China: The Great Wall of Worry for Investors

Speaker Key:

DP	David Pett
KM	Kevin McCreadie
RC	Regina Chi
KA	Keith Abell

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00:00:00	DP	China's rise to superpower status may be an opportunity that investors can't ignore, but it's also one of significant risk. On this episode of Inside Perspectives, Kevin McCreadie, AGF CEO and Chief Investment Officer, welcomes AGF Portfolio Manager, Regina Chi, and Keith Abell of the US National Committee on US China Relations, to discuss how China's geopolitical stance and economic initiatives are influencing global markets, and making investors uneasy.
00:00:31		I'm your host, David Pett. Let's get into it. Regina, Kevin and I are glad you're back for another episode. And Keith, the two of us want to thank you, especially, for joining the conversation today. I know that you and Kevin have met several times because of AGF's relationship with WaveFront Global Asset Management. But all of us are equally excited to hear your thoughts on China, a country you've spent a career getting to know in the very finest of detail.
00:01:02		Maybe the first question I want to ask you, Keith, is why China? What attracted you to the country?
	KA	Thank you. Delighted to be here. My interest in China really started as a boy. I was a Kung Fu fanatic, and determined, after I graduated from Brown, to get over to China and study Tai Chi with the Wudang Mountain Taoist masters.

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		Well, it was 1979 and China was closed to foreigners, so I wound up going to Taiwan and study with the Taoists.
00:01:28		But it did start me off that, and I did achieve fluency in Chinese. And, it led, ultimately, to professionalising as a China scholar at Wharton School in the University of Pennsylvania, and a job at Goldman Sachs. Then a job at Blackstone, to pioneer their Asia market entry, and I opened up their first offices in, both Tokyo and in Hong Kong, and did their first deal in China. And also, became a financial advisor to many of their clients. So, I was involved from their earliest days. I have watched China go through many phases of its development.
00:02:00		And, it's my view that the latest phase really is the opening of their markets for foreign investment. Not of a direct investment nature, but of portfolio investment nature. I think this is a great opportunity for foreign investors, and an imperative for China, for their own reasons, their own internal reasons. It's that confluence of interests between the US and China that makes things possible, despite the many complexities in the relationship between the two countries.
	DP	Kevin and Regina, I hate to put you on the spot after hearing all of that, but Kevin, have you been to China before?
00:02:31	KM	I would say, China is a place for me that, it moved in decades, in what would be two or three years of time. I was there in the late 80s, and travelled there from Hong Kong on a two-lane road that took 12 hours. And then, to come back five years later, six years later, to see a massive super-highway. And, you can say the same thing about Beijing, which was early 90s, mid-90s, folks on bicycles at intersections, to cars everywhere in seven or eight years. So, the pace of change was amazing to me.
00:02:59	DP	And Regina, you've travelled there for work purposes, but certainly, I guess, not over the last couple of years, since

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		everything's been shut down. When was the last time you were there?
	RC	Yes, sure. The last time I was there was 2018, right at the beginning of the US China trade war. I've always been fascinated with the country, given the sheer amount of people and the growth opportunities. And, the way that the economy has managed to move up the quality curve, and the government's commitment to changing the dynamics of their economy. This is going to continue to evolve over time, and it's going to be really fascinating to see what's going to happen over the next five to ten years.
00:03:33	DP	Let's get into the bulk of our conversation now. I want to start with my simplistic interpretation of the average global investor's current attitude towards China. On one hand, I think most of them still accept the idea that the world's second-largest economy has an abundance of opportunity attached to it. On the other, there seems to be a growing nervousness, by the day in fact, about the risks that come with that abundance. In other words, it feels like some investors are asking themselves, why should I bother?
00:04:02		If I've got this right, Kevin, what's the cause of so much concern?
	KM	Let's start with your first point, David. I mean, it's the second-largest economy in the world, and it's probably one, still, despite it's certainly one of the better places where you can find economic growth. And in the middle-classation of a population that we'll find only, maybe, one other country. Potentially, India. Right, so the opportunity for an investor is enormous. And then, when you frame that, though, you step back and say, well, all regions of the world, there are risks. And here, there may be more risks than many people would normally see.

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00:04:31		You have geopolitical risk, with which [unclear], maybe Keith can enlighten us on, in terms of what happens with Taiwan, what just happened with Hong Kong? That maybe causes some concern. And then you really look at the more recent issues which are around this common prosperity initiative, which we can dig into. Which has basically made capital markets' participants step back and say, which direction are we going to go? You've had, whether it be the full private education sector, or the tax sector.
00:04:56		Even, more importantly, the real estate sector, to the Chinese economy, a hand of regulation that has caused shareholders and bondholders, to probably say, okay. What don't I understand about some of this, and what does it really mean? So, I'd say, then we can broaden out the risks of some of the things that Regina touched on, which are, where does trade go? Trade wars. What does the eventual next phase of that look like between the US, China, even Europe and China? So, I'd say, you have to step back from, it's the second-largest economy. But again, it's also, it's a big weight in terms of what you can invest in, within the emerging markets. China alone is probably 30 percent of the emerging markets index. So, it's hard to ignore it without understanding some of those risks.
00:05:33	RC	I totally agree with Kevin that, as China's heavy hand in the recent wave of regulations that we've been seeing, that's the biggest cause of concern. And, the abundance that you spoke about, you could speak about two. It's the growing digital space and the real estate sector, and this is where we're seeing the most amount of regulation recently. And, if you start with the digital space, we had huge amounts of capital going into this area, and so some of these companies had gotten just so big, and gained a lot of market share against bricks-and-mortars companies. Especially during last year, which we had the great lockdown.

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00:06:04		And so, in the last three to four months, we've seen a greater regulation for platform companies, and of course, this surprised markets and it caused a lot of volatility. But you have to remember though, that for many of these companies, they've been able to grow without any oversight. So, effectively, what we're seeing is a catch-up in regulation, and the government is very much committed to anti-trust law-enforcement, data protection, and cyber security.
00:06:28		And, we have to remember that China is not alone in cracking down on gig economy companies. And, in general, I don't think that regulation is bad, in itself. As for real estate, we've seen that this has been an area of fundamental capital, and given that the importance of the real estate sector, it's about a quarter of China's GDP, it's quite important how they're going to deal with this sector.
	DP	And Keith, maybe I'll just get you to follow up on that. I want to get to the geopolitical situation in a little bit. But any thoughts on what Regina's just described? As I understand it, a lot of this it tied to China's common prosperity initiative?
00:07:04	KA	You know, the issue with China has always been, from the very start, whether or not their approach to modernisation, which to a certain degree, has modelled other nations in the West in their trajectory. When, in other ways, is unique, and unique to the Chinese history and the Chinese sense of its own destiny.
00:07:25		And, in the West, we tend to look at China, somewhat schizophrenically. Looking at their approach which has always been a mixture of trying to extract from free-market mechanisms and philosophies, what's valuable and effective, while, at the same time, trying to benefit from industrial policy and what a strong, central government is capable of doing. We call this model, state capitalism. It's all brand new and we tend to go from, inefficient. The state should not be

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		interfering in markets. It's going to create dislocations and imbalances. And, that's true.
00:07:57		And then we go into a love mode, where, this is an amazing powerful competitive tool. How can, when the state and private industry work together for a common purpose, how can you expect our individual companies to possibly compete? It's not fair. And, we're destined to be overtaken by these folk, this new model. It's an onslaught that we need to figure out how to deal with. So, we go from this, China's going to take over the world, to, China's going to be a big mess. Back and forth. Back and forth. Ever since the opening of the floor. And we're still there. Both sides are true.
00:08:27		The upside has never looked more promising for China. Google the US news and world report top 50 computer science schools. 18 of them are in China and Hong Kong. My first job in China was working for Xerox, and we didn't think that the Chinese could make a copy machine that was exportable. Look at them now, in just a blink of an eye. That potential has only accelerated. So, that's really exciting on the one hand. On the other hand, indeed they've had massive dislocations.
00:08:54		And, as the power of the central government enforced stability and managed through those crises, one crisis after another, as they as they engineer an unbelievable transformation of, essentially, planned state economy, pre-industrial, into what it is today, is breath-taking. I don't think any other country in the world could have ever done it. Certainly not at this [unclear]. So, they still have all of those, potentially, still have all that capacity to act, but the challenges they face today are, in many respects, bigger and more complicated than ever. And the question is, once again, what is state capitalism going to do if faced with this new phase of development? Is

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		it up to the task? Will the tools work? Have things gotten too complicated for them?
00:09:33		Or, will they manage through this one again, and emerge on the other side, in a way that's just hard to predict? And, that's the moment that we faced right now. I don't want to make too much about the issue of common prosperity. There's always three dimensions to things in China. There's the economic, there's the political, and there's the geopolitical. The issue of common prosperity is political. The stability of the regime is always paramount, in their minds. And, they have an issue about wealth disparity, just as we do. It has the potential to be socially destabilising there, just as it is here. They don't want that anymore than we do. On the one hand.
00:10:05		On the other hand, the communist party really does not want competitors, for influence in power inside China itself, so they're reluctant to allow private sector actors to become political and social forces in their own right.
	KM	Yes, maybe I can just simplify for everybody, because I think what Keith and Regina just said is really, probably the underlying theme on common prosperity is, basically, it's something that Regina told me. Which is, prioritising the stakeholder, i.e., the citizen, the average citizen, over the shareholder, or the bondholder.
00:10:34		So, putting the average citizen in this disparity issue, front and centre, politically, over some of the capitalist issues that have gotten far ahead of the country. Maybe, because of some hyper-growth in some of these areas, like technology.
	RC	I think the market got concerned with the idea that company [inaudible] a Robin-Hood-style wealth redistribution. I just don't believe that it's going to be a uniform egalitarian approach.
00:10:58		To me, it's about proving the equality of living for all. And, the government actually, recently came out and said that

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		common prosperity will take time to achieve. So, I think it's a relative term, not an absolute term. And, as Keith mentioned, there is a global shift towards greater equality. So, I think that the issue in China is that the policies are very well intended, but the implementation can be abrupt, which tends to shock businesses and investors, and create volatility.
00:11:27	KA	You know, Deng Xiaoping warned, or predicted that some people were destined to get rich first. And, that was a necessary part of China becoming rich as a country. That's destabilising on the one hand, but it's inevitable. He signalled to the leadership that that was something they were going to need to tolerate. Having said that, necessary though it may be, it doesn't mean that they're prepared to allow it to fundamentally alter their vision for what kind of society they want to create.
00:11:59	DP	I want to talk about geopolitics, obviously, as it relates to China. What, in your mind, are the key issues that investors must not ignore, as we head into a new year, over the next 12 months?
	KA	If you look at this from 30,000 feet, China's economic and technological transformation has been accompanied by a military transformation that's equally stunning. China, as it emerges as a superpower, is determined to act like a superpower.
00:12:27		This is problem for the United States. It never had a peer competitor in the history of anybody that's listening to this. We've had Japan as a powerful economic competitor. We've had the Soviet Union as a powerful military competitor. We've had various countries as technological competitors. But somebody that's all three, of a country of 1.4 billion people, with this kind of dramatic growth, entirely different system of social organisation, this is an unproven, unprecedented model in the history of mankind.

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00:12:59		And, for investors, advancing trajectory of China, do you really want to be out of it? Are you so scared about the fact that they have a different path, that you just want to sit on the side-lines and wait till this whole process plays out? Or, do you want to be a participant in it and accept the risks along with the rewards. You know, that's a question that's not easy to answer because, in uncertain times like these, path is perilous. I don't believe anybody who is reasonable, thinks that the United States and China are heading for an armed conflict, intentionally. I think the concern among people that are close to the issue, is miscalculation over something like Taiwan.
00:13:33		Because, you know, for us, for the United States, and this is a US, and I realise there are many Canadians on this call and I am happy to be a green-card holder in Canada. But the geopolitical conflict that's going to define this next part of the 21st century, is the conflicts between the United States and China. It's not at all clear how we're going to reconcile our different world views as peers. China had to take a subordinate view when it was weak and wanted to learn from the West, to modernise.
00:14:01		But now that it has modernised, it's not going to accept, on a wholesale basis, a global world order that was essentially created after World War II, by the United States. They want to have their own input. They want to have their own dignity. And they want to have areas where they're preeminent, and they'd like to have as many of those as possible. Without sugaring the United States, they have some kind of extreme reaction to having its own position threatened. And, that path is not clear cut at all. That creates uncertainty. That creates the possibility of miscalculation and accident. Therein lies the risk, but that risk is global. It goes far beyond investing in China.
00:14:35	RC	What I worry about with this ongoing centralisation of power and control by the Chinese government, is that by the way

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		we're heading into the National People's Congress next year, where Xi Jinping will get his third term. He's going to be the most powerful leader since Mao Zedong. The key troubling part about this is that it's very difficult to manage a sprawling bureaucracy.
00:14:57		And, we have recently seen other officials taking orders too far, as in the case of the coal mining and power shortages, leading to a national energy crisis. Or, they're paralysed by fear and they fail to take autonomous decisions. Or, policies are completely erratic and not well-devised, causing complete chaos, like they did with the after-school tutoring sector. So, I hear your point. All your attributes you mentioned, definitely sets China apart. But this ongoing centralisation could, potentially, sap China's economic dynamism, and the future of the SME economy and the entrepreneurs.
00:15:32		And, this is particularly in the case, as the central authorities are pushing for dual circulation policy, focus on self-reliance, and then, with this common prosperity agenda that we just spoke about. So, this is all happening at a time where growth is slowing right now. The country faces challenges with not only, a higher regulation aging workforce, and then the real estate, mounting debt that we're seeing. And so, these are the things that I'd think about over the next couple of years. They shut down capital markets to listings, and so, loss-making companies can't access capital to grow.
00:16:04		They have to go through the channels, which is the Hong Kong Stock Exchange, or the Shanghai, where deferrals are much more difficult to list. And so, I'd hope that they recognise that they need to be better balanced to ensure that innovation will continue on their paths. You come out of the middle-income trap, and so that they could permanently eliminate poverty and move up the value chain.

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	DP	Given everything that we've just discussed, it seems to me that investors can't just ignore China entirely.
00:16:30		Some might choose not to invest directly in the country's financial markets, but exactly how plausible is that for most investors? And besides, doesn't China's influence stretch well beyond its borders now?
	KM	Yes. I mean, for a lot of investors, the question of, is the market investable, is really on their minds, because of all the issues we just talked about. All markets will adjust to the multiple, if they'll give company, or a country, based upon those risks, right. So, there is the right price you can pay for something, to take on those risks.
00:16:58		You have to remember which market within China you are looking at. You're down 20-odd percent or more this year, relative to the rest of the world, which is up double digits, whether for Europe or the US. So, there's a fair amount that's being priced in about. I'd say, for the region again, if you think about it, there's going to be a transition. You're looking at many western companies thinking, all right, do I want to have all my supply chain there? Do I need to have a diversification of my supply chains? Does that mean, for the region, places like Vietnam, etc., become more a sourcing place for that supply chain. So, I think you're going to make those adjustments, but from the market perspective, I think, well, put the right discount rate for those risks on it, but I think it's hard to ignore.
00:17:33		You take a look at multinational companies. They all went into China because of the size of that market. They're not retrenching. It may be harder for them, as China prioritises Chinese companies, but they all look at the opportunities out there, and I think, we as investors in Chinese companies, if we're in the emerging markets, can't ignore it either. When you add up China, Hong Kong and Taiwan, you're probably looking at a number that's north of 40 percent of

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		the EM index. So, figure out what the multiple you want to pay, and the discount you want to put on that, because I don't think you can ignore it.
00:17:58	RC	Caution is definitely more warranted, especially in those areas and sectors where there is greater oversight and regulation. And, I agree with Kevin, that everything has a price. We like China. We've been underway China for most of this year, and we're getting much more optimistic about it. To Kevin's point, valuation is much more attractive now. I believe that the market has discounted that regulation is here to stay. We have seen multiple de-rating, but I think it's priced in. And, we do think that policy support will come, especially as the economy has slowed, and where the government's trying to manage the real estate situation currently.
00:18:33		And, with policy support, we think that that's going to be very supportive for equity markets. What we're buying now, right now, are companies that are aligned to China's long-term strategy, with respect to self-sufficiency, localisation, as well as decarbonisation. And so, we're finding a lot of our new names in the A-share market, and we're finding that these companies are most aligned to the Chinese government's long-term objectives.
	DP	And then, Keith, any correctly all of that you've said today, we have to make this work. We're too far down the road not to.
00:19:03	KA	I think, geopolitically, that's true. That doesn't mean investors have to invest in it. But I'm in the camp that state capitalism has great strengths. I could spend a long time talking about the weaknesses of our system, too. And, if we want to focus on the weaknesses of the Chinese system, there's plenty of weaknesses. Having said that, the Chinese economic miracle would not have been possible without centralised control and power of the state. You have to credit them with that.

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00:19:30		And, this is not the moment of greatest state involvement, or state control in the economy that we've seen since the beginning of economic reform, 30, 40 years ago. It's been fits and starts, experimental, as the Chinese have tried this and tried that, and opened this up, and closed that down. Had excesses here, and let's readjust there. They think, this has been their process. Deng Xiaoping famously said, we're going to cross the stream by stepping from stone to stone. So, they have a very experimental approach to things, which makes the folks in the West uncomfortable.
00:19:59		But for them, it's been effective, and undeniably so. And I think that we're at a moment now where the sunset industries that have fuelled China's economic growth up until now, real estate and infrastructure, well, you know, the whole country urbanises. You just build railroads, and build cities, and build new infrastructure, and that could drive economic growth for a long, long time, and it has. But they're built. Inevitably, you reach a moment. And we've reached it. Where China has to evolve into its next phase, and that one is harder to predict.
00:20:29		So, this uncertainty makes investors uncomfortable because, will China develop the companies of the future? Biotech, chemicals, aerospace, computers, services. They show every sign that they have the capacity to do that. The issue is, the transition from an economy built on the growth of sunset industries, into an economy that is going to be fuelled by sunrise industries. It's the biggest challenge [unclear] the central government has ever faced. And, the way they're going to manage that is going to be unprecedented again, in the history of the world. Like so many things they've done, that's unprecedented.
00:21:01		I would argue, that as money comes out of the real estate sector, unless the economy, assets and household wealth, evaporates, that money is going to have to be reallocated into securities and into the stock market.

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		There ought to be liquidity-driven benefit to all that, as long as a society-wide economic upheaval of such a dramatic shift isn't too damaging. And the question is, can the central government manage that?
00:21:29	DP	I hate to do this, but I think I've got to end there. This has been a fascinating conversation. Keith, thanks so much for being with us. Regina, also, thank you for joining us. And Kevin, until next time. For a full transcript of today's episode, visit AGF dot com slash podcast, and don't forget to subscribe to hear more from us at Apple Podcasts, Spotify, Google Play Music, Stitcher, Podcast Addict, and Pocket Casts.
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