Tough questions

Hayden Briscoe, Head of Asia Pacific Fixed Income, answers tough questions about China and the challenges involved with investing there.

China's government frequently gets accused of falsifying data, shouldn't that be a red flag for investors and a strong reason not to get China exposure?

These accusations have been flying around for years.

Yes, there's been some cases of local officials inflating data but it's one thing for an investor to go from acknowledging these cases to then concluding - wrongly, in my opinion - that the whole system of reporting data is rigged.

If you come to that conclusion and then decide you can't invest successfully in China or don't want to, you may miss out on huge opportunities.

Successful investors in China acknowledge that there are information challenges and then they adapt.

I see three specific challenges when trying to find good information in China.

Firstly, China's financial sector just doesn't have the same depth or range of media coverage as in more developed markets – you can argue about the reasons for that and whether its right or not but it's just a reality; secondly, Chinese companies and sectors are relatively under-researched compared to the levels of analyst coverage in say the US and Europe and, finally, coverage of China in the Western press, whether through editorial bias, misunderstanding, or lack of China research resources, can sometimes be sensationalist and inaccurate.

How we deal with this situation is invest in our onshore teams and build up a team of analysts and sector specialists who know where to find information, can interpret nuances of government policy, and have experience of investing in China's markets.

More than that, we take a bottom-up approach to research in China where we visit companies, talk to industry experts, and do market research to get a more nuanced picture of the companies and sectors we invest in.

By doing that, we create the resources to get the insight about what is happening in China that you can't get from government data and which addresses the informational challenges I discussed.

China is supposed to be reforming but not much seems to have changed. Given that reform is so important to the economy's long-term growth potential – isn't this a problem?

Reform is a process and not an event.

Too often commentators expect reforms to happen rapidly, like those in the UK in the early 1980s and Russia in the early 1990s.

For China, reforms need to change the economic model and the basis of a society that is made up of 1.3 billion people . With the future of so many people - let alone the government - riding on getting reforms right, reforms have to be gradual, not the kind of rapid 'big bang' changes that would satisfy headline writers but jeopardize the livelihoods of millions.

But let's look at the facts about reform in China. In the past few years, we have seen relaxation of the one-child policy, targeted removal of controls on rural-to-urban migration, roll-out of social safety nets, opening up to foreign investment and majority ownership in selected sectors, forced closure of companies in overcapacity sectors, tighter controls on shadow banking, removal of fuel subsidies, and a much tougher raft of environmental standards to cut down on pollution.

More specifically, there have been major reforms in the financial sector, like the Stock and Bond Connects, which have opened up onshore markets to overseas investors. These are major changes from previous years and are so significant that global benchmarks, like MSCI and Bloomberg, are putting China equities and bonds in their indices, precisely because reforms brought in have been effective.

What's ironic is that these changes are just the same ones that the IMF and World Bank have been recommending for years. Having seen these changes close-up and talked to regulators throughout the markets, we're convinced that China is reforming its economy and we expect the reform process to continue in the coming years.

The RMB isn't market-driven and it is volatile, why should an investor even consider having RMB exposure?

Currency risk is part of being an international investor and you can't get away from it.

That said, a lot of uncertainty about the RMB stems from policy changes brought by the People's Bank of China in 2015 and 2016 that caused the RMB to devalue. Ironically, those changes were meant to make the RMB more market-oriented, something the US has been requesting for years.

We haven't seen any events like that since, and that's because China has learnt its lesson.

But let's focus on the more precise changes on a day-to-day basis. The fact is that the RMB is less volatile on a day-to-day basis than other major currencies, so if you are concerned about volatility in the RMB, you need to apply the same brush to other currencies around the world.

Additionally, too much attention is placed on the CNY/USD relationship, when what investors should be looking at is the relationship between the RMB and the CFETS basket – a trade-weighted basket on currencies, where the RMB has been trading in a relatively tight range in the past couple of years.

I'd also say you need to look at the RMB with a long-term view. Trends like opening onshore markets to international investors, creating oil contracts in RMB, joining the IMF SDR currency basket are all part of internationalizing the RMB, and that's a trend that investors shouldn't ignore.

China's debt levels are high, doesn't this pose a risk of a major financial crisis?

China's debt pile is large at approximately 260% of GDP , no doubt about it.

China is the second largest net creditor nation in the world, no one is calling them on their capital and no one is pushing them around.

If you think of China as one corporate entity, we think of debt to GDP as their EBITDA, as China is still growing they can afford to have structurally lower EBITDA as they address the debt.

Most of the debt is concentrated in the state-owned-enterprise sector and owed to the government, rather than international institutions. Companies in the private sector, in comparison have lower debt levels.

What I'd say is that debt is a problem if your economy is not growing, but China's economy is growing and there's more potential for the economy to grow from further reforms and productivity gains.

Additionally, we're seeing definite steps from the government to take leverage out of the economy – almost to the extent that they forced a major economic slowdown in 2018.

Shadow banking is a great example here. Once a major area of concern, the government has reined in shadow lending with a huge range of regulations.

Now the problem for the government is how does it replace these lending channels through the formal banking sector.

In summary, I wouldsay that yes debt levels in China are high, but I'm not seeing an impending crisis because the structure of the debt means the burden is internalized and, importantly, China is also being aggressive about reining in leverage in the system.

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