Investment Insight:
China - Miracle or Normalisation?

September 2013

Defined benefit: **Relevant**
Defined contribution: **Of interest**

China in our hands

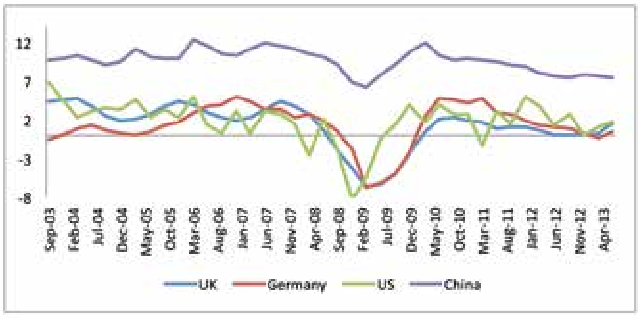
Our latest Investment Insight discusses what might be in store for the Chinese economy and shines a light on how UK pension schemes can access investments in this hitherto restricted market.

Global economic growth over the last decade has increasingly relied on emerging economies, with China the key driver:

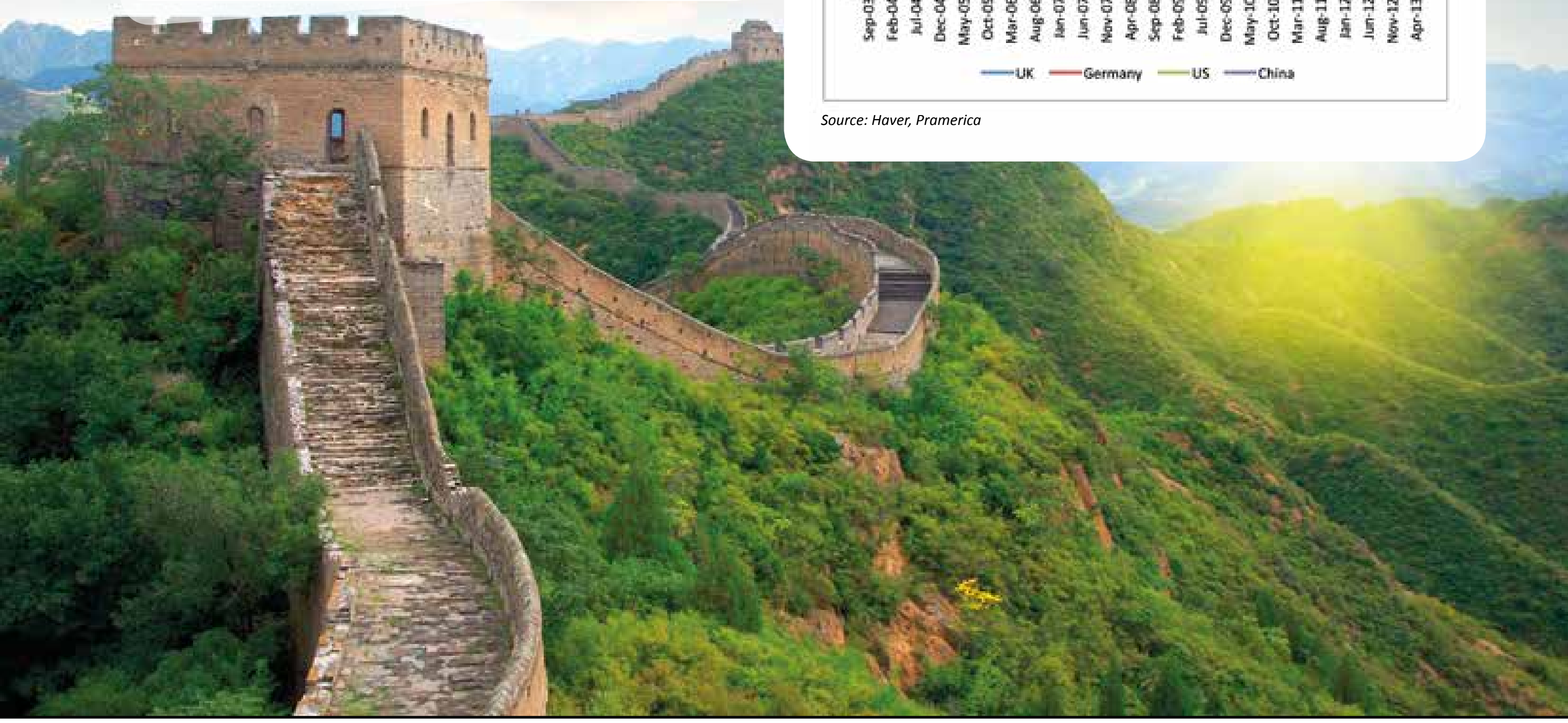
- China is the largest exporter in the world
- China has the second largest economy in the world, second only to the US
- China has a population of 1.4 billion people

Until recently China's economic juggernaut seemed unstoppable (See Chart 1). But is this about to change? The IMF[1] expects the Chinese economy to grow by 7.75% in 2013 (compared to the heady heights of 12% a few years ago) with the risks to the downside given 'both external and domestic uncertainties'. Other commentators point to a slowdown in GDP to around 6% in 2014. There is general agreement that the path of least resistance for the Chinese economy is now downwards, at least in the short term.

Chart 1: Real Quarterly GDP Annualised Year-on-Year %



Source: Haver, Pramerica



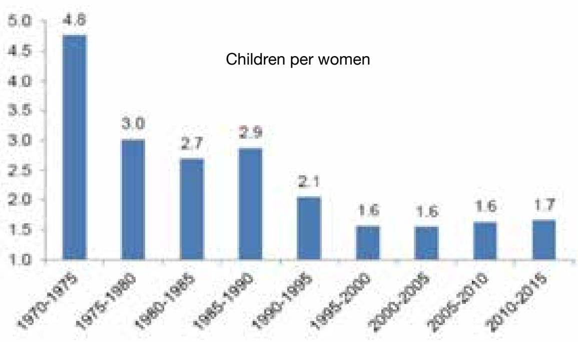
[1] International Monetary Fund 'People's Republic of China' Article 4 Consultation, July 2013.

NAPF
Securing the future of pensions

What's happened to the miracle?

China, it could be argued, has become a victim of its own success. Population growth has dropped sharply (Chart 2), the pool of cheap rural labour is drying up as many have moved to the cities and, linked to this, competitiveness gains are harder to come by as workers demand higher wages.

Chart 2: Fertility Rate



Source: UN, Credit Suisse

The economic growth model which has delivered stunning results has largely been due to the mix of exports, investment, credit and fiscal stimulus. But this is no longer deemed to be sustainable. Very high levels of investment (around half of GDP) and the unprecedented amount of pump priming in recent years has led to very high levels of leverage. This is now a cause for concern for investors as well as for governments across the globe.

China's Premier, Li Keqiang, who came to power in March, stated that deep reforms would be implemented to help boost consumption and private investment. This suggests a movement away, it appears, from the investment-centric economic model for growth and perhaps indicates a greater tolerance for lower growth.

The new era for reforms led to huge turbulence in the Chinese financial markets in June this year. The Shanghai interbank offered rate (Shibor) — China's once-anonymous version of London's LIBOR — made news around the world when it suddenly spiked to all-time highs. Expected to lower this rate by injecting cash into struggling Chinese banks, the People's Bank of China (the country's equivalent of the Bank of England) instead did nothing, leading to speculation that China's leaders were finally prepared to tackle the economy's overheating problem. In the process, the authorities also appear to have finally taken notice of the potential dangers of off-balance sheet lending, inter-corporate finance and, most prominently, shadow banking. According to Fitch[2], China's shadow banking sector may be responsible for as much as $2trn worth of risky assets in off-balance sheet lending.

What are the required reforms?

Specifically, structural reforms currently under consideration may target state-owned enterprises and local governments, exposing them to the realities of hard budget constraints— including market prices for their inputs— and cutting off the preferential access to credit. It is unclear at this juncture how smooth the transition to the new economic model will be. What can be surmised, however, is that it will likely result in an increase in corporate defaults, non-performing loans and the deterioration in bank balance sheets. In the short-term reforms will have a negative impact on demand and growth: the hope is that they will boost long-term growth prospects and put the Chinese economy on a sustainable economic path.

So how does a UK Pension Scheme access the Chinese market?

The Backdrop

When looking at emerging markets, it is important to distinguish between local and hard currency bonds. The term 'hard currency' usually refers to bonds denominated in major currencies such as the US dollar, the euro or the Japanese yen. In the past, foreign investors focused on hard currency bonds in order to achieve diversification in terms of issuer risk while at the same time avoiding currency risk. With emerging economies outshining developed markets since the financial crisis, investors have become increasingly attracted to the potential for local currency appreciation.

[2] Fitch ratings agency, Charlene Chu, senior director, interview June 2013.

China, as an export-driven economy, has for many years protected itself from outside capital in order to manage the Renminbi's appreciation and to prevent poorly controlled capital inflows and outflows. China has only recently started to gradually allow its financial markets to open the door to outside investors. For prospective local bond investors, the most significant step was taken with the implementation of the Qualified Foreign Institutional Investor (QFII) scheme ten years ago. This has enabled foreign institutional investors that have been granted QFII status to trade A-Shares (equities), government bonds, corporate bonds, convertible bonds and other instruments approved by the Chinese Securities Regulatory Commission. More on this later…

According to our Annual Survey[3], the average UK pension scheme held on average 2.3% of its assets in emerging market (EM) and high yield (HY) debt and 1.6% in emerging equities in 2007. Roll the clocks five years forward and the average fund had 4.2% in EM and HY debt and 2.5% in EM equities. Pre-financial crisis, UK pension schemes' preferred route into emerging markets was through their global investment managers with pooled funds linked to (primarily) the MSCI EM equity index or the J.P. Morgan EMBI Global Bond Index. Investments were generally tactical and opportunistic, representing a small part of the scheme's asset allocation. In the last three years, there has been a strong pick up in investments in emerging markets on a strategic basis as emerging assets have performed strongly.

> "A continued China slowdown is inevitable. The export-driven growth model has run its course. China is already the world's largest exporter and second-largest economy, making it difficult for it to sustain continued rapid export growth."
>
> ***Arvind Rajan**,*
> *Pramerica Fixed Income*

Now pension schemes are drilling down further and looking at opportunities to invest directly in the local emerging corporate debt, infrastructure and private placement markets. Here are the 'ins and outs' of investing directly in Chinese assets:

The Chinese Bond Market

The Chinese bond market is the fourth largest in the world (after US, Japan and Italy), valued at over £3trn[4]. It is highly regulated and restricted with less than 5% of the total outstanding market owned by non-Chinese entities, half of which is believed to be owned by foreign central banks. There are four different types of markets for investment into China, each with its own regulations and characteristics:

1. **The China Interbank Bond Market (CIBM)** is the largest and most liquid Chinese bond market making up over 95% of the total market. This is for domestic investors and foreign central banks.
2. **The Qualified Foreign Institutional Investor (QFII) Scheme** is open to overseas asset managers, pension schemes, insurance companies and commercial banks. The Chinese Securities Regulatory Commission issues licences for this market with limits of 10% of the market for individual foreign investors and an overall 30% limit for all foreign investors.
3. **The Renminbi QFII or the 'mini QFII' scheme** was, until recently, limited to Hong Kong and Taiwan-based securities firms, asset managers and banks giving them access to domestic bonds via a quota system. This has recently been expanded to Singapore and London-based investors.
4. **The CNH (the currency code for the Renminbi) bond market** is the offshore Renminbi market that trades in Hong Kong and is also known as the 'dim sum' market. This is a very small market and highly illiquid, open to all investors trading government bonds and corporates.

3 NAPF Annual Survey 2007 and 2012. Defined benefit schemes' investments (private and public sector) in emerging equities and 'Other Fixed Income'.
4 Pramerica Fixed Income.

Chinese Equities

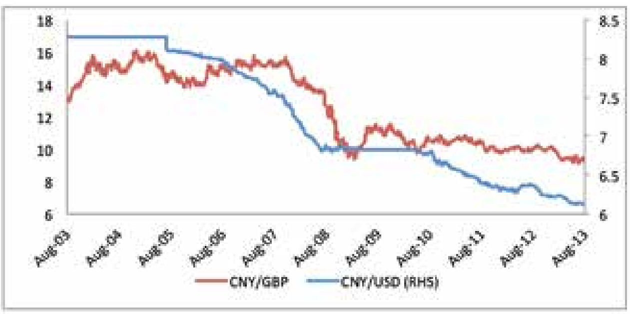
Shares in the domestic Chinese stock market denominated in Renminbi are known as A-shares. The combined market capitalisation for A-shares on the Shanghai and Shenzen stock exchanges is over two trillion pounds[5]. Mainland China shares are currently excluded from global equity benchmarks, but would account for around 7% of world markets. A-shares could offer greater diversification and exposure to China's structural growth than available from the H-share offshore market based in Hong Kong. The Chinese A-share market is accessible to QFIIs.

In the wake of the financial crisis, investors are generally more aware of and cautious about investing in firms in countries with lower standards of corporate governance, especially without a high level of market-specific expertise and insight. Opacity around ownership structures and the general level of corporate disclosures are specific issues which a number of investors are wary about when it comes to investing in Chinese corporates. Because of these corporate governance concerns there is often a desire for a higher rate of return to offset the additional risk.

Chinese Currency

While it is difficult to pinpoint the exact behaviour of UK pension funds it is fair to say there has been a growth in institutional investors seeking to gain an exposure to the Renminbi over the last three years. The profile of the Renminbi as an investable currency has been boosted by the process of internationalisation and partial rolling back of China's capital borders. It is this that has led some analysts to believe that the Renminbi will achieve reserve currency status by the end of this decade. From an allocation perspective, the Renminbi has offered currency investors both a low realised volatility and a sustained appreciation over the past few years (Chart 3). These characteristics have made the currency an attractive investment proposition, particularly since the Eurozone crisis.

Chart 3: Renminbi's Appreciation



Source: Haver, Pramerica

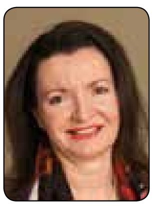
Investors can gain a long exposure to the Renminbi through a number of channels. As mentioned earlier, the Chinese authorities have recently expanded their QFII scheme, allowing institutional investors wider access to capital market securities on the mainland. In terms of a pure currency play, the development of the offshore CNH market has allowed market participants to hold and take delivery of the Renminbi in Hong Kong-based accounts. This has acted as the main vehicle for currency investments in the recent past. Currency exposure can be accessed either through a dedicated separate account or a pooled fund. A separate account can be unfunded and specific to that investor, but will generate cash flows, require a custodial relationship etc. Given this, a dedicated separate account may suit larger schemes; smaller pension funds may want to look at a pooled fund structure which could offer exposure to a broader range of emerging market currencies than just the Renminbi.

Conclusion

UK pension schemes have become more involved in investing in emerging assets in recent years on a strategic basis. Navigating the regulatory complexities, liquidity and capacity hurdles involved in investing directly in China have been highlighted here and few UK pension schemes have, to date, taken this route. What has become very apparent to every investor however is that what is happening to China as a global exporter and, (as domestic demand grows), a global importer is pivotal to the performance of assets across the globe. China may be slowing but it will remain a formidable force.

“China's domestic policy agenda seems to be tilting towards reducing long-term risks, even if the cost is more short-term volatility. For institutional investors, this is preferable to the alternative.”

Sunil Krishnan,
BT Pension Scheme



If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our investment specialist: **Helen.Roberts@napf.co.uk**.

[5] HSBC, July 2013.