Foot on the brakes

The US will struggle to stop China...

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"The United States has a profound interest in seeing Chinese economic growth slow considerably in the years ahead," writes John Mearsheimer, in the final page of his book The Tragedy of Great Power Politics. "For much of the past decade, however, the US has pursued a strategy intended to have the opposite effect... it is not too late for the US to reverse course and do what it can to slow the rise of China. In fact, the structural imperatives of the international system, which are powerful, will probably force the US to abandon its policy of constructive engagement in the near future."

Mearsheimer gets a lot of hate but today his words, written almost 25 years ago, feel prescient – as does much of his other work. The West has indeed shot itself in the foot by building up China and is now facing the consequences of doing so. And if you wanted a sign that the US is concerned with slowing the rise of the world's second-largest economy, the decision this week to place a 100% tariff on Chinese car imports feels like a rather clear one.

Complaints that Chinese practices are 'unfair' because their products are subsidised are hollow –what was the US Inflation Reduction Act aimed at doing, after all? Why has the US government attacked TikTok so much, if not to protect its own technology industry? Other claims that China is 'stealing' IP fail to hold water and feel more like a coping mechanism for people in denial about how far the country's technological capabilities have evolved.

Moreover, even if these claims about IP are true, they're irrelevant. Western countries may believe that there are a set of rules which we should play by, but the world is fundamentally an anarchic place and there isn't much you can do to stop a country as large as China from failing to abide by those rules if it refuses to do so. The fact that Xi Jinping chose to kick off his speech at the 100th anniversary of the founding of the Communist Party of China in 2021 by discussing the 1840 Opium War and its subsequent effects, suggests Chinese politicians – like much of the world – do not take the West's claims about rules and superior moral standards seriously either.

This is not to say that we are big fans of the Chinese Communist Party or that they represent a bastion of ethical behaviour. However, many people in the West continue to believe that their sense of moral superiority is going to translate into economic and political superiority as well, despite more and more evidence to the contrary. Indeed, looking back at our own history, the UK was far more innovative during the Industrial Revolution than it is now, and that was with a political system that most people today would argue was deeply unethical for a range of reasons, like the fact that less than 30% of the adult population, including a blanket ban on women, were legally eligible to vote prior to 1918.

Where does this leave us as investors? Some managers are more bullish on China than others. For example, in our latest research on **JPMorgan Asia Growth and Income (JAGI)** we noted that the managers' models indicated Chinese stocks offered the most attractive prospective returns, with the caveat that risks still remained. Nonetheless, the trust was, with a 0.9% underweight position, close to flat on the benchmark at the end of March so that hasn't led to any outsized positions in Chinese stocks.

Fidelity Emerging Markets (FEML) also has a somewhat unique take on China. It has shorted poor performing real estate companies but also invested in SOEs that it believes are less likely to be subject to changes in policymaking. The trust is substantially underweight stocks listed in mainland China.

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However, it has sizeable exposure to the country through holdings listed in off-benchmark Hong Kong, as well as via South Africa-listed Naspers, which is one of the largest shareholders in Chinese tech conglomerate Tencent.

Other managers are more sanguine. For example, Robin Parbrook and King Fuei Lee, managers of **Schroder Asian Total Return (ATR)** believe China faces long-term structural problems, including an ageing population, decreasing productivity, and the move to reshore supply chains. Unsurprisingly then, they have a substantial underweight position to Chinese stocks, which comprised 8.2% of the portfolio at the end of March, compared to 25.8% of the benchmark.

Emerging and frontier markets fund **Mobius Investment Trust (MMIT)** also has a more cautious approach to China. The trust runs an absolute returns strategy and is benchmark agnostic. The trust has a concentrated portfolio, with 29 holdings at the end of March and a 3.4% weighting to China. Like the ATR managers, MMIT's team have argued that China faces structural problems that may crib growth. However, they also argue that fickle government policy and poor corporate governance are two other key drivers which prevent them from taking stakes in Chinese companies. They note that holdings like Taiwanese semiconductor company Elite Material are a better way to take advantage of China's economic growth, as it has – to paraphrase them - Chinese revenues but Taiwanese transparency and corporate governance standards.

The MMIT managers wrote in a February note that, despite the concerns they have, "no investor can afford to ignore the world's second largest economy." It is hard to disagree. To give one anecdote, this author visited Mexico at the end of last year. After ordering an Uber, I was picked up in a flash looking electric car, with black cab levels of space in the back. I had never seen a car like it before and being the curious minded Kepler employee that I am, I had to ask what model it was.

"Chinese car," said the happy driver in broken English. "Less money and drives good."

Ford must be trembling in its boots...

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