



# Is China an Emerging Market or a Developed one?

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The answer is “it depends”.

It is a hybrid market exhibiting both EM and DM characteristics.

When modeling equities, Chinese stocks behave much more like emerging markets, especially in cases where policy decisions matter more than company or industry fundamentals.

But the country’s bond markets (sovereign, quasi-sovereign, and corporates) are more akin to developed markets.

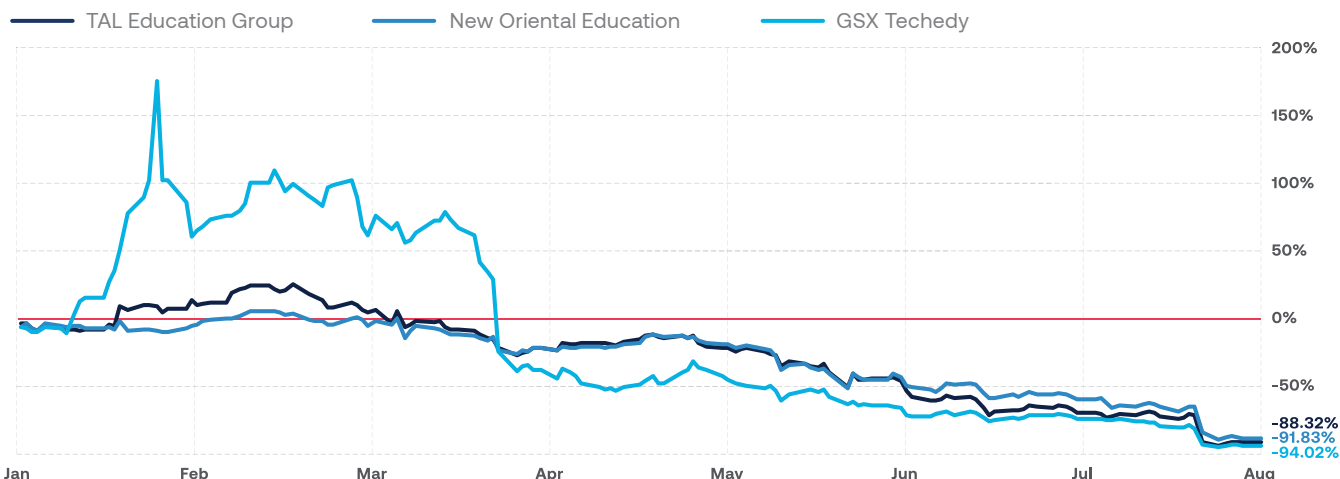
The policy-induced July market sell-off on the Mainland validated our thesis to use Chinese sovereign bonds as a diversified, carry-rich, uncorrelated safe-haven asset.

At the same time, this same catalyst served as a reminder that investors should rethink their equity investments mindful of the government’s new regulatory approach emphasizing data security, social equality, and self-sufficiency.

Recently, this question came up during one of our team meetings. It was not meant as either a prelude to a prolonged academic debate, or as a starting point for a grand strategic discussion. Rather, it was a technical question posed by someone inquiring how to classify for reporting purposes our new investment in Chinese sovereign, quasi-sovereign, and corporate bonds within our model portfolios. This seemingly innocuous inquiry stumped everyone, including myself.

**“Let me think about this, and I’ll get back to you”** was my slithery way of avoiding an immediate decision. If you ask most analysts, strategists, and investors, most will undoubtedly say that China unequivocally belongs in emerging market sleeves within global asset allocations. Indeed, they did nothing to dispel that supposition on July 23rd when they suddenly wiped out an entire industry, the private tutorial sector, that included companies like New Oriental Education and TAL Education Group. Beijing’s *coup de grâce* slashed over two-thirds of their market value in an instance and resulted in YTD losses exceeding -90%.

### Performance of Chinese education companies, YTD



Source: Bloomberg (as of August 2, 2021)

This was quintessential, emerging market-style value destruction reminiscent of nationalizations in Latin America and other parts of the developing world decades ago. It is no wonder that the unexpected move by Chinese authorities, already on the back of tightening regulations in Big Tech names like Alibaba and Tencent and the property sector triggered a massive capital flight and risk-off event. **Investors were correct to question whether China's pain threshold for tolerating slower economic growth and capital flows at the expense of their social policy goals was higher than previously assumed.**

So, has China given up on the capitalist model that propelled it forward for over 20 years and turned it into the world's second largest economy (first on a PPP-basis)? Certainly, Xi Jinping is not Deng Xiaoping or even Hu Jintao, two leaders who championed the export-led model of economic growth and the role of private enterprise. But he is not Mao Zedong either. He is the intellectual father of *Xi Jinping Thought*, or "Socialism with Chinese Characteristics for a New Era". These are the core set of ideas and principles espoused by the Paramount Leader and incorporated into the Constitution of the Chinese Communist Party (the "CCP") in 2017 and the national Constitution a year later. The overarching principle is that the CCP sits at the center of all political, social, economic, and military life, and that every other organ must always respond to the national will as embodied in the Party. When this foundational tenet is understood, it sheds illuminating light on the regulatory crackdown that China has leveled on Big Tech. Data is the new currency of the realm, and these behemoths dominated data acquisition, deployment, and intelligence to a degree that made the CCP uncomfortable. Doubtlessly, China needs the innovation these companies unleashed. But innovation must always be subject to and responsive to the Party's goals – the public good. Alibaba's Jack Ma is a phenomenal entrepreneur, but Xi Jinping cannot allow him to become bigger than the Party. When Alibaba entrenches itself as a monopoly,

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accruing large profits, and controlling data independent of or to the detriment of the CCP, it becomes a threat. In a way, Xi Jinping told Jack Ma that he got too big for his own good. To be sure, the American government is dealing with these same issues. Not so much from the data control perspective, but from the public good one. When Google (or Amazon, or Facebook, etc.) simply buy out all their competition, is that now less-competitive market better for the American economy's competitiveness and innovation? Remember, what is good for a shareholder is not necessarily what is best for the economy. The difference, however, is that the American answer to Big Tech's growing monopoly power must come from consensus-making, a sometimes long and laborious (but ultimately optimal) process. China's answer can manifest itself after a phone call from the right person, an emerging market-like response. While more likely to produce suboptimal outcomes in the long run, it can appear more decisive and fruitful in the near-term.

A corollary of Xi Jinping Thought is that the government must adopt a people-centric approach to the public interest. This belief explains the actions of the government to “socialize” highly profitable after-school tutoring businesses by turning them into essentially public utilities. For years now, the Chinese people have been complaining about the cost of education.

— “So, how do we play this shift where China is now finding a new equilibrium between social goals and free capital markets? The key is to identify the areas where the Chinese government is prioritizing social fairness and stability over shareholders.”

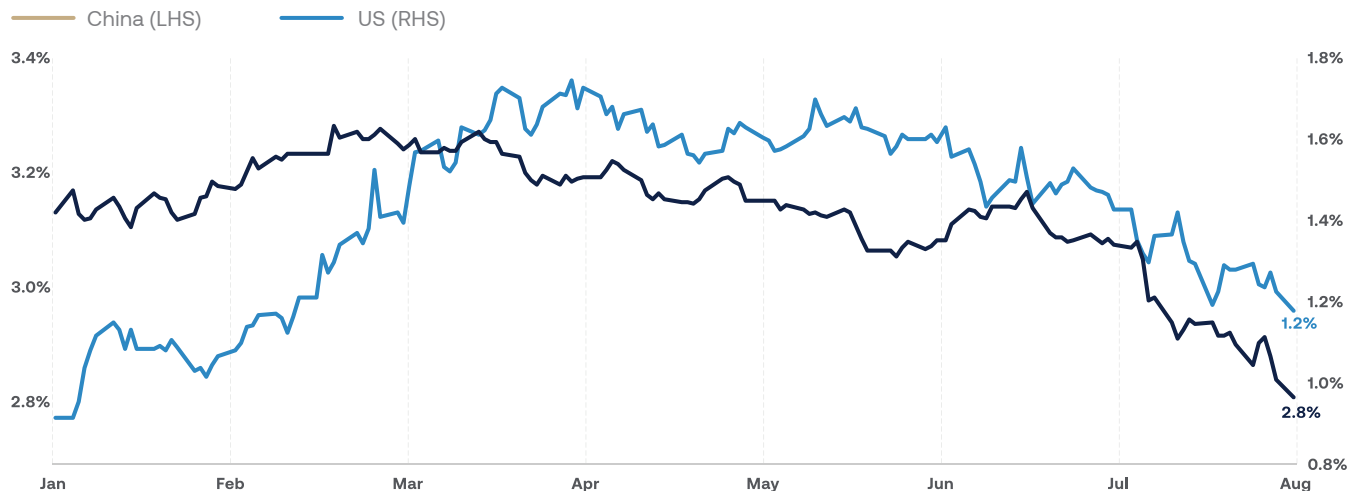
In a nation where students advance only as far as standardized testing takes them, Chinese families spend approximately 9.5% of their household budget on education, up from 7.5% in 2013 and one of the highest rates in the world especially for a low to middle-income country like China. Then came the results of the 2020 population census that alarmingly showed that China’s fertility rate had fallen to 1.3 in 2020, one of the lowest fertility rates anywhere and well below the replacement level of 2.1. This means that China’s population will begin outright declining sometime around the middle of this decade and not in the mid-2030s, faster than previous already somber projections envisioned. Well, one of the biggest gripes that Chinese households have pointed to in not having more children is the incredibly high cost of educating them. Hence, the crackdown on education. In a democracy, a nation can protest unresponsive policy-makers at the ballot box. In China, the CCP either listens to the people and responds, or they will have to find another way to release frustrations when the vote is not permitted.

Certainly, investors can make a plethora of money investing in emerging markets. However, it is paramount to know you are investing in one, and not get caught thinking they are in the developed world. The past two weeks have revealed the pitfalls of investing in a dynamic, high-powered economy that runs parallel to an authoritarian government preoccupied with control. **It is hard to navigate these waters, but not impossible and price-discovery can be quite lucrative.**

So, how do we play this shift where China is now finding a new equilibrium between social goals and free capital markets? The key is to identify the areas where the Chinese government is prioritizing social fairness and stability over the shareholders. These in turn will be driven by public goods and areas of strategic importance. In practice, this looks like avoiding consumer internet, but investing in things like semiconductors and tech manufacturing. This is obviously not clear or easy to do. But lest you think that this problem will only be endemic to China, remember that every government must contend with populist backlashes. How long before Amazon shareholders must deal with mounting pressures for higher wages and higher corporate taxes? In a sense, China might be ahead of the curve here *vis-à-vis* their American bureaucratic counterparts even if their methods rile up the most *laissez faire* sensibilities.

For now, we would avoid the offshore market in China and only invest in the onshore A-share market, as these are more domestically-focused and domestically-owned securities. Another route is to use top-tier active managers that can navigate this changing spectrum, and avoid broad passive investments, like ETFs, that provide blanket exposure. But **investors should not abandon long-term exposure to the world’s second largest economy. Instead, they should seek to find the proper balance of growth and lower regulatory risk.**

**YTD behavior – US 10-year Treasury vs Chinese 10-year bond** | Source: Bloomberg (as of August 2, 2021)

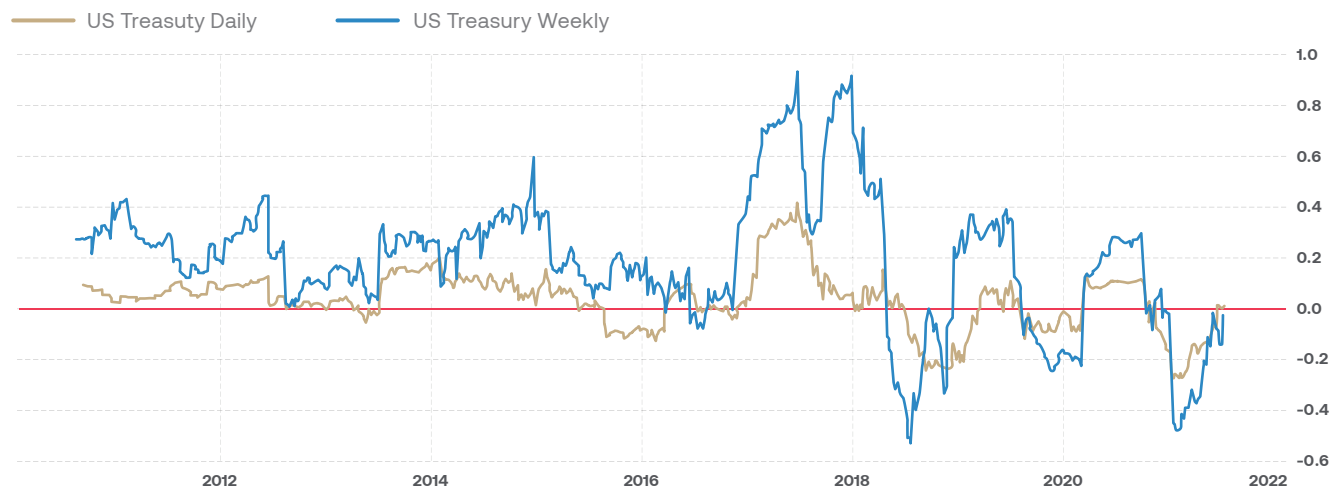


In the fixed income markets, the landscape looks quite different. **This graphs shows that even amid a China-centered, risk sell-off, the country’s sovereign bonds functioned as a countercyclical safe-haven.**

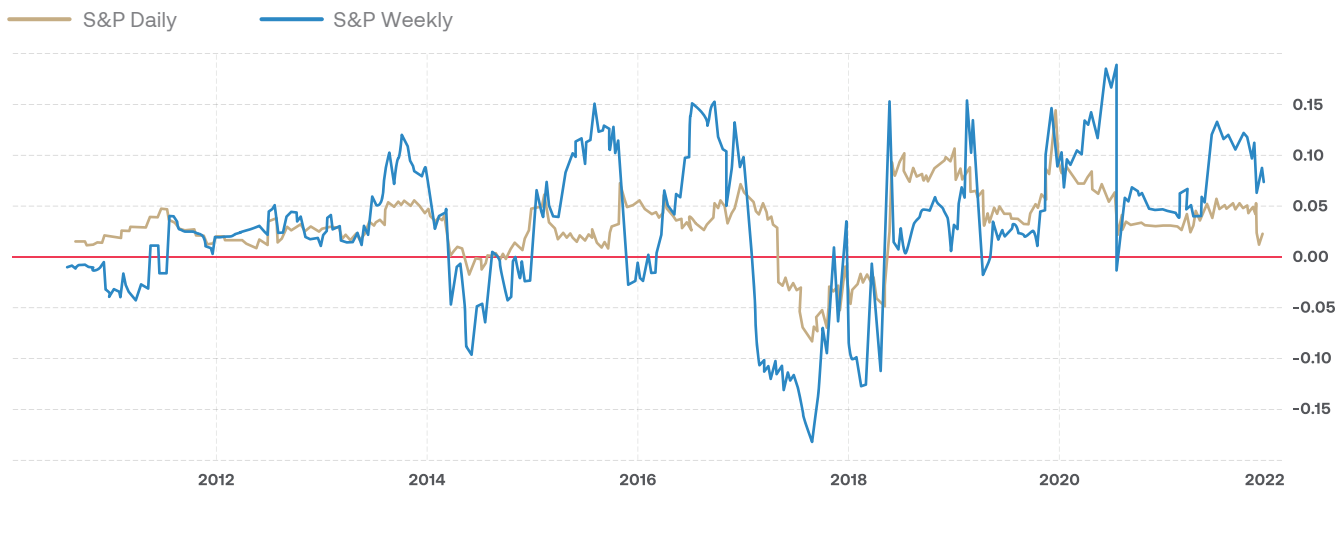
We first noticed this phenomenon last year during the height of the pandemic-induced market turmoil when Chinese sovereign bonds were less volatile than their developed market counterparts like US Treasuries, German Bunds, JGBs, and UK Gilts. We started taking a closer look at their behavior. We wanted to know if

Chinese sovereign bonds were truly acting as risk-off assets by studying their price movements and correlations to key indices like Treasuries, the S&P 500, and the MSCI All Country World index. The initial results showed that, indeed, they were exhibiting safe-haven characteristics especially after the pandemic while being lowly correlated to global equity risk and US Treasuries. As these studies demonstrated (**see Chart 3, Chart 4, and Chart 5**), we used a mix of ordinary least square and rolling regression techniques to study the historical price movements and correlation

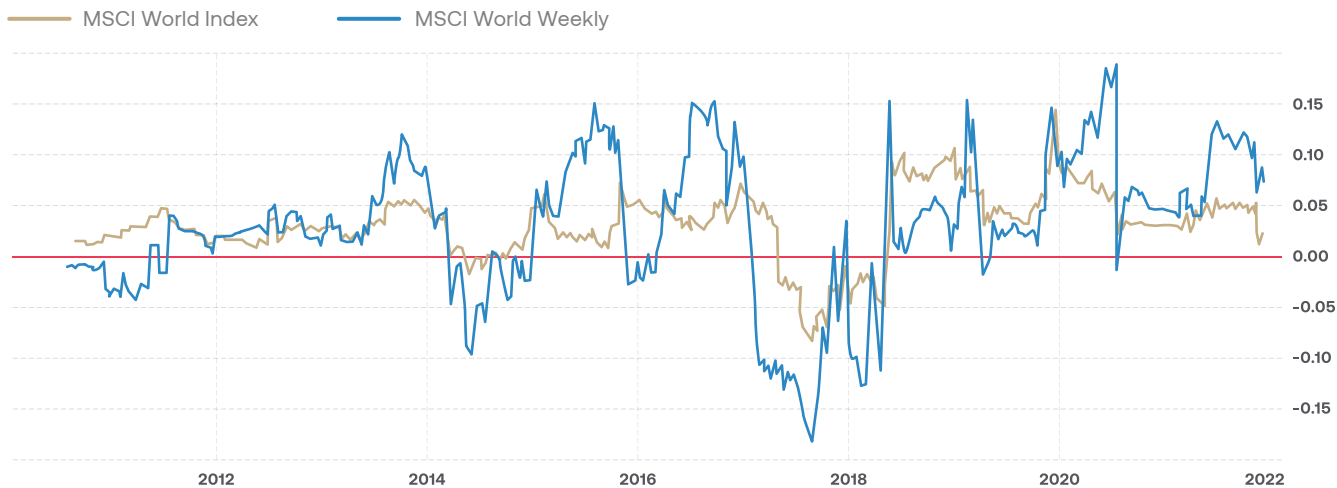
**Chart 3: Rolling Regressions – UST vs Barclays China index** | Source: Insigneo (as of June 29, 2021)



**Chart 4: Rolling Regressions – S&P 500 vs Barclays China index** | Source: Insigneo (as of June 29, 2021)



**Chart 5: Rolling Regressions – MSCI World Daily vs Barclays China index** | Source: Insigneo (as of June 29, 2021)



between a Renminbi non-hedged Chinese sovereign bond index and other indices. The results show that, in broad terms, Chinese sovereign bonds are lowly correlated to indexes such as the S&P 500, the ACWI, and Treasuries. In fact, during the pandemic, the correlation with US Treasuries considerably increased and the equity correlation remained stable. In other words, they are starting to look more like Treasuries and less like risky emerging market equity assets.

These price movements are starting to match the reality on the ground. While China was ground zero and grappled with the pandemic first, it too was the first to emerge from the crisis with the least number of fiscal scars. While the US has run a fiscal deficit of more than 20% of GDP and will return to pre-pandemic growth only this year, China is already operating above its pre-pandemic output level while running only a 5% fiscal shortfall. The country is increasingly

running at its own pace, further removed from the global cycle than ever before. One other reason that the bonds are attractive is that they possess a very attractive carry vis-à-vis other developed market sovereign bonds because they are structurally under-owned by investors around the world. As that first chart also demonstrated [see Chart 1], the 10-year Chinese bond yields more than twice its American equivalent. Taken together, all these considerations point to a bond market that should be within the developed world – perhaps the most attractive one

on the planet now. A rational investor may correctly surmise that the only way to play the China growth story is through investments higher up in the capital structure where the regulatory sickle is unlikelier to reap.

In the end, the answer to our original question is not an easy one, it is fraught with nuances and consequences. But it is also not simply an academic one as the answers portend real-world capital allocation decisions. Afterall, there is money to be made here.



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# House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
<b>US Equities<sup>1</sup></b>	NEUTRAL	OVERWEIGHT
<b>European Equities</b>	OVERWEIGHT	OVERWEIGHT
<b>Japanese Equities</b>	NEUTRAL	NEUTRAL
<b>Emerging Market Equities</b>	UNDERWEIGHT	OVERWEIGHT
<b>Chinese Equities</b>	NEUTRAL	OVERWEIGHT
<b>US Treasuries<sup>2</sup></b>	UNDERWEIGHT	UNDERWEIGHT
<b>Investment Grade Fixed Income</b>	NEUTRAL	NEUTRAL
<b>High Yield Fixed Income</b>	NEUTRAL	NEUTRAL
<b>Emerging Market Sovereign</b>	NEUTRAL	OVERWEIGHT
<b>US Dollar</b>	NEUTRAL	UNDERWEIGHT
<b>Energy<sup>3</sup></b>	OVERWEIGHT	OVERWEIGHT
<b>Precious Metals</b>	NEUTRAL	OVERWEIGHT
<b>Cash</b>	OVERWEIGHT	NEUTRAL

<sup>1</sup> Relative to global equities in USD

<sup>2</sup> Relative to aggregate fixed income markets in USD

<sup>3</sup> Relative to an overall commodity allocation



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