# TAKING STOCK: CHINA TRANSITIONS, AN NEPC 2021 KEY MARKET THEME

NEPC Research

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NEPC *Key Market Themes* represent our view of the current drivers of the global economy. The themes evolve and interact over time, influencing asset values and opportunities. A disruption of a theme likely alters market dynamics and our investment outlook.

## CHINA TRANSITIONS

China is in the midst of a complex metamorphosis: Not only is it moving towards a service- and consumption-oriented economy from the manufacturing and export behemoth it is today, but it is also dealing with demographic shifts that could potentially come in the way of its economic transformation.

*China Transitions* is our longest-running theme, one that we believe will define markets far into the future as it remains a global growth engine. China is expected to power nearly 25% of the world's GDP growth over the next five years — equivalent to creating a new Spain annually. China's heft on the global stage and in investment portfolios likely mean that changes within the country will have an outsized impact, with disruptions potentially fueling considerable volatility in currency and equity markets. Add into this mix its testy relations with the United States and countries in the Asian subcontinent, and the stakes get even higher.

At NEPC, we are closely studying the numerous disruptions that could occur as a result of China's transitions. The last few years have seen several global market corrections emanate from the world's second-largest economy and its most populous nation; triggers have included volatility spikes in the yuan, changes in capital controls, and shifts in demand for commodities. For the future, an acceleration of credit growth and real estate development pose a systemic risk to the local economy with the potential to expose structural weaknesses. Also, China is facing a rapidly aging population due to its previous one-child policy and increased life expectancy. Unless countered by advances in innovation and productivity, this shift in its demographic profile could slow the higher levels of per-capita-GDP growth the country seeks to attain.

Meanwhile, in the international arena, China's ascendancy as a strategic competitor to the U.S. sets the stage for two of the world's largest economies facing off across a wide range of sectors, for instance, artificial intelligence and 5G. Its growing economic and geopolitical prowess relative to the U.S. can be viewed as a Thucydides Trap, where an established power feels threatened by a rising force. While competitive tensions between China and the United States will likely intensify and, at times, incite volatility and unrest in markets, we do not anticipate trade disputes escalating to the point where they limit the flow of goods and services; we also believe there is little risk of military conflict because of the extent of the economic integration between the two countries. There is also the matter of the Chinese government, which holds substantial sway over all businesses and investments in the country. As a result, regulatory changes can rapidly shift and potentially dampen investor sentiment.

That said, we believe China has worked hard to attract foreign investors and will likely steer clear of any sudden moves that will drive away investment. It will continue to exercise caution over its monetary and fiscal policies, while gradually liberalizing capital markets. Achieving a harmonious balance should allow its economy to reach a per-capita-GDP in line with the developed world over the next 15 years. Recent data highlight the country's discipline and commitment to manage credit growth levels while balancing its goal of sustainable economic growth.

For investment portfolios, China's ongoing economic transition means growing access to its local financial markets and the planned inclusion by global index providers will expand its already large share of the emerging markets. Increasing strategic asset allocation targets to China will be required to maintain a neutral market beta exposure to the country. To that end, we are actively looking at the best ways to access this long-term structural opportunity.

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