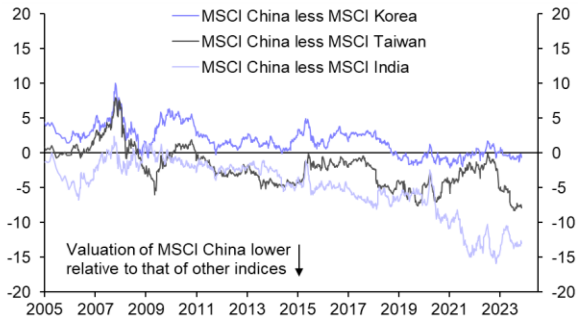
ASSET ALLOCATION UPDATE

The US/China relationship and global financial markets

- **With a lot of pessimism seemingly already priced in to China's "risky" assets, we suspect a thawing in US/China relations could give them a boost. But we think their longer-term outlook is less rosy. Meanwhile, we don't think US/China tensions will have much bearing on global "safe" assets – despite China's still-large holdings of them – which we think will rally regardless.**
- **The Biden/Xi meeting at APEC this week has thrust the US/China relationship back into the spotlight.** We covered the economic implications in a recent Drop-In; click here to view a replay. Here's how we are thinking through the implications for global financial markets of any improvement in that relationship.
- **Risky asset markets. We suspect any further reduction in tensions would give China's risky assets a boost relative to those elsewhere. But we doubt it would be large, nor see them outperform over the long run.**
- **The main channel through which that would occur would be a reduction in the "China risk premium" that seems to have become embedded in the country's risky asset prices over time.** Equity valuations – as measured by price/forward earnings (PE) ratios, for example – are now quite low in China relative to those elsewhere. And that's not just a story of sky-high US valuations: the PE ratio of the MSCI China Index is also low relative to those of non-US developed market equities and of other regional emerging market indices. (See Charts 1 & 2.)

Chart 1: PE Ratio Of MSCI China Index Less PE Ratios Of Other MSCI Indices

Chart 2: PE Ratio Of MSCI China Index Less PE Ratios Of Other MSCI Indices



Sources: Refinitiv, Capital Economics

- Corporate bond valuations tell a similar story: high-yield credit spreads (as measured by the relevant ICE BofA Corporate Bond Indices) are unusually high in China relative to, for example, those in the US or the euro-zone, even though they've fallen recently. (See Chart 3.)
- This discount reflects, in our view, a lot of things, among them the authorities' "common prosperity" agenda and broader antagonism towards the private sector; worries about the future of China's growth; and the implications of all that for its highly leveraged property companies. But we suspect that trade tensions with the US have been a key driver as well. Not only do tariffs and trade restrictions place Chinese companies' future profits at risk, but investors may well be worried about the risk of stranded assets (as happened in Russia) should relations with the West take a sharp turn for the worse.
- Admittedly, trade restrictions affect companies' profits outside of China as well, given their supply chains in, and sales to, the country. But they do seem to weigh on Chinese equities more heavily: not only did China's equities underperform those of the US over much of the last couple of years as trade restrictions continued to be ramped up, but they also suffered more throughout the 2018/19 "trade war" under the Trump administration. (See Chart 4.)

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Chart 3: Option-Adjusted Spreads Of ICE BofA High Yield Corporate Bond Indices (bp)

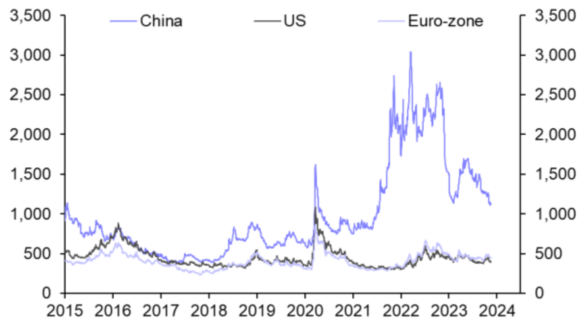
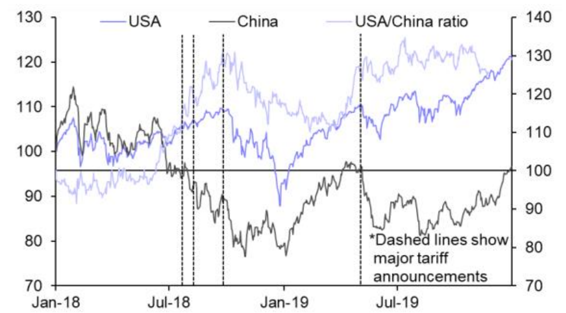


Chart 4: MSCI Equity Indices* (1st January 2018 = 100, US$)



Sources: Refinitiv, Capital Economics

- China's equities actually sold off following this week's Biden/Xi meeting, suggesting that investors were disappointed with the ultimate outcome. (The release of some disappointing data on the country's real estate market around the same time probably didn't help either.) But the risk premium *does* seem to have shrunk somewhat over the preceding few months. (See Charts 1 – 3 again.) Given how large it still is, and the implicit degree of pessimism therefore priced into China's risky assets, we suspect there's plenty of scope for it to continue to narrow if the two countries make further incremental steps towards an improved relationship, which would probably give China's risky assets a near-term boost relative to those elsewhere.
- But we doubt that would prompt a particularly large or sustained rally. As noted earlier, we don't think trade tensions are the only driver behind the risk premium, and the other drivers seem unlikely, to us, to go away any time soon. That could limit any gains.
- And the story further ahead is, in our view, even less positive. Even if relations improve in the near term we think the *long-run* trend is for the worse, and that the global economy will, ultimately, only fracture further. (See here.) That's been emphasised by the challenging nature of some of the issues raised at the latest meetings, which speak to large differences in outlook. And with much of the world's financial heft still in the US camp (see our new interactive dashboard), that would probably create a challenging environment for China's asset markets. The country's long-run economic growth prospects, which we think are pretty dire, might be another headwind.
- **Safe asset markets.** Foreign demand for developed market sovereign bonds has been back in focus lately amid the apparent rise – and then partial retreat – in Treasury term premia. And it was China's reserve accumulation throughout the 2000s that some believe played such an important role in supressing term premia back then. Over the past couple of years, there's been speculation that China has attempted to reduce its exposure to Treasuries, given its fractious relationship with the US, potentially contributing to higher term premia and, therefore, higher yields. So perhaps a thawing could see the country's reserve managers return into that market.
- We're sceptical, though, that China's demand is set to be a big driver of Treasury yields in either direction. We always doubted that it would be able to reduce its exposure to US assets by all that much, given the small size and undesirable risk profile of assets in many of the countries it might consider closer allies. And so far there seems to be little evidence of a genuine effort by the country's authorities to do so, even if they seem to have slightly reallocated their investments *within* the US out of Treasuries and into agency bonds.
- In any case, we suspect that the most important factors driving China's demand for US assets, including Treasuries, will continue to be driven the authorities' desire to intervene in currency markets and the need to recycle the country's current account surplus, rather than geopolitical tensions. And they seem reluctant to make much use of their reserves for now: even with the renminbi around its weakest level against the greenback in some time, they appear mostly to have directed state banks to prop it up rather than intervening directly. So while we do think that foreign demand will continue to be an important risk to Treasuries we don't think China is set to resume the role of key buyer it played in the mid-2000s.
- (We think Treasuries will continue their recent rally anyway, as the Fed turns more dovish than investors seem to expect: see here.)

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