



TAKING STOCK: CHINA TRANSITIONS

An NEPC 2022 Key Market Theme

By NEPC Research

February 2022

Key Market Themes represent our view of current drivers for the global economy. Over time, themes evolve and interact, 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 impede 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 equal the size of the U.S. economy in 15 years. Its 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 to this mix its testy relations with the United States and the stakes are even higher.

At NEPC, we are closely studying the numerous disruptions that could occur as a result of China's transitions. We have seen several global market corrections emanate from the world's second-largest economy and its most populous nation; triggers have included changes in regulatory and capital controls, volatility spikes in the yuan, and shifts in demand for commodities. In addition, accelerated 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 economic 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. The

regulatory reset in 2021, which ushered in new anti-monopoly and industry-specific rules, underscores the potential for economic and market volatility and damping investor sentiment.

That said, we believe China has worked hard to attract foreign investors and will likely steer clear of moves that will drive away investment. It will continue to exercise caution over its monetary and fiscal policies, while gradually liberalizing capital markets.

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.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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