Rocaton

INSIGHTS

What's Your Exposure to China?

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EXECUTIVE SUMMARY

- We believe China has risen to become one of the most significant drivers of returns and risk for virtually all asset classes, particularly as the country continues to be a significant source of global growth.
- Chinese asset purchases in global markets may increase global liquidity and increase global asset prices for as long as asset flows are positive.
- Investors often have only modest direct exposure to Chinese equity and fixed income markets, but asset classes such as developed market equities and U.S. fixed income are highly influenced by Chinese demand patterns.
- Commodity markets and emerging market currencies are often heavily influenced by Chinese demand therefore impacting the return and risk profile of these and related asset classes.
- While China presents risk to most major asset classes, we believe investors should continue to maintain globally diverse portfolios and seek out asset classes with differentiating risk profiles. Private market strategies that invest in private real estate strategies focused on income generation or asset backed securities are examples of strategies which we believe could be additive to investor portfolios.
- We also encourage investors to maintain exposure to high quality fixed income which can potentially act as a diversifier and a store of wealth during market corrections.

Introduction

How much exposure do you have to China? This is arguably one of the most important questions for investors to ponder. Investors might assume their exposure to China is quite low, perhaps only 1-2% at the total portfolio level. Investors with large exposures to emerging market investments (equity or debt) might assume their exposure to China is a bit higher, perhaps 5-10% at the total portfolio level. The actual answer is more nuanced. In our opinion, a significant portion of an investor's portfolio is exposed to China. Of course, we are not speaking to the direct exposure in a portfolio, but rather the potential risk exposure that exists. As one of the world's largest and fastest growing economies, the ramifications from Chinese actions are typically felt across global capital markets. The balance of this paper will detail the direct exposure investors have to China, but more importantly, we will highlight the indirect exposure investors have to China and the implications for portfolios.

Indirect Exposure to China

As we mentioned at the outset, we believe China will be a significant driver of returns and risk for virtually all asset classes. As a result, the indirect exposure that investors have to China is meaningful. By indirect exposure (sometimes referred to as economic exposure), we are referring to the potential risk investors have in their portfolio that will be influenced by Chinese actions (e.g., economic growth, inflation, currency fluctuations, etc.). To begin, China is a significant source of revenue for U.S. and non-U.S. companies. The top ten companies in the S&P 500 derive more than 7% of their revenue, on average, from China with companies such as Apple sourcing more than 20% of their revenue from China. Taking a more global approach, all companies in the MSCI All Country World Index (ex. China) derive approximately 9% of their revenues from China. Beyond revenue, China is also a significant trading partner for most economies. As shown in Figure 1, China exported nearly $400 billion to the United States in 2016. Other major developed economies such as Japan and Germany are also meaningful trade partners with China.

Figure 1:

China's Exports and Imports ($ billions)

China's Exports and Imports to:	United States	Hong Kong	Japan	South Korea	Taiwan	Germany	Australia	Malaysia	Russia	Brazil
Exports	$390	$294	$130	$96	$41	$66	$38	$39	$38	$22
Imports	$135	$17	$146	$159	$140	$86	$70	$49	$32	$45
Total Trade	$525	$311	$275	$255	$181	$152	$108	$88	$70	$68

Source: FactSet; National Bureau of Statistics of China. Data is for 2016.

While the U.S. economy is broadly diversified, and therefore less reliant on China, other countries rely heavily on China for economic growth. For example, countries with significant exposure to raw materials, like Australia and Brazil, can face serious headwinds when Chinese demand for iron ore (and other commodities which these countries export) declines. In the case of Australia, approximately one-third of the country's total exports are with China. These types of substantial relationships exist across the globe and, therefore, link China's economy to virtually all asset classes owned by investors.

In the case of commodities, for example, it should not be surprising that China has the potential to drive a significant part of that asset class's return and volatility. It is estimated that China consumes approximately half of the world's aluminum, nickel, copper, zinc and tin. As Chinese demand for these commodities ebbs and flows, the prices in these markets are also likely to move. Further, a significant fall in commodity prices driven by slowing Chinese demand (as witnessed in recent years) has the potential to pull down economic growth broadly as capital invested in the commodities industry becomes impaired due to falling prices.

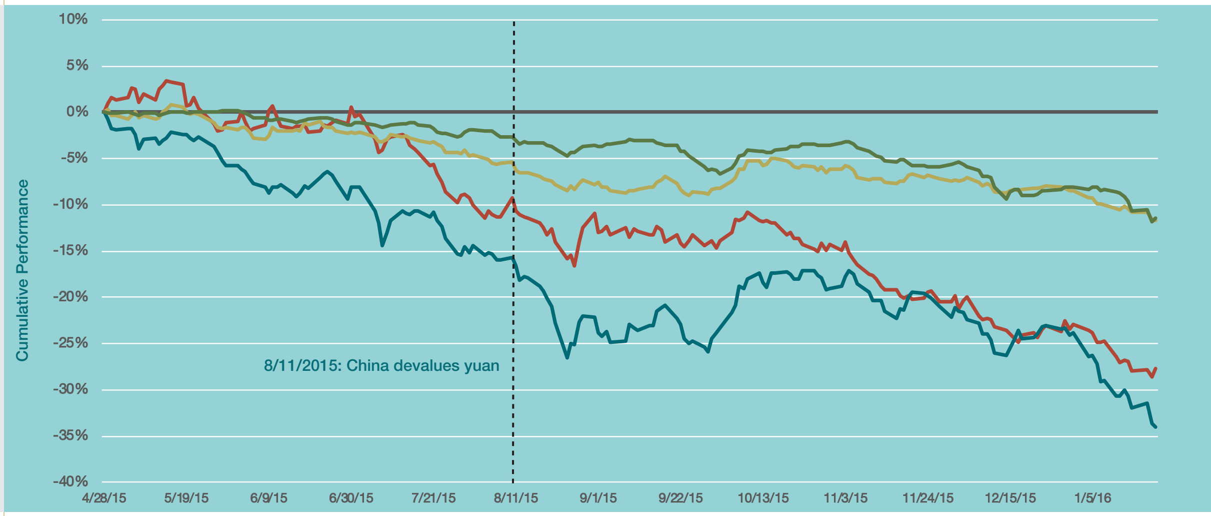
Following on this theme, the currencies of countries who rely heavily on exporting commodities are also subject to move based on Chinese demand for certain commodities. Consider the time period between mid-2015 and early-2016. During this time period, investors began to question Chinese growth prospects, oil prices were falling sharply, primarily due to a supply glut and worries over global demand for oil, and China devalued the yuan. As shown in Figure 2, emerging equity markets (of which China is a large portion), commodity futures and emerging market currencies all sold off materially. U.S. corporate high yield also declined materially given the energy exposure inherent in the asset class. Investors who had hoped for some diversification benefits by owning four different asset classes were instead faced with a group of highly correlated asset classes. Taking a longer-term view, empirical data shows that Chinese equity markets are becoming more correlated with other asset classes commonly held by institutional investors, such as corporate high yield and emerging market debt. For example, over the trailing 5-years ending September 30, 2017, Chinese equities had a 0.53 correlation to high yield fixed income. This compares to a correlation of 0.09 for the same two asset classes over the five-year period ending September 30, 2007.

While the relationship between China and some asset classes, such as commodities and emerging market equities, is fairly obvious, there are other asset classes where the relationship may be less apparent. One such asset class is U.S. Treasuries as even U.S. government bonds may be influenced by China as the country is the largest foreign holder of Treasury securities. As of August 2017, China held $1.2 trillion in U.S. Treasuries, or approximately 5% of total U.S. government debt outstanding. We believe it is fair to say that there are potential consequences for investors should China decide to meaningfully unwind its U.S. Treasury holdings. To be clear, we are not suggesting that U.S. Treasuries will sell-off should China start to reduce their holdings. Rather, we are merely pointing out the fact that the U.S. Treasury market has the potential to be influenced by Chinese policy.

Figure 2:

Cumulative Asset Performance

- High Yield
- Emerging Market Currencies
- Emerging Market Equities
- Commodity Futures



Time period is April 28, 2015 to January 21, 2016 which represents the peak-to-trough period for emerging market equities in 2015/2016. Based on daily data. Indexes are the Bloomberg Commodity Index, MSCI Emerging Market Equity Index (in USD terms), J.P. Morgan ELMI+ and Bloomberg Barclays High Yield. Source: FactSet.

Direct Exposure to China

While we have highlighted the indirect exposure that investors have to China, we also appreciate that investors likely want to understand their direct exposure to China. Direct exposure to China for institutional investors is often derived through dedicated emerging market equity or debt mandates. Investors may also get exposure through actively managed global or non-U.S. developed mandates which can allocate to emerging markets. As an example, institutional investors are increasingly getting exposure to some of the Chinese global companies such as Baidu, Alibaba and TenCent as developed equity managers add non-benchmark, higher growth names to their portfolios.

Exposure to Chinese equities (either through direct mandates or as part of global mandates) is largely through "H-shares", mainland companies that are traded in Hong Kong. As of September 30, 2017, H-shares represented 29.6% of the MSCI Emerging Markets Index (up from 16.2% in September 2007). China A-shares, local-currency shares traded on the domestic exchanges in China, will be included in the MSCI Emerging Markets Index beginning in June 2018[1]. Importantly, the allocation to A-shares within the MSCI Emerging Markets Index will be limited to less than 1% at the outset, however this figure is likely to increase over time. Currently, investors with a 10% allocation to emerging market equities have approximately 3% of direct exposure to China at the total portfolio level.

[1]See Rocaton Insights - An Explanation of China A-Shares (link) for more detail.

For emerging market debt investors, the allocations to China can be even smaller. Hard currency mandates, such as those benchmarked to the J.P. Morgan EMBI (or EMBI Global Diversified), likely have limited direct China exposure as the country is a small weight in the hard currency benchmarks. Of course, we recognize that some actively managed hard currency strategies may take overweight positions in China securities. Corporate emerging market debt strategies, such as those benchmarked to the J.P. Morgan Corporate Emerging Markets Index, likely have meaningful exposure as the aforementioned benchmark does include a 22.5% weight to China. The weight in the CEMBI Broad Diversified Index, however, is only 8.2%. Local currency emerging debt mandates likely have modest exposure as well given that the J.P. Morgan Emerging Local Markets Index Plus includes a 10.1% exposure to China. A typical institutional investor may have a 3-5% allocation to emerging market debt (at the total portfolio level) and, therefore, will have negligible direct exposure to China via emerging debt holdings. Over the next decade, we expect China to open its fixed income markets to the outside world and we believe Chinese exposure will become a larger portion of the global opportunity set in fixed income.

Figure 3:

Direct China Exposure by Asset Class

Market	Index	Weight in Index as of 9/30/2017	Weight in Index as of 9/30/2007
Hard Currency (U.S. $) Emerging Market Debt	J.P. Morgan EMBI GD Index	4.3%	3.5%
Local Currency Emerging Market Debt	J.P. Morgan GBI-EM GD Index	0.0%	0.0%
Local Currency Emerging Market FX	J.P. Morgan ELMI+ Index	10.1%	1.9%
Corporate Emerging Market Debt	J.P. Morgan CEMBI Broad Index	22.8%	3.1%
Corporate Emerging Market Debt	J.P. Morgan CEMBI Broad Diversified Index	8.2%	4.3%
Emerging Market Equity	MSCI Emerging Markets Index	29.6%	16.2%
Global Equity ex. U.S.	MSCI ACWI ex. U.S. Index	7.1%	2.9%
Global Equity	MSCI ACWI Index	3.4%	1.7%

China exposure for all equity markets is based on H-share index weights.
Consistent with J.P. Morgan methdology, CEMBI index exposure does not include Hong Kong. All other emerging debt indexes include China and Hong Kong exposure.
Sources: FactSet; J.P. Morgan.

Impact on Portfolios

With the understanding that many asset classes will likely be exposed to the Chinese economy, investors may be asking themselves how best to position their portfolios. Admittedly, we find it difficult to identify asset classes which are truly diversifying and will be isolated from Chinese events. For that reason, we encourage investors to maintain broadly diversified portfolios which include global exposure to public equity markets (including emerging markets), broad exposure to investment grade and below investment grade fixed income, and exposure to alternative asset classes. While U.S. investors have taken steps towards globalizing their portfolios in recent years, generally speaking, many investors still have a home country bias. As such, we believe diversification into non-U.S. equity markets continues to make sense from a strategic perspective. We have less conviction in non-U.S. developed market fixed income and would not encourage allocations to this asset class at this time.

We also suggest that investors look for truly diversifying asset classes and not overly concentrate exposures to risk factors. For example, we previously pointed out how commodities and emerging market currencies can be quite correlated during periods of market stress. Investors may also want to consider adding exposure to risk factors not typically found in portfolios. This can include allocations to private market opportunities, including private real estate strategies focused on income generation or asset backed securities strategies also focusing on high income generation, all of which should provide some diversification relative to the corporate credit risk often found in public equity and credit fixed income asset classes. Exposure to high quality fixed income assets continues to make sense for many investors, despite the current low rate environment. Longer duration U.S. Treasuries, despite the connection to Chinese demand, have proven to be one of the most diversifying assets available, particularly during equity market declines. High quality fixed income (either taxable bonds or municipals) can act as a store of wealth and can be a source of funds when new opportunities are identified. In the event of a Chinese growth slowdown, there is the potential for pockets of market dislocation. We believe that investors should seek to identify these dislocations when they occur and allocate capital to relative value opportunities in out-of-favor markets.

Conclusion

We do not claim to be experts in predicting Chinese growth, nor do we have any unique insight into how the country's transition from an industrial to services-led economy will unfold. However, we do believe that China will have a significant impact on the global economy and investor portfolios, regardless of how much direct exposure investors hold. As we have outlined, we believe outcomes in China have the ability to impact global capital markets. We continue to believe that investors should maintain broadly diversified portfolios while also seeking out risk exposures that may be less commonly held and which may be less impacted by Chinese influence.

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