Investments

Allocation to China in a new world order

Rising US-China tensions and de-globalisation are wrong reasons to avoid China

Chinese capital markets have continued to become more accessible to global investors. The attractions are diversification benefits, opportunities for active management and a way to position for a new world order.

In brief

Over recent years, there have been increasing concerns about setbacks in globalisation and rising trade/geopolitical tensions between the US and China. These events were perceived to be negative for China's economic prospects and led to elevated market volatility. We are aware that some investors have viewed these developments as reasons not to allocate to China.

In this paper, we argue that the case for long-term investors to increase allocations to China remains strong and has not been undermined by recent developments. Indeed, we postulate that rather than representing setbacks, US-China tensions and de-globalisation are signs that the world is morphing into a new world order.

Using a scenario learning framework, we suggest that over the next 10 years global investors should consider whether to substantially increase their allocation to China, from the current level of 5% to potentially around 20%. The opening up and reforms of Chinese capital markets are expected to continue apace over the coming decade. This should allow global investors to become more knowledgeable and more comfortable when it comes to owning Chinese assets.

Building exposure to China is best viewed as a journey that balances the pace of market improvements with the imperative to achieve structural geographical diversity in a global portfolio.

In a 2019 publication,[1] we put forward a threefold investment case for global investors to allocate to China, based on:

1. Accessing diversifying cash flows;
2. Ample opportunities for active management and;
3. Positioning for a new world order.

Just a year later, the global economic and geopolitical environment for China has markedly deteriorated. As a result of COVID-19, many governments have learned a painful lesson about relying on global supply chains to produce critical goods. The desire to bring more of them onshore is strong. Economic re-shoring is expected to have a direct impact on China given its prominence in global supply chains.

Geopolitically, over the course of the COVID-19 crisis, the world has watched relations between the US and China deteriorate. In July 2020, China's foreign minister, Wang Yi, reportedly acknowledged[2] that China's ties with the US are at their lowest point since the normalisation of relations in 1979.

For many investors, these developments were vivid reminders of the risks and challenges when it comes to investing in China. De-globalisation and rising geopolitical tensions have long been cited as among key factors holding investors back from allocating to China. The COVID-19 crisis amplified these trends in investors' minds.

Are investors rightfully concerned? From a short-term perspective, these developments indeed created a high level of market volatility and, more importantly, uncertainty over the global economic and political backdrop. Nonetheless, for investors with a long time horizon who are well-positioned to look beyond short-term market uncertainty, we argue that **recent events** in fact **reinforced**, as opposed to weakened, **the case for global investors to own more Chinese assets**.

The future is, of course, impossible to predict. There are reasons to believe that the current era of globalisation is under serious threat. China, as one of the biggest beneficiaries of globalisation, is not immune from the de-globalisation trend that has been unfolding for some time, and which has seen global trade and economic integration peaking and plateauing since the global financial crisis. However, "moving factories out of China" is often easier said than done given China's unique and evolving competitiveness in global supply chains.

How the superpower rivalry between the US and China will unfold is also highly uncertain. There is a viable, although by no means inevitable, path for China to replace the US as the global hegemony, given its much larger population. But that path is going to be bumpy.

[1]www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2020/01/Chinese_capital_markets
[2]www.ft.com/content/cb2aab03-8a77-49fd-a928-b470948bebdf

Learn about, as opposed to predict, the future using scenarios

We believe, strongly, that the best strategy for investors is to embrace the uncertainty, rather than attempt to suppress it to a single prediction. This is where scenarios[3] help. In this paper, we construct a thought experiment where the world is shaped only by two key dimensions: global economic integration and global geopolitical order, from which we build a number of future scenarios. For this scenario learning exercise, the time horizon we choose is 10 years from now (i.e. 2030).

With regards to global economic integration, we adopt the framing from this Credit Suisse Research Institute study.[4] This gives three plausible paths globalisation could take for the next decade:

- **Globalisation**
- **Regionalisation**
- **The end of globalisation**

In the **globalisation** path, global trade stays close to its current high level or even regains new momentum (trade at around 50-60% of global GDP). The localisation of supply chains never materialises on a large scale. Global economic interdependence remains at an elevated level. Global financial markets stay highly integrated, resulting in capital markets moving in tandem with the risk of wide-spread market shocks.

In the **regionalisation** path, the rise of Asia and a stabilisation of the Eurozone means the world economy rests, broadly speaking, on three pillars – Americas or United States/US, Europe and Asia (led by China). Supply chains are brought closer to these three regional powers. There are increasing barriers to inter-region trade. In the corporate world, regional champions thrive while multinationals get dismantled.

The **end of globalisation** path is a repeat of 1913 where, in a leaderless world, great powers adopted a dangerous zero-sum mentality driven by populism and nationalism. This path is expected to be highly disruptive to global economic and political stability. The world sees a meltdown of global trade. Financial markets cease to operate globally with many nations adopting harsh capital control measures. Geopolitical clashes are regular occurrences.

[3] www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2019/07/Scenario_learning_VUCA
[4] www.credit-suisse.com/media/assets/corporate/docs/about-us/research/publications/csri-getting-over-globalization.pdf

For the world's geopolitical order, we also see three potential paths.

First, China's ambition to overtake the US as the global hegemony could fail and China becomes Japan 2.0, that is it remains a sizeable economy but is nowhere near powerful enough to challenge US leadership on the global stage. The world goes back to the post-war **US-led unipolar** world order.

Alternatively, the relative decline of the US continues. Across the pacific, China surpasses US in economic, technology and military powers. The alleged threat on western liberal values proves largely overstated. The world experiences a peaceful power transition from the US to China which looks to shape, as opposed to demolish, the existing global institutions. **China-led unipolarity** enters the global stage.

A third path is that neither the US nor China is powerful enough to become the single pole of the world order. They either learn to co-exist and operate within their own sphere of influence or become increasingly hostile to each other. Other great powers could also emerge, in which case the world becomes **multi-polar**.

In constructing future scenarios, we combine these two dimensions in a 3x3 table. Each scenario denotes where a global economic integration path crosses with a global geopolitical order path. As these two dimensions are not independent of each other, some of these crossed paths are counter-intuitive, which leaves us with five scenarios (from top left to bottom right in *Figure 1*):

1. Globalisation regains new momentum in a world of US-led unipolarity
2. Globalisation regains new momentum in a world of China-led unipolarity
3. Globalisation regains new momentum in a multi-polar world
4. Regionalisation in a multi-polar world
5. Disruptive end to globalisation in a multi-polar world.

Figure 1: **Future scenarios**

Global geopolitical order →
Global economic integration ↕

	US-led unipolarity	China-led unipolarity	US-China bi-polarity (or multi-polarity)
Globalisation regains new momentum or at least stays around the current level	▪ Global trade continues to grow ▪ Globalisation of supply chains continues ▪ Dollar continues to act as the world's reserve currency ▪ US multinationals continue to dominate the global business landscape ▪ Open door policy for immigrants ▪ The fabric of international law and institutions are still western in nature	▪ Global trade continues to grow ▪ Globalisation of supply chains continues ▪ Yuan replaces the dollar as the world's reserve currency ▪ Chinese multinationals dominate ▪ Open door policy for immigrants ▪ The fabric of international law and institutions are re-shaped by eastern values and rules	▪ Global trade continues to grow ▪ Globalisation of supply chains continues ▪ Dollar, Yuan and Euro are key anchor currencies ▪ Multinationals dominate the global business landscape ▪ Open door policy for immigrants
Regionalisation shapes the map of influence			▪ High level of trade within each economic bloc while trade across regions is limited ▪ Dollar, Yuan and Euro are key anchor currencies ▪ Rise of regional champions ▪ Regionalisation of supply chains
Nationalism surges, bringing a disruptive end to globalisation			▪ Global trade activities and cross-border investments in free fall ▪ Rising chance of currency and capital wars ▪ Global financial markets become fragmented ▪ National champions dominate ▪ Rising chance of military clash between powerful nations

What does this mean for allocation to China?

At the risk of over-simplifying, for each scenario we[5] provide a likelihood estimate based on our own subjective assessment (see the *Figure 2*). There is another percentage number and that is a sensible level of portfolio weight in a globally diversified portfolio we would assign to Chinese assets, given economic and geo-political developments described in each scenario.

Regionalisation in a bi-polar or multi-polar world is in our view the most likely scenario in the next 10 years. We assign a likelihood of 45% to it. In this scenario, we argue that global investors should aim to allocate 25% of their total portfolios to China given its economic significance and the need to reduce exposure to Western economies when its global influence is progressively declining.

We assign 20% probability to a globalised multi-polar world and a lower allocation to China in that scenario. The rationale is that in a highly integrated, global economy, global investors can access China's economic growth partially via multinationals listed in the western stock exchanges (e.g. US investors holding Apple stocks), reducing the need to hold direct exposures. This is a very important point. **If you expect the major economies in the world – particularly the US and China – to decouple from each other, the case for geographic diversification is stronger, not weaker**. That is also driven by declining correlations among the asset returns of different countries when economic ties between countries globally loosen.

A disruptive end to globalisation is assigned a 10% chance and under this scenario we believe that the benefit of geographic diversification is outweighed by its risks. The return of capital becomes a real concern in an increasingly hostile investing environment with stringent capital control measures and rising chance of outright asset confiscation.

Where do all these percentages bring us to? The probability weighted average allocation to China based on our assessment is around 20%. This number is not far off China's expected share of global GDP in 2030, estimated to be around 25%.

Figure 2: **Likelihood estimate and investment allocation**

Global geopolitical order →

Global economic integration ↕

	US-led unipolarity	China-led unipolarity	US-China bi-polarity (or multi-polarity)
Globalisation regains new momentum or at least stays around the current level	Likelihood: 15% Allocation to China: 10%	Likelihood: 10% Allocation to China: 35%	Likelihood: 20% Allocation to China: 20%
Regionalisation shapes the map of influence			Likelihood: 45% Allocation to China: 25%
Nationalism surges, bringing a disruptive end to globalisation			Likelihood: 10% Allocation to China: 0%

[5]This reflects the general sentiment and perspective of Willis Towers Watson and is indicative only. Actual results may vary.

Most investors are significantly under-allocated to China

How does this compare with investors' current allocation to China? As of June 2020, MSCI ACWI index has a country weight to China of just below 5%.[6] As a comparison, the US has a country weight well over 50%. A 2020 Matthews Asia and Greenwich Associates[7] report that surveyed 78 institutional investors globally finds that, on average, their exposure to China is 4.6%.

An allocation of **4-5%** is strikingly low compared to the 20% our scenario framework produces. This under-allocation primarily reflects that, for decades, China's capital markets have been closed to outside investors. The opening-up process[8] has fundamentally changed that. Some forward-looking investors have moved to take advantage of this new opportunity set. The Canada Pension Plan Investment Board (CPPIB) reportedly[9] plans to increase its total China exposure to one sixth of its total portfolio by 2025, up from the current 13%. Only four years ago in 2016, CPPIB had less than 5% of its total portfolio allocated to China.

The opening-up and reforms of Chinese capital markets are expected to continue strongly over the coming decade. That would allow global investors to become more knowledgeable and more comfortable when it comes to owning Chinese assets. Building exposure to China is a journey that balances the pace of market improvements with the imperative to achieve structural geographical diversity in a global portfolio. We believe the time to start building that knowledge and exposure is now.

Déjà vu

In 1916,[10] the US economic output overtook that of the entire British empire for the first time, marking the dawn of the American century. The UK's capital market underperformance started long before that (see *Figure 3*). Investors who had not diversified sufficiently away from the old world order saw decades of disappointing returns, in particular in relative terms.[11]

More than 100 years later, the world is entering another junction point of similar magnitude. We urge investors not to make the same costly mistakes again.

Figure 3: **Equity excess returns**

1900s	
United States	**83%**
France	9%
Germany	9%
Russia	-7%
United Kingdom	**-34%**

1910s	
United States	**10%**
France	-35%
United Kingdom	-44%
Germany	-92%
Russia	-100%

1920s	
Germany	178%
United States	**170%**
Canada	134%
United Kingdom	87%
Spain	72%
France	41%
Sweden	24%

Source: Bridgewater (2019)[12]

[6]This includes both offshore listed shares and China A shares.
[7]www.greenwich.com/crafting-optimal-china-allocation-strategy-asset-owners-perspective-report-download
[8]www.thinkingaheadinstitute.org/-/media/TAI/Pdf/Research-Ideas/a_public/ACOT_Chinese_capital_markets.pdf?modified=20200417141717
[9]www.caixinglobal.com/2020-07-15/top-canadian-institutional-investor-bets-heavily-on-china-101580236.html
[10]www.theatlantic.com/international/archive/2014/12/the-real-story-of-how-america-became-an-economic-superpower/384034/
[11]It is important to note that while the study in *Figure 3* highlights that US equity, as the rising power, outperformed UK equity over the first 30 years of the 20th century, it does not suggest that history will necessarily repeat itself. The key message is that a diversified allocation works best over very long periods, even when investors have correctly identified the emergent economic powerhouse.
[12]www.bridgewater.com/research-library/daily-observations/geographic-diversification-can-be-a-lifesaver

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