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Flash Note
17 January 2025

# China and its Directed Capitalism: Should this Stock Market Have a Structural Place in My Portfolio?

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I have learned, thanks to the patience of those who took the time to explain it to me, that in the world of Wealth Management there is a rule worth engraving in stone: **"Always be long on the S&P and the German Bund."** Why? Because when things turn ugly, the Federal Reserve will deploy policies to support the S&P, while the Bundesbank will do the same for the Bund. This is due to a simple reason: the majority of Americans own equity, whereas most Germans invest in government bonds. This cultural difference reflects how each country perceives the risk-return trade off. The original rule, in fact, is slightly different: **"When the market panics, buy the S&P and Bunds."** My reflection is that, even in the absence of panic, do it anyway. Why? Knowing that the Fed puts a floor under the market makes it logical to always stay long on the S&P. If I had followed this maxim to the letter during my investing career, I would be significantly wealthier today. After all, the S&P is at all-time highs, and the Bund (almost) is as well.

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What does China have to do with this? Between the 1990s and today, the Bundesbank was absorbed by the ECB. While there was initial resistance, Draghi's ideological locomotive of Modern Monetary Theory steamrolled over the old German dogma, relegating the Bundesbank, and with it, ourmarket rule (or at least part of it). Without the Bundesbank in place, now replaced by the ECB, I suspect the rule now only applies in its first part regarding to the S&P. This rule assumed that the German government, in addition to defending investments in its domestic bonds during downturns, also guaranteed them. This circumstance required fiscal capacities and metrics that no longer exist in Europe today. And I say Europe because now we are dealing with the ECB (and not the Bundesbank).

Here is where China comes in. Today, there is a central bank playing a role similar to the one the Bundesbank played in the 1990s. Like Germany back then, China is a giant exporter, accumulates substantial reserves, and prioritizes, in this order: debt, currency, and equity. Meanwhile, in the United States, government priorities have remained unchanged for decades: first comes equity, then bonds, and finally the currency. Hence the famous phrase by John Connally (then U.S Secretary of the Treasury): **"Our currency, your problem,"** uttered in 1971 during the Bretton Woods crisis and Nixon's decision to suspend the dollar's convertibility into gold, leading to the collapse of the fixed exchange rate system.

Keeping in mind each government's priorities, any investor should ask themselves: would you invest in a Chinese equity market where stocks are the government's last priority? Perhaps this explains why the Chinese stock market has lost not only its luster but also much of its prominence over the last 15 years, representing today only

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a fraction of its historical weight in the MSCI AC. Beijing's focus has been on the solidity of its debt assets. The reasoning is that only a country with a large and liquid debt market can have a currency capable of becoming a reserve currency. I agree. Aware that the USD is the world's most powerful financial weapon, it makes sense that Beijing's hierarchy of priorities is debt, currency, and equity. For this reason, our new investment rule becomes: **"Always be long on the S&P and Chinese Bonds."**

Let's return to Chinese stocks. Beijing has deployed stimulus measures to revitalize its market, but will it be enough? My answer is: No, not as long as China operates under the "Hunger Games Capitalism," a concept aptly described by Louis-Vincent Gave not long ago. Much like in the movie *The Hunger Games,* where an authoritarian government imposes a brutal game involving one representative (a "tribute") from each of the city's 12 districts, where only one can survive, Beijing decrees a competition in various sectors it deems critical for China to lead globally. Such is the case for solar panels, electric vehicles (EVs), and other industries. Provincial and municipal governments, along with banks, are tasked with financing these sectors and keeping them well-oiled to meet the government's goal of making the country the top world producer in these segments. The result? More than a hundred producers/competitors in sectors like EVs and solar panels.

Beijing has deployed stimulus measures to revitalize its stock market, but will it be enough? My answer is: no, as long as China continues to operate under "Hunger Games capitalism."

Here is where the "Hunger Games" begins. To survive, these competitors must meet two requirements: produce the levels desired by Beijing and sell all that production (to avoid bankruptcy). If there were only 10 competitors, as in Europe, it wouldn't be a problem—there is room for 10 players. But when we are talking about over a hundred competitors, things get complicated. First, they flood the domestic market with their products, engaging in suicidal pricing strategies to avoid accumulating in their warehouses a lethal level of excess supply. Even so, the domestic market's absorption capacity is limited, forcing them to aggressively place this excess production in foreign markets, creating tensions with other countries and giving rise to tariffs. For the Chinese consumer, this system is fantastic (an EV for less than $10,000? What a bargain!), but for shareholders and investors, it's a nightmare. This is not capitalism. I know this because a company operating in a free market system has an optimal production level that maximizes profits and minimizes excess supply. This is known as the level of production at the marginal equilibrium point. I don't see this happening in these sectors in China. To summarize, in China, the state's interests come first (what we know as national policy), and what benefits the state's interests is at the expense of shareholders. It goes without saying that the international capital markets do not align with this approach.

In a decision tree for China, the key questions are: **Does government policy allow a stock's price to rise without restrictions? Can a sector avoid becoming trapped in these 'Hunger Games'?** The answer lies in identifying sectors outside the government's radar—companies for which the government has no "higher plan." However, this is no guarantee, as the CCP can redirect its focus to any sector at any time. Nevertheless, let's proceed with the exercise by identifying sectors in the Chinese equity market that have performed well, as these are likely the ones that have

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experienced the least state interference. These sectors are: casinos, specialized internet platforms, and energy. Education also warrants observation. Allow me to elaborate.

**Casinos:** Operating in Macau, they are outside the strict regulations of the mainland, avoiding the dynamics of suicidal competition.

**Internet platforms:** Specialized platforms like Alipay, Baidumarket, WeChat, or Tenpay are practically monopolies. Other platforms like JD.com, Pinduoduo, or Alibaba face competition but have managed to generate positive and growing cash flow from operations, unlike sectors caught in the "Hunger Games."

**Energy:** This is a government-protected sector (it does not allow it to suffer), where most listed energy companies are state-owned and operate as quasi-monopolies.

Companies operating in a free market system have an optimal production target known as the **level at the marginal equilibrium point**. This concept does not exist in certain sectors in China

**Education:** In 2021, the CCP cracked down on extracurricular education companies, causing stocks like EDU and TAL to plummet 90%, leaving investors burned. However, this “purge” seems to have consolidated the private education sector, with dominant positions for major players, reducing the risk of cutthroat competition.

**Conclusion.**

While regulatory risks persist in these sectors, Beijing’s newfound “sensitivity” toward equity markets, coupled with the cleanup seen in 2021 in sectors like technology and education, makes further political interference in these sectors seem unlikely.

My approach to investing in China would be this. A partial focus, targeting a few specific sectors, while steering clear of the idea of structurally investing in the Chinese market as a whole.

**Best regards**

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