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Grappling with the changing face of China

Decoupling from the West is easier said than done

Global Emerging Markets Equities

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The changing face of China in the world

China has been on a trend towards greater economic and especially technological self-sufficiency, a trend that continues following the Communist Party Congress that took place in October. At the same time, China continues to focus on maintaining the standards of living for its broader population.

While there are currently tensions between these two goals, we would not expect either of these priorities to trump the other.

In the US, policymakers of both political stripes are clearly making concerted efforts to reduce the reliance of the US economy on Chinese imports and slow China's economic and technological ascendancy. The Biden administration has made no effort to roll back former President Trump's tariffs and indeed has ramped up decoupling efforts with the imposition of sanctions against the provision of advanced node US semiconductor technology in any form.

This pressure is noticeable in that the share of Chinese exports going to the US has fallen since 2017. The unknown here is the degree to which the EU and the UK will follow the US example and reduce reliance on China across industries. In Germany, lessons have been learned in terms of (over) reliance on Russian energy, and the risks of material dependency, and these could influence decision-making by the EU when it comes to reliance on China.

However, diversifying away from China may not happen quickly as supply chains are so integrated and have been built over decades. For many consumer goods and resources, China remains firmly embedded in global supply chains – particularly in Asia.

As a result, it is incredibly tricky for the West to isolate China in the next decade without inflicting tremendous economic pain on itself and, even more so, on many Asian allies. In addition, no other emerging market today can match China's manufacturing scale, productivity, or efficiency.

Wages elsewhere, for example in Thailand and Vietnam, are lower than in China, but the trade-off is often lower productivity – which requires both time and committed investment to improve. It is also likely that, rather than decoupling at scale, any unravelling will be narrower and industry-focused. As mentioned above, technology is one of the most obvious sectors to be affected, as well as some parts of the financial system.

While this could be the case in some small corners of the market, more broadly, we would expect little change. Given what we see as very attractive valuations, we believe that markets have already factored in a lot of uncertainty.

How to invest in China: stay diversified

In periods of increased market volatility, we believe investors should be selective, stay diversified and focus on long-term themes.

In a sharp decoupling scenario, we consider the most exposed economies to be South Korea and Taiwan, although much of South-East Asia is also likely to be negatively impacted. The beneficiaries of efforts to reduce reliance on China would include India, Thailand and Vietnam within Asia, and Mexico within the context of the USMCA (formerly NAFTA), ie, the US, Mexico & Canada free-trade agreement.

De-risking China from your investment thesis

The extent to which investors choose to de-risk from China will be a function of risk appetite and investment horizon. However, with valuations at generational lows, reducing exposure now may come at a high opportunity cost. We think that for active investors like us there are good opportunities at these valuations and, while we remain selective, we are looking to take advantage of these opportunities. Longer term, asset allocators may look to cap their exposure to China. However, the impact of such a move in the near term may not be substantial, as global investors are so underweight both China and broader emerging markets relative to the global market.

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