated in context: During that same period, the US economy only grew by about 50%, the eurozone by about 30%, and Japan by less than 12%.

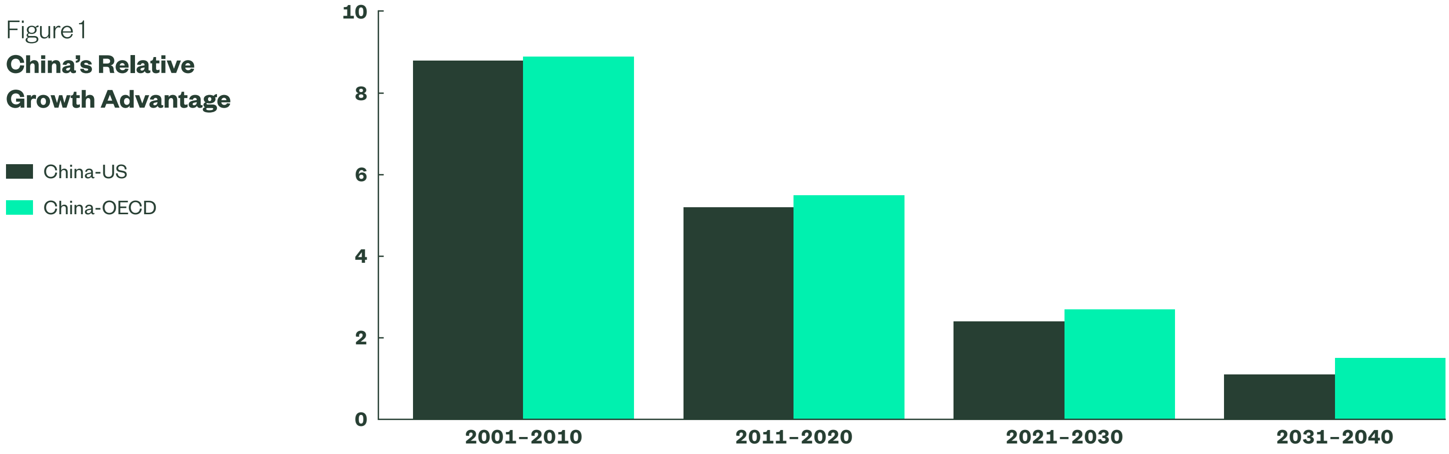
For decades, China's size, and its vast supply of low-cost labour, made the country's export-led growth model run very effectively. This allowed China to overtake Japan as the world's second-largest exporter within three years of joining the WTO (in 2001) — and then overtake the US as the largest exporter three years later. The size and depth of China's domestic market mean that only the United States can match it as a business incubator. The process of validating business ideas in China's local market is so stringent that any successful national champions are likely to have the competitive features to become global leaders.

Of course, investors can't simply extrapolate China's future growth from its growth history or assume that its advantages will remain fixed and unchanging. Size, for example, is a source of strength for China's economy, but it may also pose a threat to China's future growth, simply because the rest of the world is not growing fast enough to continue to absorb the kind of export growth in the future that has fueled China's growth in the past. As China is forced to rotate away from the industrial production that has historically fueled its GDP growth toward lower-productivity service delivery, lower growth may follow. Deteriorating demographics also suggest slower future growth; China's working-age population started contracting about five years ago, and UN population projections predict that this trend is poised to intensify.[1] And finally, the convergence of the transition to services and weakening demographics has increased China's reliance on leverage to sustain high growth, creating concerns about excessive debt accumulation that could also pose a threat to future growth. China's debt ratio seems high relative to other economies, including the US and Japan. China has also reached these high debt ratios at a point in time when its per-capita income remains a fraction of that exhibited by the US and Japan when those countries reached their peak debt ratios.

A range of factors may well help to mitigate these forces. For example, China made an effort to engineer a demographic reversal by dropping its One-Child policy in 2016. Rapid educational improvement may also outpace the demographic slowdown in China and help to offset the negative effect of deteriorating demographics. On the debt front, it's important to note that China's debt is heavily tilted toward investment, which has helped to create a robust, modern infrastructure that is likely to lend support to economic development over the long term.

In sum, we believe that Chinese growth is likely to slow on an absolute basis in coming years. China may have harvested much of the low-hanging fruit that has contributed to its growth in recent decades. GDP growth is now decelerating at a pace that would see China's growth advantage versus the US largely disappear by the end of the 2030s (see Figure 1). Several trends, including the continued transition to services, changing demographics, and relatively high debt levels leading to a slower pace of credit growth, will continue to contribute to this lower growth, although certain factors may come into play to slow the trend. Ultimately, the question is not whether annual GDP growth will persistently dip below the 5% mark, but rather how soon it will happen.

Figure 1
China's Relative Growth Advantage



Source: State Street Global Advisors Economics, Oxford Economics.

A Sizable, but Diminishing, Relative Growth Advantage

Even if Chinese growth is very likely to slow, from an investment perspective it is important to consider *relative* growth.

The difference in China's GDP growth versus the US and Europe has been astronomical in recent decades (see Figure 1). But as GDP growth in China decelerates due to the size, demographic, and debt factors we've already discussed, the GDP growth gap between China and other countries is narrowing. At this pace, China's growth advantage versus the US and Europe is likely to largely disappear over the course of the next two decades. Until then, however, China will continue to increase its share of the global economy — if at a gradually slowing pace. For that reason, we believe that it's important for investors not only to maintain their exposure to China, but also to consider affirmatively increasing their allocation to China in order to continue to participate in China's evolving growth story.

Continuing Support for Growth

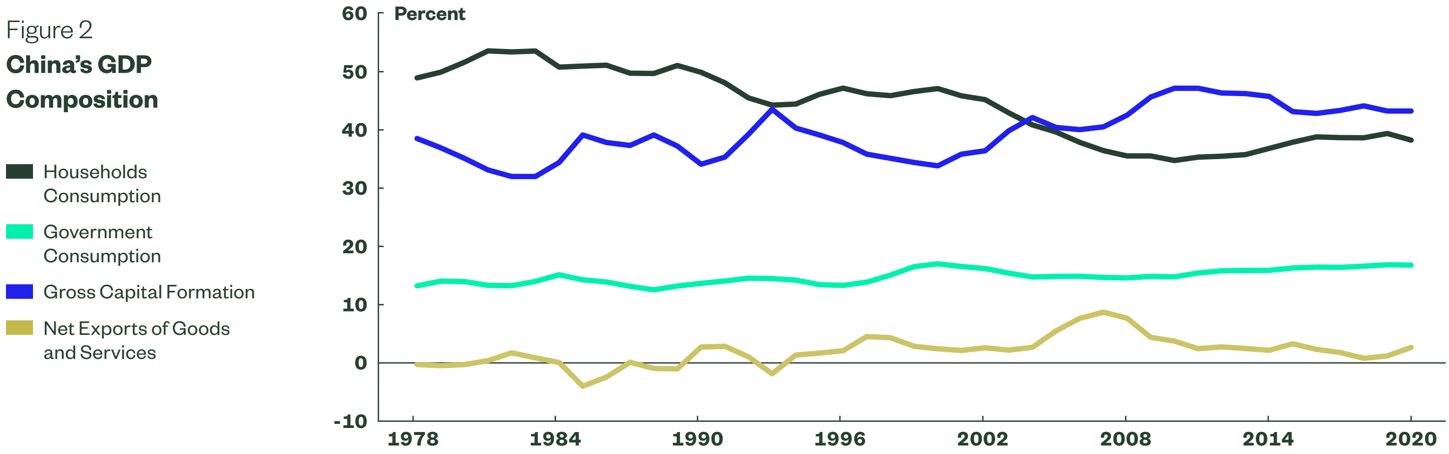
Whether China's growth slowdown takes shape quickly or slowly may depend in large part on the Chinese government's commitment to supporting growth through domestic policy, including regulation. In general, we believe that China's government remains committed to furthering and supporting growth as it navigates China's transition to a developed market.

After 40 years of economic reforms that both support a vibrant private sector and maintain heavy state involvement in the economy, China remains an emerging market country. For China's policy makers, a key question is whether the country will be able to glide over the "mid-income trap" that has snared many other EM countries.

Whether China succeeds in avoiding this trap may be determined by the fact that, in contrast to many EM peers, China has invested significantly in a broad capital stock and in technological innovation. China has been increasing its R&D expenditures both in nominal terms and as a percentage of GDP, accounting for nearly a quarter of global R&D spending and making China the second largest R&D spending economy.[2] Its investments in capital stock include: physical transportation infrastructure such as highways, high-speed rail, and airports; digital infrastructure such as broadband and 5G networks; and human capital with 8 million university graduates each year.

All of these investments have boosted productivity and provided a platform for future economic growth, although the challenge of pivoting the economy away from highly leveraged fixed-asset investment and toward domestic consumption remains (see Figure 2). Such a pivot will require higher household incomes, mainly via higher wages, which means better-paying jobs through growth in the industries of the future.

Figure 2
China's GDP Composition



Source: National Bureau of Statistics of China, 1978–2020.

Interestingly, one of the unnerving aspects (for investors) of the well-publicised wave of regulatory actions in 2021 was the realisation that most interventions were directed at future-oriented sectors, e.g., Fintech, e-commerce, food delivery, ride-hailing, education, on-line gaming, and social media. Investors wondered if these actions reflect an emerging anti-private stance by the government, i.e., one that would undermine China's future economic trajectory. On balance, we do not see evidence that the government intends to constrict private capital. Many of the regulatory actions address legitimate issues, including anti-competitive practices, predatory pricing, financial stability risks, regulatory catch-up and capacity-building, data protection, abusive labour practices, and environmental protection. We feel that damage to the private sector would be an unintended consequence of regulatory action, as the Chinese government has been clear that private businesses are a key driving force of economic growth, given their significant contribution to the total economy (see Figure 3).

Figure 3
Private Sector Contribution to the Chinese Economy (%)

Source: McKinsey & Company, China Consumer Report 2021, Understanding Chinese Consumers: Growth Engine of the World . Private enterprises defined as private enterprises and foreign enterprises.

With all of this in mind, what further issues might emerge to complicate the Chinese growth story we've presented so far? Capital account risk and geopolitical risk (if conflict impacts trade) lead the list.

Capital Account Risk

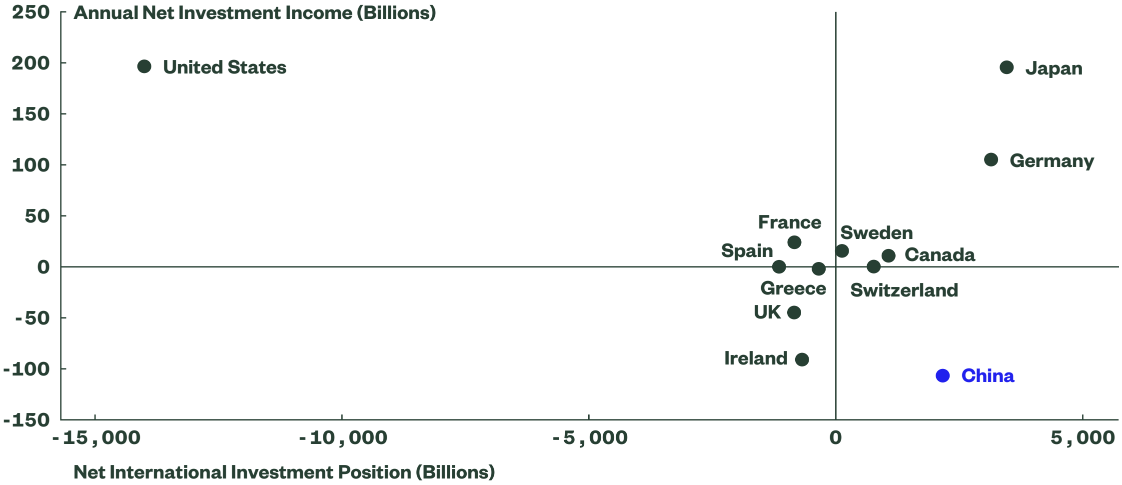
The implosion of real estate development company Evergrande reflects several key features of China's financial landscape. Most importantly, this story encapsulates the semi-closed nature of China's capital account, which prevents the efficient investment of excess savings, thereby leading to domestic asset bubbles and exacerbating a debt-driven growth model.

In this regard, China's path mirrored other emerging markets. EM countries have often used a fixed exchange rate to ensure FX stability, to attract foreign investment, and to ease transactions. As the export base grows and the country prospers, this usually morphs into a managed exchange rate where some of the stability is forsaken in order to capture gains in purchasing power.

The next step typically sees the currency gain international usage and allows domestic savers to invest abroad, thus offsetting current account surpluses and stemming appreciation pressure. China was pursuing this development, but pulled back after 2015-2016, when capital outflows triggered currency volatility. In an unconventional reserve management policy, China's official foreign exchange reserves were kept stable to minimise their signal power for currency markets. This approach to capital account management has three consequences for how China invests its savings.

First, China as a whole still derives negative net income on its current account, a remarkable feat for a country with a net creditor position of roughly US $2 trillion (see Figure 4). This is partially explained by the negative carry the official sector needs to pay on its domestic liabilities.

Figure 4
Net International Investment Position versus Net Investment Income, 2020
$ Billions



Source: State Street Global Advisors Global Macro Policy Research, Macrobond.

Second, the restrictions on the capital account are imperfect, so China continues to record capital outflows in the form of net errors and omissions to the tune of close to $200 billion annually.

Third, domestic savers who do not manage to acquire foreign assets are also penalised. The inability to optimise resident savings pools in global portfolios leads to repeated domestic asset bubbles. Excess savings mean Chinese banks enjoy plenty of deposits, which in turn has facilitated the high-growth strategy on the back of high debt leverage. And when banks were tightly restricted in their lending, deposits flowed to the shadow banking sector to perform a similar function. No matter the regulatory choice, the build-up of excess capital inevitably leads to episodes of financial stress, reflecting a chronic misallocation of capital.

Although it is important to carefully consider capital account risk, several factors may also help to mitigate its effects. First, China has considerable financial resources. It remains a large net creditor to the rest of the world and thus can easily manage balance of payments pressures. Second, the government also has resources to deal with large-scale defaults, and more regulatory power than Western governments to smooth spillover risks. Third, recent progress toward opening China's domestic financial market to foreign capital should impose better overall market discipline. Finally, any broader reforms to reduce overcapacity in leveraged sectors would also be welcome, as they could alleviate the underlying pressures generating asset bubbles.

Geopolitical Risk

Geopolitical competition today revolves around economic primacy; it is important to identify where this can trigger investment risks. We believe that the core geopolitical risk for investors in China comes in the form of broader policy surprises driven by geopolitical concerns.[3] The Trump tariffs were a taste of the nature of competition, but future policy measures are likely to be more complex in their application. The main arena of battle ranges from domestic subsidies and arcane sector regulations to cross-border agreements that affect trade and capital flows. As geopolitical tensions escalate, policy battlegrounds are likely to broaden further to include non-economic areas such as data governance and climate policy. (For example, the technical definition and implementation of carbon border taxes could establish high *de facto* barriers to Chinese trade.)

What impact might such measures have? The obvious primary risk would be Chinese exports facing additional hurdles and losing competitiveness. A secondary risk would be limiting access to foreign capital — less important as a source of financing than as a source of knowledge sharing and market discipline. In fact, this is where we believe China faces its greatest geopolitical risk — namely, the potential exclusion from research networks and access to key supply chains of critical technology.

Geopolitical risks to Chinese investment are certainly worthy of careful consideration. At the same time, various forces may help to mitigate some of these risks. China's transition to sectors and industries of the future depends on international collaboration. In this regard, China has positioned itself as a leader in several areas, e.g., electric vehicles, batteries, and solar (although its prominent position will be challenged by other regions seeking to develop their own domestic industries). There remains room for export growth in new sectors and through trade integration among China-friendly nations, which could partly offset some of the loss in market share in developed countries, should some of these geopolitical risks come to be realised.

The Bottom Line

China's size and share of the global economy make it impossible to ignore. China's growth story will continue, although that story is changing and becoming more complex. China's contribution to global growth continues to increase — if at a slower pace — and we believe that the China investment opportunity remains compelling. Given China's idiosyncratic path compared with other emerging markets, the ongoing evolution of its growth story and associated return opportunities, and the unique risks involved, we believe that investors would be well-served to give particular, dedicated consideration to China investment. This may even include a separate portfolio allocation to China, which would allow investors to tailor and adjust their China exposures to meet their particular return and risk objectives over time.

For more information on how best to reap the benefits of the China growth story, please contact your State Street Global Advisors relationship manager.

Endnotes

1 Source: State Street Global Advisors Economics; UNDESA, 2019 World Population Prospects (most recent).

2 Global Research and Development Expenditures: FactSheet, Congressional Research Services, September 2021.

3 While there are undoubtedly major tail risks in the form of military conflict, e.g., with Taiwan, these are hard to price or hedge against.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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