WHY INVESTORS SHOULD STICK WITH CHINA DESPITE THE TRADE WAR

It is approaching one year since the trade tensions between the United States and China began, and there is still no clear end in sight. The uncertainty and volatility caused by tariffs has led to concerns about whether China’s economy can get through or whether it faces a recession.

The good news is that most observers believe China’s economy is strong enough to withstand the impact from the trade war, with the consensus forecast suggesting the current tariff regime will shave just 0.5% off GDP growth in 2019.

In addition, in recent years China has taken steps to reorient its economy away from being reliant on exports to a model that is more consumer driven. Not only does this shift mean that any trade conflict will have less impact over the longer term, it also means China’s economic growth model will look more like what the developed countries lived in those past decades. As a result, a slowdown in China’s economy could be viewed as a natural outcome of its changing economic model, and one the Chinese government is prepared for and committed to managing prudently.

FEWER BARRIERS TO ENTRY

Over the past 12 months, China’s leadership has repeatedly reiterated its commitment to removing market barriers. For example, at a meeting with foreign chief executives in Beijing in June, Premier Li Keqiang said that China will “relax (restrictions on) access to even more fields to create a market-oriented, law-based internationalised business environment.”

Meanwhile, plans have also been announced to revise the Qualified Foreign Institutional Investor scheme (QFII) and its renminbi equivalent (RQFII) to improve overseas access to Chinese capital markets. This change is in addition to recent reforms to the Stock- and Bond Connect channels that have allowed A-shares and Chinese bonds to be included in major investment indices.

And while some market participants have expressed concern that China will reverse some of these reforms if it continues to face pressure over trade, the opposite may be true according to Jason Lui, Head of Equity and Derivative Strategy for Asia Pacific at BNP Paribas. China will keep improving market access for foreign investors to offset the impact of the trade war, he explains...

FULL SPEED AHEAD FOR FINANCIAL REFORMS

From a balance of payment standpoint, Chinese policymakers are fully aware of the structural shift in the current account balance due to the trade tensions and they are committed to attracting more foreign capital to compensate while promoting the internationalisation of the Renminbi.

- Jason Lui,
  Head of Equity and Derivative Strategy for Asia Pacific, BNP Paribas

The most active area of reform has been in China’s financial sector. Recent initiatives include permitting foreign ratings agencies to operate onshore, and overseas asset managers and investment banks to own majority stakes in Chinese joint ventures.

Reforms aside, a key area of concern from offshore investors remains China’s high level of debt. Over the last decade Chinese corporate, government and household debts have increased up to $33 trillion. This has led to the perception that the country is in the grip of a debt bubble. However, China is likely to be able to sustain a higher debt level thanks to three important factors: a strong economic growth, a high domestic savings rate and a closed capital account which allows 98% of the debt to be owned by domestic investors. China also has the tools and the knowledge to manage the risks, says Lui.
China's efforts to reduce debt levels include encouraging banks to lend more prudently, which has also led to stricter guidelines for classifying loans as non-performing. The country has also established a number of bad debt managers, known as AMCs (Asset management companies), to acquire non-performing assets from the banks which can then be restructured or sold on.

**BELT & ROAD BOOST**

First announced in 2013, China’s Belt and Road Initiative seeks to develop infrastructure and trade links between China and countries across Asia, Africa, Middle East, Europe and Latin America. In light of Washington's strategy of implementing tariffs to achieve its trade aims, many governments are re-evaluating their trading relationships and looking for partners that want to remove barriers and promote free trade. As a result, the BRI will mitigate the impact of the trade war over the longer-term by helping to foster new trade links between countries and creating new avenues for growth.

2. [https://www.ft.com/content/5e1a8c8a-22d9-11e9-b329-c7e6b9b5f6df](https://www.ft.com/content/5e1a8c8a-22d9-11e9-b329-c7e6b9b5f6df)
4. [https://stats.bis.org/statssrv/table1f12](https://stats.bis.org/statssrv/table1f12)

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**Belt & Road Initiative**

The Chinese government is still very involved in the economy – the biggest lenders and the biggest borrowers are state-owned – which means it is in a strong position to resolve the debt problem in a controlled manner, something it has been very effective at doing.

**INVESTORS NEED TO TAKE ACTION**

The past year has shown that trade tensions between the world’s two biggest economies are unlikely to be resolved quickly. However, China has already shown it has the capacity to withstand the impact of higher tariffs and the government is taking action to manage indebtedness, accelerate financial market reform and move away from an export-led economy.

And while it is true that the trade war has increased volatility in China's capital markets, high volatility is not unique to China; many emerging markets tend to experience a higher level of price fluctuation than developed markets due to the more speculative nature of the investment base and the impact of foreign capital flows.

Moreover, high volatility means there is a greater probability of share prices overshooting or undershooting their fundamentals, which should allow more value-oriented foreign investors to monetise the dislocations. The key is to develop the expertise and capabilities to be able to navigate China’s markets as they continue to grow and open up to foreign investors.

Given the steps China has taken to reform its economy, the country still presents a clear opportunity for investors. Certainly, foreign participation in China’s capital markets is a long-term, secular trend and the sooner investors start preparing to enter the market, the greater advantage they will have.