MANAGED ASSET PORTFOLIOS

A Global Manager Without Exposure To Mainland China

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During the firm's two-decade-plus history of managing global portfolios, we cannot begin to count how often clients and prospects have questioned us on our avoidance of purchasing mainland China stocks. Clients often cite a vast population, growing middle class, and "cranes in the skylines" to support their bullish theses. However, a lack of transparency and a free market always kept us on the sidelines. On August 29, 2023, U.S. Commerce Secretary Gina Raimondo said that U.S. companies tell her that China is becoming increasingly "uninvestable" because of growing risks. "There are the traditional concerns that they've become accustomed to dealing with. And then there's a whole new set of concerns, the sum total of which is making China feel too risky for them to invest."[1] During a visit to China, the Secretary said that U.S. firms face new challenges, such as fines and ambiguity around a new anti-espionage law and continuing issues involving intellectual property theft and competition with subsidized Chinese firms.

Now that China is in the headlines with increasing regularity (and not in a positive way), we thought it would be worthwhile to discuss our continued cautious stance on investing in China, while at the same time acknowledging that as an Investment Team, we are in a distinct minority on this stance relative to many other global managers.

Active Versus Passive Management

Over the past several years, the popularity of indexing has grown substantially, with passively managed index funds constituting 45% percent of the total assets managed by investment companies in the U.S., up from 21% in 2012.[2] In addition, many investment managers are considered "closet indexers." Such managers claim to be active (they charge active management fees), but, in reality, only deviate slightly from their stated benchmarks. This is a primary reason why the media continues to talk about the underperformance of "active" managers relative to their benchmarks.

An active manager is measured by its active share – a measure of the percentage of stock holdings in a manager's portfolio that differs from a benchmark index. A score of zero indicates that a portfolio manager is replicating a benchmark index and engaging in a passive investment strategy, whereas a score of 100 indicates no overlap with a benchmark index, or active management. At MAP, we proudly state that our active share is consistently near 90 for our global strategies, which means we are neither an indexer nor a closet indexer.

Currently, China is the sixth largest country weighting in the MSCI ACWI index (the primary benchmark of MAP's global strategies), coming in at 2.83%; trailing the U.S. (61.33%) and Japan (5.49%).[3] For comparison, Chinese stocks make up over one-fourth of the MSCI Emerging Market index[4], up from only about 14.74% 10 years ago.[5] Our absence from investing in mainland China is an identifiable contributor to the active share mentioned above.

China: From Developing To Developed?

Recent economic data following the re-opening of China post-COVID lockdowns has disappointed. The world's second largest economy grew at a 6.3% annual pace in the April-June quarter, slower than the 7%-plus growth analysts had forecasted. Furthermore, unemployment among youths aged 16 to 24 rose to a record 21.3% in June, up from 20.8% the month before. Finally, investment in property development, a driver of both industrial and consumer demand, sank 7.9% in the first half of the year compared to a year ago.[6]

Welcome To A Lack Of Transparency

After reporting its youth unemployment rate, China conveniently announced that it would stop reporting the data, saying it needs to refine how it calculates the jobless rate for people ages 16 to 24. As you can imagine, the Chinese stock markets haven't fared well as economic data has disappointed. In response, Bloomberg reported on August 16, 2023, that "Chinese authorities asked some investment funds to avoid being net sellers of equities," as a sell-off in the nation's financial markets deepened. And as most of the world battles to dampen continued inflation that hit four-decade highs last year, China has an even more severe problem: *deflation*.

We all know firsthand how painful inflation can be, but deflation – a prolonged period of price declines - is even worse. On the surface, this may sound like a good problem, but it is not. Over time, deflation leads to a reduction in demand as consumers defer purchases, waiting for even lower prices. Would you purchase a new car today if you thought prices would be lower six months from now? Deflation was one of the chief causes of the Great Depression in the 1930s. Deflationary fears are why the Federal Reserve responded as they did during the Great Financial Crisis (GFC) of 2008-2009 and, more recently, during the COVID pandemic. In order to prevent deflation from occurring, they elected to inflate its balance sheet and artificially depress interest rates so that the U.S. could avoid a reoccurrence of the 1930s.

In response to their deflationary problems, the Chinese government cut interest rates twice since June (although not aggressively – only 20 basis points in total) and began censoring the word "deflation" to stop fears from spreading and further stalling the economy.

Summary

Since the end of the GFC, China's economy has proven to be the world's growth engine. From 2010 to 2019, China's GDP growth ranged from 6.0% in 2019 to 10.6% in 2010. In 2020, China's GDP was 2.2% due to its zero COVID tolerance. Growth bounced back to 8.4% in 2021 but fell below 3% last year.[7] As referenced above, many economists had expected that the reopening of China post-COVID would be a boon for the economy. It has not. China's economy is struggling with the fallout of a bruising trade war with the U.S., a struggling property market, and a growing debt load. China has been financing much of its past debt through issuing new debt. In 2008, China's debt stood at about 160% of GDP.

By 2022, it had grown to about 360% of GDP.[8] To put this in context relative to other nations, Japan is around 260%, and their economy has struggled for decades despite record-low interest rates and a weakening Yen. Debt-laden European countries such as Greece, Italy, and Spain came in at 175%, 144%, and 113%, respectively. As a further reference point, in 2022, the U.S. had a debt-to-GDP ratio of approximately 123%.[9]

Finally, while China has a vast population, it is aging. The median age of its population is currently 39 years old and is expected to hit 50 years old by 2050.[10] The aging of China's population is the result of several factors, including the one-child policy the government had in place for over 30 years and the nation's birth rate is decreasing.[11] These difficult demographic trends set the stage for an economic headwind down the road.

At MAP, we do not fear going against the grain if we believe doing so is in our clients' best interest. We have avoided investing in mainland China over the years due to the nation's lack of transparency and the fact that the Chinese Communist Party determines winners or losers, not the free market. While we can't rule out a large stimulus package by the Chinese Government to attempt to help their poorly performing stock market, a challenged economy spurred by trade wars, weakness in the property sector, sky-high debt levels, and unfavorable demographic trends are all reason why we choose to avoid investing in China.

This analysis supports one of our investment principles: What you don't own is as important as what you do own. Please do not hesitate to contact your MAP representative with any questions.

Managed Asset Portfolios Investment Team

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[1]https://www.bloomberg.com/news/articles/2023-08-29/raimondo-says-us-firms-tell-herchina-is-becoming-uninvestable?srnd=premium
[2]https://www.statista.com/statistics/1262209/active-passive-investment-funds-usa/#:~:text=While%20passively%2Dmanaged%20index%20funds,to%2045%20percent%20by%202022
[3]MSCI ACWI Index (MXWD), data as of 08/31/2023
[4]MSCI Emerging Markets Index (MXEF), data as of 08/31/2023
[5]MSCI Emerging Markets Index (MXEF), data as of 08/31/2013
[6]https://apnews.com/article/china-gdp-economy-growth-slowing-03e226aff4a911ec71854f75814ebf8f
[7]World Bank Group; GDP Growth Annual % China, data as of 12/31/2022
[8]Bloomberg Economics; China Debt as a Percentage of GDP, data as of 12/31/2022
[9]https://www.ceicdata.com/
[10]https://database.earth/population/china/median-age#:~:text=Historic%20Median%20Age%20of%20China,of%20the%20population%20in%20total
[11]https://data.worldbank.org/indicator/SP.DYN.TFRT.IN?locations=CN

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