The great decoupling with China will reshape markets

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ABSTRACT (ENGLISH)

First of all, countries and multinationals will need to pick sides more. Global banking and capital markets will be the next to decouple. [...]the great decoupling is set to create new opportunities for Western equity investors as countries and firms that can attract the capital and investment that is leaving China will benefit.

FULL TEXT

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People talk about “reading the tea leaves” on China, but the results of the 20th party congress in Beijing this month were clear to anyone: Xi Jinping made a clean sweep, putting his men in the top party positions. He now has a clear field to pursue his preferred policies, and those policies are unlikely to be investor-friendly.

Markets have taken the outcome of the Congress badly. Investors must now reposition for a China where Xi Jinping’s credo reigns supreme. They must also brace for the expected backlash from the US, in the form of more sanctions and increased scrutiny of supply chains and investment ties that were once encouraged, a mere decade ago.

In other words, the great decoupling, which I first identified as a major investment theme three years ago, is now in full swing.

What does this mean? First of all, countries and multinationals will need to pick sides more. Companies that have put too many eggs in the China basket will be forced into a painful and costly reorientation. If they have too much manufacturing in China, they will need to reallocate; if they are too dependent on the Chinese consumer, they’ll need to brace for very slow growth for the foreseeable future.

Ideology and national security trump all other considerations for Xi, including growth. He will double down on “common prosperity”, achieving economic self-sufficiency and pressing to bring Taiwan definitively under mainland control. For foreign investors in China, this means new investments will be “steered” (more or less politely) to the priorities set by the Chinese state. Foreigners should not be surprised to find that operations at their joint ventures are “steered” too, with less of an eye for profitability and more of an eye for policy co-operation and doing the party’s bidding.

Meanwhile, US politicians and policymakers increasingly view any contact with China as suspicious. A Republican victory in the midterms would likely fast-track more measures against the country.

The fragmenting and doubling up of supply chains, as multinationals create parallel US-oriented and China-oriented production plans, will lower productivity globally. And it will continue to fuel inflation as the bifurcation of global supply chains sweeps from sector to sector over a lengthy period of time. Remember when China was said to “export deflation” post its 2001 entry into the World Trade Organization —now the reverse process is under way.

Global banking and capital markets will be the next to decouple. US restrictions of capital flows into China are on the horizon as Washington prepares to prevent America from funding the economic development of its main strategic adversary. Beijing is also working hard on creating its own sphere of economic and financial influence. It is intent on decoupling from the dollar-based global financial order as it views any such dependence as a strategic vulnerability.

China can do very little in the short-term to advance financial self-reliance. But the financial sanctions imposed by the west on Russia in response to its invasion of Ukraine have added urgency to Beijing's efforts to promote the international use of its own currency and cross-border payment system.

One financial measure China pounced on is initiating the break-up of HSBC. Mainland insurer Ping An, the bank's chief shareholder, may claim that the east-west split of the venerable Hong Kong bank would unlock more profitability, but make no mistake that the geopolitical considerations for a divorce are much more compelling.

Most of all, investors positioning themselves for the great decoupling must ensure their portfolios are insured against the risk of a conflict over Taiwan which now looms large.

"Bullish China" was a decades-long play that made many investors in Chinese companies listed abroad very rich. Now portfolio investors in countries which are likely to fall in the US sphere of influence would be wise to avoid Chinese onshore markets despite Beijing finally opening them to foreigners more or less fully.

But the great decoupling is set to create new opportunities for Western equity investors as countries and firms that can attract the capital and investment that is leaving China will benefit. Investors should look into companies that are less exposed to China than their peers from either a revenue or supply chain point of view. What lies ahead is nothing short of a fundamental rewiring of how the world works —but as ever, there will be winners as well as losers.

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