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Check-In with China

How to think about the recent volatility

Despite its rapid growth and economic might, investing in China comes with amplified risk. That was laid bare in recent months as the government cracked down on many industries. Here, we examine the implications and outlook.

Private Wealth Management Research

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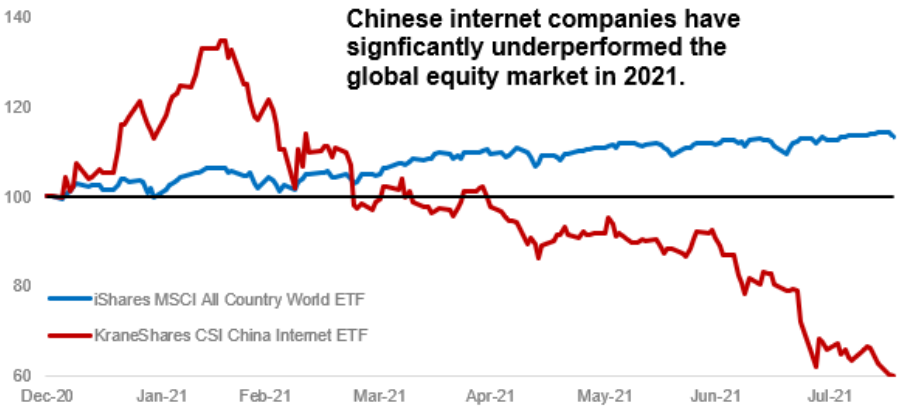
CHANGE IN CHINA

Once known as the "world's factory," China transformed into a more consumer- and technology-oriented economy over the past few decades. The evolution was driven in part by the government's decision to open its economy and markets to foreign investment. Today, China has a diversified economy, a burgeoning middle class, and one of the largest equity markets in the world. While China has clearly benefited from embracing some capitalistic elements, the country remains unquestionably a communist regime.

CHINA CRACKS DOWN

The Chinese government has the authority to respond quickly and sometimes severely to activities that conflict with the goals of the PRC. Recently, Chinese authorities cracked down on monopolistic behavior, cybersecurity violations, and overseas stock listings. Additionally, the Chinese government surprised investors last month when it announced its decision to convert private education companies into non-profits. The Chinese government also released its 5-year strategic plan, which outlined goals to further strengthen its power over several industries. In other words, the heightened regulatory environment is likely here to stay.



TENSIONS RISE

It's possible that China's goals will improve competition and benefit the middle class over the long-term. However, in the near-term, the heightened regulatory risk from China and the US is worth monitoring. For instance, our partners at Strategas note that Congress recently passed a law where firms could be delisted from US exchanges if they fail to comply with US accounting rules after 3 years. The SEC is also ramping up regulation on China-based IPOs (with a heavy focus on regulatory risk from the Chinese government). Similarly, China has punished companies like DiDi for listing in the US.

With pressures building from Washington and Beijing, the sum of these moves could accelerate the delisting of Chinese companies. We have already seen some of the most well-known Chinese stocks dual list in Hong Kong (e.g., Alibaba in 2019) in case tensions between the two superpowers escalate. From China's perspective, the benefits from opening its markets to foreign investors might be in question.

CONSIDERING YOUR EXPOSURE

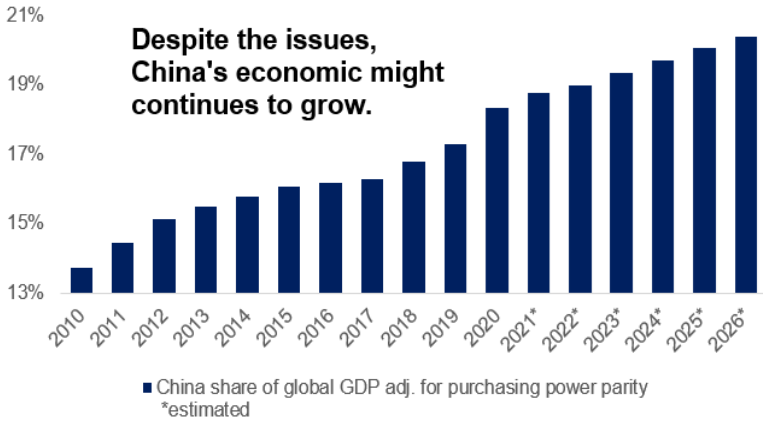
Many investors may underestimate their exposure to these issues, as well. As China expanded in size and influence, its representation in passive indexes has also grown. Even after Chinese stocks sold off in July, the country still represented 35% of the MSCI Emerging Market Index (with Taiwan, where China continues to exert pressure, an additional 15%). This concentration has been a boost to Emerging Market performance over the past decade, but comes with the downside risk we've seen lately. Much like FAANG in the US: so goes China, so go Emerging markets.

Of course, there are also plenty of reasons to maintain exposure to China (and Emerging Markets more broadly). For one, the diversification benefits to a portfolio can be significant, especially since the fluctuation between US and Global outperformance tend to move in long cycles. While domestic equities significantly outperformed over the last decade, China and Emerging Markets crushed the US during the 2000's. Recency bias might make it feel like the US has always outperformed, but in fact, we're merely experiencing one of the longer cycles in favor of US equities.

The US dollar also tends to be cyclical in nature and is a key factor in performance from foreign investments. While the last decade saw fairly consistent strength from the USD, there are signs that this cycle may be abating. Our partners at Strategas anticipate a weaker dollar regime may develop as America's twin deficits (trade + budget) weigh on foreign investment. Any weakening over the coming years would be a massive tailwind for global stocks.

Finally, past diversification, Emerging Markets offer additional benefits and opportunities, including:

- **Strong demographic profile.** While China is aging, they have a burgeoning middle class to fuel a consumer-based economy. More broadly, Emerging countries tend to have younger and more able-bodied populations.
- **They've got the people**. Emerging market countries have 80%+ of the world's population (and 70%+ of the land mass). Human capital is one of the great assets a market can have.
- **Specific industry exposure.** As an example, alcohol: the top seven most-sold beers in the world are all from companies headquartered internationally. Three of the seven are based in China.
- **Growth.** By 2030, it is estimated that ~70% of the world's growth will come from Emerging Market nations. China alone is responsible for a ~20% (and growing) share of global GDP growth (see Figure).
- **Innovative firms.** Emerging countries have the most downloaded app of 2020 (TikTok, China), 4 of the 5 biggest ride sharing apps, and global leadership in video games, e-commerce, electric vehicles, and much more.



BRINGING IT HOME

By definition, investing requires the assumption of risk. That risk grows as you venture into Emerging markets, where political risk is elevated, liquidity is sparser, and currencies are more volatile. And while China has many traits of a more developed country, the risks posed by the Communist Party to China's capitalist sectors cannot be overlooked. These past months have proven that investing in China remains a high-risk, high-reward affair.

Of course, for many, that fits in with a larger investment and financial plan. And there remain benefits to investing in China and EM countries, both from a diversification perspective and for the abundant growth opportunities. In the end, the question remains how much – and what types – of risk you are willing to take. Talk to your Baird Advisor today.

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