Allocation insight

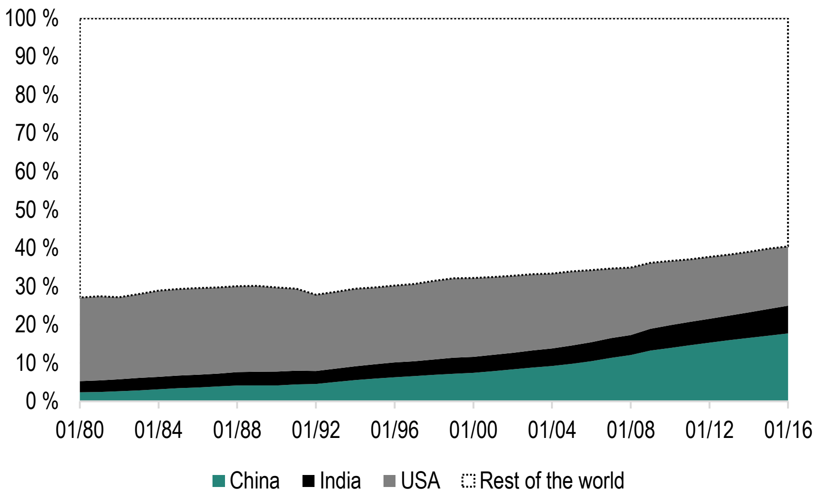
7 November 2017

China's political stability is important in terms of the investment environment. General Secretary Xi Jinping's October policy speech confirmed expectations that the current administration will carry on and that investments to solve China's massive environmental issues will continue. China's role as a driver of global economic growth should not be underestimated because the country's share of the world's economic growth has grown dramatically over the last decades.

China's political stability and mandate of heaven

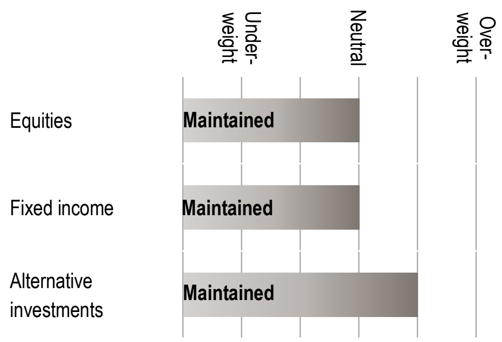
In China, the 19th National Congress ended in October with the Central Committee's session in Beijing. The session's main focus was on General Secretary Xi Jinping's policy speech on the Chinese state's economic and societal focal areas over the next decades and the selection of the Politburo Standing Committee members. In addition, an amendment was made to the Communist Party's constitution that cements Xi's position as China's leader well into the 2020s. He was given the mandate of heaven. This is good for investors.

Confucianism is the foundation of Chinese society. It is not a religion, but a moral guideline for both individuals and society. According to Confucius, a country's ruler must be particularly humble and morally good (heavenly), which gives him the right to rule. This idea of governance has historically proven to be relatively stable from a global perspective. From an investment viewpoint, political stability is better than a lack thereof. A ruler must, however, continually show through their actions that they are worthy of the mandate of heaven. The speech held by Xi at the National Congress and his ideological policies recorded in the constitution were one indication of this.

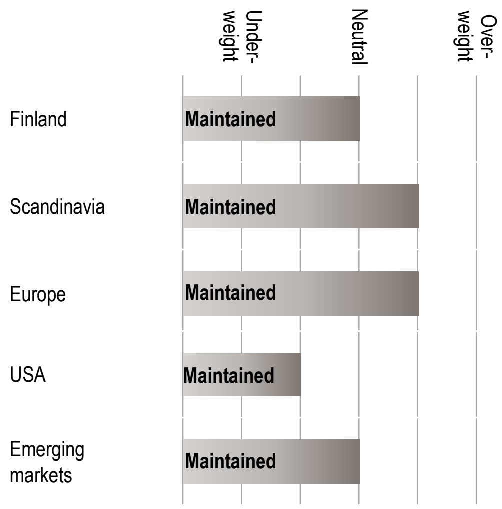


Picture 1: China's share of the global economy 1980–2016. Source: Bloomberg

Asset classes



Equities



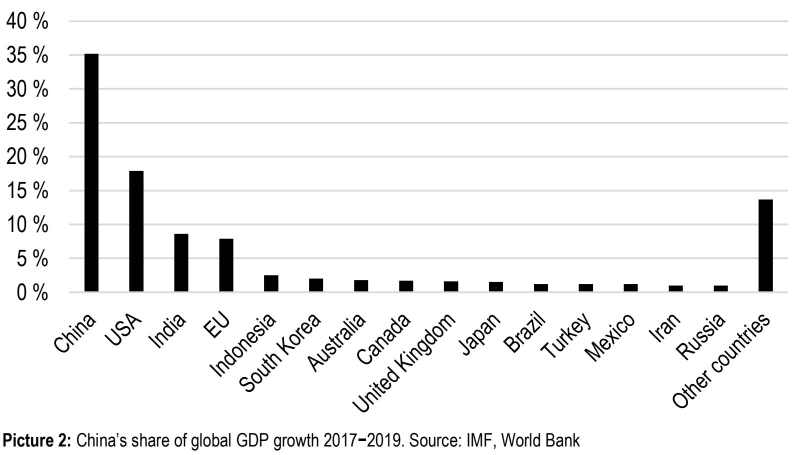
China's role as a driver of global economic growth should not be underestimated

China's share of the global GDP has grown dramatically over the past few decades (Figure 1). This development will most likely continue, presuming that China's major societal problems can be solved. In his speech, Xi mentioned many of them, above all the environmental issues. "We should treat the environment as our own lives" was in reference to China's continued investments in solving its massive environmental problems through added investments in renewable energy and developing environmental technology. Also, the manufacturing and polluting industry's share of the economy must be reduced, but nevertheless, taking into account any negative impacts on employment figures. This is being dealt with by restructuring state-owned companies.

The sharp rise in the prices of flats in major Chinese cities in recent years has slowed down urbanisation and increased inequality. The rise in prices is mostly the outcome of debt-driven housing investment operations. The other key message of the speech was "Houses are built to be inhabited, not for speculation". This is most likely in reference to the fact that the recently begun curbing of the availability of home loans will continue. If this curbing takes place too rapidly, the impacts on consumption will be negative.

Investments in solving China's massive environmental issues will continue through added investments in renewable energy and the development of environmental technology.

The last, and perhaps the most interesting for the markets, was the numerical economic growth target, which was left out of the speech. This is intended, most likely, to send out a message of greater flexibility on the economic growth path, among other things, to promote the above-mentioned issues. For investors, this is worth noting because China's direct position as a driver of global economic growth is considerable, and even greater indirectly (Figure 2). If China's economic growth were allowed to flex downwards, the global investment environment would turn significantly weaker than it is now. For now, there are no strong indications that this will take place.

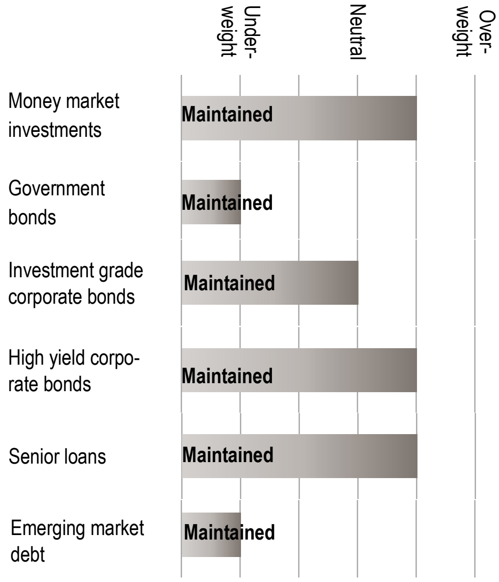


Picture 2: China's share of global GDP growth 2017–2019. Source: IMF, World Bank

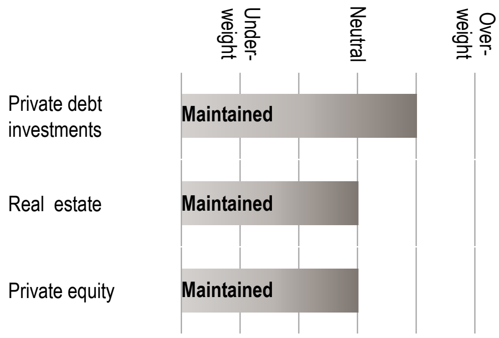
Global economy's key factors remain unchanged, we are maintaining our asset class allocation at neutral

The global economic growth driven by China is expected to remain stable globally (+3.5% in 2018). Also indicators measuring the confidence of companies and consumers are strong worldwide. Stable economic growth and companies' solid earnings performance give the equity market a positive vibe. The Q3 earnings season has been successful. In the US, earnings growth has been an average of +8%, while in Europe, it has been around +2.5%. What is especially positive, however, is that both in Europe and the US, sales growth seems to be accelerating. Even taking this into consideration, valuation levels are higher than historical averages. The still relatively attractive return expectation, particularly when compared with fixed income investments, speaks in favour of making equity investments. We maintain our equity-fixed income recommendation at neutral.

Fixed income



Alternative investments



At the start of October, we reduced the weight of the emerging markets in equity investments by some 2 percentage points. The emerging markets have performed better than the Western markets this year, mostly due to Chinese equities, which had raised the weight of the asset class in our portfolios.

Particularly the valuation levels of Asian technology companies with large index weights are at hard-to-justify levels. The recently positive momentum of emerging market equities has also shown signs of a turnaround. Following the measure, the weight of emerging markets remains neutral.

Europe took an expected step towards monetary policy normalisation

Stable economic growth and companies' solid earnings performance give the equity market a positive vibe.

The ECB announced, as expected, that it will be reducing its stimulus measures from the start of the year and continuing its stimulus measures until September 2018 at least, but longer if necessary. President Draghi also highlighted the fact that the ECB will continue the stimulus until the central bank's inflation forecast corresponds to its target, and emphasised that the key interest rate would remain low for a long time to come.

The normalisation of US monetary policy is also maintaining pressure for interest rates to rise. This directly affects, not only dollar-denominated investments, but also countries whose currency is tied to the dollar, such as China. In the short term, the impacts on the supply of cash in China are most likely negligible, but combined with the monetary policy goals of China's central bank, it is clear that the level of complexity will rise, which will, at its worst, result in exposure to policy mistakes.

Risk in fixed income investments maintained at a low level

The credit risk premiums of fixed income investments continued to narrow in October due to, for example, the comments made by Draghi concerning stimulus measures. That is why we have been cautious and selective in making new investments. We have further increased our cash weight. The fixed income investments' interest rate risk, measured in duration, is more moderate than the market index's interest rate risk.

In fixed income investments, the focus is on Nordic corporate bonds. We see corporate bonds as more attractive, with low government bond return levels and with moderate pressure on the interest rate to rise in the medium term. In early October, we slightly increased the share of American, short-maturity investment grade corporate bonds in the portfolios, as a result of which the dollar risk hedging ratio is slightly below 70%.

Oral Hammaslääkärit sold from alternative investments

In alternative investments, we did not make any new commitments in October. Our existing investments performed well, when the sale of Oral Hammaslääkärit in the CapMan Buyout X fund reflected positively on the value of the fund. The investment commitment rate for alternative investments is close to maximum, at around 128 per cent.

The return expectations of alternative investments clearly exceed the return on liquid fixed income investments, which is why we weight alternative investments at the expense of traditional fixed income investments in our asset allocation.

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