

4<sup>th</sup> quarter 2019

# Investment Views



# Focus on China

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# Current market assessment

The tables below summarise VP Bank's trend assessments for all asset classes in our investment universe. The arrows reflect the forecasts of our investment strategists for the coming three to six months.

	Q3 forecast	Current forecast	
<b>Money market and currencies</b> (pages 6-9)			
<b>Currencies</b>			
EUR vs. USD	→	→	
EUR vs. CHF	→	↗	New
USD vs. CHF	→	→	
GBP vs. USD	↗	↗	
USD vs. JPY	→	→	
AUD vs. USD	→	↘	New
USD vs. SGD	↗	↗	
USD vs. RUB	→	→	
<b>Key interest rates</b>			
Switzerland	→	→	
Europe (EMU)	→	↘	New
USA	↗	↘	New
<b>Bond yields</b> (pages 10-13)			
<b>Investment grade government bonds</b>			
Switzerland	→	→	
Europe	→	→	
USA	→	→	
<b>Investment grade corporate bonds</b>			
Switzerland	→	→	
Europe	→	→	
USA	→	→	
<b>Bonds: total return</b> (pages 10-13)			
<b>High yield bonds</b>			
High yield	↘	↘	
<b>Emerging market bonds</b>			
Hard currency bonds	→	→	
Local currency bonds	→	→	
<b>Equities</b> (pages 14-17)			
Switzerland	→	↘	New
Europe	→	↘	New
North America	→	↘	New
Pacific	→	↘	New
Emerging markets	→	↘	New
<b>Alternative investments</b> (pages 18-21)			
Commodities	→	→	
Crude oil	→	→	
Gold	↗	↗	
Real estate shares	→	→	
Private equity	→	→	
Convertible bonds	→	→	
Hedge funds	↗	↗	

// China: a major  
theme in our  
investment thinking //



Dr Felix Brill  
Chief Investment Officer

# Dear Reader

1 October 2019 will mark the 70th anniversary of the founding of the People's Republic of China. This milestone will be solemnised by massive official celebrations. Meanwhile government representatives around the world are racking their brains to find the right words of congratulation. Should they concentrate on China's economic ascent in recent decades? Or is this also an opportunity to broach more difficult subjects? The trade conflict? Hong Kong?

Ahead of the upcoming celebrations, we are devoting this issue of Investment Views exclusively to China. We analyse China's importance for the global economy and the financial markets and also look at the problems that China faces.

In his opening contribution Bernd Hartmann offers a broad survey of China's past achievements and future challenges. The growth model that China has followed so successfully in the past is reaching the limits of its usefulness. The Chinese leadership is now busily seeking ways to put economic growth on a more sustainable footing. In the next article Dr Thomas Gitzel explains the short-term difficulties associated with this transformation process and highlights the negative impact of the current trade conflict on the Chinese economy. China's problems also have far-reaching knock-on effects on the rest of the world.

The powerful growth of the Chinese economy is an increasingly important factor for international investors. The next three contributions examine the implications for major asset classes. Harald Brandl explains the radical changes that have occurred in the make-up of the Chinese equity market, while Bernhard Allgäuer shows how Chinese demographics affect the global bond market. Finally Jérôme Mäser looks at the impact of China's revamped growth model on global commodity markets.

We do not, of course, know exactly what the future will bring. But one thing is certain: China will remain a major theme in our investment thinking.



**CHINA'S MISSION**

# China in the world economy: an open window lets in flies

ITS SUCCESSFUL ECONOMIC MODEL IS NOW REACHING THE END OF ITS SHELF LIFE. CHINA IS AMBITIOUS, BUT FUTURE SUCCESS WILL DEPEND ON FINDING A NEW ROLE. THIS CHANGE OF COURSE INVOLVES RISKS, BOTH ECONOMIC AND POLITICAL.

China's economic ascent since the death of Mao Zedong in 1976 is an unprecedented success story. In that year, China's standard of living, as measured by per capita GDP, was below that of countries like Haiti, Niger, Somalia and Afghanistan. Today it outranks the Balkan nations and many countries in Latin America. Hunger has been banished, poverty reduced and life expectancy lengthened. While the West marvels at China's progress, the Chinese themselves view it as a return to lost greatness. According to OECD estimates, 200 years ago China accounted for about a third of global GDP, significantly more than Europe (23%) and the USA (2%) combined. Today it is the world's second largest economy, though per capita income is still nearer that of the emerging economies than the developed nations.

## China's meteoric development since the end of the Mao era

	1976	2018
Population in millions	931	1,393
Life expectancy in years	65	75
Per capita GDP in USD	165	9,711
GDP in USD billions	154	13,608
Exports as % of GDP	4.5%	19.5%
Agriculture as % of GDP	32.4%	7.9%*
% of all pupils in tertiary education	0.6%	51.0%

\* 2017

Sources: World Bank, UN Population Division, UNESCO

## Limits to growth

Despite the success of the reform strategy and the gradual opening-up of the economy, China is now clearly stretching the limits of its growth potential.

- A high saving rate and low consumption are encouraging borrowing and intensive investment.
- But returns on investment are falling, with an increased danger of misallocations.
- The influx of cheap migrant labour into the coastal cities had kept wage growth disproportionately low, despite productivity improvements. This reservoir of cheap labour is now exhausted and the influx is drying up.
- Higher wages and cheap competition from other countries are making Chinese products less competitive. Textile manufacture, for example, has migrated to Bangladesh and Vietnam and is now moving on to Ethiopia.
- China's export dependence and trade surplus make it vulnerable to external influences. This vulnerability became evident during the financial crisis and has resurfaced under the impact of the current trade conflict.
- Economic progress has not been accompanied by an adequate improvement in the protection of intellectual property. The laws on patent and trademark protection have been beefed up, but they are not being properly enforced. This sours relations with China's trading partners and prompts resistance to Chinese acquisitions of foreign companies.
- The focus on rapid growth has lifted millions of people out of poverty but has resulted in huge inequalities. The classless society now exists only on paper.
- The disparities are not just social but also geographical. China's western and central regions cannot keep up with the enormous improvement in the standard of living along the coast. Per capita GDP in Gansu in the north-west is less than a third of that of Shanghai.
- Relentless growth has been achieved at the cost of damaging the environment, threatening citizens' health and ultimately imperilling social harmony.
- The negative consequences of the one-child policy are coming to the fore. China has an unusually disadvantageous age structure for an up-and-coming economy. (See "The problem with China's saving rate" on page 12).

### China's plan for the economic future

China's leaders are aware of these challenges and want to move away from the "workshop of the world" model that has served the country so well in the past. No new growth targets will be set when the current five-year plan expires in 2020. Even so, economic growth will still be at the centre of government thinking. The government's legitimacy depends on continuously raising the population's standard of living.

Restructuring the economy and reducing dependence on exports is a mammoth task. But progress is being made. Personal consumption as a proportion of GDP has been rising since 2009 and now accounts for around two-thirds of the growth rate. The focus is shifting from wage restraint as a means of maintaining international competitiveness to measures designed to enhance purchasing power (see "Europe and Asia infected by China's slowdown" on page 8). But increased consumption also means more imports. Exchange rate policy is therefore moving away from a cheap renminbi – a shift that facilitates the internationalisation of the Chinese currency.

This, however, poses challenges for the export industry. China wants to continue to be a major manufacturing nation. But that means reshaping its industrial base, for example by switching to less labour intensive products that have a higher added value. Moreover, the country that invented movable type printing 400 years before Europe will not just want to be a producer but will also aim to play a part in research and development. With their Confucian traditions, the Chinese have a vast hunger for knowledge. There is certainly no shortage of students. The Ministry of Education states that almost six million young adults are studying at university level while a further 2.7 million are in post-diploma education and another 400,000 are studying for a doctorate. Quantity is no guarantee of quality, of course. Innovation cannot be enforced. China scores well in the OECD's Programme for International Student Assessment (PISA), but the education system still focuses on rote learning and regurgitation of facts in exams. To make the next generation more fit for the future, syllabuses now include courses in creative thinking. Other Asian countries like Japan and Korea have already moved in that direction. Research has shown that when a country devises and patents more inventions, protection for intellectual property tends to improve.

The shift from quantitative to qualitative growth is at the heart of the "Made in China 2025" strategy unveiled in 2015. China wants to shed its emerging market status and become a full-fledged industrialised nation. Future-looking industries like robotics and environmental technology are key elements in this strategy. In many new technologies, notably artificial intelligence, China is directly challenging the USA, whose corporations are leaders in these fields. The two countries' ambition to spearhead the technologies of the future is likely to be a tricky issue when negotiating a resolution of the current trade conflict.

### Move closer to the customers

In its quest for new competitive advantages, China has recognised the vital importance of direct and rapid links with its trading partners. Fast delivery is crucial for achieving maximum flexibility in reacting to customers' needs. This is the motive behind the Belt and Road Initiative (BRI), a mammoth undertaking designed to bring Chinese suppliers logistically closer to their foreign customers via the northern land route and southern sea route. Here again China is harking back to historical precedents, which is why the project is also known as the new Silk Road. It takes six weeks to transport Chinese goods to Europe by sea. As part of the BRI, a direct freight rail service between China and Austria will be created alongside the already existing China-Duisburg connection. Rail transport cuts delivery time to two weeks.

These infrastructure improvements are not only economically motivated but also serve strategic interests. The construction of the 135 kilometre Kra Canal in southern Thailand, for instance, would mean that ships no longer have to sail through the strategically sensitive Strait of Malacca. But these gigantic construction projects swallow up enormous sums of money. In the context of the Belt and Road Initiative China is carrying out numerous infrastructure projects in financially weak countries. This results in a huge increase in power and influence, pushing these countries into one-sided dependence on China. That is why the Belt and Road Initiative has become so controversial internationally.



Economic, ecological and social developments mean that China's success model is reaching the end of its usefulness. China is now aiming even higher and hoping to regain lost glory. The romantic desire to relive China's powerful past fits in well with hard-headed government self-interest. As long as large swathes of the population enjoy a rising standard of living, social inequalities will be accepted and the political status quo will remain unchallenged. A major weakening of the economy cannot be permitted. Even so, the restructuring of the economy inevitably involves short-term risks to growth.

### Playing safe politically

President Xi Jinping is responding to these risks by strengthening his power base and revamping government policy. In March 2018 the National People's Congress abolished the limit on the President's term of office - a limit that was introduced after Mao's death and had been respected ever since. Thus Xi is now President for life. However, this is the least important of the three offices of state that he holds. The presidency is primarily a ceremonial office - its political clout is limited. Much more powerful is the office of General Secretary of the Communist Party, which Xi also holds and which has never been time-limited. He is also Chairman of the Central Military Commission, giving him direct authority over China's armed forces. This concentration of powers puts Xi on a par with Mao Zedong.

Xi pursues a two-pronged political course. Internationally he likes to appear as a champion of globalisation, as he did two years ago at the World Economic Forum in Davos. In his speech to world leaders he criticised nationalistic trends, especially President Trump's America First policy. On the home front, however, Xi is an unapologetic advocate of a China First approach. He invokes Chinese identity and national values and talks of China's "rightful place at the centre of the world". Freedom of expression in the press and social media has been curtailed. Xi regards the Communist Party as the sole moral authority able to combat the erosion of values. A key ingredient in this process is the deployment of mass surveillance using new technologies like ultra-sophisticated CCTV, face recognition and artificial intelligence.

This concentration of power is unusual even for China. The leadership justifies it by referring to the need for stability while the economy is put on a new footing. The emphasis on Chinese ideology is also intended to ensure the unbroken supremacy of the Communist Party in case economic turbulence should raise questions about the Party's position. Policies that stress national identity also create a counterweight to Western influences, which will undoubtedly grow as China opens up. This is an age-old fear of the Chinese, who have a saying that "If you open the window to let in fresh air, you'll also let in the flies."

### Conclusion

The increasingly obvious limits to the previous growth model, combined with new ambitious objectives, mean that China stands on the threshold of major changes. The political leadership is alive to the challenges that the country faces and has already initiated various projects. The aim is to achieve more sustainable growth focused on higher quality. But that means abandoning the unsustainably high growth rates of the past. The improved standard of living generated by rapid growth helps explain why the power of the Communist Party has so far not been seriously questioned. The revamping of the economic model will pose increased risks in the short term. The leadership is therefore resorting to political measures to shore up its position. In this way it also hopes to counter the intrusion of foreign influences as the country opens up. Be that as it may, China needs the rest of the world just as much as the rest of the world needs China.



**STILL DEMAND  
FOR THE  
WORKSHOP**

# Market overview

EUR/CHF and EUR/USD: exchange rates since September 2017



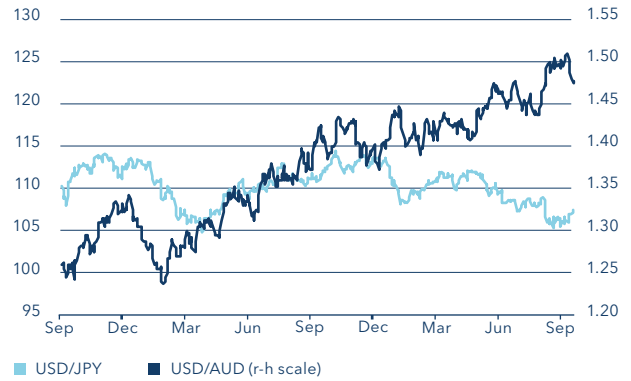
USD/CHF: exchange rate since September 2017



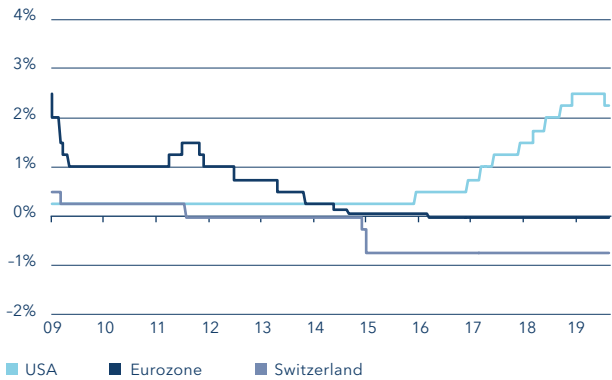
GBP/CHF and GBP/USD: exchange rates since September 2017



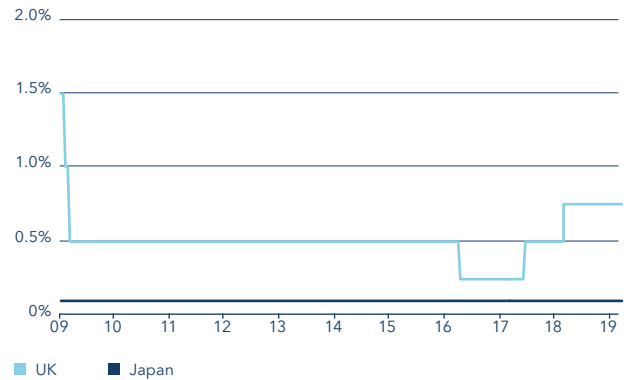
USD/JPY and USD/AUD: exchange rates since September 2017



Key interest rates in Switzerland, eurozone, USA: since January 2009



Key interest rates in UK and Japan: since January 2009

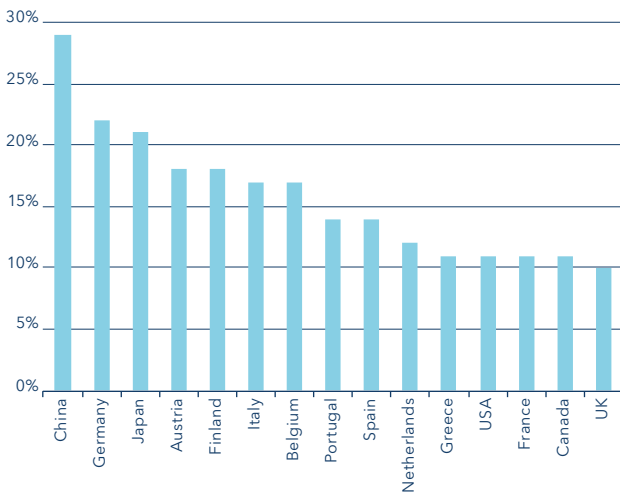


# When China sneezes

IT HAS LONG BEEN SAID THAT WHEN AMERICA SNEEZES, THE REST OF THE WORLD CATCHES COLD. BUT TODAY'S INFECTIOUS SNEEZER IS CHINA. THE TRADE WAR IS HURTING THE CHINESE ECONOMY, HIGHLIGHTING ITS HEAVY DEPENDENCE ON EXPORTS.

The world economy is in a fragile state. Donald Trump's trade policies have triggered an earthquake. Industrial production in the seven leading developed countries (G7) is lower than it was last year. In plain words: the manufacturing sector is in recession. The main sufferer is China - hardly surprising given that China is the target of the US President's trade war. Manufacturing plays an enormously important role in the Chinese economy, accounting for almost 30% of GDP. This explains the scale of the current negative impact (see chart).

Manufacturing as % of gross value added



Source: IMF

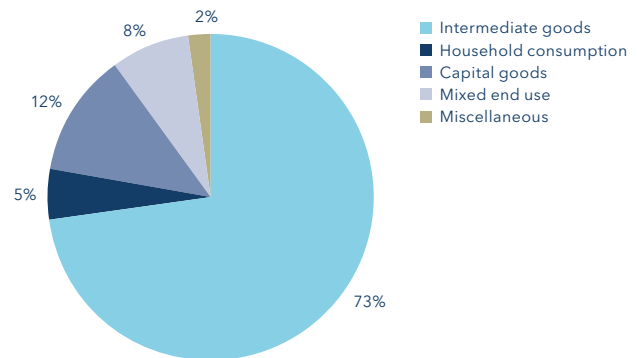
The trade war has severely dented the flow of goods between the USA and China. Chinese exports to the USA in the first half of 2019 were down by almost 10% compared with the same period last year. No wonder, then, that China's industrial output is sputtering. Economic growth in China is now at its slowest rate in almost 30 years. GDP growth in the second quarter was only 6.2% year on year. As these figures

are apt to be massaged for political convenience, the real rate could be even lower. This inevitably has an impact on the export performance of neighbouring Asian countries. Vietnam's exports to China are down by 16% compared with last year, while South Korea's have fallen by an eye-watering 20%.

## China still the world's workshop

This loss of economic momentum puts a strain on the world economy. Measured by imports, China is the world's second largest source of global demand after the USA. The country is still the "workshop of the world", despite the Beijing government's efforts to move away from the previous economic model. The country's USD 2.1 trillion worth of imports are not a symptom of high consumer demand but reflect industry's need for intermediate and capital goods, which account for 85% of the import bill (see chart below). Given China's continuing preeminent status as a manufacturing location, merchandise imports are therefore functionally dependent on exports. Thus countries that are important suppliers to China are being hit hard. The biggest exporter to China is the European Union, followed by South Korea, Japan and Taiwan. The USA comes fifth. Looking at the relation-

China's imports by end use (2017, in %)



Source: IMF

ship from the other side, China is the most important export destination for South Korea, Japan and Taiwan and the second most important for the EU. For the USA it is the third largest, accounting for only 7.2% of US exports. After that come the countries of the Asia-Pacific region. Given this dependence, it is no surprise that the manufacturing sector in large parts of Asia and Europe is now in recession. Both these regions are direct and indirect victims of the trade war.

China occupies a pivotal position in the global supply chains for many products (see page 20). Its advantageous production infrastructure usually means that it handles the final stages of the manufacturing process. OECD figures show that the foreign-sourced component of China's gross exports is exceptionally high compared with other countries. The figure for the electronics and mineral industries is around 40%. In other words, the manufacture of these products involves a large imported component. This highlights the importance of China's economy for numerous other countries.

#### Increased emphasis on personal consumption

The government in Beijing is taking measures to counteract weakness in the manufacturing sector. Record tax cuts have been implemented in an attempt to reinvigorate the economy. Continued efforts are being made to revamp the country's "business model", with a greater focus on consumer spending. The aim is to make the economy more stable and less exposed to external influences. So far the success of these efforts has been mixed. At the start of the 1990s the contribution of personal consumption to total GDP was 50%. This fell to 35% in 2011 but has since risen to 39%. Thus consumer spending growth has outstripped economic expansion in recent years.

Beijing wants the percentage to return to 50% by the year 2030. But this is a difficult task. The government's current stimulus measures are mainly directed at investment and therefore tend to reduce the GDP contribution of consumer spending. This, however, is a cyclical phenomenon. At the structural level, China's State Council is determined to push up disposable income and encourage people into the shops. Despite temporary setbacks, the transformation of the Chinese economy therefore looks set to continue.

#### Chinese contagion

- The world economy has cooled down significantly under the impact of the trade war.
- This not only hurts China but also has serious knock-on effects throughout Asia and Europe.
- The consequences are felt wherever industries are heavily dependent on exports to China.

#### Conclusion

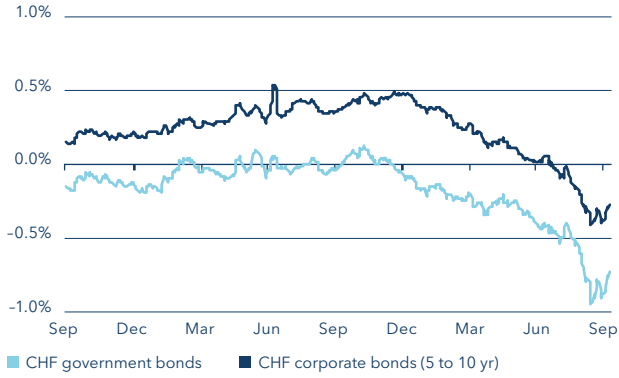
China is still the workshop of the world. Figures published by the IMF and OECD confirm this. China is often the final link in the supply chain, which means that import volume is crucially dependent on the level of exports. So if the tariff war causes less to go out, fewer intermediate and capital goods will come in. This hits exporters in Europe and Asia. The trade war therefore has to be resolved in order to get the world economy into a higher gear. China, meanwhile, will press ahead with the restructuring of its economy and seek to carve out a bigger role for personal consumption in the long term.



**WANTED:  
FOREIGN CAPITAL**

# Bond yields – overview

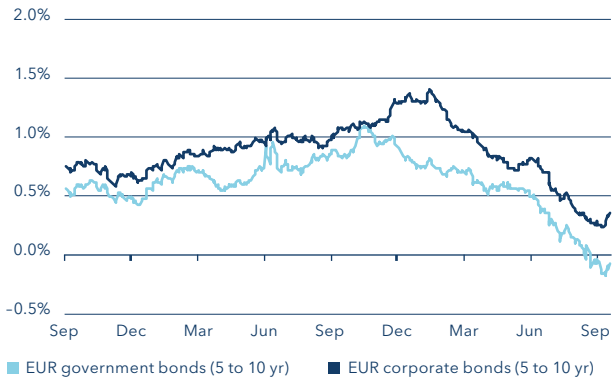
Switzerland: yields since September 2017



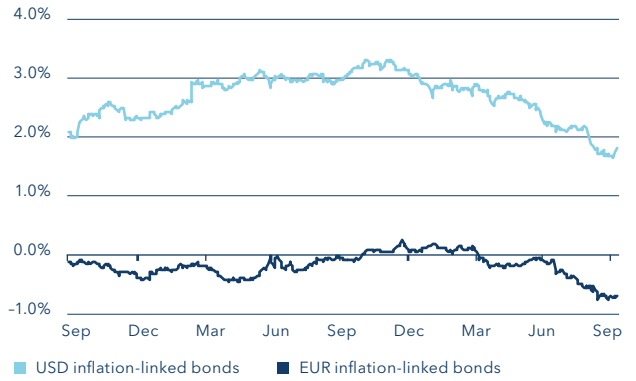
Emerging markets: yields since September 2017



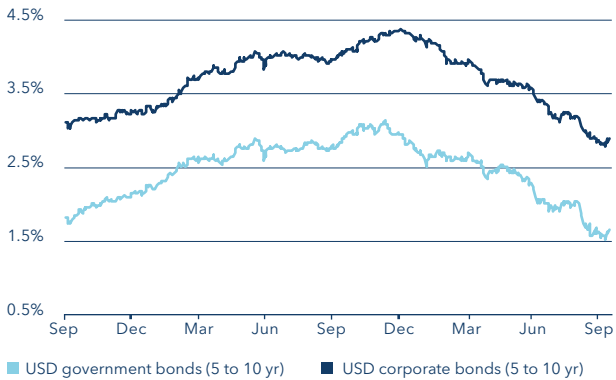
Europe: yields since September 2017



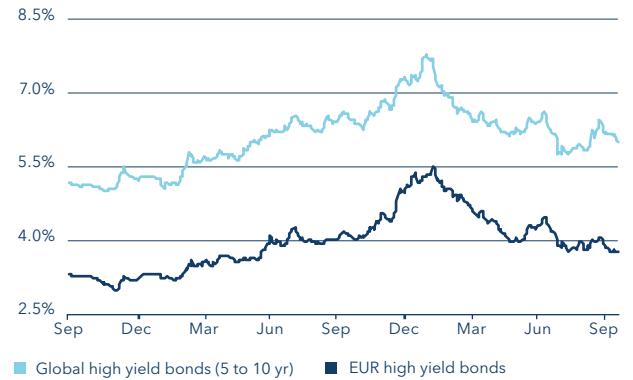
Inflation-linked bonds: yields since September 2017



USA: yields since September 2017



High yield bonds: yields since September 2017



# The problem with China's saving rate

SAVING IS VIRTUOUS, BUT ITS PATTERN AND CONSEQUENCES DEPEND ON DEMOGRAPHICS. THIS IS PARTICULARLY IMPORTANT IN THE CASE OF CHINA, WHICH WILL SOON BE IN NEED OF FOREIGN CAPITAL.

Demographics can explain a lot of things, including long-term changes in asset prices. Demographic factors have provided strong support for the capital markets since 1980. The changing age make-up of the world's population has fuelled a bonanza in global saving. This has driven up bond prices, with a concomitant decline in yields. As a result, discount rates for equities and other risk assets have been squeezed, underpinning the long bull run that the markets enjoyed until the outbreak of the financial crisis in 2008.

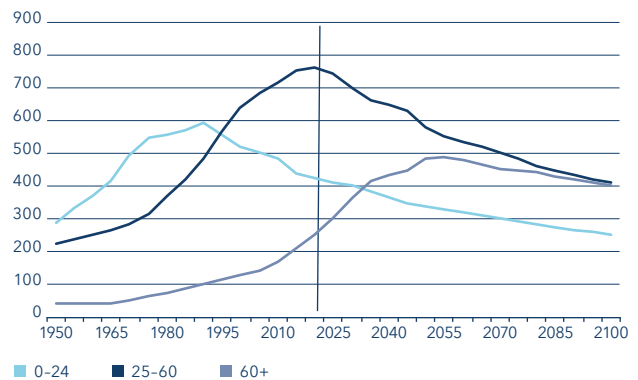
It was Ben Bernanke, later head of the Federal Reserve, who in 2005 sounded the alarm about the resultant global imbalances and coined the phrase "global saving glut". At that time the USA was running a current account deficit of USD 635 billion a year, equivalent to over 5% of GDP. In other words, the US economy was being financed to an important extent by other countries' savings. Bernanke referred explicitly to the emerging nations, which had been transformed from borrowers into lenders. Since then, however, the demographic boost has weakened and could develop into a headwind for the capital markets in the future.

## Demographically driven saving rate

The Brookings Institution has carried out an empirical study of the relationship between age and the saving rate in 85 countries. The rate is highest in the 35 to 60 age bracket. That makes sense intuitively. Children and young people in education earn nothing, but they consume a lot. Thus their saving rate is negative. After completion of their education they are still not big earners, but they have heavy outgoings (house, car, etc.) and therefore cannot save much (age group 25 to 35). The saving rate only takes off in the 35 to 60 bracket, when wages and salaries are at their highest and big ticket spending decreases. In an economy in which this group predominates, saving outstrips investment and the resulting surplus can be invested at home or be lent to other countries. Globally, saving and investment are brought into equilibrium by the

price mechanism (real interest rates). The worldwide decline of yields since 1980 has to be seen against the background of the saving glut.

Age trends in China (millions of people per age bracket)



Source: United Nations Population Division

## China's baby boom was a one-off

China has experienced extreme demographic shifts. The famine precipitated by the Great Leap Forward in 1959 was followed by a baby boom in the 1960s and 1970s. The population explosion did not abate until the nationwide imposition of the one-child policy in 1980. When the baby boomers themselves started to have children, this sparked a second wave of high birth rates from 1990 onwards. In the coming seven to ten years these children will become savers, but the proportion of the population in gainful employment will contract and the number of pensioners (negative savers) will grow. It will therefore not be long before China has to start borrowing capital from abroad. Global real interest rates will then have to rise in order to bring saving and investment back into balance. It looks as if that could happen by around 2027.

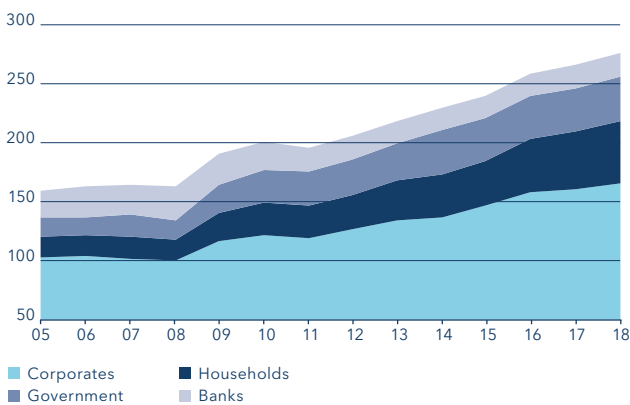


### Changing patterns of capital exports

We have already seen a similar development in Japan. Over the last forty years Japan has been one of the world's biggest exporters of capital thanks to an exceptionally large percentage of income earners in its population.

Today Japan and China are still America's biggest creditors. Of the USD 22 trillion worth of US public debt, USD 6.6 trillion is held by foreigners. Asian investors' fondness for US Treasuries is probably a hangover from the Asia crisis of 1997/1998, which was triggered principally by inadequate foreign currency reserves. Japanese lenders now hold USD 1,123 billion worth of US Treasuries. Until June of this year the biggest creditor was still China, which formerly invested the bulk of its trade surplus in the US government bond market. This strategy changed, however, in the wake of the global financial crisis. Since 2013 Chinese savings have been channelled back into the home country and parked in domestic banks and other financial institutions. These, in turn, have lent the money chiefly to state-owned enterprises, which have used it for capital spending to keep the wheels of the economy turning.

Chinese debt (% of GDP)



Sources: Bloomberg, VP Bank

### China opens up - because it must

As long as China maintains its growth momentum and there are enough savers to provide the investment capital that the economy needs, the country's high level of debt is manageable. In the future, however, the demographics will force China to depend on

### China bonds

- All major bond index providers (Bloomberg Barclays, FTSE, J.P. Morgan) have announced the inclusion of Chinese government bonds in their benchmark indices.
- This move provides investors in index-tracking vehicles and managed funds with access to a low-correlation asset class.
- China's bond market is the third largest in the world after the USA and Japan.

savings from abroad. That is why China has gradually opened up its capital markets. This year's inclusion of Chinese bonds in the major global bond indices is a big success for China. With a volume of around USD 13 trillion, the Chinese fixed income market is now the third largest after the USA and Japan. But so far only 1.6% of Chinese bonds are held by foreigners. The corresponding figure for US bonds is over 28%. This is likely to change very quickly. The volume of the Chinese market is growing by leaps and bounds. Given their low correlation with other fixed income markets, Chinese bonds offer advantages as a portfolio diversifier. Now that China has been included in the global benchmarks, almost every western pension fund, insurance company and sovereign fund will have to invest directly or indirectly in Chinese bonds. It is calculated that the gradual raising of the Chinese weighting in the indices will necessitate reallocations to the tune of around USD 900 billion within five years.

### Conclusion

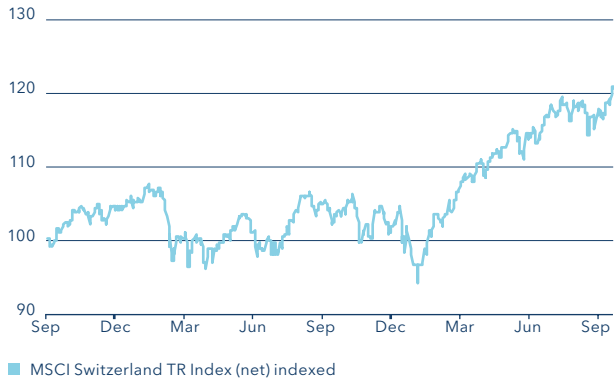
Demographic factors have kept global real interest rates very low during the last three decades. This phase will come to an end in the next ten years. The situation will then be reversed, with China becoming dependent of foreign savings. Chinese businesses will be confronted with a situation in which borrowed capital is no longer available in almost unlimited amounts and at ever lower interest rates. This heralds a major upheaval on the world's capital markets, with significant consequences for interest rates.



**TECHNOLOGY  
TO THE FORE**

# Equity indices – overview

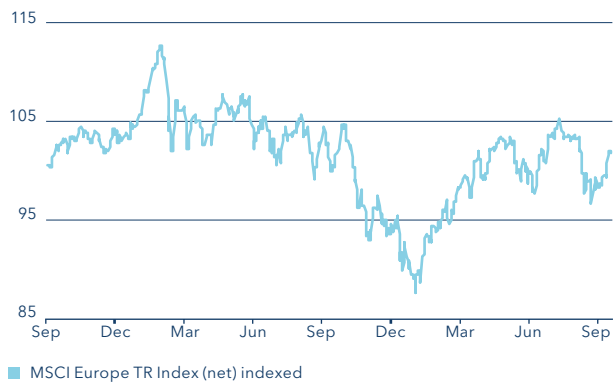
Switzerland: market movement since September 2017 (indexed)



Pacific: market movement since September 2017 (indexed)



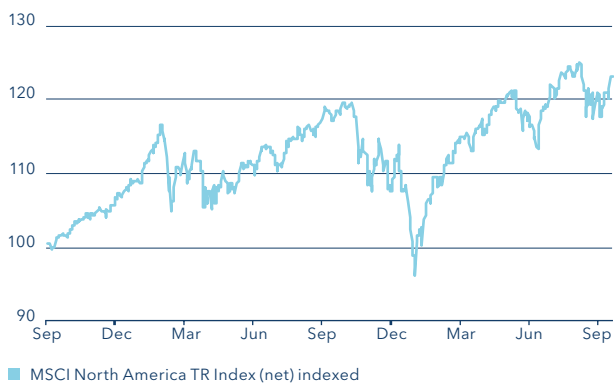
Europe: market movement since September 2017 (indexed)



Emerging markets: market movement since September 2017 (indexed)



North America: market movement since September 2017 (indexed)



United Kingdom: market movement since September 2017 (indexed)



# Chinese equities in a sceptical world

CHINA IS RESHAPING ITS ECONOMY. TECHNOLOGY, CONSUMPTION AND SERVICES ARE SET TO BECOME THE MAIN DRIVERS OF GROWTH. BUT FOREIGN INVESTORS REMAIN SCEPTICAL ABOUT CHINESE EQUITIES.

China's continuing high growth rate masks fundamental changes in the economy. Below the surface, industrial structures are being transformed at breakneck speed. The sectoral rotation in the Chinese equity market is clear evidence of this.

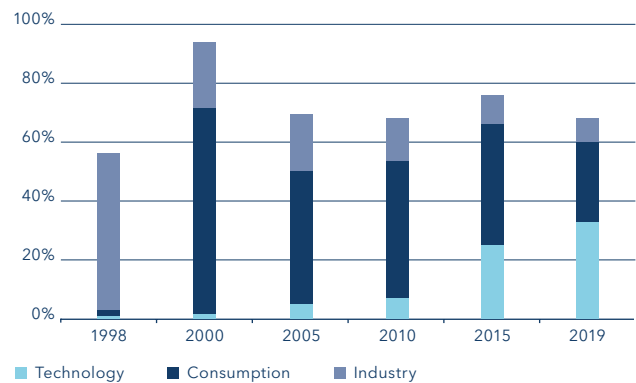
China's equity market used to be a mirror of the country's industrialisation and urbanisation. Before the turn of the century, industrials, commodities and energy accounted for the bulk of the market's capitalisation (see chart). But the growing consumer sector gradually took over, with the cyclical industrial sector being squeezed to a fraction of its previous share. The capitalisation of the financial sector has likewise climbed significantly since 2007, helped by the fact that China's banks came through the global financial crisis comparatively unscathed. Meanwhile, the technology sector has blossomed. The MSCI China equity index is now dominated by consumer shares, technology and internet-based enterprises.

Leading protagonists include the internet-based companies Tencent and Alibaba, which are now the most highly capitalised firms in the Chinese market at almost USD 500 billion each. These two heavyweights are well known in the West, but in terms of sales volume they are not China's biggest. There are over 30 companies in the MSCI China that boast higher sales. In third and fourth place in the capitalisation league come two financial companies: China Construction Bank and Ping An Insurance.

The changing shape of the Chinese equity market reflects the restructuring of the Chinese economy. Ten years ago the bulk of the market consisted of so-called "red chips", partially privatised state enterprises whose shares could be bought by foreigners on the Hong Kong stock exchange. These companies operate in traditional sectors like finance and oil and are often beset by poor profitability and high debt. The new heavyweights like Alibaba are fully private businesses that can stand comparison with their foreign rivals. Indeed, their closeness to their

Chinese customers puts them at a big advantage. Amid these changes, it is noteworthy that China's equity market structure is gradually becoming similar to America's.

MSCI China: changing sector make-up (in % of total market)



Sources: VP Bank, MSCI, Lazard AM

## Investor perceptions

Equity price movements and valuations are an interesting guide to investors' perceptions about a country's potential. Ten years ago the world's top ten companies in terms of market capitalisation included three Chinese giants: PetroChina (rank 1), Industrial & Commercial Bank of China, ICBC (rank 3) and China Construction Bank (rank 7). These companies were catapulted into the premier league by the meteoric advance of Chinese share prices, which more than tripled between autumn 1999 and 2009. Since then, however, the overall return on the Chinese market, at 66%, has lagged way behind the global market's 154%.

Today there are still two Chinese companies in the global top 10: Alibaba (rank 7) and Tencent (rank 8). These Chinese champions are very competitive players, but the relative decline of the Chinese contingent testifies to investors' wary attitude towards the Chinese market.

Although China has generated below-average returns for equity investors in recent years, it is now the world's second largest equity market. But access for international investors is still limited. Only just over 30% of the market's current capitalisation of around USD 8.3 trillion is available to non-Chinese investors. Shares accessible to foreigners are mainly listed in Hong Kong or on western exchanges.

### Changing face of the market

So-called "A shares" are the largest segment of the Chinese market with a capitalisation of over USD 5.2 trillion. They are traded in renminbi either in Shanghai or in Shenzhen. This segment was for a long time barred to foreign investors, but there is now limited access via certain banks, including VP Bank.

As a result of this fragmented availability, there are major differences in the investor base between shares traded on the Chinese mainland and those that are bought and sold in Hong Kong or the USA. The mainland market is dominated by local private investors, who account for over 80% of total holdings. This makes it systemically liable to higher fluctuations than Hong Kong. The absence of institutional investors, whose behaviour is driven less by emotion than by hard economic facts, means that the local market is vulnerable to excesses on the down- and upside.

Shares of companies incorporated in mainland China but traded on the Hong Kong stock exchange are known as "H shares". Over 70% of them are in institutional hands. China's opening-up to foreign capital is gradually increasing the presence of institutional investors in the mainland equity market too. In 2018 the major international index provider MSCI responded to these trends by starting to include Chinese A shares in its key indices. This not only results in improved risk diversification but also increases the opportunities for investors.

### China still attractive as an investment destination

The trade war between China and the USA is distracting attention from the restructuring of the Chinese economy and the fundamental attractiveness of the Chinese equity market.

### Investing in China's future

- Only about a third of the Chinese equity market's capitalisation is accessible to international investors.
- Buyers of the Chinese market gain access to the technology and consumer sectors. The changing structure of the Chinese economy has reduced the importance of industrials.
- The status of Chinese equities has been enhanced by their inclusion in key international benchmarks.

Chinese equities are cheap. At their current PEG ratio (price/earnings to growth ratio based on expected earnings growth over the next three years), Chinese shares are being traded at a 60% discount versus Europe and the USA. In other words, many of the challenges that this market faces are already priced in.

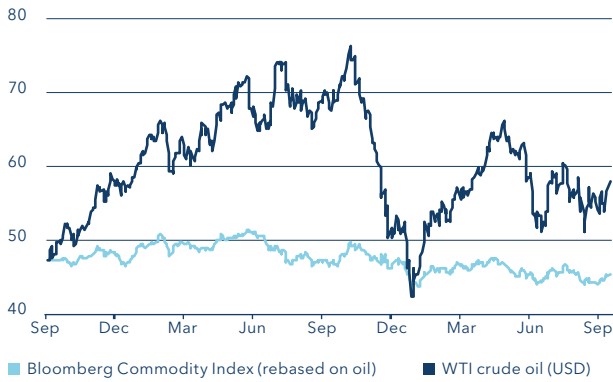
Despite the gradual opening-up of the market, many investors still find it difficult to invest in China. In this environment well diversified investment vehicles - e.g. regional investment funds or funds focussing on themes related to China's economic transformation - are still the preferred route into the Chinese market.



**COMMODITY  
SUPERPOWER**

# Alternative investments – overview

Commodities: performance since September 2017



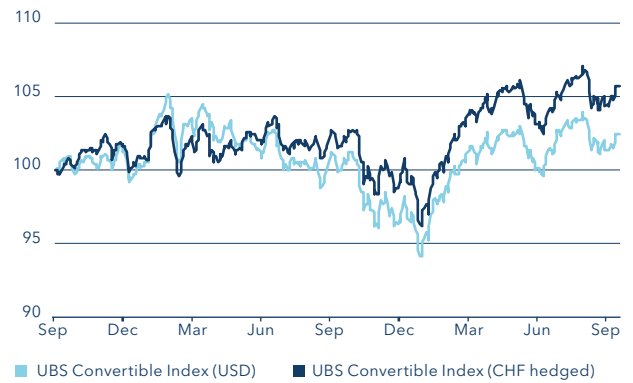
Private equity: performance since September 2017 (indexed)



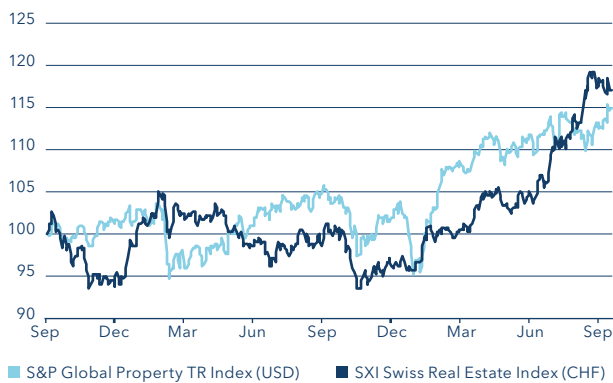
Precious metals: performance since September 2017



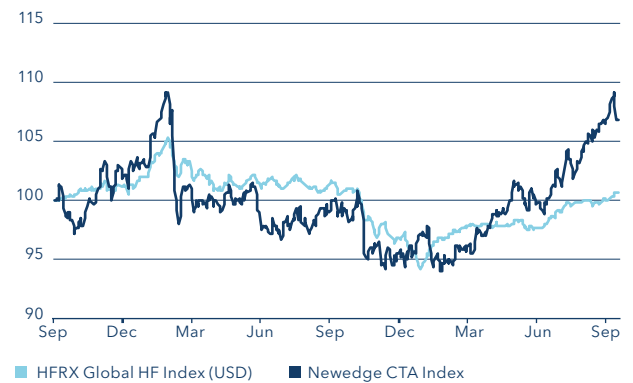
Convertible bonds: performance since September 2017 (indexed)



Real estate: performance since September 2017 (indexed)



Hedge funds: performance since September 2017 (indexed)



# Commodities: China's crucial influence

ALTHOUGH CHINA IS HUGELY RICH IN NATURAL RESOURCES, ITS RESERVES ARE NOWHERE NEAR ENOUGH TO SUSTAIN THE COUNTRY'S HEADLONG ECONOMIC GROWTH. THIS POSES RISKS FOR THE WORLD'S COMMODITY MARKETS.

China's meteoric rise to no. 2 among the world's economies has established it as a global power in the commodities market. The latest country comparison carried out by Germany's Federal Institute for Geosciences and Natural Resources (BGR) in 2017 shows that China produces 19% of the world's mineral output, making it the world's top producer of raw materials. China has an even more dominant position in the refinery sector, accounting for half the global volume of refined products. It would be very wrong, however, to conclude that China is self-supporting in raw materials.

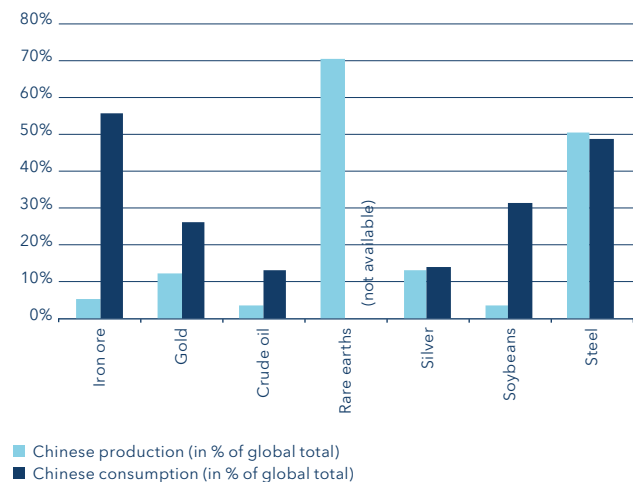
In fact, China is still the world's biggest net importer of mineral resources, notably metals, gravel, sand and salt. The latest figures from the BGR put China's net mineral imports at over USD 151 billion, well ahead of second-ranked India (USD 37.7 billion). To put these figures into perspective, the net mineral exports of Australia (the world's biggest supplier) amount to USD 118.1 billion a year and would therefore not be enough to satisfy China's mineral hunger. This situation has major implications for global supply and China's dependence on commodity imports.

## Yin and yang in the rare earths sector

China's important role is especially evident in the market for the chemical elements known as rare earths. These metals are indirectly involved in the ongoing trade war between China and America. Thanks to their magnetic and optical attributes, they are used in the manufacture of mobile phones, screens, batteries and LEDs as well as in wind turbines, electric motors and automated guidance systems for rockets. Although only 37% of global reserves of rare earths are situated in China, a report by the US Geological Survey in 2018 estimated that China accounts for around 71% of global output. Thanks to China's unique refinery capacity, 80% of all rare earths produced outside China are processed in Chinese facilities. This makes China the largest exporter and importer of rare earths. The whole

world, including the big tech companies of the USA, is therefore dependent on China in this market. If China were to impose restrictions on rare earth exports, the consequences would be enormous. In 2014-2017 imports from China accounted for 80% of US rare earth consumption.

China's position in world commodity markets



Sources: Industrial organisations

China's steel industry has been attracting a lot of attention in recent months. Steel prices, already depressed by global oversupply, were pushed down further by America's imposition of import tariffs. The World Steel Association reckons that China accounts for 51% of global steel output.

Alongside rare earths and steel, China is also one of the biggest producers of precious metals. Figures published by the World Gold Council show that China was the world's top gold producer in 2018, accounting for 12% of global output. It is also the third largest producer of silver, with a global share of 13%. China is likewise a big player in the agricultural commodities sector, being a major producer of cereals, cotton, rapeseed and vegetables.



### Resource hunger - China's Achilles heel

These statistics might suggest that China holds the whip hand as a producer in the global commodity markets. But Chinese supremacy is an illusion. China does not have enough to meet its own needs. The shortfall in numerous classes of commodity has to be covered by imports.

A case in point is crude oil. For decades the USA was the world's biggest importer of oil, but that has changed since 2015. America still consumes one barrel in five of the world's output, but the growth of domestic shale oil production has enabled it to scale down imports dramatically. China is less well endowed. At the start of the 1990s it was still able to cover its crude oil requirements, but it is now the world's biggest oil importer. In 2018 it accounted for almost 14% of global oil consumption, i.e. 13.5 million barrels a day, of which around 10 million barrels were imported. Its main suppliers are Russia, Saudi Arabia, Angola, Iraq and Oman.

China is also dependent on imports of iron ore, which is used mainly for the production of steel. Uneconomic low grade ores and stringent environmental regulations have forced many Chinese iron mines to close down. Domestic output has therefore declined steeply in recent years, making China much more reliant on imports. Almost a half of the world's iron ore output now goes to China. The main suppliers are Brazil and Australia, together accounting for almost 80% of Chinese iron ore imports.

Official Chinese statistics show that China is also heavily dependent of imports of agricultural products. 90% of the country's soybean consumption is imported, a third of it from the USA. China is also a net importer of gold.

The message is clear: China cannot get by without imported commodities. Dependence on imports is intrinsically negative, because it lets foreign producers call the tune. But if China's economic growth flags and demand weakens, the resultant supply glut could quickly drive prices down, putting the buyer in the driving seat.

### Key role in the commodity markets

- China is the biggest producer of many commodities but also the biggest importer.
- Thanks to its huge refinery capacity China dominates the market in rare earths, which are vital for the manufacture of many high tech products.
- The reshaping of the Chinese economy will cause major changes in global commodity markets.

### Pivotal position in the resources markets

China accounts for the bulk of demand for many types of commodity. The degree to which Chinese demand will drive commodity prices depends on China's growth rate and the changing shape of its economy. We believe that the Chinese economy will stay on a powerful expansion track in the years ahead and continue to drive the commodity markets. China's future economic strategy will crucially determine which commodities it needs. If China continues to prioritise capital spending, the expansion of the country's infrastructure will underpin demand for products like cement, iron and steel. But if the emphasis shifts to consumption, the growing importance of the retail sector will boost demand for commodities such as aluminium and oil. We regard the latter scenario as more likely (see page 9). The transformation of China's economy will therefore have a major impact on the structure and pricing of the world's commodity markets.



## 4. APPENDIX

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**Published by**

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**Periodicity**

Quarterly

**Publication date**

30 September 2019

**This publication was finalised on**

18 September 2019

**Closing prices as at**

10 September 2019, unless otherwise stated

**Sources for charts and statistics**

Bloomberg, Reuters, Thomson Financial Datastream,  
unless otherwise stated

**Photos**

Roland Korner, Triesen  
Rich Stapleton, London

**Printed by**

BVD Druck+Verlag AG, Schaan



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Paper from  
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