Cougar Global Viewpoints

Why not China?

A non-exhaustive look at the challenges facing the communist republic, and its investment case

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There are many reasons we are currently wary of investing in China, despite its position as an economic superpower. Those include:

- Chinese freedoms and protections are fraying;
- China's population is aging and outright shrinking;
- Unproductive investments will be a drag on the economy; and
- Informative data is under threat.

In 2018, Chinese President Xi Jinping changed the constitution to remove term limits on his office, effectively making him emperor for life. He has since amalgamated roles and teams further to consolidate his power. More and more, the Chinese system created since the constitutional change brings to mind the adage, "Absolute power corrupts absolutely."

From this standpoint, it should be no surprise that Chinese freedoms and protections are fraying. Anecdotes of people welded into their homes during coronavirus-related lockdowns lit up the internet. Chinese businesses operate under vast uncertainties that the whims of Xi (via the political party) could upend entire industries at a moment's notice. For example, for-profit tutoring was banned in 2021. In the same year, the country outlawed the provision of cryptocurrency services. Bloomberg reports that since then many entrepreneurs have fled China. Furthermore, news reports of international Chinese police stations may show the desperation of the party to coerce people to comply with its wishes. In contrast, a society setup with proper incentive structures typically works without force.

According to the latest United Nations projections in April, China's population level began its decline this year. Falling fertility rates and the former "one child policy" is coming back to haunt the administration. This is somewhat good news for the West since the shrinking of its population might hamper its military might. In addition,

China's population is aging rapidly. A smaller proportion of working-age people may hold back economic growth and make supporting the growing elderly population challenging. Already, social safety nets are mostly non-existent in China. Pension-like investments are only now starting to go mainstream.

The so-called Chinese growth miracle may have been more a mirage. Excess investment was unproductive, as can be seen by the overbuilding in Tier II and III cities across China (not to mention the poor balance sheets of most developers). Despite a few measures to boost property demand, new housing starts (as measured by floor space started) continue to fall. In the face of falling asset prices and slipping property demand, the central government can somewhat directly continue to support the flow of credit via state-owned banks. However, the success of any stimulus measures depends on the willingness of parties to borrow and spend. Considering China only recently emerged from COVID lockdowns and yet had nearly no inflation over the last year may speak to the impairment of demand. In fact, China had the lowest annual inflation rate in the Organisation for Economic Co-operation and Development (OECD) this May despite strong inflation globally.

Outwardly, China wanted to grow its influence and needed to find ways to keep its construction and associated industries active. Intertwined with its Belt and Road Initiative, China lent vast sums to developing countries to finance new infrastructure projects. Unfortunately for many of the newly indebted countries, most of the projects are not even close to meeting the projected outcomes (e.g., low usage rates of new transportation structures or reports of poorly constructed dams that have forced entire towns to move). China may hold some power over its debtors but repayment from countries that could barely afford the work to begin with may never come.

At the same time, assessing the situation in China will become increasingly challenging as the central government further limits data-sharing. In April, the communist party passed a vague counterespionage law that expanded the list of activities that may be considered spying and raided various consulting firms. Authorities have even discontinued reporting of data deemed to be too negative. To wit: China ceased publication last year of daily transactions by foreign investors after there were record outflows from the nation's bond market.

Additionally, ongoing battles between Beijing and Washington work to crank up the risks for foreign investors (even if coordinated export controls on advanced semiconductors were a significant step in containing Chinese ambitions). U.S. President Joe Biden may wish to avoid escalating tensions leading up to the 2024 U.S. presidential election. Meanwhile, Xi has limited incentive to back down due to upcoming elections in Taiwan and instability at home.

For now, we say, "Foreign investors beware."

Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful. Small-capitalization companies are subject to higher volatility than those of large-capitalized companies. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be appropriate for all investors. Stock investing involves risk, including the risk of loss. Investments in emerging market issuers are subject to a greater risk of loss than investments in issuers located or operating in more developed markets. This is due to, among other things, the potential for greater market volatility, lower trading volume, higher levels of inflation, political and economic instability, greater risk of a market shutdown and more governmental limitations on foreign investments in emerging market countries. High Yield/Junk Bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors. Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extensions risk, the opposite of prepayment risk, and interest rate risk. Investing in IAU involves additional risks. The market price of the Shares will be as unpredictable as the price of gold has historically been and the price received upon the sale of Shares may be less than the value of the gold represented by them. Government bonds and Treasury bills are guaranteed by the U.S. Government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. The fund's concentrated holding will subject it to greater volatility than a fund that invests more broadly. The fast price swings of commodities will result in significant volatility in an investor's holdings. Precious metal investing is subject to substantial fluctuation and potential for loss. All indexes mentioned are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The indexes don't reflect charges, expenses, fees and is not indicative of any particular investment. Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, disease, and regulatory developments.

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DEFINITIONS

The one-child policy was an official program of the Chinese Communist Party and government of China launched in 1980 that restricted most families in China to one child each. The policy aimed to reduce the growth rate of China's population. The program ended in early 2016.

Real estate market tiers categorize cities as Tier I, Tier II, or Tier III based on how developed their real estate markets are. Tier I cities have developed and established real estate markets with expensive real estate and highly developed schools, facilities, and commercial sectors. Tier II cities are in the process of developing their real estate markets but have not reached their peak. While real estate in Tier II cities typically is less expensive, costs tend to rise with growth. Tier III cities have undeveloped or nonexistent real estate markets and inexpensive real estate.

The Organisation for Economic Co-operation and Development, based in Paris, is an international policy and research organization with more than three dozen member countries. It works to shape policies that foster prosperity, equality, opportunity and well-being for all.

The China Belt and Road Initiative, sometimes referred to as the New Silk Road, is a massive global infrastructure initiative launched in 2013 by President Xi Jinping. The focus of the project, which encompasses a vast network of railways, energy pipelines, highways, and streamlined border crossings, has expanded from East Asia and Europe to include Africa, Oceania, and Latin America.

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