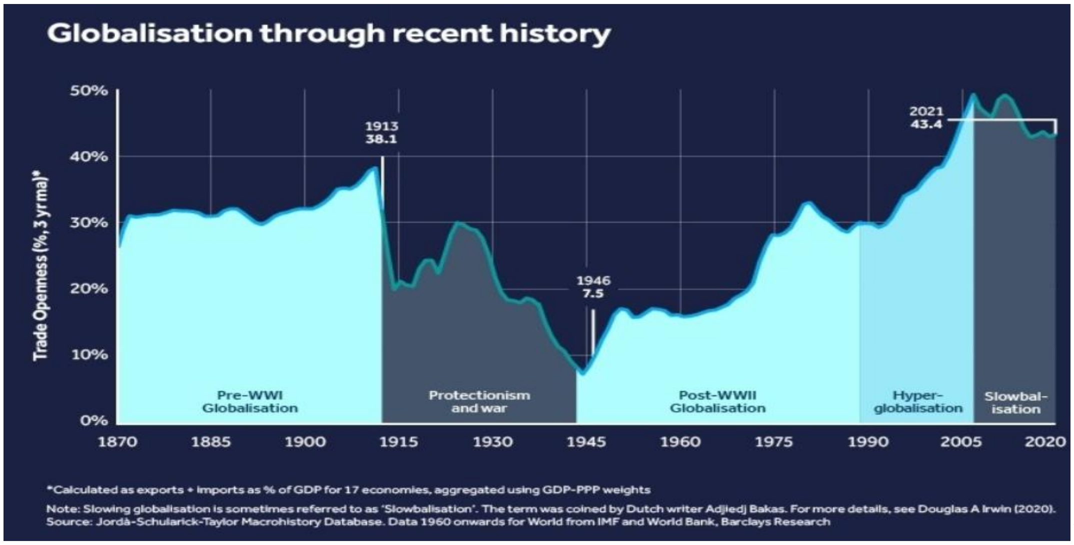
The China Challenge

"Slowbalization"

Much of modern economic advancement has been defined through the increase of globalization and how connected international financial systems have become. Yet, it is hard to overlook the current turning of the tides. In response to COVID-19, geopolitical tensions, and climate change movements, corporations are beginning to choose the safety of in-house production over the benefits of global supply chains. **Trade relations with major players have been inconsistent if not tenuous.** While these factors are significant and will undoubtably cause a ripple effect in the markets, they are not enough to cease the existing momentum behind globalization. **Therein lies a common trap for most investors, where they frame their thinking to look at any economic challenges as a domestic issue, not realizing how integrated revenues are on a global scale.** For example, the S&P 500 is commonly used as a proxy for the US economy, despite core companies like Exxon Mobil, Chevron, and Pfizer generating ~50% of their revenues outside of the United States. If revenue derived from large cap companies in the United States and Canada is the litmus test for larger scale success, then externalities outside our borders are vital for the health of these corporations. Regardless of current headwinds or opposition impeding the open-door policy we are used to; multinationals will still harvest profits from outside their headquarter country lines. Thus, the focus for investors should not exclusively default to the North American markets. Even if sentiment is shifting to stagnated partnerships, all stakeholders should still recognize how the sustainability of one region has a direct correlation to the strength of others.



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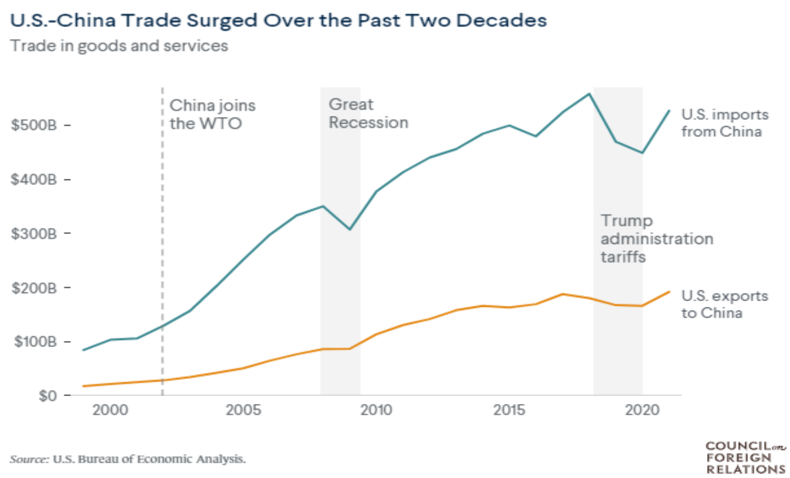
When examining the impact of foreign economies on North American markets, one in particular stands out amongst the rest. There has been a host of sweeping statements regarding the health of the worlds second largest economy. Over the past few decades China has been deemed the engine of growth, managing to outpace the giant that is the American economy. Together China and the US represent 40% of global output and are therefore intertwined to preserve their backbone status [2]. If either giant were to falter at the global level this certainly would not be a benign outcome. Still, the tone of this partnership has lacked congruency or symbiosis. **Although competing political agendas have been furthering the divide between these two nations, it would be presumptuous to believe that deglobalization or nearshoring is the answer.** Looking closer to home, it's imperative to consider the impact of international policies on domestic prosperity.



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The Challenges

For approximately thirty years after the formation of the People's Republic of China in 1949, there was virtually no bilateral trade between the two economic giants. Following 1979, the United States and China stabilized relations which lead to an influx of trade [4]. This was all at a stage where China was undergoing economic reform and relaxed state control which allowed the advance of private industry. The two decades since joining the World Trade Organization only enhanced the synergistic value add. Specifically on the import side, China was (and still is) a critical cog in global supply chains.

Moving forward to a modern outlook, China's delayed pandemic reopening afforded them the unique opportunity of retaking the driver's seat in global economic growth. Despite this promising setup, China has instead been struggling to find firm economic data points, navigating undoubtedly high rates of youth unemployment and real estate woes. A setback of sorts could be perilous to the globalization regime.

Regarding the youth unemployment rates, for people ages 16 to 24, the rate rose from 15.3% in 2022 to over 21% this past June. This 25% increase is so high that it prompted Beijing to cease making updates on monthly figures [5]. The consequences of high unemployment figures and lack of skill matching jobs for the next cohort could pose costs to the forward-looking condition of the Chinese economy.

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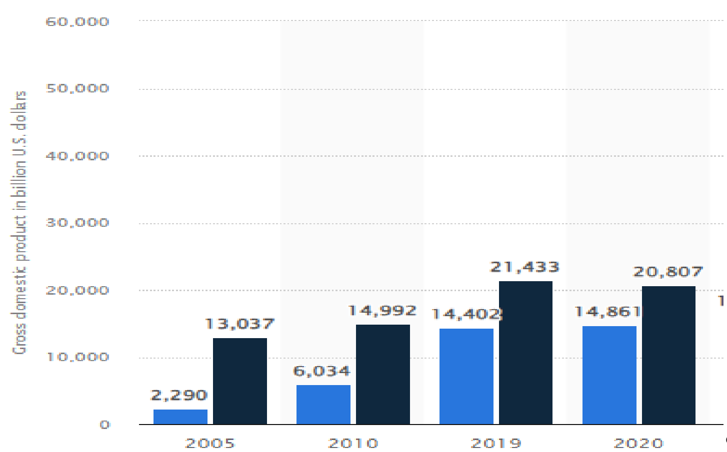
Another looming struggle for China is the state of their real estate market. China's property market was once seen as the locomotive of its unparalleled economic growth. This is the result of cheap debt fuelling a property bubble that is now under stress as demand is drying up. Following the 2015 downturn in Asia, the government incentivized production from private developers by offering cash to residents whose homes were torn down to create further urban redevelopments. Developers were able to lever up heavily to finance their outsized expansions. Speculative buying became widespread resulting in 29% of China's GDP being attributed to the real estate sector [6]. As leverage on large developer balance sheets got too high, the government intervened to put limits on the amount they could borrow. This led to large names like Evergrande filing for bankruptcy protection and more recently, Country Garden narrowly avoiding default. The result has led to property investment falling for the 18th straight month. As of August, investment into real estate was down 19.1% year over year [7]. Falling house prices ultimately weigh on the country's overall wealth, which has a trickle-down effect on overall spending and GDP growth. China has since imposed a series of policy measures to alleviate home purchase restrictions and it is a proverbial coin flip as to where prices will move. If empirical evidence in other countries holds true, reducing payment requirements and cutting mortgage rates should bid a boost in the sector.

So, what does this all mean from an investor lens?

During periods of calamity, investors can get short-sighted and assume a recency bias in thinking top of mind issues will continue perpetually. Before the implications of Covid, it is important to note that between 2005 and 2020 the GDP of China grew from 2.3 trillion to ~15 trillion USD. Meanwhile, over that same period, the GDP of the United States grew from 13 trillion to ~21 trillion USD [8]. While there were undoubtable pockets of turbulence in both markets throughout that period, it still rings true that patience is a virtue when investing in globally embedded companies.



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Already, the Chinese economy is showing resilience as of August. Industrial production and retail sales have bounced back amidst a real estate slump. These numbers have a promising implication on publicly traded markets. China's Foreign Ministry spokesperson Mao Ning recently stated with a level

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of optimism, **"All sorts of comments predicting the collapse of China's economy keep surfacing every now and then. But what has collapsed is such rhetoric, not China's economy. China's economy will remain a major engine for the global economy [10]."**

Furthermore, we should not sell ourselves short by only taking into consideration the impact of one foreign economy on our portfolios. There are many markets that are rapidly growing and industrializing that are worth consideration. Although countries in this camp (Argentina, Brazil, South Africa, India, etc.) face lower income levels, currency swings, and higher volatility than their developed counterparts, there is far more potential for higher returns. MSCI Emerging Market Index, launched in 1988, accurately tracks these markets. The 24 countries making up this index grew substantially since its inception to represent ~53% of the worlds nominal GDP growth over the past 10 years [11].

As investors review their current portfolio allocations, emerging markets are an attractive space to provide future upside. They have traditionally lower correlations with developed markets which provides a diversification enhancement to portfolios heavy in North American and other developed market equities. We will always face "perpetual uncertainty" inside our borders and abroad. China is a great example of a challenging climate that can prompt knee jerk reactions adversely modifying one's globally diversified asset allocation. China and India have larger populations than all developed countries combined and will continue to have quite the runway. As always, investing in these markets needs to coincide with one's risk tolerance and investment horizon.

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Continued ...

1) Deglobalisation: here's what you need to know | World Economic Forum (weforum.org)
2) U.S. and China, by the Numbers - The New York Times (nytimes.com)
3) The Contentious U.S.-China Trade Relationship | Council on Foreign Relations (cfr.org)
4) The Contentious U.S.-China Trade Relationship | Council on Foreign Relations (cfr.org)
5) China's youth unemployment crisis could dent world's second-biggest economy (aol.com)
6) China Risks Property Debt (reuters.com)
7) China's property slump worsens, clouding recovery prospects | Reuters
8) GDP at current prices of China and the U.S. 2005-2035 | Statista
9) GDP at current prices of China and the U.S. 2005-2035 | Statista
10) China's economy shows signs of improvement but real estate is still a weak spot | CNN Business
11) Is Investing in Emerging Markets Worth the Trouble? | Morningstar

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