Weekly Digest

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The weekly insight into world stock markets

Investec
Wealth & Investment

Three Score And Ten

Today China will begin a week of celebrations to mark seventy years since the founding of the People's Republic of China, no doubt confident that its lifespan will be appreciably longer than that ascribed to humans in the Bible. However, it comes at a very interesting, not to say sensitive time for the country, embroiled as it is in a number of disagreements with the United States while struggling to re-establish faster growth domestically. At the same time it is having to cope with protests in Hong Kong, the territory that still acts as the main financial gateway to China for international investors. We can probably expect a lot of puffed out chests and braggadocio, as much to gee up the locals as to send a message to the rest of the world.

The increasing importance of China to international investors is reflected in its growing weight in global indices, although those weightings are nowhere near commensurate with its share of the global economy. China's Gross Domestic Product share in nominal dollar terms is around 16%, putting it second behind the United States' 24%. Interestingly, though, on a Purchasing Power Parity basis (according to the International Monetary Fund), China is already the world's largest economy, claiming a 19% share against the US's 15%. For reference the UK ranks 7th on this basis, behind China, the US, India, Germany, Russia and Indonesia. In equity index terms, China accounts for 32% of the MSCI Emerging Markets Index. Emerging Markets themselves account for 8% of global equity indices, thus China would make up just 2.6% of our equity holdings if held in line.

It seems almost inevitable that China weightings will continue to rise in the years ahead, but it's informative to look at what sort of exposure you get as an index investor. Four of the largest non-bank companies in China are Alibaba (internet content and e-commerce), Tencent (internet and mobile services), Ping An (financial services, mainly insurance) and China Mobile (guess!). The respective share of their revenues generated domestically in China is 83%, 94%, 100% and 100%. For now, at least, investing in large capitalisation Chinese companies is all about investing in China's economy. Compare that to some of the big beasts in the US, and their share of revenues generated in the home market: Microsoft (51%); Apple (40% - and 25% in China); Amazon (60%) and Facebook (50%). All data from Bloomberg. These are much more global in their reach. It remains impractical (although not impossible) for us to invest in individual shares in China, and we also acknowledge that being five thousand miles away from the action might put us at something of a disadvantage to the locals. However we have access to a diverse, growing selection of experienced fund managers that benefit from local expertise.

And it's not just equities that are on the radar. Last week we had a visit from a bond fund manager who specialises in China, who pointed out to us that the size of the total bond market there (including government and company debt) is north of $13 trillion. That remains well short of the United States' $42 trillion market, but China's is the world's second largest bond market, with Japan the next biggest at $12.4 trillion. A huge chunk of that is in the hands of the central bank under its Quantitative Easing programme. The UK's total bond market, by comparison, is just shy of $6 trillion (all data from the Bank of International Settlements, March 2019).

Just because a bond market is very big, it doesn't mean that we have to be exposed to it, though. After all, a big bond market is indicative of an equally big pile of liabilities that have to be serviced with interest payments, as well as (theoretically) repaid at some point in the future. However, a big bond market will tend to offer lots of liquidity as well as a very wide range of investable securities. One of the arguments for looking at China's government bond market is that the yield on its 10-year debt is a relatively attractive 3.15%, compared with 0.5% for UK Gilts, 1.69% for US Treasuries and minus 0.57% for German Bunds. We judge China's credit to be good – headline government debt-to-GDP, at 50%, is substantially lower than pretty much all developed economies – and, although growth is slowing from a previous break-neck pace, we do not think a major downturn is imminent.

Of course, things are never as straightforward as one would like, and in this case we would also have to consider foreign exchange risk. It's no good buying supposedly "safe" bonds and then taking a big hit on the currency. Although exchange rate moves would generally have been of benefit to sterling investors for much of the last decade (first when the Renminbi was appreciating against most of the world's currencies, and then when the pound was similarly depreciating), it's a harder call from here. The recent bounce in sterling highlights the risk of being "short" of pounds, especially if there is a Brexit solution that is deemed positive by markets. Hedging the exposure is a possibility, but current interest rate differentials mean that it would cost around 1.5% per annum, negating a big chunk of the yield advantage. However, in the event of persistent weak growth, China's bond yields can potentially fall a lot further before hitting any perceived "yield floor", thus offering the potential for capital gains.

In sum, we do not yet have a specific line for China in our Strategic or Tactical Asset Allocation models, but such a move is possible in future as China's influence increases. Until then, at least we have a growing suite of products from which to choose as we look to diversify risk and seek out new ways to add value to portfolios.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

TUI AG	12.4%
EasyJet plc	9.2%
3i Group plc	6.7%
Reckitt Benckiser	5.5%
Compass Group	5.0%
RELX Group	4.2%
Standard Life Aberdeen	3.9%

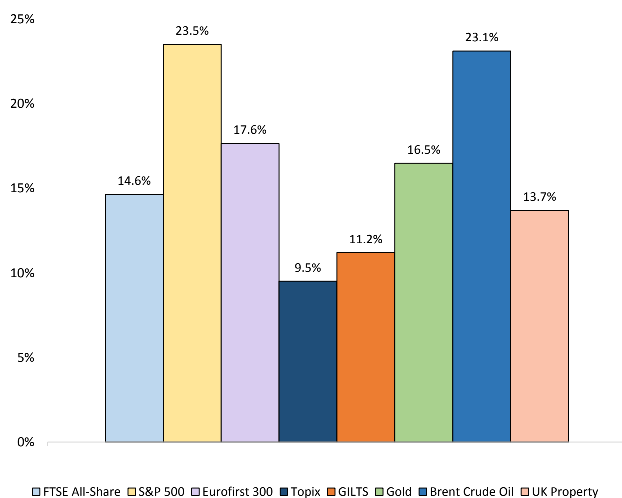
Source:FactSet

FTSE 100 Weekly Losers

Imperial Brands	-17.0%
Pearson	-13.8%
John Wood Group	--10.7%
Carnival	-8.7%
Royal Mail	-5.5%
Evraz	-4.8%
NMC Health	-4.7%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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