Silky Road or Rocky Road? Assessing risks and opportunities in China

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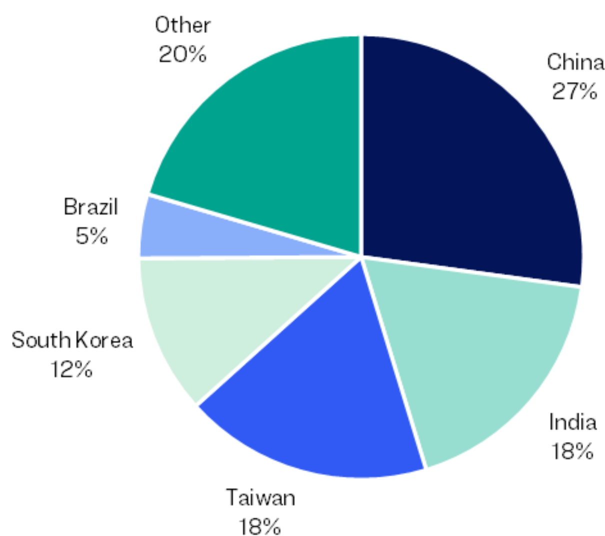
As the second biggest economy in the world, China looms large in every asset allocation decision for institutional and wealth management investors. Recently, we have fielded two recurring questions related to investments in China: 1) Given the economic malaise of the Chinese economy and the geopolitical standoff with the U.S. and its allies, why should we have any allocation to China? 2) Given attractive valuations and the improving equity performance year-to-date (YTD), why are we not increasing our allocation to China?

We currently have a neutral allocation to China commensurate to its share of the emerging market index (Figure 1) as part of our broadly diversified portfolio strategies.

Figure 1 - Country share of the MSCI Emerging Market Index



Source: MSCI

While we are mindful of the risks that come with investing in a country that is currently a geopolitical adversary of the U.S., we take a measured approach and look at both risks and opportunities. This approach is informed by one simple fact: China is the second largest economy in the world (~18% of world Gross Domestic Product, or GDP), its equity market represents ~24% of the widely tracked MSCI Emerging Markets benchmark, and the companies within all major global equity indexes have a sizeable direct and indirect exposure to its economy. For instance, around 7% of revenues generated by companies listed on the S&P 500, Euro Stoxx 600, UK FTSE 100 and Japan Nikkei 225 originate in China, and this number is considerably higher for some of the leading sectors like the S&P 500 Technology sector (14%) or the Stoxx 600 Auto sector (12%). For the MSCI "All Country World" benchmark excluding the U.S., this number is 15%.

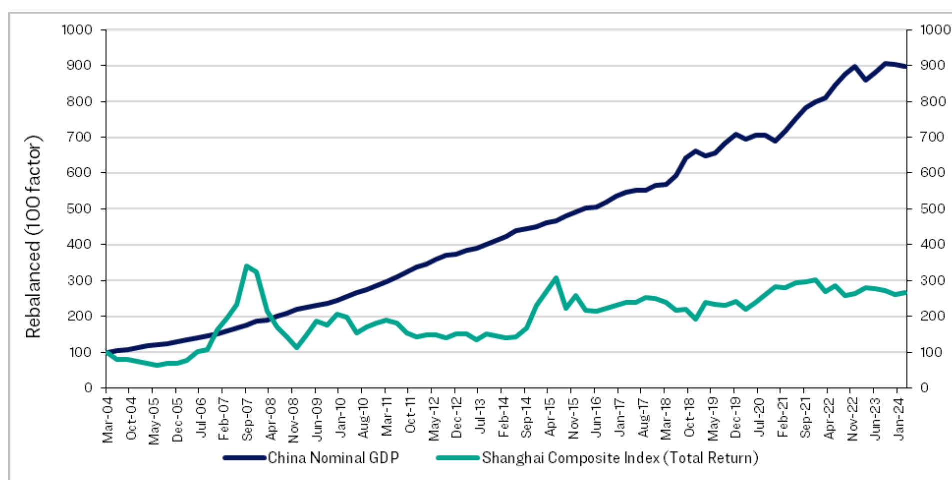
Therefore, TIAA's Wealth Chief Investment Office spends considerable time and resources studying the evolution of the Chinese economy, and in this Focus*Point*, we outline our current macro view on China, some positive developments that we are noticing, as well as a few risks that we are monitoring. Our conclusion is that, while conditions are not in place for an upgrade of the Chinese equity outlook, attractive valuations, government actions to enhance the quality of the equity market, and some measures aimed at stabilizing the economy support a neutral stance on China.

Macro View – Rebalancing Needed

During the decade following China's admission into the World Trade Organization (WTO) in December 2001, GDP growth averaged more than 10% per year. Between 2011 and 2021, GDP growth averaged 7% per year. In 2022, economic growth stalled, dragged down by strict Covid lockdowns and worsening cracks in the real estate sector. After growing only 2.9% (inflation-adjusted) in Q4 2022, well below the official government target of "around 5%", GDP grew 5.3% in Q1 2024 as the economy continues to recover. However, the headline data hides imbalances that should spur a broad reexamination of China's economic model. In particular, while industrial production grew 6.7% year-over-year (YoY) in Q1 2024, in line with the pre-Covid YoY average (since 2015), retail sales only grew 2.3% YoY in Q1, a big step down from the pre-Covid quarterly average of around 9%. The Chinese growth model is geared towards industrial policy rather than private consumption, which is at the core of weak household sentiment and industrial overcapacity. This is transitioning into a persistent issue that can be addressed in one of two ways: by stimulating private consumption through accommodative fiscal and monetary policy, or by creating an environment conducive to higher exports through subsidies and a gradually weaker currency. The latter solution would allow China to rely on international demand, rather than domestic consumption, to prop up GDP growth, and seems to be the government's preferred route.

The imbalance between investments and consumption is evidenced by the extremely high gross domestic savings rate (GDP net of final consumption expenditures) which was 47% at the end of 2022. The allocation of these savings leads to an equally high gross investment rate of 43%. This is at the core of an economic model that is excellent at growing the economy, but not as good at creating wealth, which is exemplified by the wide divergence since 2004 between nominal GDP growth (up almost 8-fold in dollar terms) and the Shanghai Composite equity index total return (up just ~170% as of March '24) (Figure 2). It also leads to capital misallocation, overcapacity, and large inventories.

Figure 2 - Chinese Nominal GDP vs Chinese Equity Total Return



Source: Bloomberg, TIAA Wealth Chief Investment Office

Look no further than the real estate sector to see this dynamic at play. Residential investments accounted for almost 20% of GDP at their peak before Covid (relative to ~4% in the U.S.), but the sector has been plagued by high leverage and overinvestments that have led to 8 billion square feet of finished but unsold apartments as of March 2024. As a result, property investments fell 9.8% in April. Given the importance of the property sector both as a driver of economic growth and as a major component of households' net worth, it is no surprise that its decline is dampening consumer sentiment, which in turn has led to deflation, with the Purchasing Price Index (PPI) down 2.5% YoY and the Consumer Price Index (CPI) only up 0.3% YoY as of April.

As discussed above, monetary and fiscal stimulus would go a long way reviving consumer spending and rebalancing the growth model in a way that would also be conducive to a more favorable financial market outlook. So far, such stimulus has been mostly bite-sized and targeted at infrastructure and property investments, and authorities have been unwilling to run a significant fiscal and monetary stimulus program.

Nine Measures to improve market quality

In April 2024, the Chinese State Council issued new capital market guidelines, also known as "Nine Measures," with the goal of strengthening the supervision and quality of domestic financial markets. We focus on two key deliverables: raising the quality of listed companies and promoting a long-term investment environment.

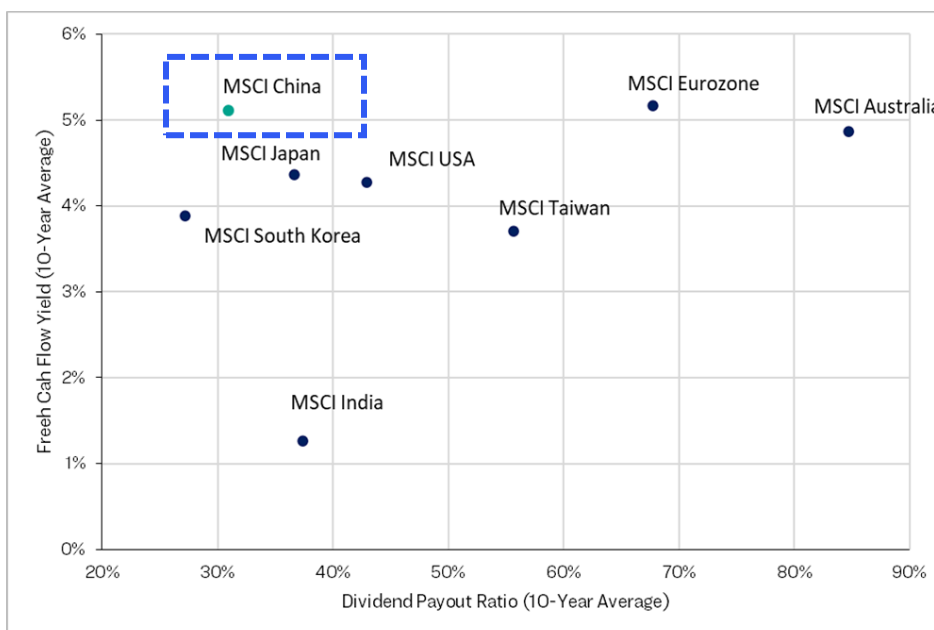
Raising the quality of listed companies

The quality of the Chinese equity market is one of the main causes of low international participation, lower stock valuations, and poor performance. Since 2005, the number of companies listed on the Shanghai and Shenzhen stock exchanges has grown from 1,400 to more than 5,000 and since 2020, there have been more than 1,600 initial public offerings (worth ~3% of stock market capitalization at the end of 2019) at a time of poor performance and lackluster investor demand. According to the Institute of International Finance (IIF), net nonresident equity portfolio inflows into Chinese equities were only $5 billion in 2023, and net resident equity portfolio outflows totaled more than $300 billion between 2020 and 2023.

Another issue is the lack of an enforceable delisting mechanism that would shed those stocks that no longer meet minimum listing criteria. There are 115 Special Treatment companies that have underperformed for years or do not meet other regulatory requirements, but are still listed, thereby lowering the average quality and profitability of the equity index.

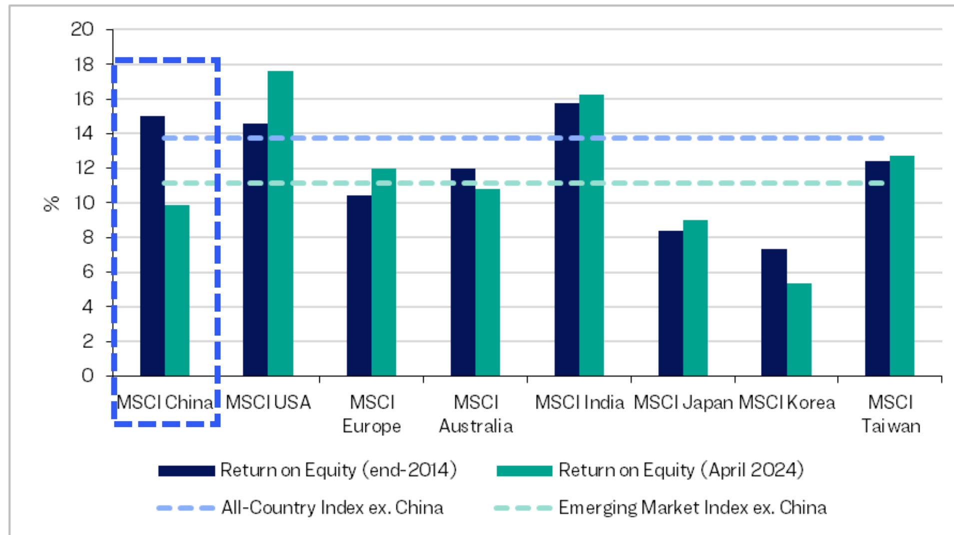
The Nine Measures seem to be highly attuned to this issue, and we expect more actions being taken to raise the standards for listing and staying listed on stock exchanges. In addition, the Nine Measures also place emphasis on improving shareholder returns. Higher dividends and a more attractive return on equity (ROE) would provide more downside protection against macro uncertainty and volatility and act as a catalyst for higher allocations from long-term foreign investors. We see significant capacity for Chinese companies to lift their dividend payments, given that they currently only distribute around 30% of their earnings while producing a solid 5% free cash flow yield (Figure 3). Markets with a similar free cash flow generation, like Europe and Australia, distribute more than twice as many earnings as China. From an ROE perspective, Figure 4 shows how the average return on equity for Chinese stocks has materially dropped since 2014, which is mostly driven by shrinking profit margins. A focus on cost efficiency and higher quality revenues should translate into an improved ROE, which in turn should result in richer valuations.

Figure 3 – Solid cash flow generation supports bigger dividend payments



Source: Bloomberg, TIAA Wealth Chief Investment Office

Figure 4 – Return on Equity has fallen in China since 2014 as profit margins have shrunk



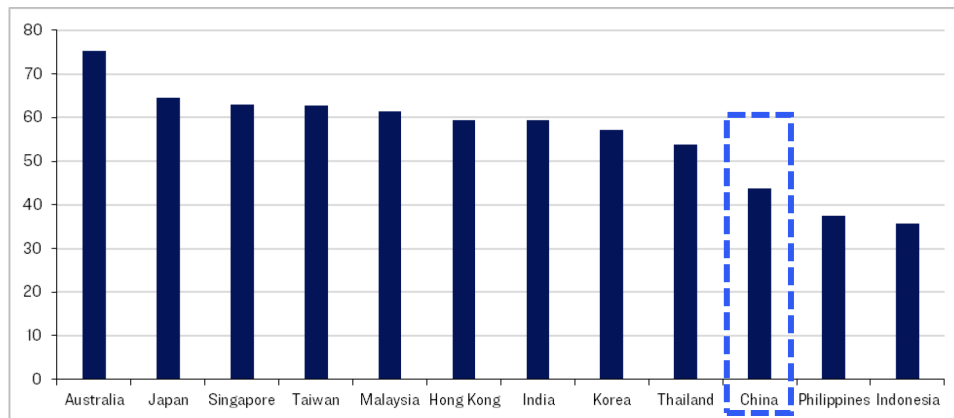
Source: Bloomberg, TIAA Wealth Chief Investment Office

Promoting a long-term investment environment

Fostering an environment conducive to higher participation by foreign and institutional investors is also crucial since these categories tend to be long-term investors with a more patient and professional capital allocation style. The combination of foreign investors and domestic financial institutions accounts for around 15% of total ownership of the Chinese equity market — significantly lower than the U.S. (55%) and other major members of the emerging market index like India (35%) and South Korea (50%).

The Nine Measures focus on enhancing investor protection, a key prerogative for a market with one of the lowest corporate governance ratings in the Asia Pacific area, according to the Asian Corporate Governance Association (Figure 5). Reducing governance risks could better align China with some of its major emerging market peers and help attract foreign investment flows.

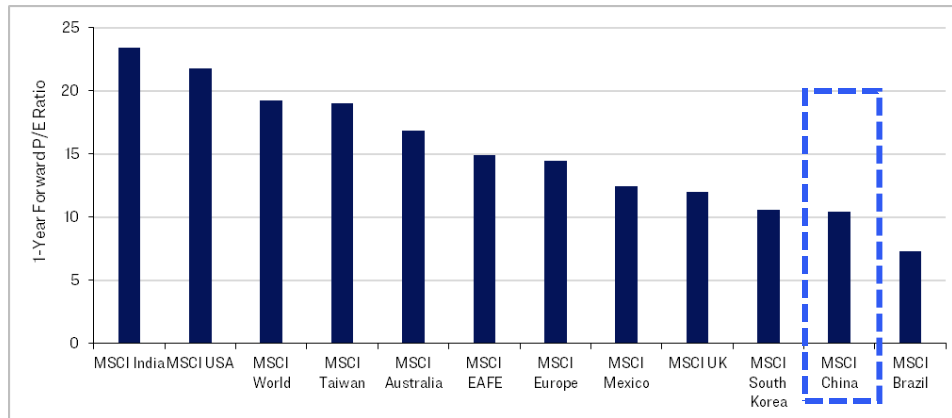
Figure 5 – Corporate Governance Rankings



Source: Asian Corporate Governance Association

As discussed above, higher profitability, return of capital, and cost efficiency are key ingredients of a high-quality market likely to attract institutional and foreign capital. Other benefits to long-term investors are low equity valuations (Figure 6) and Chinese markets' low correlation to U.S. stocks. Ultimately, better participation by long-term investors would become self-fulfilling, given their ability to more efficiently allocate capital (therefore organically raising the quality of the equity market), and would lead to lower price volatility.

Figure 6 – Forward Price/Earnings Ratio



Source: Bloomberg, TIAA Wealth Chief Investment Office

Long-term risks

While we see some green shoots in the measures that are being proactively adopted to boost the attractiveness of the Chinese market, we are mindful of the following medium- and long-term risks:

- **Demographics:** As a key ingredient of long-term growth alongside total productivity, China's projected decline in the working age population (aged 15 to 64) represents a structural economic and profitability headwind. According to World Bank projections, the working-age population is expected to decline by more than 40 million people over the next 10 years and by 150 million people over the next 20 years. The dependency ratio, or the number of dependents aged zero to 14 and over 64 compared to the working-age population, is projected to surge to 62% by 2044, up from 44% currently. The low fertility rate (1.2 births per woman in China, compared to the world average of 2.3) and negative contribution from migration flows (there have been on average ~300,000 more emigrants than immigrants every year since 2000) are the main culprits.

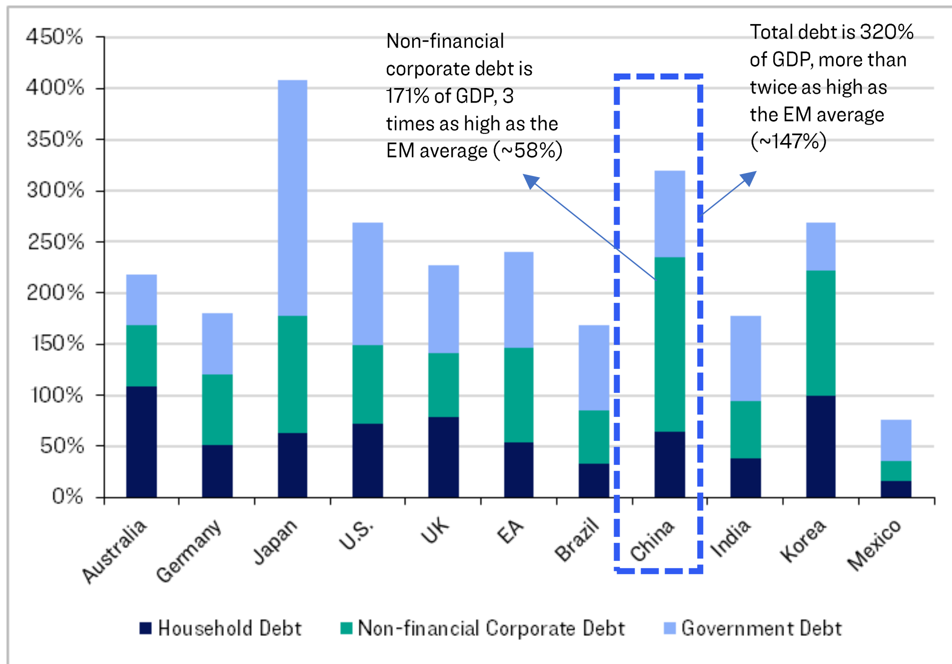
- **Fracturing of international relationships:** The growing wedge between China, the U.S. and its Western allies is driven by geopolitics, from Taiwan to human rights and climate policies, and protectionism centered around semiconductor chips and unfair trade practices. The overcapacity issues discussed above are at the core of a growing consensus in the U.S. and Europe that more tariffs on Chinese goods are warranted. Most recently, the Biden administration announced increased tariffs on several Chinese goods including a 100% levy on electric vehicles, while the European Union announced tariffs ranging from 17.4% to 38.1% on Chinese electric vehicles. Given the prominence of this issue on the campaign trail leading up to the U.S. Presidential election in November, and the severity of some of the measures under discussions (like former President Trump's 60% tariff on all Chinese goods), we expect sustained volatility as trade tensions ebb and flow over the next several months.

- **Leverage:** The Chinese growth model has relied heavily on debt across all layers of the economy and meaningful pockets of stress, including over-levered local governments and real-estate developers, are a key reason why the Chinese government is now reluctant to implement sizeable fiscal and monetary measures (Figure 7). If the Chinese government wants to facilitate a gradual reduction of corporate debt without causing lower investments and productivity, it needs to be willing to replace it with more government debt (similar to what the U.S. government has done since 2008). Thus far, its willingness to do so has been tepid.

- **Currency devaluation:** As discussed above, if the Chinese government remains hesitant to stimulate domestic consumption, the other option to spur sales of large industrial inventories is to rely on foreign demand through stronger exports. A weaker currency would make Chinese goods more competitive and while the Chinese Yuan has depreciated against the U.S. dollar over the last decade, its slide has been slow and controlled. A more severe and faster weakening of the Yuan would ripple through the global economy, cause significant volatility, and reduce the

dollar value of Chinese assets. Since this move would most likely cause Western governments to quickly impose extensive tariffs on China, its likelihood remains low for the time being, in our view. However, we are mindful of the risk.

Figure 7 – Debt as a percentage of GDP (as of Q1 2024)



Source: Institute of International Finance, TIAA Wealth Chief Investment Office

Conclusions

We currently have a neutral allocation to China commensurate to its share of the emerging market index as part of our broadly diversified portfolio strategies. On one hand, given the unresolved imbalances in its economy, resistance from policymakers to stimulate household consumption, and the long-term risks outlined above, our macro view does not support an upgrade of the Chinese equity outlook. On the other hand, depressed equity valuations seem to be discounting the short-term uncertainty, and clear steps to make China's financial markets more palatable to international and long-term investors should improve their attractiveness. As a result, we see benefits to maintaining our existing allocation.

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GWP-3645000PR-Y0624W (06/24)