BlackRock.

**Portfolio perspectives**
May 2021

# Sizing China in strategic allocations

Globalization rewired and the role for Chinese assets

BlackRock
**Investment**
Institute

# Introduction

BlackRock's focus on investing for the long term is reflected in the way we approach markets that are new to many global investors. Investors tend to be late in "discovering" economies that have already reached critical importance. China is no different. The country's economy and capital markets have rapidly grown to become the second-largest in the world, yet foreign investors own only about 4% of onshore equities and about 3% of onshore government bonds.[1]

The BlackRock Investment Institute introduced a strategic overweight to Chinese assets in late 2019 for their potential diversification and return opportunities. Since then, the geopolitical trend toward a bipolar U.S.-China world order has accelerated, with competition and bifurcation in the technology sector at its core. We are seeing increased emphasis in both countries on seeking self-sufficiency in the critical industries of the future.

Intense rivalry looks set to affect nearly every dimension of the U.S.-China relationship. The U.S. has criticized Beijing on human rights issues. Other countries will increasingly be pushed to choose sides. Covid-19 has supercharged the strategic competition and also led to a rewiring of global supply chains for greater resiliency. We believe all this means that investors need exposure to both markets, especially as the center of gravity of global growth is moving to Asia.

Investors need to balance the investment case for gaining exposure to both centers of growth with their objectives and constraints, as well as with possible investment restrictions on each side. Greater geopolitical fragmentation means that portfolio resilience will have to be driven by deliberate diversification across countries, sectors and companies.

How to implement exposure to the Chinese sphere of growth? First, it is often hard to separate politics from markets, and we believe this is partly why the Chinese risk premium – the compensation investors demand for holding Chinese assets – is elevated. Geopolitical risks are real yet we believe investors should focus on the assets and company characteristics.

Second, engagement enables investors to share expectations for companies in which they invest. BlackRock's Investment Stewardship team engages with companies, including Chinese ones, to champion the governance and sustainability goals of our global engagement priorities. Finally, it's not just about Chinese assets; it's about investing in countries, sectors and companies that are leveraged to Chinese growth. This is why this publication is about *China-related* assets.

**Philipp Hildebrand**
Vice Chairman, BlackRock

**Rachel Lord**
Head of Asia Pacific, BlackRock

# Table of Contents



1. People's Bank of China, as of Q4 2020, includes publicly-listed Chinese equity securities denominated in renminbi, incorporated in China and onshore bond issuance, including both government and corporate debt.

# Summary


- China has emerged from the pandemic with renewed confidence – just as it did after the global financial crisis (GFC). Growth has bounced back to trend, and foreign direct investment inflows are surging. Concerns over high debt levels are no longer the starting point in our conversations about investing in China given the joint monetary-fiscal policy coordination in developed market economies that has seen their debt levels soar to record levels.
- Balanced geographic exposures are vital for real portfolio resilience in a world where globalization is being rewired. The bifurcation of the world into dual poles of growth – one U.S.-centric and one China-centric – is accelerating even as deep linkages between the two persist. The competition for dominance in key technologies, in particular, is intensifying, in our view, as China strives for self-reliance.
- A stable domestic economic backdrop and increasing strategic competition with the U.S. have Chinese authorities emphasizing the *quality* of growth over the *quantity*, in our view. This points to greater emphasis on reducing risks in the financial sector, pursuing self-sufficiency in energy and reducing dependency on imported technological know-how. We think China's focus on quality should lead to more productive companies over time.
- The size of China's economy already dwarfs the country's weight in global equity and debt benchmarks. The sheer magnitude of China's growth and its improving quality are among the reasons why we see return and diversification opportunities over a strategic horizon. Our research on a hypothetical portfolio suggests that allocations to China may have helped cushion past episodes of market turbulence. And we expect returns on Chinese equities and bonds to outpace developed market peers on a strategic horizon thanks to relatively high earnings growth, equity risk premia and bond yields, albeit with greater uncertainty.
- We see deliberate China exposures, taken directly or indirectly, across public and private markets as core strategic holdings distinct from emerging markets (EMs). Yet such exposures are absent in many investor portfolios or held in very small quantities via broad EM allocations. An internal BlackRock survey of institutional investors across EMEA shows investor allocations to China are nowhere near global benchmark weights – and we believe these already underrepresent China's importance to global portfolios. We believe even a "neutral" strategic allocation to China, by contrast, is significantly higher than current index weights.
- Popular wisdom has it that investing in China and being climate-friendly are at odds. We disagree. China's commitment to a net-zero economy by 2060 was an important step – not just for its own economy, but for global progress toward climate goals. Our work shows China's economy stands to benefit the most among major nations from a "green" transition to a more sustainable world, rather than a scenario of no climate action. An important caveat: we believe it is in China's interests to tackle climate change, yet we will have to monitor closely whether its actions and policies match commitments at the same level as we are seeing in the U.S. and the euro area.
- From an investing perspective, the sector composition of China equity indexes differs from the broader economy and is much more tilted toward sectors that we believe will benefit in the long green transition, such as technology. Concerns around social and governance issues are likely to persist. Yet we believe it is important to distinguish between the state of play today versus the direction of travel and to engage with companies on sustainability goals.
- The bottom line: We believe the need to gain exposure to the Chinese pole of growth in portfolios has only gotten stronger since we first wrote about our overweight stance in the *Portfolio perspectives* of November 2019. The risks to holding Chinese assets – such as the escalating tensions with the West – cannot be overlooked. Yet we expect investors to be compensated for these risks over a strategic horizon.


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# A stronger narrative post-Covid

The narrative around China has shifted away markedly, in our view, from concerns about the health of its financial system and credit-fueled growth. Its economic and market outperformance through yet another global shock has brought sharply into focus the important role Chinese assets can play in helping bring resilience to strategic portfolios. It has also deepened our conviction in an overall overweight stance on Chinese assets. Such a view was already in place due to relatively better expected returns for Chinese assets over peers and their diversification potential.

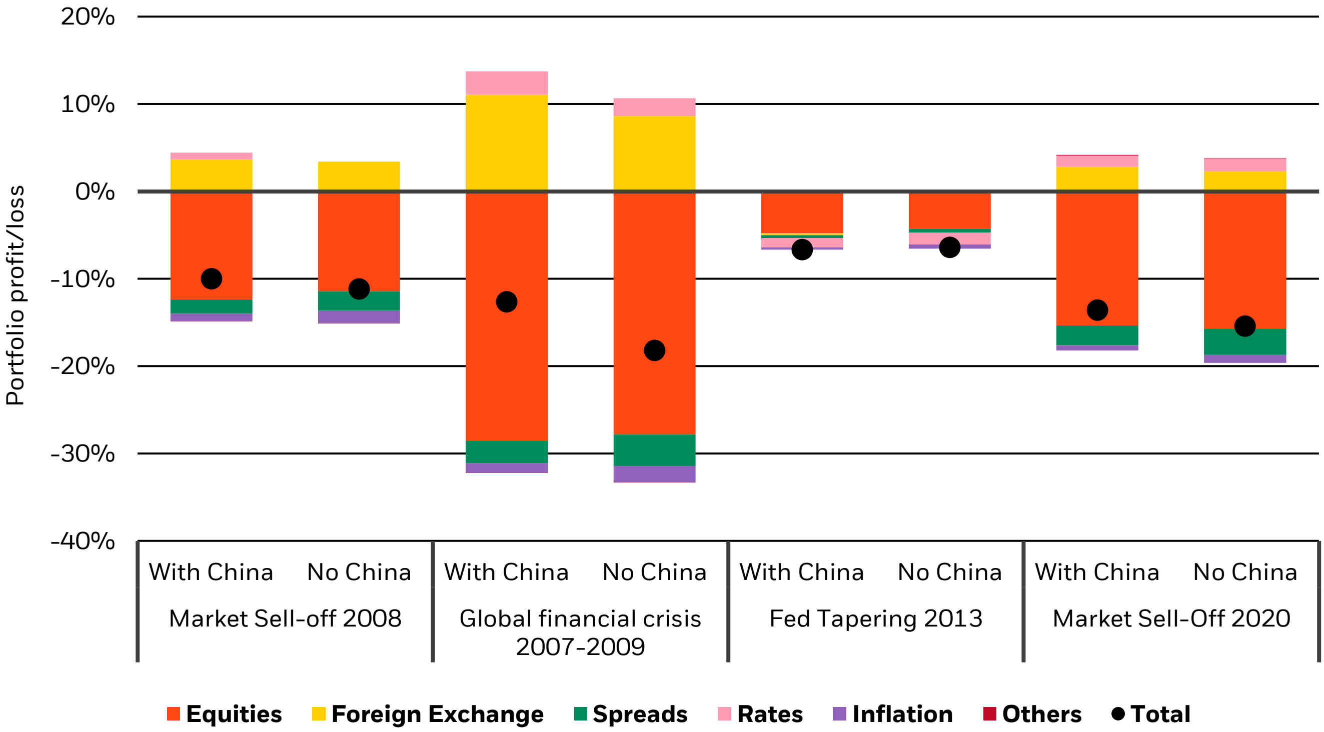
In 2019, we argued an above-index weight allocation to China-related assets could increase a portfolio's potential returns and diversification. The acceleration of structural trends in the aftermath of the Covid shock has helped further crystalize our views on Chinese assets. The joint monetary-fiscal revolution in developed economies has seen developed market interest rates plummet and lengthened the lower-for-longer outlook, adding to questions around the role of nominal government bonds as portfolio ballast. The income and portfolio ballast properties of China government bonds look relatively attractive at a time when developed market government bonds' ballast properties have been diminished. Global debt levels have risen sharply as Western governments have put in place a fiscal impulse many multiples of what was seen during the GFC even as the overall estimated economic loss from the Covid shock is expected to be a fraction. We believe China's overall debt levels should be viewed in this context.

More importantly, the policy response in China to the Covid shock has been more measured. The economy has rebounded without adding huge new debt – an important evolution that speaks to the focus on the quality of growth over the quantity, as we discuss on page 6. Record growth in foreign direct investment and Chinese exports through the past year went against popular expectations around an overhaul of global supply chains away from China. This economic resilience is ever more important in a bi-polar world with two poles of growth – one U.S.-centric and the other China-centric – that is likely to result in a decoupling of economies and investment opportunities.

The chart below shows the performance of a hypothetical UK multi-asset portfolio with and without an explicit allocation to Chinese government bonds and equities through four major market events in the past 15 years. See the appendix on page 12 for a full breakdown of assets in the portfolios. In three of the four periods, an allocation to Chinese assets may have helped the portfolio better weather these episodes of market turbulence.

### Seeking new diversification

Performance of hypothetical UK multi-asset portfolio with and without China assets during various risk-off periods




**The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selection a product or strategy. Indexes are unmanaged and not subject to fees. It is not possible to invest in an index** Sources: BlackRock Investment Institute, with data from Refinitiv, May 2021. Notes: The chart shows the performance of a hypothetical UK family office multi-asset portfolio through four periods of global market stress in the last 15 years. The dates for the specific scenarios considered are: 2008 market selloff (Sept.12-Nov. 3, 2008), Global financial crisis (Dec 3, 2007 – Mar 9, 2009), Fed tapering (May 21, 2013 – June 24, 2013), market selloff 2020 (Feb. 19, 2020 – March 23, 2020). Risk calculations are performed using BlackRock Solutions Aladdin risk model. Index proxies are shown on page 12 in the appendix. The chart performance analysis shown above is for informational purposes only. It should not be misinterpreted as constituting the actual performance of any particular asset class or strategy and should not be relied upon in connection with any investment decision. This data presented represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any security in particular.

# Globalization rewired

China's presence on the global stage is becoming ever more prominent. Yet the country's representation in benchmark indexes is far below its rising economic and technological heft, as shown in the chart below on the left. Trade volumes have rebounded as March 2021 data from China's National Bureau of Statistics showed while data from the Ministry of Commerce showed foreign direct investment hit a record in 2020. Both suggest that U.S.-China trade tensions did little to impede the country's rise. Yet the true picture is more nuanced. To be sure, the path forward for U.S.-China relations may be more predictable under U.S. President Joe Biden's administration compared with recent years. The U.S. and China have committed to working together to tackle climate change, suggesting some re-engagement on key global issues. Yet we believe the strategic rivalry between the two powers – across multiple dimensions – is likely to persist.

Economically, China's ambition is to double gross domestic product (GDP) by 2035 – to surpass the U.S. and firmly shift the center of gravity for global growth to Asia.[2] See the chart on the right. China's wide-ranging plans touch many flash points in the U.S.-China relationship, with the Covid pandemic amplifying each country's focus on economic resilience. Secure supply chains and self-sufficiency in critical technologies and industries are a strategic priority and could drive a rewiring of global trade. Intensifying competition on key technologies, such as 5G and semiconductors, is one example.

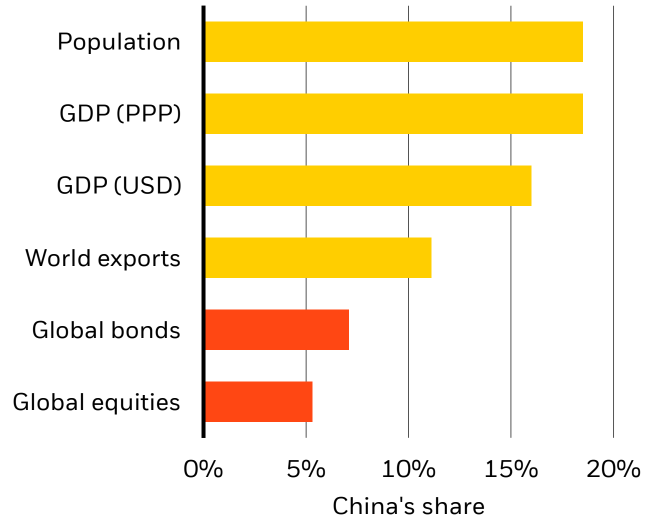
A key component of China's strategy is "dual circulation." First floated by China's leadership in May 2020, dual circulation is the concept of increasing the economy's resilience by a greater emphasis on supply and demand within the domestic economy while also increasing economic links with the rest of the world. Recent trade deals indicate changing future trade patterns rather than declining trade - between China and its regional partners through the RCEP (Regional Comprehensive Economic Partnership) and further afield with the European Union. RCEP – covering 30% of global GDP - brings China closer to South Korea, Japan and Southeast Asia.[3] We could increasingly see countries aligning with the two poles of growth – U.S.- and China-led – and even being forced to choose between the two.

China's linkages with global markets are poised to deepen – via greater index inclusion and openness to foreign investors – at the same time economic linkages are being remapped. For decades, the world was moving in a more globalized direction. Broadly, this meant that geographic exposures, such as country and region selection, were becoming less important. We believe that a considered approach to geographical diversification becomes increasingly important in a world where the almost one-way direction of travel for globalization has been interrupted. The splits across countries and regions - particularly the U.S. and China - and sectors such as technology are growing in prominence. This is true both from a return perspective - taking exposure to both engines of growth, as well as from a risk and diversification perspective - holding a greater balance of assets that are less correlated to each other.

The potential role Chinese assets can play in strategic portfolios highlights a key tenet of our broader investment views: portfolio resilience may well be driven by deliberate diversification across countries, sectors and regions rather than broad asset class correlations. Growing return dispersion between regions due to a bifurcated world with the U.S. and China at opposite poles – see the *Engines of growth* chart below – creates more return diversification potential.

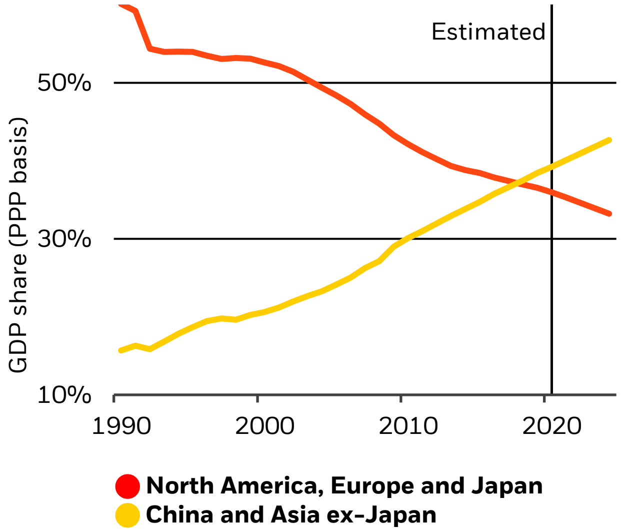
### Too big to miss

China's global share in various categories, April 2020




### Engines of growth and diversification

Regional share of global GDP, 1990-2024




**This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index** Sources: BlackRock Investment Institute and IMF, with data from Datastream Refinitiv, June 2020. Notes: The left chart show shows China's representation across major macro and market metrics. We use the Bloomberg Barclays Global Aggregate Index and MSCI ACWI equity index as proxies for global bonds and equities respectively. The right chart shows each region's combined share of global GDP on a purchasing power parity basis.

2. President Xi Jinping speech outlining China's 14th Five-Year Plan. http://www.xinhuanet.com/english/2020-11/03/c_139488075.htm
3. Brookings Institute, November 2020. RCEP: A new trade agreement that will shape global economics and politics, November 2020.

# China's quality revolution

Both the West and China are undergoing a *policy revolution* – one of our key themes since the Covid-19 shock struck. But crucially, these revolutions are very different. Western economies are blending large fiscal and monetary stimulus, with the hope that the scale of such policy support can help achieve societal aims beyond a narrow inflation goal. In China, we believe the revolution is a sincere effort to move away from an overriding focus on the quantity of growth towards a greater focus on the *quality* of growth. The chart below shows how the rise in overall indebtedness in the West has brought total debt as a share of GDP in the U.S. and euro area to a similar level to that of China's.

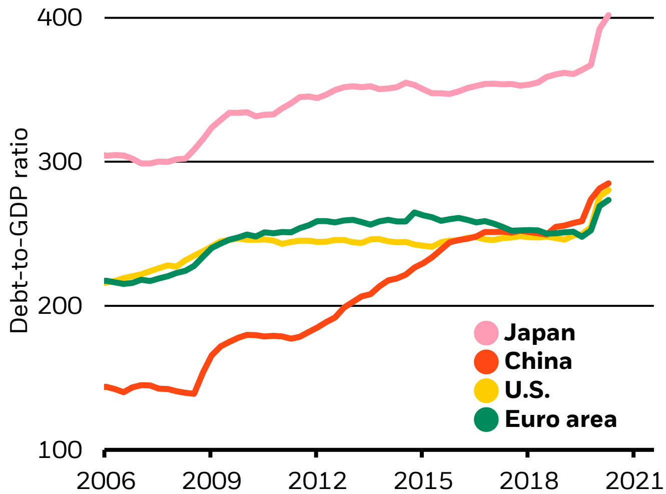
What does "quality" entail? In the context of China's growth outlook, we believe it covers at least three areas highlighted by President Xi Jinping in 2017: the environment, economic wellbeing and stability of the financial system.[4] In other words, China wants to become a more productive economy with each unit of incremental GDP generating proportionately less pollution, inequality and financial risk (debt). The chart on the right shows China's spending on scientific research and development as a share of GDP has doubled over the past two decades – another step toward achieving its ambition of becoming an advanced, self-reliant country. We believe China will prioritize reforms that emphasize these goals as policymakers view them as mission-critical.

There is a lot of complexity to answering the question on whether China has taken steps to achieve its aims. But overall, we would say it has. Take for instance the battle against financial instability. Even under the stress of U.S.-China tensions and a pandemic – and the perennial concerns around China's financial system fragility – China is a notable outlier among the world's largest economies with its relative lack of sizable fiscal stimulus over the last year. Why? Partly because China needed less stimulus due to its relatively better experience during the pandemic. But beyond this, we would contend that it also speaks to how leery China is of hitting the stimulus gas pedal. This is very different from the experience in previous downturns – most obviously during the GFC. Indeed, China has not only avoided hitting the gas pedal on stimulus, but it has also erred on the side of keeping its overall policy stance somewhat tight. This is a fundamentally different approach to that which we are seeing in major economies. We expect major economies will tolerate more inflation in order to prioritize more inclusive growth. China's bias is for somewhat tighter policy as a fundamental part of fighting the "critical battle" against financial instability.

Two risks investors may need to watch for are China's effort to restructure its credit markets and crack down on monopolistic practices, particularly in the private sector. Allowing so-called 'zombie' companies to fail is one aspect of the former, while reining in the tech sector is an example of the latter. We don't believe letting zombie companies fail will lead to systemic risks. In fact, we see it as a step towards a healthier economy. We believe the focus on quality should lead to more productive companies over time, providing investors opportunities in onshore credit and equity markets. Yet it raises the risk in the near term of defaults, job losses and worries around systemic stability. The re-assertion of state control over the economy could also undermine the rule of law if state-owned enterprises are favored over private companies. Near-term uncertainties suggest we are unlikely to see a repeat of 2020's China risk asset rally this year even as its restart accelerates. Selectivity is key, and on a tactical basis we prefer pivoting equity exposures toward cyclical and domestically oriented sectors. We are also sticking by our preference for local Chinese government bonds even as monetary policy becomes relatively tighter given their portfolio diversification potential.

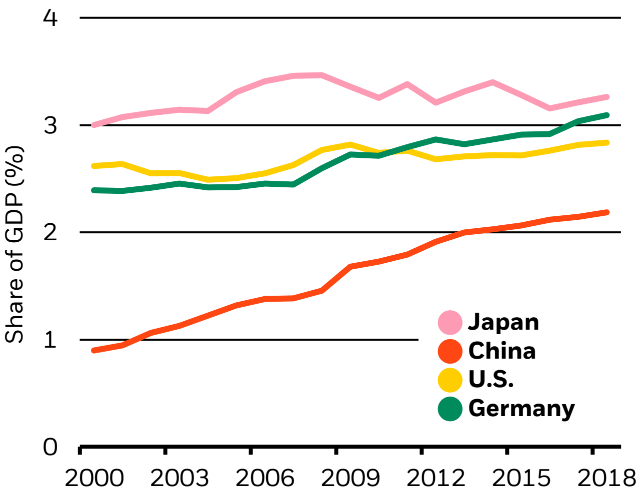
**Policy revolutions**

Debt-to-GDP, 2006-2021




**Up the value chain**

R&D spending as share of GDP, 2000-2018




Sources: BlackRock Investment Institute, Bank for International Settlements, WIND and Refinitiv Datastream, May2021. Notes: The left chart shows total debt comprising government debt, household debt and borrowing by non-financial corporates as a percentage of GDP. Data is as of Q3 2020. The chart on the right shows the share of annual GDP that each country spends on research and development.

4. President Xi Jinping outlined China's priorities at the keynote speech of the World Economic Forum gathering in Davos in January 2017.

# Tapping into private markets

China's quality revolution and the structural changes we see unfolding in the economy have important implications for the fast-growing market for private assets. The dual circulation strategy, a push to become carbon neutral by 2060 and urbanization are long-term transformations that may not be fully captured by assets listed and traded on public markets today, in our view. Asia-Pacific private capital returns over longer time horizons such as the past five, 10- or 20-years have outpaced those in regional public markets, according to Preqin data as of September 2020. Yet we believe manager selection is key when it comes to private markets. Investors wanting to participate in China's structural transformations may want to consider doing so via private markets but should be cognizant of the risks involved.

Private market investing in emerging economies is not a new concept, yet the risks and uncertainty are higher than in developed economies. Investors in private markets are typically tying up capital for long periods of time. This long investment horizon may leave them vulnerable to changes in rules and regulation that evolve more rapidly in developing economies than they do in developed peers. Local expertise is essential to understanding the nuances, complex structures in place and potential counterparty risks. Maintaining long-term relationships with sponsors, Chinese banks and companies is also key, in our view. Data availability and verification is difficult – a key reason why we do not currently estimate returns for Chinese private market assets as part of our capital market assumptions (CMAs). We believe private markets offer opportunities for investors cognizant of these risks, and we see the asset class as more of an "alpha" story where selectivity will be key rather than a story of "beta," or broad exposure.

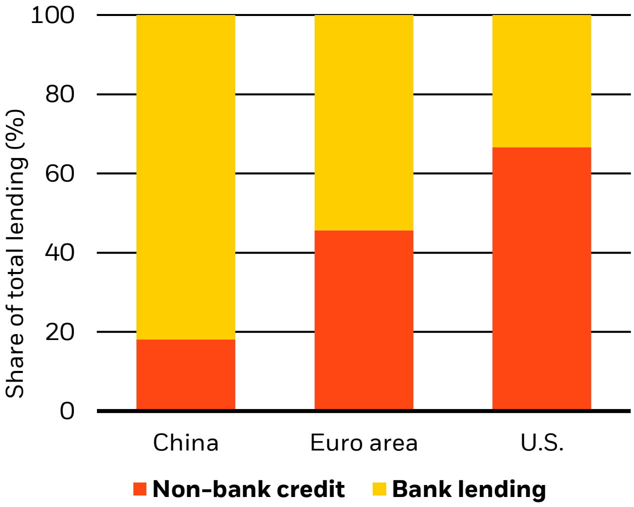
Private market activity in China has been traditionally led by domestic investors. Yet elements of the quality revolution may help change this. We think Chinese authorities see it in the economy's interests to entice foreign capital to play a bigger role in the development of its onshore financial system. Last year the country's Qualified Foreign Institutional Investor scheme was changed to open up onshore private funds to foreign investors – one sign that authorities are warming up to foreign capital.

Private credit, real estate and private equity are among the areas we see growing rapidly in China. Stability of the financial system is another core tenet of China's quality revolution. An important pillar of this objective is a desire among policymakers to crack down on shadow banking while gradually promoting sources of capital outside of the traditional banking system. The chart on the left below compares how non-bank credit as a share of total corporate borrowing in China compared to selected peers as of last year. We believe private lending has an important role to play in plugging the gap created by the retreat of shadow banking. Changes to bankruptcy laws will help create a healthier and deeper credit market, in our view.

We believe private markets may be better placed to offer targeted exposure to emerging domestic trends in China. A Bain & Company Asia-Pacific private equity survey found investors expect the biggest growth in funding businesses driven by digitization, as shown on the right below. Simple allocations to onshore equity markets mean less exposure to sectors with growth opportunities, underscoring the appeal of tapping private markets. China's urbanization drive – a major policy initiative – is another example. Urbanization in China still lags behind global peers, yet is growing at a fast clip. A McKinsey study showed China's headed for an urbanization rate of about 58 percent by 2030 – a level well below that of high-income economies, creating opportunities in residential real estate and infrastructure, in our view.[5]

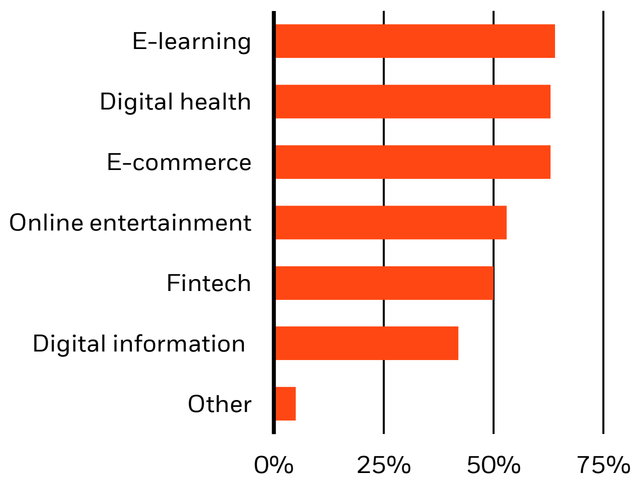
### Room to grow

Breakdown of corporate lending, September 2020




### Growth opportunities

Private market sectors seeing long-term growth , 2021




Sources: Blackrock Investment Institute, Bank for International Settlements, Bain & Company, May 2021. Notes: the left chart shows the share of banks and non-banking financial institutions in total corporate lending in China, the euro area as a whole and the U.S. Data is as of September 2020, the latest available from the BIS. The chart on the right shows the sectors in which Asia-Pacific private market investors expect long-term growth according to a Bain & Co 2021 survey

5. McKinsey Global Institute, June 2019, China and the World

# Sustainability in focus

Sustainability will be a powerful driver of global returns in the medium term, in our view, and ever more central to all investment decisions. There are many aspects to sustainability – and the weight placed on each differs across investors. As a result, the overall assessment of China is investor specific. We consider both the current status as well as the direction of travel when it comes to assessing China's sustainability credentials. We see improvement on several fronts – notably its environmental commitments – but recognize there is further to go, and commitments need to be realized.

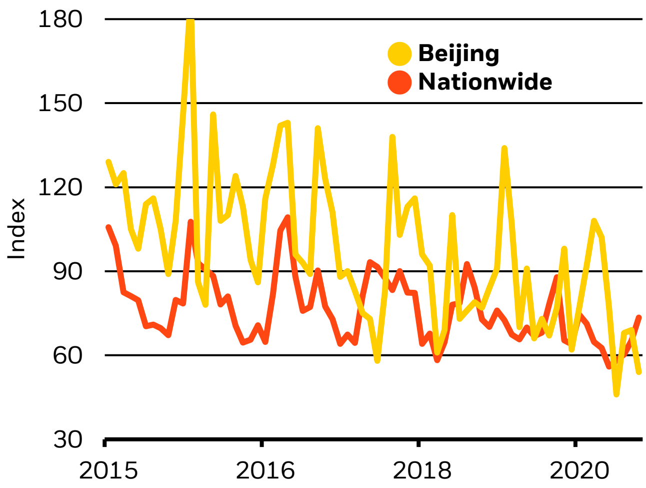
Our CMAs incorporate the impact of climate change on long-term asset returns. We believe the popular wisdom that investing in China is incompatible with being climate-friendly is wrong. In our CMAs we focus on the E in ESG. Why? First, there is wide recognition of the importance of climate change for economic and social outcomes. Second, there is consensus on the measurement of an entity's contribution to climate change via carbon emissions. These factors suggest climate change will be a driver of returns at the broad market level. See our paper *Climate change: Turning investment risk into opportunity* of February 2021 for more. Our overweight to Chinese assets versus benchmark indexes does not change after taking into account the impact on climate change on expected returns. The composition of Chinese equity indexes is better aligned than the broader economy to the transition to a low-carbon world, in our view. For instance, data from the World Bank shows China's industrial sector accounting for about 39% of GDP in 2019. Yet industrials only make up 5% of the MSCI China index, which has a higher concentration in the 'greener' sectors, such as consumer discretionary (34%) and consumer services (20%), according to a March 31, 2021 MSCI fact sheet.

China's rapid economic development has come at a high environmental cost, much like today's developed nations experienced in previous centuries. Yet we are in the midst of a turnaround, in our view. China spends about 1.2% of its GDP on environmental protection - similar to European countries, according to the World Bank.[6] Chinese cities have seen a significant improvement in air quality over the past five years – though they still lag that of most developed economies. See the chart below. There is significant political pressure driving the clean-up. Achieving climate goals is likely to be a means toward another policy goal – attracting more foreign capital into the country. China's 14th Five-Year Plan puts greater focus on decarbonization. China has committed to achieving net-zero carbon emissions by 2060 – a critical contribution to the global fight against climate change and also critical domestically, to protect from climate damages and secure energy self-reliance. China's national emissions trading scheme is expected to be one of the largest globally, bringing the total share of global greenhouse gas emissions covered by a carbon trading scheme to about 23%, according to Goldman Sachs research in January 2021.

Incorporating sustainability in the investment process requires distinguishing between current conditions and potential opportunities. The focus of China's leaders on achieving a carbon-neutral economy will likely filter through to corporate priorities and objectives. The BlackRock Investment Stewardship team engages with Chinese companies – just as in other jurisdictions – to strengthen sustainability disclosures: see its framework for dealing with broader ESG issues in its global engagement priorities for 2021. We recognize that disclosures have a long way to go. Yet we believe this should not detract from the fundamental case for Chinese assets in strategic portfolios. Some concerns on sustainability will likely persist. We expect social and governance issues to take on greater prominence in the wake of Covid-19. We see sustainability rising beyond the mere labels of E, S and G. That brings along complications that often relate to lack of proper data. There is some ways to go on achieving adequate disclosures – but we see this as a potential area of evolution and progress in coming years that should be closely watched.

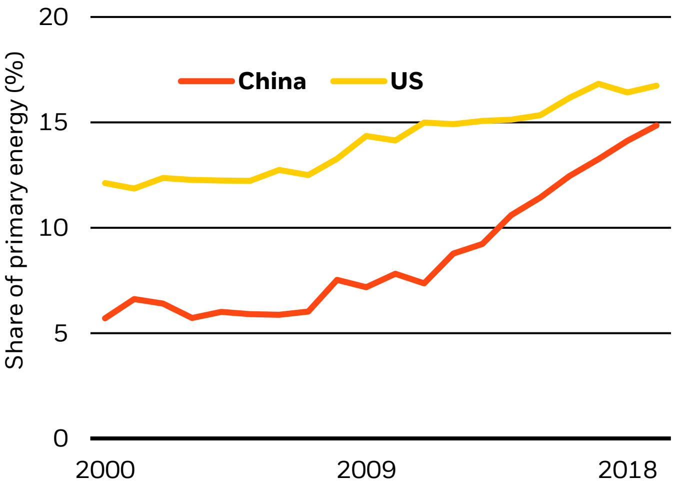
**Fighting pollution**

China air quality indexes, 2015-2021




**Shift to a low-carbon economy**

Low-carbon sources in energy production, 2000-2019




**This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.** Sources: BlackRock Investment Institute, with data from CEIC and Wind, May 2021. Notes: The left chart shows CEIC's China air quality index for Beijing and nationwide. A value of "0" on the index indicates no pollution. See here for more details. The chart on the right shows the share of low-carbon sources as a share of overall energy production.

6. China 2030 : building a modern, harmonious, and creative society (English). Washington, D.C. : World Bank Group. http://documents.worldbank.org/curated/en/781101468239669951/China-2030-building-a-modern-harmonious-and-creative-society

# Risk and return

The Chinese economy and markets have evolved rapidly, so views on expected risk and return cannot be anchored entirely on the past. The chart below shows our five-year median expected returns for selected asset classes along with our uncertainty bands for each. Our expected returns for onshore Chinese equities and government bonds outpace those of EM and DM peers. China's fast-changing economy, relatively limited historical data and lower transparency than DM counterparts prompt us to assume higher uncertainty around our median return assumptions. See the light shaded bars in the chart. Yet even after allowing for explicitly higher uncertainty around return estimates, we see a case for above-benchmark allocations to Chinese assets in strategic portfolios.

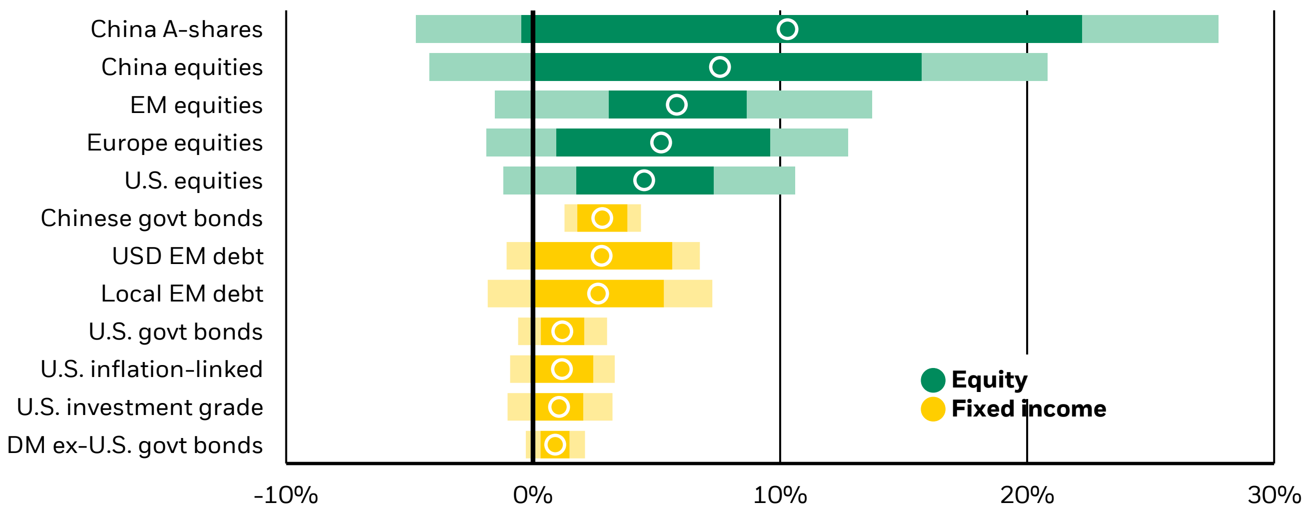
Our case for "why China" is not based on better economic growth expectations. In fact, our estimates of Chinese growth are modest relative to history: the assumption embedded in our expected returns is that annual real GDP growth on average will be less than 4% in a decade. Market-based earnings estimates, the outlook for profit margins, valuations and the path of domestic interest rates have a greater bearing on our expected returns. Our estimate of the equity risk premium – our preferred metric to gauge valuations - stands near 7% for the mainland stock market compared with around 4.5% for the U.S., pointing to attractive risk-reward for the former. See the appendix and our CMA interactive for methodology details.

Over a strategic horizon, we expect Chinese onshore equity returns to outpace broad EM and DM aggregate indexes, driven mainly by higher earnings growth and higher payout ratios than the past due to demands from international investors and pressure from the Chinese securities regulator. The domestic orientation of the A-share market means it gives unique access to the Chinese economy and sectors. We believe a mix of structural reforms that gradually tilt the economy toward domestic consumption – combined with reduced barriers to entry for foreign investors – mean that China's onshore asset prices will likely better reflect domestic growth. The dominance of retail investors in onshore markets often sparks concerns around the apparent disconnect between Chinese equity performance and fundamentals. This may be true on very short horizons. But we find that on a five-year horizon, earnings-per-share growth better explains the variability of Chinese equity returns than U.S. equity returns, suggesting that fundamentals do ultimately matter.

Bond yields for Chinese government and policy bonds are much higher than major economy equivalents. The Bloomberg Barclays China Treasury-Policy Bank index also has much lower duration than DM peers, making the index less sensitive to interest rate risk. We expect Chinese yields to rise, yet on a risk-adjusted basis see returns more attractive than comparable developed and emerging market government bonds. Our five-year annualized expected returns for Chinese government bonds are higher than for U.S. Treasuries. See the chart below. For expected returns on Chinese bonds to equal the expected return on U.S. Treasuries, we would need to see China government bond yields to rise sharply from current levels – an unlikely event, in our view.

### Capital market assumptions

Estimated five-year annualized returns and uncertainty bands, May 2021




**This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.** Sources: BlackRock Investment Institute, May 2021. Data are as of December 31, 2020. Notes: The chart shows expected total nominal returns from a U.S. dollar perspective. Asset return expectations are gross of fees. There are two sets of bands around our mean return expectations. The darker bands show our estimates of uncertainty in our mean return estimates. The lighter bands are based on the 25th and 75th percentile of expected return outcomes – the interquartile range. The regional equity markets are represented by the MSCI regional indexes. China A-shares are represented by the MSCI China A-share onshore index and China equities by MSCI China. The fixed income indexes in order are: the Bloomberg Barclays China Treasury+Policy Bank Total Return Index, the JP Morgan GBI EM Index, the JP Morgan EMBI Global Diversified Index, Bloomberg Barclays U.S. Government Index, Bloomberg Barclays U.S. Government Inflation-Linked Bond Index, Bloomberg Barclays U.S. Credit Index and Bloomberg Barclays Global Aggregate Treasury Index ex U.S. Indexes are unmanaged, do not account for fees and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

# Above-benchmark allocation

We believe a neutral starting point allocation to China for most investors is significantly greater than that implied by benchmark indexes today. We are strategically overweight Chinese assets, particularly government bonds, relative to their weight in broad global benchmark indexes. Our regional tilts for equities and government bond allocations for China, emerging markets ex-China and developed markets relative to their respective weights in global benchmark indexes are shown in the chart below.

Relying on existing index weights means investors have to make large implicit assumptions with regards to Chinese assets. Our regional tilts assume an investor can make explicit country allocations to China. Other routes to gaining China portfolio exposure is through less granular, regional allocations or through indirect allocations, for example, to markets with close economic ties to China. Each approach could give an investor some China exposure. In our portfolio construction process we find that the weight of China in a portfolio grows as more targeted allocations are permitted.

Access to onshore Chinese markets has been a hurdle in the past. This limitation is fast fading. China's domestic markets are opening up to foreign investors just as onshore Chinese assets get added to global indexes. Market infrastructure, such as the Hong Kong-Shanghai stock connect, is making access smoother. At the same time, many more offshore and onshore domiciled funds have been launched to provide access to the onshore markets, providing a wider choice of strategies – both fundamental and systematic.

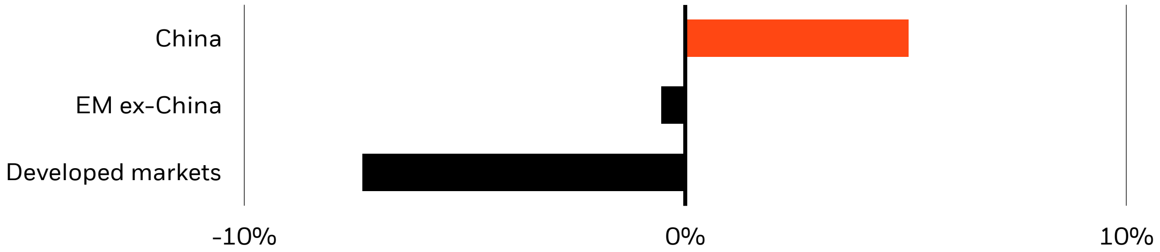
Due diligence can still pose some challenges. Many strategies still have a short track record. Assets remain concentrated amongst a small number of managers – the largest 10 consist of almost half of total assets managed in the region (across multiple strategies), as measured by Morningstar.[7] Yet the number of index strategies offering broad exposure to onshore equity and bond markets has also grown.

Institutional investor allocations to China have typically also been alpha-seeking in nature – focusing on outperforming a given index through specific security-level decisions. One reason for this could be a desire to get better exposure to the alpha-seeking funds that are able to target growth industries. But we believe viewing Chinese investments solely as an alpha opportunity risks missing the bigger picture – investors need to ensure they have greater allocation to this key pillar of global growth for potential returns and diversification, as we have argued.

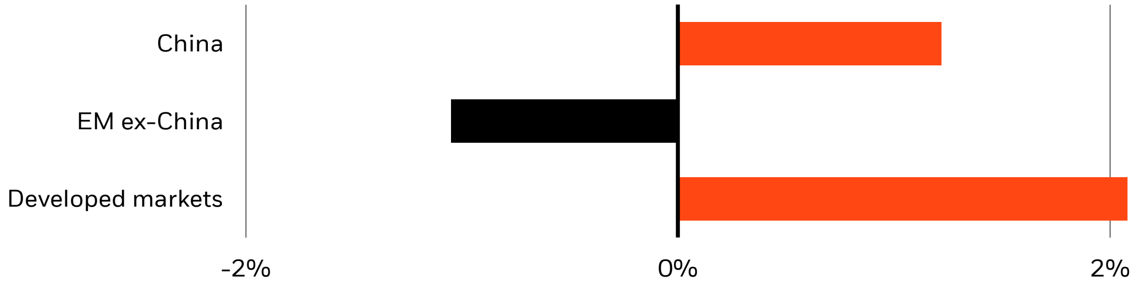
### Geographical breakdown

Regional tilts for a hypothetical unconstrained, U.S. dollar, multi-asset portfolio on 10-year horizon

**Government bonds**




**Equities**




**This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. It is not possible to invest directly in an index.** Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2021. Notes: The charts shows our regional tilts to government bonds and equities for a hypothetical, unconstrained, U.S. dollar, multi-asset portfolio on a 10-year horizon relative to their respective weights in benchmark indexes. We use the Bloomberg Barclays Global Treasury index for government bonds and MSCI AC World for equities. The hypothetical portfolio may differ from those in other jurisdictions, is intended for information purposes only and does not constitute investment advice. The allocation shown above does not represent any existing portfolio, and as such, is not an investible product. The allocation on the hypothetical portfolio is based on criteria applied with the benefit of hindsight and knowledge of factors that may have positively affected it's performance, and cannot account for risk factors that may affect an actual portfolio's performance. Actual performance may vary significantly from our hypothetical multi-asset portfolio due to transaction costs, liquidity or other market factors. Indexes are unmanaged, do not account for management fees and one cannot invest directly in an index.

7. The All China equity universe as defined by funds listed in the Morningstar database as of March 30, 2021. This list does not include separately managed accounts or private vehicles.

# Strategic opportunity

We believe investors, on average, are underinvested in Chinese assets – even below what we believe to be neutral levels suggested by current global benchmarks. China boasts the second-largest economy and the second-largest financial market in the world. Yet we believe Chinese assets are absent from many investor portfolios or are held in very small quantities, often via an aggregate emerging market exposure.

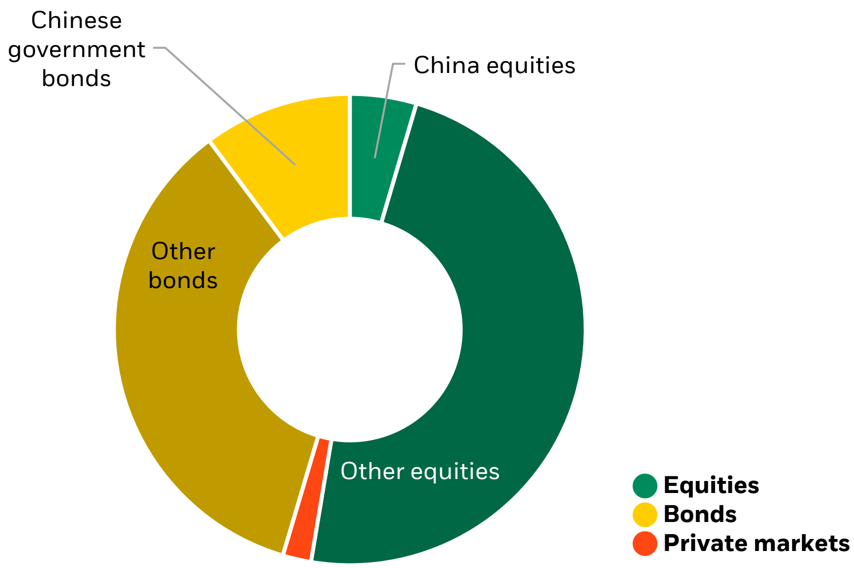
An internal survey of portfolio trends in EMEA conducted by the BlackRock Portfolio and Analytics Solutions group over the course of 2020 showed the average explicit allocation to China was just 0.3% to equities and a mere 0.05% for fixed income.[8] The implied exposure via broader emerging markets allocation was also relatively slim – under 3% for equities and under 0.5% for bonds. This compares to Chinese equities being about 5% of the MSCI All-Country World equity index and bonds comprise about 7.5% in the Bloomberg Barclays Global Aggregate Index as of March 2021.

Overall foreign ownership in onshore Chinese assets is low even after the recent surge of inflows as index inclusion has picked up. Offshore investors own 4.3% of the domestic A-share market and 2.9% of onshore bonds as of the end of 2020, according to data from the People's Bank of China. We believe global investors should look to up allocation as access opens up. We show our preferred allocation for a hypothetical UK institutional multi-asset strategic portfolio on a 10-year view in the chart below.

Implementation of these views will differ across investor types and geographies, depending on objectives, constraints and regulation. For some, it would mean direct purchase of Chinese assets. For others, it would lead to greater exposure to regional indexes with prominent Chinese representation. But we see the lack of a view and systematic process for determining allocations to China as a major investment risk: having no plan in place could leave investors accidentally underweight the world's second-largest capital market.

### Boosting allocations

Multi-asset allocation for a hypothetical UK institutional multi-asset strategic portfolio on a 10-year horizon




**This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.** Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and Bloomberg, May 2021. Notes: The chart shows a hypothetical strategic asset allocation, based on the metrics shown on our capital market assumptions website. Index proxies can be found on the Assumptions tab under the info icons in the Assumptions at a glance table. Fee assumptions are listed on the methodology tab. The allocation shown above does not represent any existing portfolio, and as such, is not an investible product. The construction of the hypothetical asset allocation is based on criteria applied with the benefit of hindsight and knowledge of factors that may have positively affected it's performance, and cannot account for risk factors that may affect the actual portfolio's performance. The actual performance may vary significantly due to transaction costs, liquidity or other market factors. Indexes are unmanaged, do not account for management fees and one cannot invest directly in an index. We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class.

8. The numbers indicate the average portfolio allocation based on an internal BlackRock Portfolio and Analytics Solutions group study of 654 institutional investors in EMEA comprising 64 asset managers, 34 asset owners and 556 wealth clients. The data was collected between 31 December 2019 and 31 December 2020.

# Appendix

The table below lists the breakdown of the index proxies used for the hypothetical portfolio shown on page 4. The table represents two hypothetical sterling-denominated strategic asset allocations. Both are designed using our portfolio construction framework including the capital market assumptions. We assume a risk target of 8% on a 10-year horizon.

| Asset | Index | Weight with China | Weight without China |
|---|---|---|---|
| Equities | MSCI Developed - US Gross TR Index | 23.4% | 23.7% |
| | MSCI Developed - United Kingdom | 1.6% | 1.6% |
| | MSCI Developed Europe ex UK Gross TR Ind | 16.3% | 18.3% |
| | MSCI Developed - Japan Gross TR Index - | 4.0% | 4.7% |
| | MSCI Daily TR Gross Developed Pacific Ex | 0.9% | 0.8% |
| | MSCI China A Inclusion NET Index | 2.3% | 0.0% |
| | MSCI Emerging - China in CNY | 2.3% | 0.0% |
| | MSCI Emerging Markets ex China (Net) | 2.8% | 2.5% |
| Bonds | Bloomberg Barclays Government Index | 6.6% | 5.8% |
| | Bloomberg Barclays Global Aggregate Euro Treasury | 4.6% | 4.0% |
| | FTSE Actuaries UK Conventional Gilts All | 1.7% | 1.5% |
| | ICE BofA Japanese Governments (G0Y0) Index | 4.4% | 9.5% |
| | Bloomberg Barclays China Treasury + Policy Bank Total Return index | 11.3% | 0.0% |
| | Bloomberg Barclays US Government Inflation-Linked Index | 7.5% | 13.2% |
| | ICE BofA EMU Direct Government Inflation | 0.4% | 0.4% |
| | FTSE Actuaries UK Index-Linked Gilts index | 0.7% | 0.6% |
| Credit | Bloomberg Barclays U.S. Credit Index | 5.5% | 4.8% |
| | Bloomberg Barclays Euro Aggregate Corporate Index | 2.0% | 1.8% |
| | ICE BofA Sterling Corporate Securities I | 0.4% | 0.4% |
| Real estate | CMA - Core Real Estate UK hedged (BlackRock proxy*) | 1.4% | 1.7% |

* We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class.



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# Appendix

## Methodology – Capital market assumptions

### Equities

We derive an aggregate implied cost of capital for equity markets using a discounted cash flow (DCF) model, as discussed by Li et al. (2013). Estimating the cost of capital over time can be attributed to an equity risk premium (ERP) and expectations for interest rates. Our work finds that linking expectations for future interest rates and the ERP can be more telling for expected equity returns rather than attempting to find a fair value for the price-to-earnings ratio alone.

Estimated current and future cost of capital become inputs to a DCF model to estimate equity market returns. Future cashflows are estimated based on consensus analyst earnings forecasts, adjusted for the typical upward bias during later stages of the economic cycle, and long-run GDP growth projections.

For Chinese equity markets, there is less historic data available and market conditions have changed markedly in the last 20 years. We assume future equity risk premium is more similar to recent observations, as we expect market liberalization and global market integration to help reduce risk premia.

### Interest rates

Our interest rate model provides a way to map out the yield curve at multiple time horizons in the future. This is based on estimating 1) the short rate, and; 2) model-implied term premia.

Estimates of short rates are based on market data in the near term and on macro-informed in the long term. More specifically, in the long term we assume expected long run inflation and real growth, coupled with changing preferences to savings and risk aversion, will determine expectations for short rates (the "long run short rate").

Term premia are computed from a model based in the affine term structure class of models (Adrian, Crump and Moench, 2013) describing the yield curve using the first five principal components of yield. The model-implied term premia from the affine term structure model are further calibrated to market implied term premia, with the relative weights dependent on the relevant time horizon.

## References

Adrian, T., Crump, R.K. and Moench, E. (2013). Pricing the Term Structure with Linear Regressions. Federal Reserve Board of New York Staff Report No. 340.

Li, Y., Ng, D.T. and Swaminathan, B., (2013). Predicting market returns using aggregate implied cost of capital. Journal of Financial Economics, 110(2), pp.419-436.

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