China: Less Growth, More Sovereign Wealth Funds

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China to continue with positive growth momentum for rest of the year

The first half of 2017 has been very positive for China in terms of growth. For the second quarter, growth rate stayed at 6.9%, topping the market expectation. Consumption spending has been the leading factor driving China's economic growth, accounting for the highest share of contribution to growth. Fixed asset investment recorded an 8.6% improvement and contributed more than 2% of GDP growth. China's external trade grew less than expected but were still resilient in August with exports and imports expanding 5.5% and 13.3% year on year, respectively. The deceleration in exports could be explained by a strong RMB in the past month as well as slightly weaker external demand, but the imports growing at two-digit rates for eight consecutive months indicates robust domestic demand. It would be expected for exports to ride on a downward trend amid tensions between China and the US and piling up global uncertainty, but the negative effects can be largely offset by stronger global demand. RMB appreciation is also expected to be temporary due to rapid wage growth rate and has likely peaked. This is forecasted to ease in the coming months, especially after the National Congress of the Communist Party celebrated in October 2017.

Consumption will be resilient for the next two years although a medium to long-term risk looms as household debt is rising extremely fast. This is related to both very high housing prices which push households to increase their leverage as well as different spending habits by younger generations with a much stronger focus on consumption. Still, some structural characteristics of the Chinese economy are there to remain, such as the limited welfare system and limited private insurance possibilities, should put brakes to the transition towards a more consumption based economy.

As regards investment, the most important driver of China's growth for many years, it has clearly held well in the first half of 2017 on the back of very lax monetary and fiscal policies. However, in the medium run, a secular slowdown is expected as a result of growth convergence.

There is also uncertainty confronting China's exports but the drag from a strong currency should be short-lived. Although the current appreciation trend of the currency has dragged down exports growth to 5.5% year on year, global recovery would add fuels to Chinese exports. Moreover, if this appreciation was just temporary, a stable export growth would follow in the second half of 2017. Overall, and not withstanding stable export growth, the increasingly consumption driven growth model should foster imports deteriorating the trade balance. The interesting thing is that, notwithstanding such deterioration, China has experienced a renewed –albeit very slow – period of accumulation of foreign reserves (for the 8th consecutive month) thanks to a better RMB sentiment and tamed capital outflows supported by draconian controls.

On the policy side, the People's Bank of China (PBoC) is still conducting a relatively lax monetary policy although less than in the past as the RMB appreciation is tightening financial conditions somewhat. Moreover, on the back of a strong currency and tamed capital outflows, the central bank has grown more confidence in its foreign exchange regime so that on September 12, it removed the FX forward reserves rule, facilitating the shortening of the RMB. So far, this has reverted the appreciation trend of the RMB. More generally, it looks reasonable to expect that the central bank will hold its stance in monetary policy and will not push forward any large-scale tightening or liquidity injection in the medium term.

Investment prospect generally optimistic notwithstanding some sectoral headwings

Although it is a fact that China has very low return on assets among emerging market economies, it is too early to be pessimistic about its long term economic prospects, at least for the short run, as the country still enjoys excess savings and huge domestic market. China continues to be one of the top recipients as well as exporters of foreign direct investment. The financial market is also undergoing reforms and relaxation of restrictions that promise huge opportunities for both domestic and global investors. At the same time, though, financial risks are looming as corporate leverage continues to pile up (already above 164% of GDP). China's leadership is taking action to address excessive corporate leverage in several fronts. One with immediate global consequences is the crack down on cross-border investment, especially purchases of iconic access in the real estate, sport or entertainment sectors. At the same time, investment in Belt and Road countries continues to be fostered. More generally, it is undeniable that private firms have incentives to channel their capital abroad given the deteriorated return on assets in China so that questions may be raised as to the extent to which such controls on some foreign acquisitions will be effective.

The grand Belt and Road Initiative (BRI) also becomes increasingly relevant to the Chinese economy as well as the rest of the world. In fact, following China's leadership aspirations, outward foreign direct investment (OFDI) from China into the BRI countries has been much more resilient to the 2017 slowdown than overall OFDI from China. In the same vein, according to the Ministry of Commerce, the newly signed foreign contracted projects in BRI countries now make up as much as 58% of China's total contracts overseas as of July 2017, rising from 45% two years ago. Trade is also increasingly geared towards the BRI countries as the growth of trade between China and these countries is clearly higher than average trade growth. 38% of Chinese goods are now exported to the BRI countries. Given that China cannot possibly finance the whole project on its own, the plan offers massive opportunities for global cooperation and investments.

Relevant risks looming in the medium term

High leverage, in the corporate sector as well as an increasingly narrow fiscal space are beyond doubt the primary risk facing China. In a longer time horizon, the household sector could further add to the debt concerns with mortgage debt being the key issue. However, at least for now, household debt is still under control, with most family holding net wealth.

While some advocates of China's successful deleverage process have cheered at M2 deceleration, the reality is that that is only a very narrow measure of leverage. A broader one, such as total social financing, offers a gloomier picture as it continues to grow well above nominal growth. The good news is that the leverage process appears to be slowing down.

Another source of risk, which is also related to corporate leverage, is the property sector. There is no doubt that real estate is still a vital sector for China to keep its growth rate target. Supported by rapid credit growth, housing prices, especially those in Tier-1 cities, have ballooned during the last two years. More recently, due to government's strong restrictions on housing investment, property prices have decelerated in first and second-tier cities since mid-2016. However, "burst of the bubble" is note expected in the property market for a number of reasons. First, the real estate sector is systemic enough not to expect a drastic and sudden correction of prices. In fact, it is closely intertwined by many other sectors of the Chinese economy. Second, the government's macro-prudential measures to tighten property prices are very much behind the current deceleration. Such measures could be eased if the fall in prices were excessively large or rapid. Third, demand will be strong as long as the capital account continues to be relatively close and no many other investment opportunities are available.

In a nutshell, short term gains both in growth and investment but increasing risks of longer term pains

The Communist Party's national congress held on 18 October and the election of the leadership of the party is another source of uncertainty. After the reelection of Xi Jinping, the party's major policy direction is a major uncertainty. It is expected that the currency and economic growth would soften following the party congress while more focus is put on deleveraging and reducing financial risks. All in all, hard landing scenario for China is quite improbable, yet the deleveraging process will dent China's growth in the short term while aging and the very low return on assets will do the rest in the medium term. Potential growth in China should be around 5% in the medium term, which - however- will not prevent China from acquiring more foreign assets abroad. On the contrary, the increasingly large accumulation of foreign assets – as rapid reversal of the current account surplus is not forecasted – coupled with a low return on domestic assets, should push China to invest abroad at a rapid pace as the stock of OFDI continues to be low compared to US or Europe. Thus, it would not be surprising to see more activity from Chinese sovereign wealth funds leading a new OFDI push in BRI countries and beyond. In the long run, rebalancing and supply side reform will determine how much China manages to grow and how successful its economic model will be.

Chinese Sovereign Funds

Chinese sovereign funds manage assets of more than two trillion dollars[1], which makes the Asian giant the reference market for this kind of world-scale institutional investors. China has six of these vehicles: China Investment Corporation, State Administration of Foreign Exchange, National Social Security Fund, Hong Kong Monetary Authority, Silk Road Fund and China-Africa Development Fund. Below, and without underestimating China-Africa Development Fund

1. This represents approximately 30% of the total assets managed by sovereign funds at a global level.

which manages assets for 10 billion dollars[2], we will analyze the composition and investment strategies of the first five. A key note is that these vehicles are not subject to the limitations and restrictions imposed by the Chinese government on investments abroad[3].

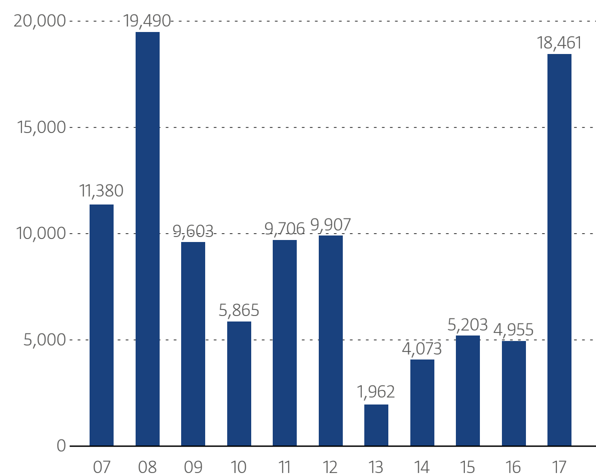
China Investment Corporation

Created by the Chinese government in 2007 with 200 billion dollars for the purpose of managing and diversifying its foreign currency reserves, this has been at the front line in the "Go Global" strategy and is one of the largest and most active sovereign funds on the planet[4]. Only in 2016 it performed 48 direct transactions. With assets of 813.5 billion dollars, CIC operates through three subsidiaries: CIC International (by means of which it manages its investment portfolio abroad), CIC Capital (through which it performs direct investments outside of China) and Central Huijin Investment (the division through which it invests in the main Chinese financial entities: in early 2016 it controlled 64% of Bank of China, 57% of China Construction Bank, 40% of Agricultural Bank of China and 35% of Industrial and Commercial Bank of China and China Development Bank).

It has a well-diversified portfolio, with the following asset allocation: variable income (45.8%), alternative assets (37.5%) and fixed income (15%). Investment in variable income is geographically distributed among the United States (51.3%), OCDE countries (37.6%) and emerging markets (11%). When it comes to lines of business, they concentrate on the financial sector (19%), information technologies (16.2%), large consumer areas (12.3%), industrial area (10.6%) and the health sector (10.5%). By contrast, in early 2016 fixed-income investments only amounted to 15% of the fund portfolio, with 53.9% corresponding to sovereign bonds of advanced economies, 27% to corporate bonds, 15.4% to structured products and the remaining 3.5% to sovereign bonds of emerging markets.

Figure 1

CIC's direct investments per year (2007-2017)



Source: Author's elaboration (2017).

If we focus on direct investments performed by CIC inside and outside of China during the period extending from 2007 to 2017, we can check that in only ten years the Chinese fund invested more than 100 billion dollars, with 2008 and 2017 having been the most active years (Figure 1).

Considering the lines of business, during the 2007-2017 period CIC devoted a significant portion of its direct investments to financial service companies (41.9 billion dollars), among which the 19 billion dollars injected into the Agricultural Bank of China through the subsidiary Central Huijin Investment in 2008 are worth mentioning, as well as the 6.8 billion dollars invested between 2007 and 2009 to acquire a share of approximately 10% in Morgan Stanley; infrastructures (25.3 billion dollars), among which are the 2.4 billion dollars contributed to China-Mexico Investment Fund in 2014 or the nearly 14 billion dollars mobilized for the purchase of Logicor in 2017; and energy companies (15 billion dollars) such as the 939 million dollars invested in 2009 to acquire 10.4% of Kazakh KazMunaiGas are worth mentioning, as well as the 3.2 billion dollars invested in 2011 to acquire 30% of the French GDF Suez (Figure 2).

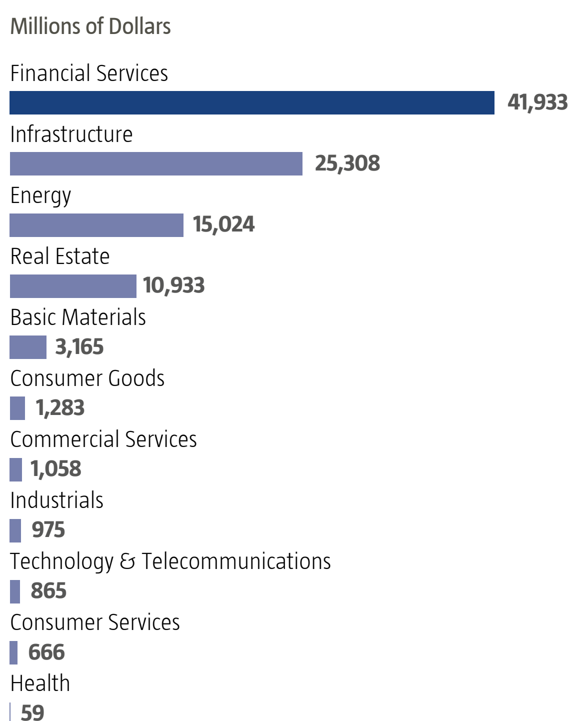
2. During the China-Africa Cooperation Forum held in Johannesburg in 2015, President Xi Jinping announced the injection of an additional 5 billion dollars into the fund to support the "10 Cooperation Programs" between China and Africa, thus raising the capacity of the fund to 10 billion dollars.

3. Policy to reduce the leveraging of Chinese companies, abate financial system risks and restrain the devaluation of Yuan and capital leakage.

4. Policy to promote the internationalization of Chinese companies and the integration of Chinese economy in the global market.

Figure 2

CIC's direct investments by sector (2007-2017)



Source: Author's elaboration (2017).

Finally, as far as regions are concerned we should point out that Asia-Pacific, with more than 39.5 billion dollars, has been the main direct investment target of the Chinese fund, followed by the Americas with 37.9 billion dollars as a whole and Europe, which received direct investments for 13.9 billion dollars during the period from 2007 to 2017 (Figure 3).

Although the share of real estate assets in the total investment portfolio is not known, CIC has been investing in this sector for years and on a direct basis in offices, retail stores and mixed-use premises, as shown by recent operations such as the purchase of 45% of the Manhattan's 1221 Avenue of the Americas for 1 billion dollars in 2016 or 1 New York Plaza for 700 million dollars, as well as in opportunity and core assets through specialized funds such as the Real Estate Turnaround Consortium, in which it invested 1 billion dollars in 2009, or GLP Japan Income Partners I, where it agreed to contribute 183 million dollars in 2012. In 2017, encouraged by the high returns resulting from the development of e-commerce, it has taken part in the second largest real estate transaction in history up to date: the purchase of Logicor from Blackstone for 13.8 billion dollars. This is one of the largest logistics companies in Europe, maintaining in Spain a logistic assets portfolio of more than 1 million square meters. With the real estate operations, CIC seeks, just like other funds, to: a) protect itself from inflation, b) obtain income on an ongoing and stable basis, and c) generate returns with minimum risk.

In early 2016, CIC rebalanced its portfolio by reducing its exposure to emerging market bonds and US bonds adjusted by inflation and by increasing its share in variable-income investments in developed economies and, therefore, in direct real assets. As of December 31, 2016, 66.11% of the fund portfolio was administered by external managers and only 33.89% was internally managed. Since its creation, it has earned 4.76% (Figure 4).

State Administration of Foreign Exchange (SAFE)

SAFE is controlled by the central bank of China and has offices in Beijing, Hong Kong, New York, Singapore and London. It manages assets for 474 billion dollars and is the agency responsible for: a) managing the foreign currency and gold reserves of the country, and b) regulating the foreign currency market within China. Since its foundation in 1997, SAFE's strategy lies in preserving the value of the foreign currency reserves it manages (3.1 trillion dollars in late 2017[5]) and controlling, as far as possible, renminbi fluctuations with respect to the US dollar. For this reason, a significant portion of the fund portfolio is invested in US dollar-denominated assets.

5. Reuters (2017).

Table 1
Main SAFE Direct Investments (2008-2015)

Name	Sector	Country	Investment (US$M)	Stake	Year
Total	Energy	France	2,832	1.6%	2008
BP	Energy	UK	1,951	0.9%	2008
Eni	Energy	Italy	1,764	2.1%	2014
Intesa Sanpaolo	Financial Services	Italy	1,216	2.0%	2015
Enel	Energy	Italy	926	2.0%	2014
Unicredit	Financial Services	Italy	724	2.0%	2015
Angel Trains	Infrastructure	UK	548	10.0%	2015
Telecom Italia	Telecommunications	Italy	438	2.0%	2014
Madrileña Red de Gas	Energy	Spain	423	30.0%	2015
Fiat Chrysler	Industrials	Italy	241	2.0%	2014

Source: Compiled by the authors (2016).

Although the composition of the fund portfolio has never been publicly disclosed, the direct investments made by SAFE over the last years show a conservative, risk-avoiding asset allocation, with practically the whole fund being invested in traditional (fixed- and variable-income) assets and where the so-called alternative assets, with the exception of real estate, are nowhere to be seen. Variable-income investments concentrate on large European corporations in widely different lines of business (Table 1) such as the financial sector (it holds 0.9% of Barclays), the energy business (it acquired 1.6% of the French Total) and telecommunications (it holds 30% in Madrileña Red de Gas).

Following the example of Italy, Spain could seize SAFE's acquisition of a shareholding in Madrileña Red de Gas to establish a closer relationship with the fund as a whole and with its European subsidiary Gingko Tree Investment in particular, with a view to attracting more investments of the fund to the country.

On the other hand, fixed-income investments are highly exposed to US treasury bonds, which represent the largest and most important item of the portfolio although, over the last years and as a result of increased trade with Europe and other emerging markets, SAFE has managed to diversify its portfolio to a certain extent. In the real estate sector, SAFE invests mainly[6] through Gingko Tree Investment[7]. Created in 2010 and headquartered in London, this vehicle 100% owned by SAFE has been used to invest in offices, residential homes and retail stores in Europe. It has also been involved in operations like the purchase in 2014 of 33 Holborn St. in London for 208 million dollars or, more recently, the purchase in 2015 of Siemens offices in Munich for 136 million Euros.

National Social Security Fund (NSSF)

Created in 2010 by the Central Committee of the Chinese Communist Party and the State Council, the main mission of NSSF is to support the Chinese public pension system by operating as a last-instance lender where provincial governments of the country are unable to meet their pension obligations. This constitutes one of the main challenges of the country, not only because of the unsettling rate of

6. In 2012 it injected 500 million dollars into Blackstone Real Estate Partners VII opportunities fund to build a presence in non-European markets such as USA and more recently, in 2015, it undertook to inject 250 million dollars in ASR Dutch Prime Retail Fund L.P. to gain more exposure in Dutch retail business.

7. This division has also been used by SAFE to invest in other sectors, such as energy (Madrileña Red de Gas in Spain) and infrastructure (Angel Trains in the United Kingdom).

population ageing but because the much desired change of the economic model consisting of moving from an export-based to an internal demand economy is largely based on consolidating a public pension and health system. Otherwise, a large portion of the population will continue to save a significant percentage of their income to: a) secure an adequate retirement pay at old age, and b) be able to cope with any upcoming health issues.

The more than 317 billion dollars currently under management come from widely different sources, the main ones being the accounts reserved for that purpose in the general budget of the Chinese state and the proceeds of the sale of stock of Chinese state companies. They are additionally increased by state fees on gambling and by funds obtained from redemption of securities.

Fifty-four per cent of its portfolio lies in the hands of external managers[8]. This fund is highly focused on the Chinese market: only 6% of its portfolio (some 17 billion dollars) is invested in assets outside of China, mainly in variable income (being authorized to invest up to 20% of the total portfolio in foreign variable income) and fixed income (it is not known what percentage of the minimum 40% of the portfolio required to be invested in fixed income is invested in foreign assets). Since its establishment, it has obtained an average return of 8.4%[9]. This is, beyond any doubt, the most domestic Chinese sovereign fund in relation to which there is the least information available.

Hong Kong Monetary Authority (HKMA)

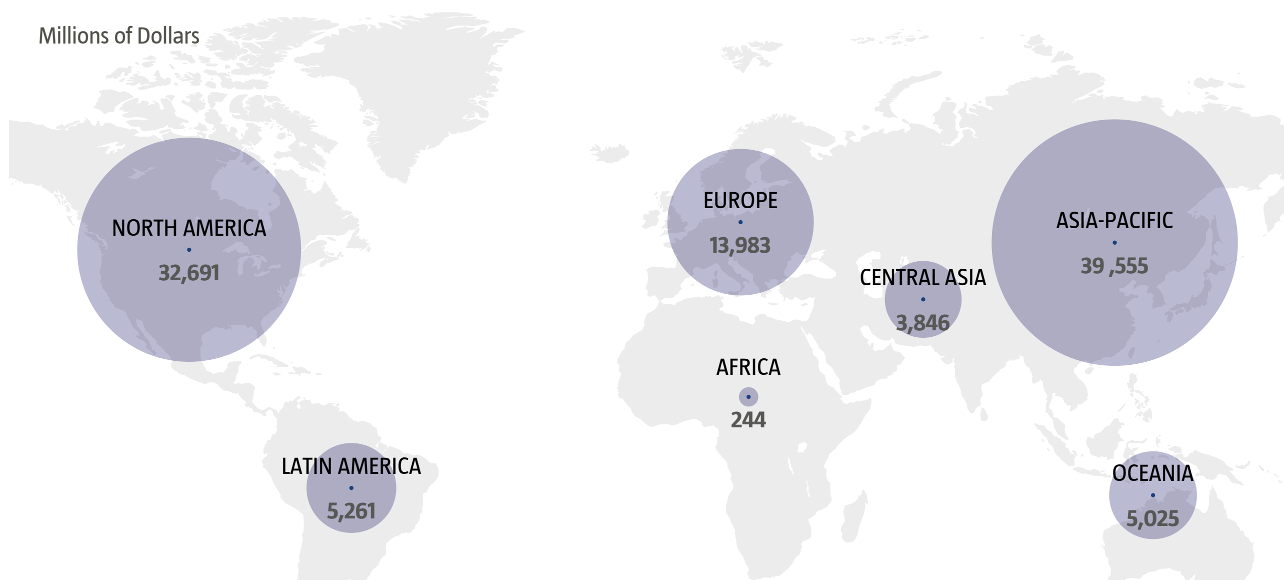
The central bank of Hong Kong, whose mission is to guarantee currency and banking stability in the special administrative region of China, has a vehicle to manage foreign currency reserves that functions as a sovereign fund: the Exchange Fund.

8. Information from late 2015.

9. Bloomberg (2017).

Figure 3

CIC's direct investments by region (2007-2017)



Source: Author's elaboration (2017).

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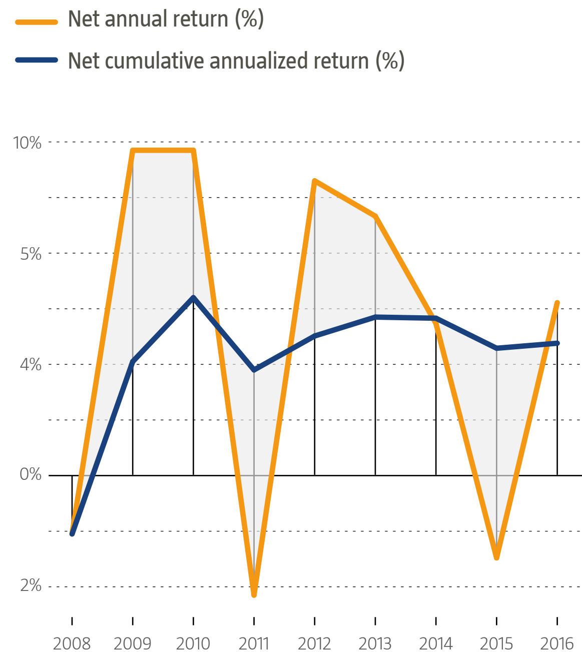
It manages assets for 500 billion dollars[10] and has a well-diversified portfolio, divided into the so-called Backing Portfolio, Investment Portfolio, Strategic Portfolio and Long-Term Growth Portfolio (LTGP), whose main purposes are: a) to preserve the capital of the fund, b) to furnish the market with liquidity to keep Hong Kong's financial and currency stability, and c) to generate attractive long-term returns for the fund. The Backing Portfolio guarantees that Hong Kong dollar is at all times fully backed by highly liquid securities denominated in US dollars. The Investment Portfolio is composed of bonds and stock of OCDE country companies, thus preserving the long-term purchasing power of the fund. The Strategic Portfolio was created in 2007 to gather Hong Kong government shares in the stock market. Finally, LTGP is the portfolio used by the fund since 2009, when it was created to invest in alternative assets such as real estate or private equity, thus enabling the vehicle to obtain higher returns.

Furthermore, since June last year it has been provided with the Future Fund[11], a 28-billion-dollar vehicle aimed at facing any budget deficits and funding the future needs of coming Hong Kong generations, with which they expect to invest 14 billion dollars in real estate and private equity in the next three years.

Approximately 25% of the Exchange Fund portfolio lies in the hands of external managers, who perform and manage all the variable-income fund investments contained in the Investment Portfolio. Toward the end of 2016, 16.1% of the Exchange Fund portfolio was invested in variable income: 25% in Hong Kong company shares and the remaining 75% in foreign company stock, mainly from OCDE countries[12]. At the mentioned dates, the fund also declared it had 68% of its total portfolio invested in fixed income (showing a clear preference for debt markets of OCDE countries over emerging markets). Besides, Exchange Fund has 3.1% invested in private equity (through distressed debt and venture capital funds, with exposure to Asia, Europe and North America) and 1.7% in real estate (prime assets in cities such as Paris, London and Los Angeles). In this sector, it invests through its subsidiary Real Gate Investment Company, with which

Figure 4

Net cumulative annualized return Vs net annual return (2008-2016)



Source: CIC Annual Report (2016).

it has performed highly publicized transactions such as the purchase in London of 10 Aldermanbury Square for 390 million dollars in 2012 or, more recently, the purchase of Century Plaza Towers in Los Angeles for 393 million dollars in 2015.

10. June 2017.

11 . Management affiliated to LTGP.

12. Over the last years, there has been an increase of its exposure to China and other emerging markets.

Silk Road Fund

This has been the latest fund to be created. It was established with a sole purpose, that of decisively contributing to the development of One Belt, One Road strategy, Beijing's pharaonic project to reinforce its leadership in world trade and strengthen China as the first economic power.

Chinese President Xi Jinping announced its launching on November 8, 2014, but it was established only on November 29 that year. For its implementation, the Chinese government mobilized 10 billion dollars, of which 6.5 billion were contributed by SAFE, 1.5 billion by CIC, another 1.5 billion by the Export-Import Bank of China and 500 million by the China Development Fund. At present, it has 40 billion dollars to be invested throughout the Silk Road Economic Belt (by land) and the 21st-Century Maritime Silk Road (by sea) in companies (equity), bonds (debt) and funds (sub-funds) for the development of different kinds of infrastructure (transportation, energy, etc.) as well as projects related to the extraction, transformation and trade of certain natural resources.

Up to March 2017, the fund had performed investments and agreed to furnish funds for 6 billion dollars, among which it is worth mentioning the purchase of 10% of the Russian petrochemical Sibur, the acquisition of a 5% share in Italian concessionaire Autostrade per l'Italia (ASPI) and the contribution of 2 billion dollars to set into operation the China-Kazakhstan Production Capacity Cooperation Fund. Spain should take advantage of the fact that Valencia has been included in the new silk road to develop a strategy aimed at: a) attracting investments to the country from this fund in particular and from Chinese funds in general, and b) helping our infrastructure, utility and other companies to develop with the help of this fund part of the ambitious plan for Beijing's expansion and internationalization