# Frontier International

Post-pandemic China: a changing economy, new investment opportunities

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# Introduction

China has been at the epicentre of the coronavirus pandemic that has changed the world.

Its size and power continue to heavily influence the global economy and investment markets in evolving ways since Frontier's last in-person visit in 2019 and our virtual update during the peak of the pandemic in mid-2020.

Frontier's Capital Markets and Asset Allocation Team recently had the chance to undertake a more comprehensive virtual trip to assess conditions.

We spoke to a wide range of financial market participants and investment managers based in Beijing, Shanghai, Guangzhou, Hong Kong and Singapore.

We assessed a range of investment opportunities, the risks they come with, and the changing nature of the economy.

There are compelling reasons to take advantage of these opportunities, particularly in the bond market, but investors need to be wary of rising sovereign, regulatory and ESG risks.

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# China: a land of unique investment opportunities

The Chinese economy has quickly recovered from the COVID-19 pandemic but investors must still navigate a set of unique risks to generate healthy returns.

China was the only major economy in the world to post positive GDP growth in 2020 thanks to its success in controlling the outbreak and targeted government support. While its growth is expected to slow, the investment opportunity remains compelling.

The government and corporate bond markets offer attractive yields although some of these benefits are eroded by currency hedging. There are also issues about market access and transparency, with some high-profile bond defaults.

While onshore equities have surged with the economic recovery, a shift in infrastructure investment towards green and digital projects suggests other regions may also back these areas in future.

Many broader macro risks remain in play and present ongoing challenges for investors.

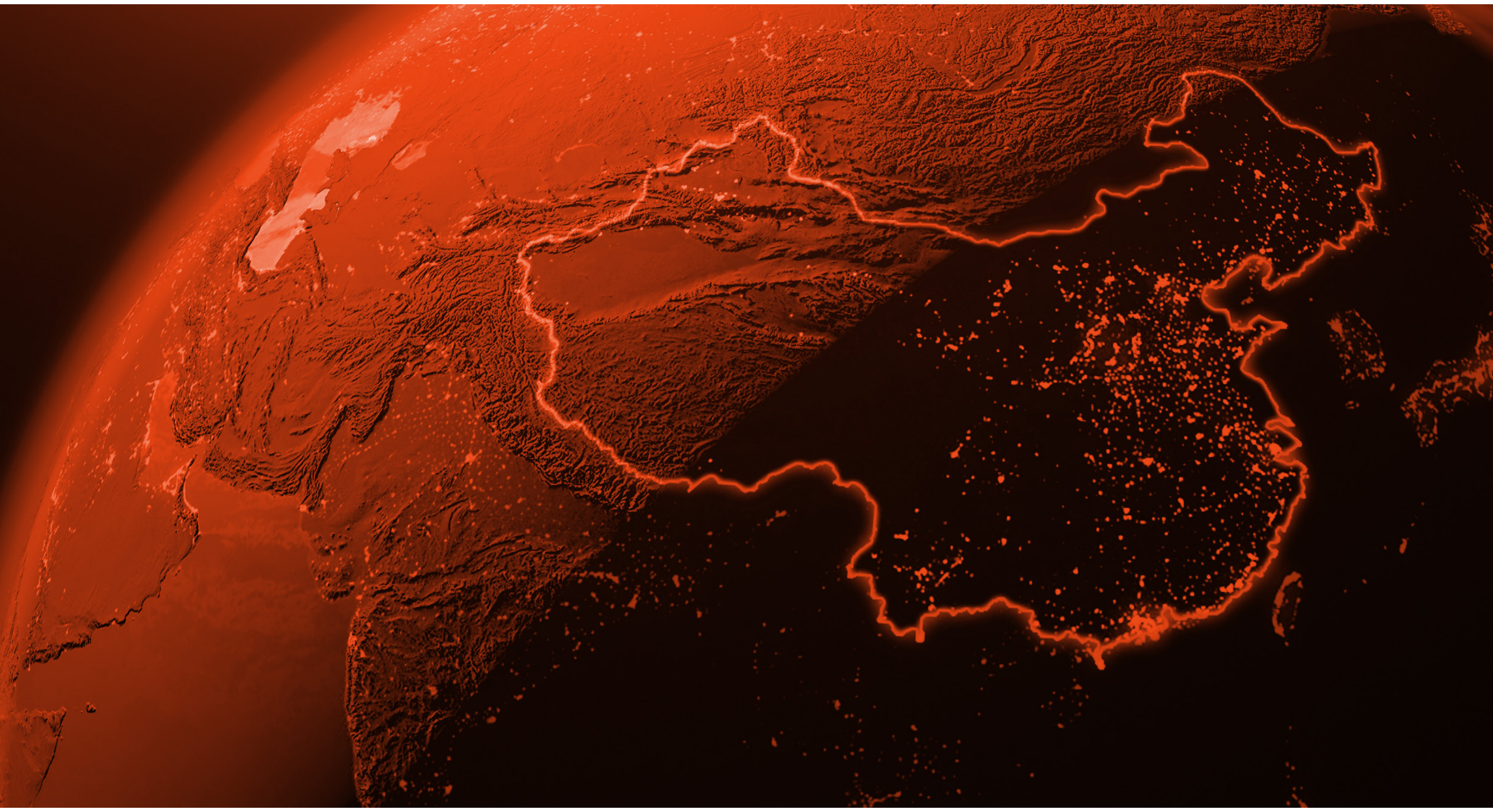
Geo-political tensions, such as China's relationships with both the US and Australia, are rising. China is also strongly asserting its interests in Taiwan and Hong Kong, while territorial disputes continue with India and in the South China Sea.

Investors also face heightened regulatory and ESG risks in the region, such as forced labour and human rights abuses.

Investors can't ignore these risks, but they also can't afford to ignore the opportunities given China's ongoing growth and influence.

## Key points

- The Chinese economy has rebounded quickly from the COVID-19 pandemic.
- The government is now focused on financial stability rather than fiscal support, as the economy moves from investment/ manufacturing to consumption.
- With interest rates around the world remaining low, the Chinese credit market offers attractive yields, although not without risk.
- China A-shares have soared in value and the market shows signs of speculative behaviour.
- A trend towards investment in green and digital infrastructure suggests the way ahead for western economies.
- While China offers investment opportunities, investors must navigate a wide range of risks encompassing sovereign, regulatory and ESG issues.



# Investment opportunities in China

Chinese financial markets have been slowly opening to foreign investors for almost two decades. The Qualified Foreign Institutional Investor Scheme (QFII) opened access to China A-shares in 2002, followed by the Renminbi Qualified Foreign Institutional Investor Scheme (RQFII) in 2011.

While there are now simpler channels to invest, such as Stock Connect and CIBM Direct, gaining access remains challenging, and the market is opaque. However, we believe there are new investment opportunities, particularly in the bond market.

## Chinese bond market offers attractive yields

The current ongoing low-yield environment continues to challenge investors as central banks again cut rates to support their economies amid the COVID-19 pandemic. The Chinese bond market presents one potential opportunity which few foreign investors have explored. Historically, it has been difficult to access the market (although the Bond Connect cross-border bond trading and settlement scheme has made that easier), and the relative risk-adjusted yields have been more attractive in developed markets.

Foreign investors only comprise about three per cent of the Chinese onshore bond market, although capital inflows have increased as investors seek higher-yielding assets.

**Table 1:** Government bond market comparison

| Market | Size (USD trn) | Duration (year) | Rating (S&P) |
|---|---|---|---|
| **China** | 6.8 | 5.8 | A+ |
| **USA** | 23.5 | 6.6 | AA+ |
| **UK** | 3.3 | 13.2 | AA |
| **Japan** | 10.4 | 12.0 | A+ |
| **Australia** | 0.9 | 7.3 | AAA |

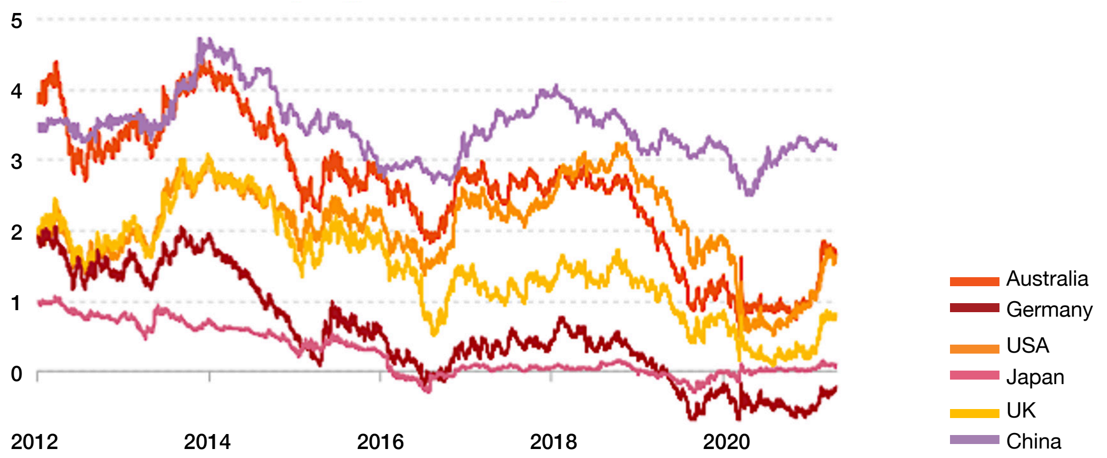
Source: BIS, Russell. Duration is based on FTSE indices updated on April 2021.

# Chinese government bond yields: higher yields but hedging an issue

The Chinese government bonds offer relatively attractive yields with lower duration compared to developed market government bonds, although the interest rate differential has recently narrowed. The asset class is also negatively correlated with equities and has a lower correlation than developed bond markets[1].

While US Treasury markets experienced some liquidity issues around March 2020 when many countries initially went into lockdown, the Chinese government bond market remained liquid.

**Chart 1:** 10-year government bond yields




Source: Refinitiv Datastream, Frontier

Although Chinese government bond yields are attractive, currency exposure remains an issue. The cost of hedging the Renminbi (CNY) has increased due to the large interest rate differential between China and Australia. This reduces the investment yield significantly on a hedged basis, resulting in a similar yield to European or Japanese bonds. As the Renminbi is relatively stable against other currencies, most foreign investors have so far chosen to invest in Chinese bonds on an unhedged basis to maintain a higher yield.

## Corporate bond yields are higher, but harder to assess default risk

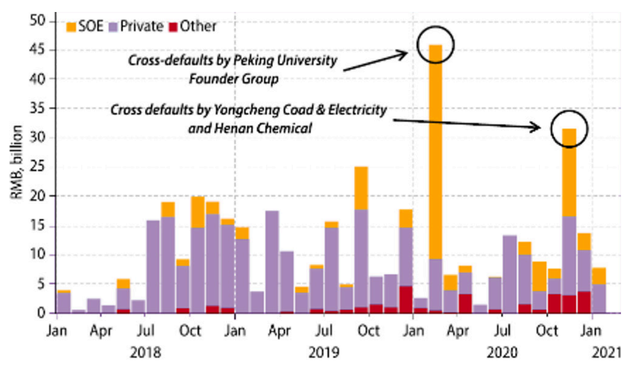
Chinese corporate credit also offers attractive yields, but the risk of default has been harder to assess.

There has been an increase in Chinese corporate bond defaults concentrated in state-owned enterprises (SOEs) as the government has withdrawn its implied government guarantee over 'zombie' enterprises. Some highly rated bonds have defaulted despite strong local credit agency ratings. These overly positive ratings have partly been due to political pressure, forcing most managers to rely on their own credit ratings.

In a positive move, the government has recently allowed international credit rating agencies to provide ratings of local credit issuers. However, this also comes with the risk of credit re-pricing.

Investment managers still aren't expecting widespread defaults and, if there are, expect the government will still step in to prevent them.

**Chart 2:** Corporate defaults by issuers




Source: Wind, Gavekal

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[1] Frontier's Debt and Currency Team has published a paper covering the Asian credit investment opportunity in more detail at https://www.frontieradvisors.com.au/opportunities-in-Asian-debt.



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# Chinese infrastructure: a sign of where developed markets are headed

A significant amount of traditional infrastructure – such as airports, seaports and rail – has already been constructed as China continues to urbanise.

Investors in Chinese infrastructure need to be hyper-aware of sovereign, political and regulatory risks. For example, there are foreign ownership restrictions on certain types of infrastructure.

Chinese infrastructure spending is now shifting away from traditional infrastructure to new segments including:

- Data centres
- 5G network/base stations
- EV charging stations
- Renewable energy

These new trends point the way to where structural shifts in infrastructure investment are set to occur globally.

## China A-shares: valuations stretched

China A-shares, which are traded on the Shanghai Stock Exchange and the Shenzhen Stock Exchange, represent the second-largest equity market in the world (by market cap) after the US.

The economic recovery following the pandemic resulted in a strong equity market rally, which has stretched valuations.

While corporate earnings have recovered to near pre-pandemic levels, there are signs of speculative investor behaviour. For example, there has been a rise in share margin trading, and retail investors still dominate the market.



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# A rising range of risks

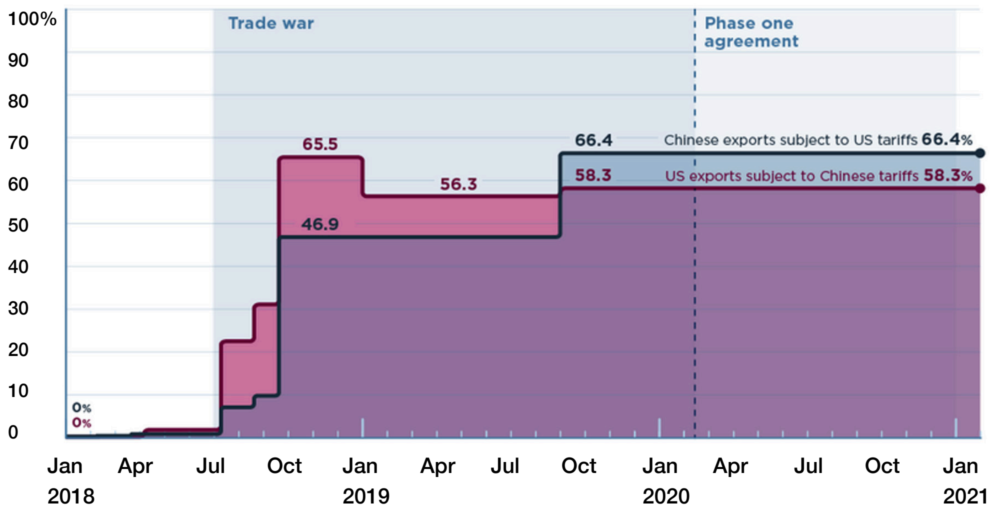
China has its own unique way of interacting with global markets and managing its domestic economy. This gives rise to a range of evolving risks for investors to consider.

## Trade tensions

Trade tensions between the US and China are driven by deeply rooted political, ideological, cultural and social differences that are difficult to resolve.

The trade war reached new heights in January 2020 with both countries imposing tariffs on each other's exports of around 21%[2]. This was vastly higher than the tariffs imposed on the rest of world, which stayed in low single digits.

**Chart 3:** Percent of US-China trade subject to tariffs




Source: Peterson Institute for International Economics

While the level of tariffs has slightly eased, US public opinion towards China has also become increasingly unfavourable. This means that although President Biden has a more measured approach to foreign policy, geopolitical tension is likely here to stay.

If the Washington-Beijing scuffle escalate again, it could disrupt global supply chains, putting upward pressure on inflation and dampening growth.

However, the ongoing trade tension between the US and China seems unlikely to escalate any time soon, with both countries focused on the state of their economies in the wake of the pandemic.

The trade tensions with the US are also affecting Australia. China has imposed strict tariffs and bans on a range of Australian exports, which may be an attempt to 'kill the chicken to scare the monkey' (i.e. using Australia to set an example to other Western countries).

Holding foreign currencies as an Australian investor is one way to try to manage this downside risk. Global bonds may not provide protection if China/Australia trade tensions escalate further.

[2] US-China Trade War Tariffs: An Up-to-Date Chart. (2021, March 16). Retrieved from https://www.piie.com/research/piie-charts/us-china-trade-war-tariffs-date-chart

## ESG risks

China's rapid industrialisation has come at an environmental cost, with carbon emissions, air quality and pollution all becoming significant problems over the past decade.

But while China has made improvements in the environmental arena (it is aiming for carbon-neutrality by 2060), there are still key issues around social and governance practices.

Investors shouldn't assume China will fall in line with Western practices, particularly in the currently tense geopolitical environment. Investors need to monitor and manage these risks, which are a key consideration when investing in China. A recent example is the alleged forced labour and human right abuses by certain cotton producers of the Xinjiang province.

Several Western companies, such as Nike and H&M, changed their cotton supplier but this led to a negative reaction from the Chinese government and consumers that will ultimately be negative for their earnings. The Xinjiang region also accounts for a large part of global production of critical solar panel parts which will impact on the renewable infrastructure sector.

The Chinese government continues to influence the private sector.

For example, authorities 'asked' banks to keep profit growth below 10% for 2020 and to 'sacrifice' CNY1.5 trillion (US$230 billion) in profit for 'national service' by offering lower lending rates, cutting fees, deferring loan repayments, and granting loans to small businesses during the COVID-19 lockdown. Authorities also made expressways, bridges and tunnels toll-free for two and a half months during the worst period of COVID-19 and had cut steel production by up to 50% to meet carbon emission reduction targets in late 2020.

Regulators have also halted Ant Group's US$37 billion IPO two days before trading for 'financial market stability' reasons.

## Territorial disputes

China occupies an important strategic space in the global landscape, with 14 countries sharing a hard border. This has led to many territorial disputes that continue to change the region.

India, the most populated country to share its border, has been implementing policies to limit its economic dependence on China. India has had recent deadly border disputes at China's western border. While the issue is largely isolated to the countries involved, it could add to greater de-coupling of the global economy.

While the forced reunification of the island of Taiwan has been a persistent issue over the years, the risk has been heightened by the Chinese government's recent rhetoric and military action.

This is a high-impact downside risk for global financial markets due to the high probability of armed conflict, which could possibly embroil Western countries such as the US and Australia.

Disputes over maritime and island territories within the South China Sea may also lead to armed conflict. Unlike the US/China geopolitical tension, the countries involved (Philippines, Vietnam, Brunei, Taiwan and Malaysia) are not as significant to the global economy. However, a significant percentage of global shipping trade goes through the disputed territories which could disrupt supply chains and increase logistic costs.

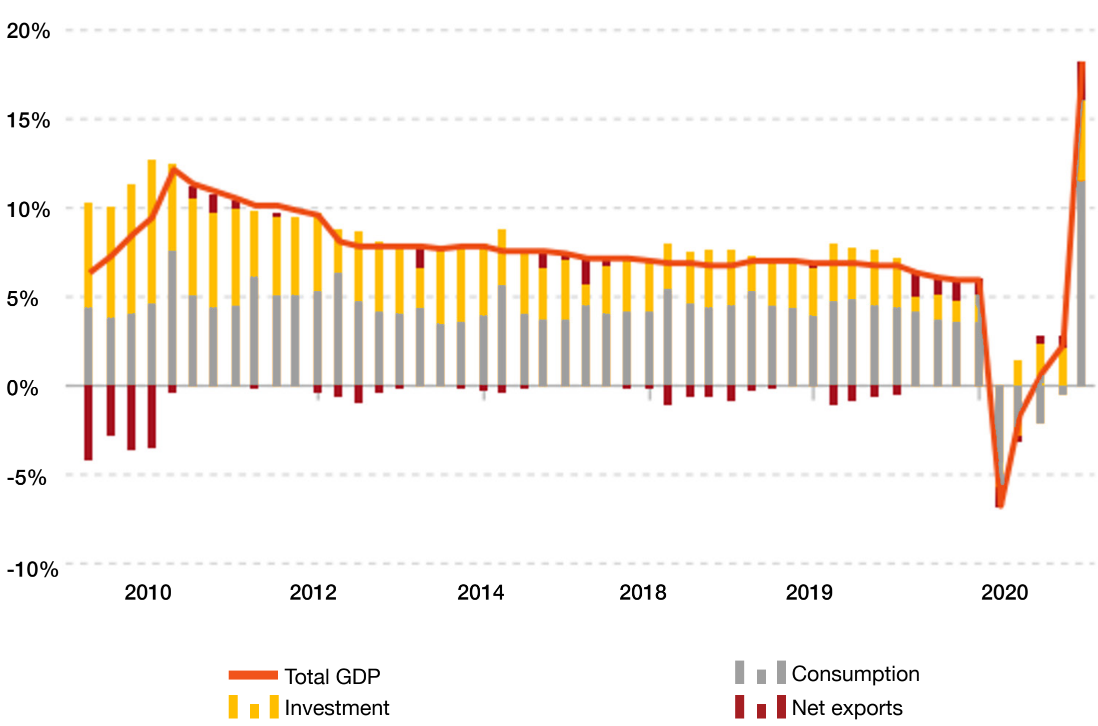
The issue of Hong Kong's autonomy, which led to mass protests in recent years, will continue to be an ongoing conflict. Sanctions imposed by Western countries because of the dispute may dampen the global economic recovery.

# How the Chinese economy is changing

China's size and urbanisation has made it an integral part of world growth, but the nature of its economy is changing. It remains on track to become the largest economy in the world by 2030, according to recent estimates, despite the impact of the pandemic.

The government's focus has recently re-shifted from supporting the economic recovery back towards financial stability.

**Chart 4:** China real GDP growth contribution




Source: Refinitiv Datastream, Frontier

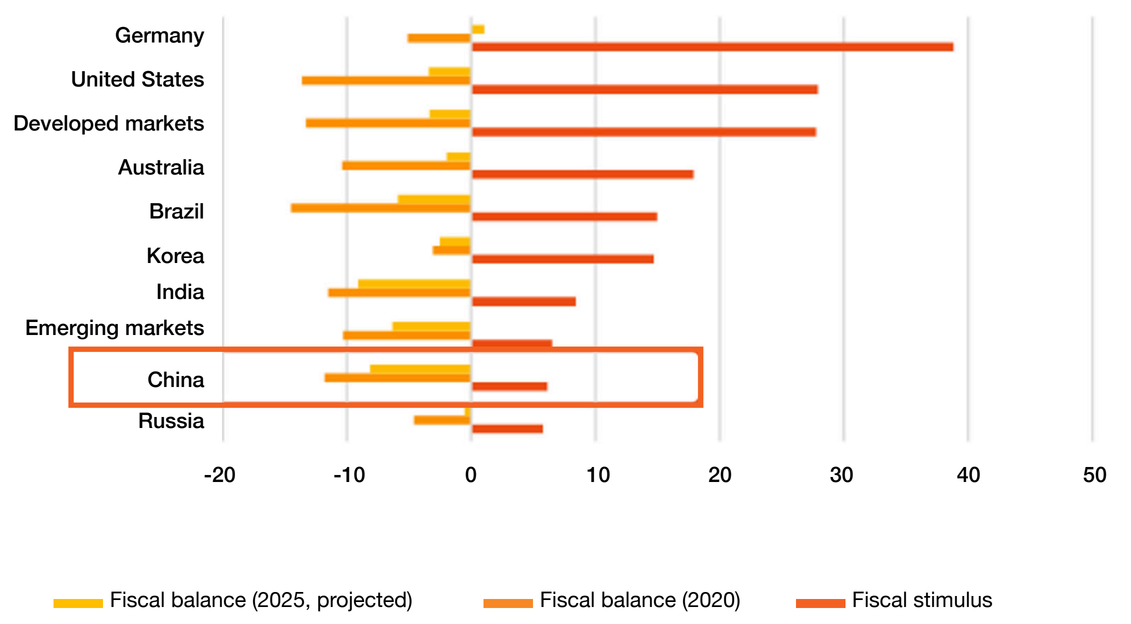
# The coronavirus pandemic: First in, first out

China was the first country to experience the economic consequences of the COVID-19 pandemic – it was also the first to recover.

Strong government support drove a V-shaped recovery, allowing China to become the only major economy to post positive GDP growth in 2020. The consumer services sector still lags, with sporadic outbreaks hampering its growth, such as the cluster in January ahead of the Lunar New Year. Some data suggests activity has picked up, but it remains below pre-pandemic levels.

There have also been some problems with China's COVID-19 vaccine rollout, which is still behind other major economies. However, the percentage of the population that has received a single vaccine dose has significantly increased since March this year.

**Chart 5:** Fiscal profiles across major economies (% of GDP)




Source: IMF, Frontier. Fiscal stimulus includes direct spending, loans and guarantees.

Due to the government's relatively tough management of the pandemic, the scale of stimulus needed in China was far less than in other countries. With the worst behind them, Chinese authorities are shifting focus from government support to managing financial risk, although the chance of aggressive tightening is low.

Private credit growth is slowing, macroprudential policies are being imposed on property developers and banks, and steel production is being cut due to carbon emission reduction targets.

## China's five-year plan

The primary goal of China's latest five-year plan is to grow the domestic economy and reduce its reliance on other nations. It also plans to preserve the environment and become technologically independent.

Economic growth is expected to slow as it faces structural constraints, including a declining labour force and productivity challenges.

The population will continue to urbanise as it has done for decades, albeit at a slower rate. Currently, urbanisation is around 60% – about 20% below developed economies.

Although the global market relies on Chinese exports for a considerable proportion of manufactured goods, China depends on foreign technology (such as semiconductor chips) for its own production. As a result, integrated circuits have become a significant part of China's imports. This is a key reason China is focusing on achieving technological self-sufficiency by 2035 particularly in an environment of geopolitical and trade tensions.

# The final word

China's influence on the world is as strong as the country is unique. China presents many opportunities for investors who are prepared to do the extra work understanding its differences and managing its risks.

These are changing rapidly in the wake of the pandemic. The Chinese economy is set to continue growing, albeit more slowly. The government is now focused on managing financial stability rather than providing more support.

Investors are increasingly finding onshore opportunities as the market opens to foreigners.

Valuations across its onshore share market may be stretched, but the government and corporate bond markets are offering attractive yields. New types of digital and green infrastructure are starting to emerge.

However, China remains an investment market defined by rapidly changing risks. Geo-political tensions are rising, while regulatory, sovereign and ESG risks continue to pose challenges.

These challenges are not insurmountable for investors who can manage them in the pursuit of potentially higher returns.

Frontier's Capital Markets and Asset Allocation Team has been closely researching China for a number of years and continues to do so. We are actively monitoring opportunities across this spectrum for investors. Please contact our team to discuss any aspects of this paper.

### Want to learn more?

We hope this paper has generated lots of ideas for your own portfolios. If this is the case, please reach out to Frontier to discuss how we can work with you in this space.

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