Rebalancing 2.0

The global shift to Chinese onshore assets

Rene Buehlmann, UBS Asset Management Head of Asia Pacific, led a distinguished panel at GCC 2019 on January 8th that explored how global capital is shifting to Chinese assets and answered key investor questions and concerns about investing in onshore China assets.

Host
Rene Buehlmann
Head, Asia Pacific, UBS Asset Management

Panelists
Dr Axel Weber
Chairman of the UBS Board of Directors

Dr Zhu Min
Chairman of the National Institute of Financial Research; Tsinghua University
Former Deputy Managing Director of IMF and Deputy Governor of the People's Bank of China.

Rene Buehlmann started the session by presenting the 'Rebalancing 2.0' process, which he defined as a fundamental, long-term shift in global asset allocation to reflect China's weight in the global economy driven by various processes, like economic reforms and index inclusion.

More than accessibility, Buehlmann showed that onshore growth opportunities will play an important role in attracting global capital to China because, over time, onshore assets have had a strong track record of delivering attractive returns and diversification compared to international markets.

But for all these fundamentals, investors still remain concerned about allocating to China and Buehlmann and his panelists addressed these concerns during a lively Q&A and here are the key questions and stand-out moments.

We have seen vast range of regulatory moves to open up China's financial markets: why is it critical for China to continue with further financial market reforms?

Dr. Zhu Min: 'In the past 15 years, I think reform has lagged and the Chinese financial sector has not caught up with the growth in the economy. Foreign banks still only have a very small share of the financial sector and this means we are not open enough.'

'There are also many other reasons why it is critical for China to continue with financial reforms. Firstly, for quality-driven growth, China needs a healthy financial sector to manage risks and improve the efficiency of resource allocation. That is very important.

Secondly, China needs to change the structure of the financial sector. Currently, the banking sector is dominant, while the equity market is relatively weak. With a bank-denominated system, firms live on loans and there aren't a diversified range of financing options or capital market structures to service the corporate sector. Therefore, it's obvious that for long-term growth, China really has to change this structure.

Finally, further reforms are absolutely necessary because there's many Chinese investors are looking for opportunities to allocate overseas. Therefore, it is critical to bring foreign capital and players into China to move Chinese capital into global markets.

For all the above I think that reform is a must.'

Dr. Axel Weber: 'Reform is absolutely the right way forward for China to build the deep and liquid capital markets that it needs and, having worked with regulators in China, I am confident they are absolutely committed to delivering a reform agenda.

The Stock and Bond Connect systems are excellent examples of the reforms needed and, over time, we're expecting further steps to both integrate China's markets more closely with the international financial system and develop the infrastructure needed for onshore capital markets.'

What are the next big regulatory steps that we should look out for?

Dr. Zhu Min: 'Don't look for the big next regulatory steps. When it comes to regulatory reforms, like in the US and Europe, it's about making small steps gradually.

In China, policy changes all start with political determination and we saw a big statement in April 2018 when President Xi Jinping announced the goal of broadly opening the financial sector.

That statement was not just about market opening and ownership issues but also about developing products, like ratings, e-payments, settlements, and credit cards.

Implementation takes time, because you not only have to change laws and regulations but also do it on a grand scale across China.

You will see regulatory changes but they aren't about big, rapid changes, the devil is in the details so I'd urge you to pay closer attention, come to China more often, meet the regulators, and enjoy Chinese hot and spicy food!'

International investors are concerned about whether the rule of law really applies and shareholders rights are truly respected. Additionally, we hear concerns from clients about taking money out of the country, e.g. sudden capital controls, and market interference.

How should investors approach and factor in these risks?

Dr Zhu Min: 'Rule of law and market interference are very separate issues.

Thinking about capital controls, I don't think reverse capital controls will happen. Every process has a 'but' though. If you move money in, it may take one day but if you move money out it may take three days. I don't think there are any rules to stop you taking your money out.

Rule of law is a big issue. 40 years we had no system at all, and only one bank at the centre of it. In 40 years you have to build all the laws and though we have made massive progress, for sure, the regulatory framework is not there yet.'

RMB internationalization is a critical factor for foreign investors. How do you assess the development of the RMB?

Dr Axel Weber: 'China is making progress with RMB internationalization by opening up onshore markets, building market infrastructure, entering the SDR system, and moving into the global index benchmarks.

But making the RMB an international investment currency requires more efforts to create onshore derivative markets, allow currency convertibility, and build liquid markets. These goals will take time to achieve but, again, we strongly believe that China is committed to them.'

Dr Zhu Min: 'The financial crisis in the 1990s taught us the dangers of being too dependent on external USD-denominated financing. For China being a big economy, internationalization is a very important strategic decision.

The good news though is that China is making progress. In Shanghai today, foreign companies in the free-trade zone can settle in RMB and they are willing to do it to save on hedging and processing costs.

International reserve pools of RMB are growing, for example with the French and German central banks adding RMB into their reserves, and these are all good things for the internationalization process and show that China is moving in that direction.'

What would you say to investors who are concerned about volatility in onshore markets, and particularly volatility in the currency?

Dr Zhu Min: 'We are moving into a new world and volatility is a good thing for China.

If there's no volatility it means the authorities are intervening and that's not good for China and certainly not good for international investors.'

Do you still consider China an emerging market? Do you think there should be an argument made for China to be a standalone allocation within the global mix?

Dr Axel Weber: 'China has emerged from being a less-developed economy to being at the forefront of development in many areas, like in technology and artificial intelligence. So should you overweight China if you want a growth portfolio and does it warrant a standalone allocation? Absolutely yes. On equity markets alone, China benchmarks have outperformed global indices on an annualized basis since late-2005 and there's a strong growth outlook as urbanization, consumer demand, and industrial upgrading play out.

But China's markets come with volatility and that means global investors need onshore expertise to both manage market volatility and uncover the growth opportunities. At UBS, that's where we see huge potential to bring our expertise and act as a 'superconnector' between offshore clients and the growing set of opportunities onshore in China.'

Summarizing the presentation and panel discussion, Buehlmann offered a range of important takeaways for investors.

Firstly, that reforms in China are here to stay, will continue, but will happen at a gradual pace.

Secondly, that the rebalancing of global assets to onshore China markets will continue and that both equity and fixed income markets offer excellent diversification benefits.

Thirdly, that active investment strategies focused on companies operating in fast-growing sectors are critical to access alpha opportunities in China.

Fourthly, that investors shouldn't be put off by volatility. If anything, volatility is a good thing because it shows that the government is becoming less interventionist.

Finally, that as China's weight in the global economy increases it may warrant a standalone allocation on the part of international investors to Chinese assets.

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