

# INVESTMENTS & WEALTH MONITOR

*A reprinted article from January/February 2023*

## It's Time for Investors to Reevaluate Their China Exposures

*By Dambisa Moyo, PhD*



INVESTMENTS & WEALTH INSTITUTE®

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**D**eglobalization is well underway, evident in numerous trends including the retrenchment of global trade, unwinding of capital flows, new barriers to migration, and weakened influence of traditional multilateral institutions such as the World Bank, International Monetary Fund (IMF), and World Trade Organization.

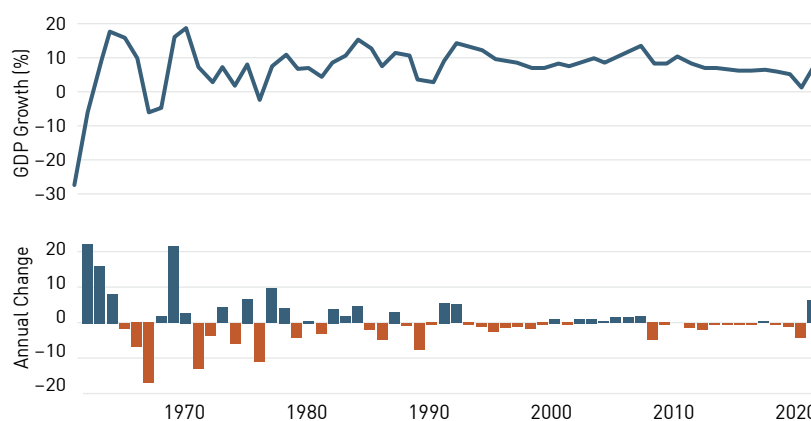
Alongside these trends, tensions continue to grow between the United States and China. So, as competition between the two countries intensifies in an increasingly deglobalized, zero-sum world, investors face a difficult decision—how should they approach investing in China?

As the world transforms from a globalized win-win framework to a deglobalized, zero-sum structure, many long-held investment assumptions about global portfolios will be upended. A zero-sum world is one that necessarily has a winner and a loser, where one side's gain equals the other side's loss. The trends of deglobalization are forcing asset managers, private investors, and business leaders and corporations to reassess how they allocate capital and other resources.

In this case, a zero-sum world frame pits China against the United States. This leaves investors making a critical call about whether to invest their marginal dollars in China versus the United States. Bluntly put, it is about whether China will continue to offer the risk-adjusted returns above the cost of capital that investors expect and are competitive on a global level.

Figure 1

## CHINA'S AVERAGE GROWTH



Source: <https://www.macrotrends.net/countries/CHN/china/gdp-growth-rate>

Against the backdrop of high inflation, slowing global growth, and war in Ukraine—and atop deepening fissures between the United States and China—it's vital to consider whether to tip investment strategies toward or away from China.

The new investment landscape, shaped by rising geopolitical tensions, differing economic and social ideologies, and an evolving world order, will impact investor understanding of risk and return. It also will force investors to decide whether to continue investing in China—a stark choice that did not exist just a few years ago.

## CONSIDERATIONS BEHIND THE INVESTMENT DECISION

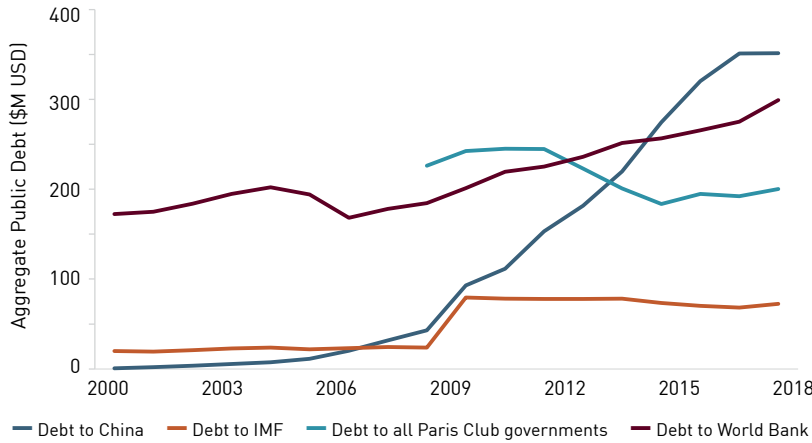
For more than a decade, a compelling narrative has spurred broad investment across the global economy, especially in China—but that narrative now is changing.

Arguments for global investment have pointed to the importance of portfolio diversification, and arguments for investing in China have pointed to the country's strong economic growth (see figure 1). China's massive investment inflows have been supported by its enormous population, the rise of its middle class, and its popularity as a low-cost production destination for global corporations.

Today China stands economically, technologically, and militarily as a formidable competitor to the United States. Over several decades the country also has made huge inroads as a global player. It stands as the largest trading partner, foreign investor, and lender to the emerging markets. Specifically, since 2014 China has been the largest creditor to the developing world—larger than the IMF, World Bank, or Paris Club (see figure 2). Furthermore, China is among the largest foreign lenders to the U.S.

Figure 2

**CHINA IS THE LARGEST OFFICIAL CREDITOR TO THE DEVELOPING WORLD**



Source: S. Horn, C. M. Reinhart, and C. Trebesch, "China's Overseas Lending," *Journal of International Economics* 133 (November 2021), <https://doi.org/10.1016/j.jinteco.2021.103539>

government, providing it with considerable leverage on global policy.

China's demand for U.S. Treasuries has helped keep U.S. interest rates low, which has allowed the U.S. government to borrow relatively cheaply to fund spending for U.S. economic growth. If China stops buying U.S. government bonds, it raises the cost of borrowing, placing additional upward pressure on U.S. borrowing costs. In this sense, keeping China as a creditor is a distinct advantage to the U.S. economy, thereby granting China some leverage on the U.S. economy.

Additionally, China is aggressively pursuing its strategic goals and global ambitions.

Through billions of dollars of investment, China's Belt and Road initiative is connecting trading regions and financial markets. In 2021, China also became a signatory to the Regional Comprehensive Economic Partnership, the largest free-trade trading bloc in history, with 15 members, including Indonesia, Japan, and South Korea, that together represent about 30 percent of the world's population and 30 percent of the world's gross domestic product (GDP) (\$29.7 trillion).

In technology and climate transition, China increasingly is seen as a global actor. In addition to its technological leadership ambitions in quantum computing and artificial intelligence (AI), China has laid out an explicit plan for reaching net zero emissions by 2060.

China already has established dominance in areas such as 5G and quantum information science.<sup>1</sup> Furthermore, China is on course to overtake the United States in AI, semiconductors, biotech, and green energy in the next 10 years.

Nevertheless, from an investor's perspective, fundamental questions are arising about investing in China.

As of October 2022, the IMF is forecasting growth in China's GDP from 3.2 percent in 2022 to 4.4 percent in 2023. In the short term, however, investors lack clarity given the economic impact of the country's strict zero-COVID policy and its relatively low-inflation environment.

These two factors are seen as hindering China's strategy of generating economic growth by shifting from an export-led economy to a consumer-led economy,

as outlined by China's policy-makers in previous plans.

In recent months, investors have been spooked by a series of announcements from China's political class. In addition to the strict COVID restrictions, markets also have reacted to China's "common prosperity" stance and the affirmation of President Xi Jinping for a third term.

The Chinese government took significant steps to scale back COVID restrictions in December 2022, including relaxing quarantine rules and deactivating the state-run Communications Itinerary Card app for tracking people's movements. Although this could bolster China's growth, the broader political climate, including a new "common prosperity" policy that aims to redistribute more of China's wealth to its poor, will remain a concern for investors.

Although compelling in its attempts to redress inequality, the common prosperity policy prompted a sell-off in the domestic stock market, particularly in Chinese A-shares, when it was announced in 2021, as well as a massive repricing of valuations in other Chinese investments. The overall China MSCI Index fell just less than 22 percent in 2021.<sup>2</sup>

These measures have been seen as anti-business and placing a brake on robust economic activity. In the month of Xi's affirmation alone, foreign investors pulled US\$8.8 billion from Chinese stocks and bonds, according to the Institute of International Finance.<sup>3</sup>

Over the long term, China's demographics, debt burden, and questions around the sustained strength of a highly centralized political system are all headwinds for jittery investors. At a high level, according to the United Nations, India soon will surpass China as the world's most populous nation.<sup>4</sup>

Meanwhile, China's working-age population is shrinking; it peaked

at 69 percent of the population in 2010 (see figure 3). The working-age proportion is predicted to fall below 50 percent by 2050.<sup>5</sup> In short, China is on course to get old before it gets rich.

China's ratio of national debt to GDP at 70 percent is below that of many western countries, but the growth rate in China's recorded debt is a deep economic concern. For example, in 2010, China's national debt to GDP stood at just 34 percent. In 2021, however, it was 71.5 percent, and it is forecast to break 100 percent in 2027 (see figure 4).<sup>6</sup>

Then there is the perennial, if not theoretical, question about how long a highly centralized system of political governance can survive in China, especially when the economy is slowing and restrictions on daily life remain in place.

For now, it is clear that President Xi has a consolidated grip on the Chinese Communist Party and, by extension, the country. In November 2022, for example, the Chinese Communist Party was able to quickly reassert control by mobilizing police to quash protests about continued lockdowns in several major Chinese cities. Furthermore, rising tensions over Taiwan are leading many policy commentators and investors to become increasingly concerned about the risk of outright conflict between the United States and China, if not militarily, then technologically.

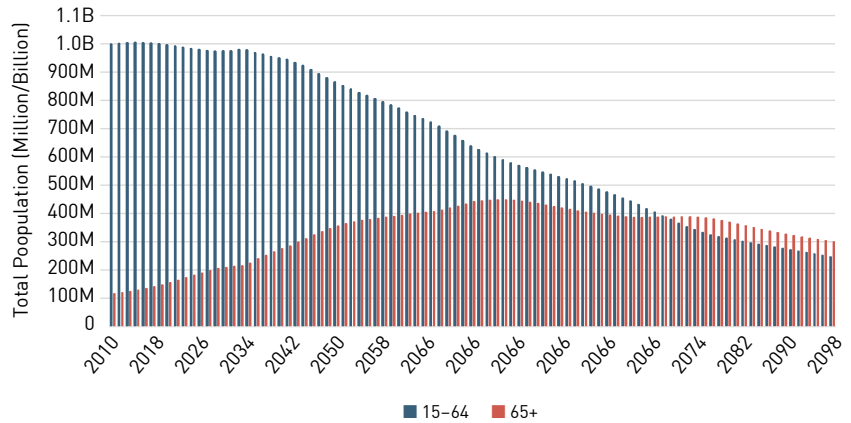
### THE IDEOLOGICAL AND INVESTMENT DIVIDE

We are at a pivotal point in which geopolitics and long-standing ideological differences are now forcing investors to rethink allocations in China.

Apart from the enormity and scale of this decision for financial markets, (China attracted \$181 billion of foreign direct investment in 2021, according to UNCTAD<sup>7</sup>), the decision on whether to remain invested in China is urgent for three reasons.

Figure 3

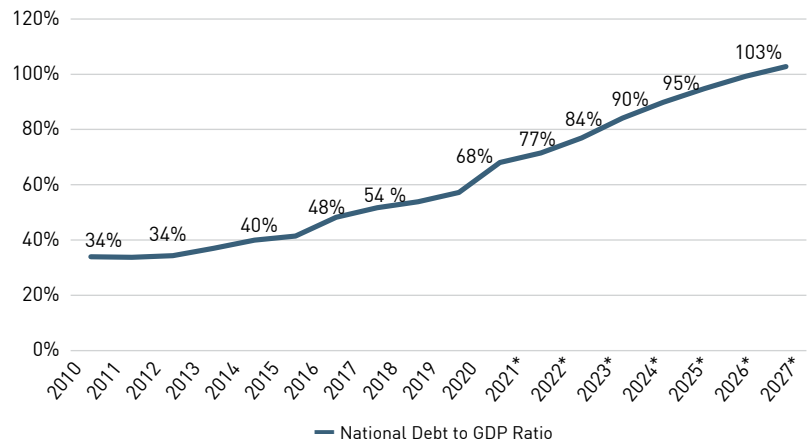
### CHINA'S WORKING-AGE POPULATION IS SHRINKING



Source: Shanghai Academy of Social Science, <https://theconversation.com/chinas-population-is-about-to-shrink-for-the-first-time-since-the-great-famine-struck-60-years-ago-heres-what-it-means-for-the-world-176377>

Figure 4

### NATIONAL DEBT OF CHINA IN RELATION TO GDP 2010-2027



Source: <https://www.statista.com/statistics/270329/national-debt-of-china-in-relation-to-gross-domestic-product-gdp>  
\* Forecasted

Even beyond Hong Kong, China clearly has become more aggressive politically, fueling economic and geopolitical fissures with the United States. Ideological differences with the West also are becoming more entrenched as Xi's grip on power has strengthened in recent months.

Meanwhile, the U.S. administration has explicitly ramped up its seemingly anti-China policy and regulatory stance. This increases the risk of remaining invested in China.

In an April 2022 speech advocating "friend-shoring," or the limitation of

supply-chain networks to allies and friendly countries, U.S. Treasury Secretary Janet Yellen said, "We cannot allow countries to use their market position in key raw materials, technologies, or products to have the power to disrupt our economy or exercise unwanted geopolitical leverage." These comments were widely interpreted as directed toward China and Russia.

More generally, in October 2022, President Joe Biden launched a new National Security Strategy aimed at the threat posed by China, saying, "The People's Republic of China harbors the intention and, increasingly, the

capacity to reshape the international order in favor of one that tilts the global playing field to its benefit.” Export controls form a part of the strategy. National Security Advisor Jake Sullivan has said controls of exports of technology, including semi-conductors, can “impose costs on adversaries and even, over time, degrade their battlefield capabilities.”<sup>8</sup>

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*Recent action by state governors and attorneys general across the United States reminds investors how political power can supersede financial arguments and imperatives.*

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Some argue that this starker anti-China stance was first observed in 2019 when the United States restricted sales of products made by Chinese technology company Huawei. That move is now seen as a prelude to the more aggressive anti-China pivot investors increasingly are worrying about today.

In 2022, new regulations and enforcement of disclosure rules led to a delisting of major Chinese companies from the New York Stock Exchange (NYSE). In August 2022, five Chinese corporations, including China Life Insurance Company, PetroChina Company Limited, and China Petroleum & Chemical Corporation, said that they would delist from the NYSE. Negotiations between these Chinese enterprises and the U.S. Public Company Accounting Oversight Board on sharing audited review data are ongoing.

Furthermore, in September 2022, President Biden issued an executive order that “explicitly ties CFIUS’ [Committee on Foreign Investment in the United States] role, actions, and capabilities with the Administration’s overall national security priorities.” This

announcement has been seen in boardrooms and by investors as a sign of further anti-Chinese investment and an extension of anti-China sentiment.

One area for potential restrictions, if United States-China tensions escalate further, is the deployment of U.S. state pension assets. There is unlikely to be regulation from on high, such as at the federal level, but more stringent guidelines are expected for how assets of state pension funds, U.S.-based institutional investors, and even company investment assets are deployed.

Recent action by state governors and attorneys general across the United States reminds investors how political power can supersede financial arguments and imperatives. If the political sentiment becomes more fervent, it is plausible that state-run pension funds, in line with an increasing anti-China stance in the United States, could ban investments in China.

For example, in February 2022, the Texas state pension fund was the first to ban asset managers that boycott the oil and gas industry, and at least 10 other states followed by October 2022. Florida, Oklahoma, Kentucky, and West Virginia also banned state pension funds from participating in environmental, social, and governance (ESG) investments.<sup>9</sup>

Business leaders are interpreting some decisions and policies as hostile moves aimed at restricting and disincentivizing Chinese companies from investing in the United States.

These measures highlight another risk, that of a tit-for-tat response by the Chinese authorities, specifically the possibility of Chinese capital restrictions that would leave foreign assets trapped inside Chinese borders.

For example, business leaders and investors are acutely concerned about how China might respond to the continued

threat of a CFIUS divestment order for TikTok over concerns that U.S. user data could be passed on to China’s government. U.S. Sen. Josh Hawley (R-MO) wrote to CFIUS chair Janet Yellen requesting enforcement in September 2022.<sup>10</sup> However, any deal between the U.S. government and TikTok is now on hold, having run into delays over further national security concerns.<sup>11</sup>

In December 2022, Alabama and Utah followed Texas, Maryland, and South Dakota in banning TikTok from being used on state devices due to security concerns.<sup>12</sup>

Not only should Chinese investors be worried about how aggressive the United States could become toward Chinese investments, but U.S. investors also should worry about retaliatory responses by the Chinese to these U.S. actions.

If China was to place extra restrictions on capital being invested in China, it would lead to changes on two fronts. It would discourage new capital investments into China, and it would prompt existing investors to worry about their capital investments getting trapped and lead them to withdraw.

### INVESTORS’ THREE OPTIONS

Against this magnitude and speed of change in the investment landscape, it is clearly time for investors to reevaluate their China exposures.

There must be no doubt that widening fissures in the China-U.S. relationship, along with notable trends of deglobalization, will transform how global businesses operate. In particular, global corporations must place under review how they finance themselves, hire across borders, centralize procurement and supply chains, and allocate capital.

How investors react to these trends clearly depends on their unique portfolios and their distinctive needs for diversification, risk appetites, and investment horizons. But ultimately investors have

three options: hold, sell, or double down on their China positions.

First, investors can sell down their entire China exposure. As a practical matter, exiting publicly traded Chinese stocks or private investments, such as a factory or a private equity investment, will most certainly be protracted as sellers try to find reasonable prices in a challenged economic environment.

Beyond this, exiting China will have meaningful consequences in tax, intellectual property rights, transfer pricing, and any possible stranded costs. In addition, taking Chinese investments to zero means investors are left without optionality to benefit from a sustained improvement in the country's investment climate. To reenter China after a complete exit likely would mean incurring high reentry costs.

A second option is for investors to write down the value of their Chinese investments but to still retain the assets on their (financial) books and records. The investor would not add any material new capital to grow or enhance the investments.

Writing down an equity portfolio would lead to actual recorded market-to-market losses. Choosing to write down the value of the stocks rather than selling the position down to zero means the investor retains some optionality if the positions rebound.

For a company, writing down the value of the assets means scaling back operations as opposed to shutting down completely. For example, a corporation might write down the asset value of a factory that would continue to function with only investments to support ongoing maintenance. That is, the investor would make no new expansionary investments or capital commitments. Again, this allows the investor to participate if an improved investment climate was to lead to a sustained market recovery.

A third option is for an investor to both hold and grow its China exposure with new capital. In this case, an investor would look to capitalize on low valuations and market weakness to expand its presence in China.

Doubling down and expanding a China investment brings risks in the prevailing market climate. Therefore, foreign investors might want to consider forming a joint venture with a local partner, helping them to hedge their investments and any risk of outright expropriation.

Any corporation cementing its China position will be well-advised to consider creating a standalone China subsidiary to house its Chinese operations. This leaves corporations facing more financial reporting and regulation, and coping with rising trade protectionism. However, it would mitigate the disruption of trying to run operations in an otherwise politically and economically volatile environment. Of course, taking this path involves establishing governance and board oversight structures of new entities that likely are listed and regulated independently only on local Chinese stock exchanges.

Already, there are signs that some investors are taking positions.

On the "buy" side, Microsoft Chief Executive Officer Satya Nadella stated in a November 2022 announcement that he is "very, very, bullish" on Asia including China and "absolutely committed to China."<sup>13</sup>

Tiger Global has taken a sell and pause option, with reports in November 2022 that the investment manager scaled back its hedge fund investment in China as geopolitical tensions rose ahead of the Chinese Communist Party Congress. The report also stated that Tiger paused new investments amid concern about President Xi's consolidation of power.<sup>14</sup>

Obviously, financial metrics will matter in the choice to sell, hold, or double

down. One warning to investors is that traditional metrics likely will have limited value in such a volatile environment. Conventionally investors will evaluate macroeconomic data such as growth and inflation, as well as price earnings multiples, internal rate of return, Sharpe ratios, and market volatility measures. These will likely, however, prove less reliable in such fast-moving and unpredictable markets.

## CONCLUSION

Asset allocators and investors may be wholly dissatisfied that this article does not recommend, for example, that an investor buy or sell China outright.

Our deliberately balanced approach reflects the unique decisions that investment managers must make, taking into consideration the different horizons and risk appetites across different sectors that drive risk-reward calculations.

Investors that have used a global portfolio allocation approach for decades must recognize how disruptions in all aspects of geopolitical, economic, and sociological trends are impacting their decisions on China. This article is more of a caution to investors that tend to reach for familiar patterns and past trends when placing bets and making long-term investment decisions.

The world is changing rapidly but also fundamentally. The sea changes we are seeing in the global economy, particularly in China, are era-defining. They are the most far-reaching shifts in more than 70 years, and they will reshape the investment landscape for a generation.

The choices outlined above will result in a fundamental disruption to the way businesses and investors have approached China for decades. This disruption also reflects the reality of a deglobalized world as China and the United States compete for economic, technological, and military preeminence. ●

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## IT'S TIME FOR INVESTORS TO REEVALUATE ...

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