# Bridgewater and UTIMCO Talk on China

By Sarah Rundell on October 17, 2019

In 1994 Bridgewater Associates set up Bridgewater China Partners with ambitions to be one of the biggest investors in China. The hedge fund invited a few pension funds to partner in the venture and began exploring opportunities, but a year in the set-up hadn’t invested in a single deal and was wound down on doubts that it would ever be profitable. Today the challenges of investing in China are just as real. Caught in an anecdote from one of Bridgewater’s China experts, who when recently scouting securities in the region, met the owner of a company who questioned paying dividends to someone he didn’t know.

“This is what you are dealing with: don’t be naive,” said Bob Prince co-chief investment officer at the $160 billion hedge fund, speaking to the board of the $41 billion University of Texas Investment Management Co at their September board meeting.

UTIMCO made its’ first investment in China in 2007 and now has a $2 billion-plus exposure divided between eight in-country relationships in public ($1.6 billion) and better-returning private ($800 million) investments in what UTIMCO CIO Britt Harris characterized as putting in the “small boats” first.

Yet he said China’s growing share of global GDP (currently 15 per cent) has implications for the entire world. Despite his circumspection that communism and China’s “terrible” demographics will continue to propel growth, plus key difficulties around building trusted relationships with Chinese partners that leaves most US investors approaching China through US centric firms with mixed results, he said China must “be taken seriously.”

From Bridgewater, which manages around $700 million in pure alpha and all-weather allocations for the endowment, the message was clear. China is too big to avoid; engagement is the only way forward.

**Cross the River by Feeling the Stones**

Developing a China strategy now will ready investors for what lies ahead. Although returns are important (though Prince noted at the moment Bridgewater “could do just as well elsewhere”) the most fruitful consequence of investing in China today comes from the experience and knowledge it brings tomorrow.

“If you are only looking at investments as a return stream, you are missing an opportunity,” he said.

Bridgewater invests in a diversified, balanced portfolio of assets avoiding individual stocks and private investments. In some cases, the fund also holds derivatives rather than the underlying security to still price in risk premiums across Chinese markets. The emphasis is on diversification at the asset class level to capture the economics of what is going on.

The approach gives the firm a window into discounted growth and inflation rates across markets, what risk premiums are doing and their effect on different assets, and how policy and the impact of the Chinese government running monetary and fiscal policy together, drives these forces. “This is our base builder to be informed and ready for the next decade,” said Prince who told UTCIMO’s gathered board it was only a matter of 10-15 years until China’s economic landscape has unfolded to the extent publicly traded liquid markets match the size of the US.

**Bloc Exposure**

Investors can access China in a variety of ways from holding assets in a “degree of intimacy” that allows them to sit on boards and get involved in governance, to investing in US companies like INTEL with large exposures to China. “There are ways to bet on China without holding China,” he said. Investing in an emerging Asian bloc offers some of the most compelling opportunities under this umbrella.

China is driving growth across an Asian bloc of interconnected peripheral economies like South Korea, Singapore and Thailand that has led to an independent economic zone. Here, Prince argued, the output and contribution to global growth is comparable to the US plus Europe.

“It’s hard to wrap your head around it,” he said. “The bloc’s contribution to global growth in the last three years has been two and a half times the contribution to global growth of the US plus Europe in a period the US and Europe were growing.”

Although the cash flows, mostly going through bloc companies are huge, the securitization of those cash flows is still small and financial markets are undeveloped. The future will see continued growth of cash flows and securitization, and markets will become increasingly accessible, he said.

Analysis of the bloc illustrates that China and the wider region is no longer just an export engine. Exports are levelling off and GDP is accelerating, driven by internal economic activity from thriving entrepreneurial businesses in the zone. The region’s independence and inward focus has implications for its historical dependence on the dollar and foreshadows the emergence of an independent monetary and credit system in the RNB. “It will be the third monetary and credit system in the world. You got the dollar and the euro, and you’re going to have the RNB,” said Prince. The growth of two monetary systems to three offers investors’ huge opportunity, particularly around diversification, he said.

Chinese businesses have outsourced to the region driven by both the private sector and more recently China’s Belt and Road Initiative (BRI) in a shift that is visible in China’s cost of labor. Rising wages have triggered less FDI into China, which is now investing outside the country into the rest of Asia in a trend fueled by plentiful sources of capital from savings and foreign exchange reserves.

“If you look at the track record of the rates of return on FDI into the Asia bloc its double digit returns over last five years, compared to the developed world at around 5-6 per cent,” said Prince.

Compounding high growth rates from the bloc’s high levels of output, are even more startling. “If you take the projected growth rates for the Asian bloc, in one year the incremental output will equal today’s Mexican economy. In five years, it will reproduce the Japanese economy and in ten years it will replicate the European economy.” It’s a “mind boggling” trajectory that contrasts with slowing growth in the west and zero and negative interest rates, he said.

**Trade War**

The emergence of an Asian bloc is also being driven by China’s increasingly testy relationship with the US, incentivizing independence as a matter of self-defense. China’s expansion should also be placed in historical context, said Bridgewater’s Ramsen Betfarhad, a senior research associate at the firm who was also presenting at the UTIMCO board.

“China was a great power and its natural destiny is to revert back to being a great power,” he said.

In 2049, the communist party will have been at the country’s helm for 100 years and is determined to place China back in the global order. It is a narrative that explains China’s growing military presence that resonates with the US and beyond, he said.

**Roll Over**

Today’s trade conflict is a manifestation of a longer-term ideological conflict of two different systems, said Prince.

“The big point is that this is not a trade issue. It is deeper and longer lasting and it depends on how well it is managed by both sides.”

Key clash points lie around the corner. Over the next ten years the US will roll over an estimated 25 per cent of GDP in treasury debt every year, a process that normally attracts little attention. However, the holders of most of this debt are Japan and China with an estimated $1 trillion each. If China decides not to roll over its existing holdings it will push Treasury prices down and yields up in a sell off that will drive the dollar down and the RNB higher, leading to a “capital war” of potentially spiraling consequence.

The crucial questions is how much China might decide to sell, flags Prince.

“Let’s just say, for example, they don’t’ roll over $100 billion. $100 billion in the US treasury market is material but not significant and would blend in with the size of other flows from mutual funds and pension funds. It would have a market impact, but it would not destroy the market.”

One of the reasons 2015 proved a tough year for US equities gripped by tightening liquidity and rising risk premiums, was because of China’s balance of payments and currency policy. As China tried to defend its currency peg it sold foreign exchange assets pushing risk premiums up and prices down in a policy that ended when it let its currency move to a more floating rate within bands.

“It was all going on and most of the world didn’t read about it,” said Prince. His conclusion: “China’s too big to avoid. It’s all about how you engage.”