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## Finding Opportunities Amid the China-U.S. Competition

**Paul Christopher, CFA**  
Head of Global Market Strategy

### Key takeaways

- » *We believe the basis for the U.S.-China trade relationship lies in how the two economies complement each other.*
- » *U.S. industrial firms made important inroads into China's manufacturing development 25 years ago, and we think that U.S. services firms could enjoy a new wave of investment opportunities in China. Yet, just as China needs the U.S., the U.S. still benefits more from lower prices on Chinese goods than for goods made in other parts of the world.*

### What it may mean for investors

- » *We believe exposure to emerging Asia should be an essential part of an emerging market equity allocation in portfolios that target asset growth.*

We believe the basis for the U.S.-China trade relationship lies in how the two economies are complementary. For example, there is room for U.S. firms to help develop China's emerging services industries. Chart 1 shows that manufacturing and construction historically were the largest parts of the Chinese economy, as China developed its infrastructure and its dominance in exported manufactured goods. Over the years, however, China's rapid economic development has raised Chinese wages, allowing Chinese consumers to afford a large and growing variety of consumer goods—and especially services.

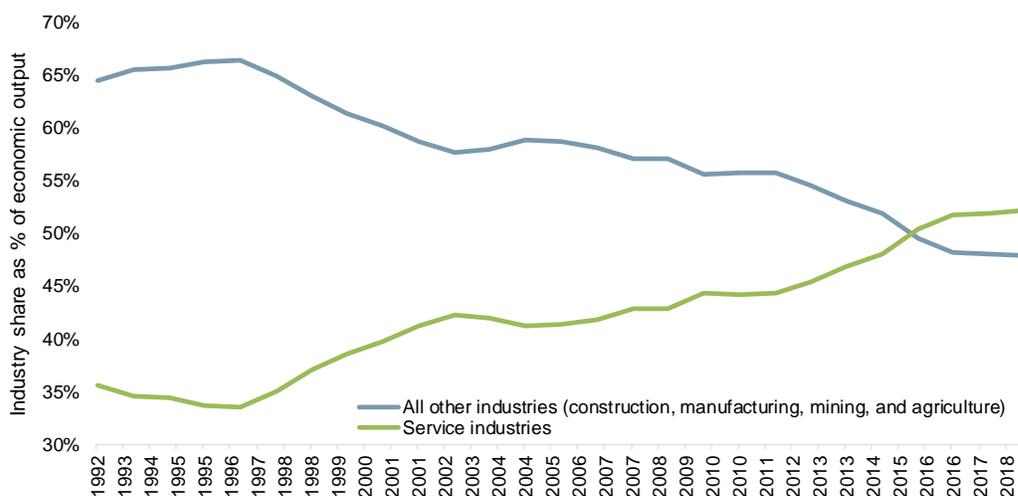
Chinese services still have ample room to develop over time. For example, Chinese medical services are still so poor in quality that many affluent Chinese still go to Taiwan for medical care, even taking their families with them during long treatments. Environmental services are also immature, as China tackles years of accumulated industrial pollution. Likewise, Chinese financial services—like expanded banking, insurance, and investment services—are still in their infancy. Finally, Chinese agriculture is very inefficient. Crop yields need to rise dramatically as urban centers in the eastern part of the country continue to grow and compete with farms for the available land. To develop these services, China is likely to tap U.S. firms. U.S. industrial firms made important inroads into China's manufacturing development 25 years ago, and we think that U.S. services firms could enjoy a new wave of investment opportunities in China.

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**Chart 1. Contributions to Chinese economic output**



Sources: National Bureau of Statistics, China; Bloomberg; Wells Fargo Investment Institute; March 1, 2019. Chart compares services versus all other industries, with shares shown in percent. Note: Economic output is measured by gross domestic product.

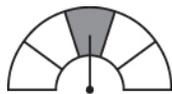
Just as China relies on foreign firms, the U.S. still benefits from China's industries. U.S. consumers have found that China is no longer strictly the home of inexpensive, plastic toys and home electronics assembled from parts manufactured elsewhere. U.S. shoppers today can easily find high-tech Chinese products that are built from synthetic materials and developed by Chinese scientists. Even as Chinese wages have grown, the level of Chinese wages is likely to remain below those in the U.S., meaning that U.S. consumers should continue to enjoy lower prices for Chinese goods than for goods made in other parts of the world.

A principal challenge to this complementarity is increasing economic and even geopolitical U.S.-China competition. China's government wants to become a global leader in new technologies by 2025 and is already competitive with many U.S. industrial leaders. China has also expressed its goal to be the dominant military and political power in East Asia. For example, as the U.S. was pulling out of its proposed Trans Pacific Partnership trade group, China offered a Regional Comprehensive Economic Partnership to promote intra-Asian trade (excluding the U.S.). The tariffs that the U.S. and China recently imposed on each other reflect the tensions arising from their growing economic, political, and military competition. That rivalry is unlikely to abate but may evolve through long-term negotiations in trade, intellectual property protection, and diplomacy in Asia.

From an investment perspective, we do not recommend individual country investments but prefer regional Asia exposure to reduce the country-specific risks. Fortunately, the growing economic ties between China and its neighbors create a potentially rewarding opportunity more broadly in Asia. Southeast Asian countries have benefited as China has outsourced some of its less sophisticated manufacturing and assembly operations to them. And India remains an important source of technological development. Collectively, we find the markets of emerging Asia attractive and believe that investment exposure there should be an essential part of an emerging market equity allocation in portfolios that target asset growth.

**Scott Wren**

Senior Global Equity Strategist



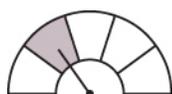
Neutral

U.S. Large Cap Equities



Neutral

U.S. Mid Cap Equities



Unfavorable

U.S. Small Cap Equities



Neutral

Developed Market  
Ex-U.S. Equities

Most Favorable

Emerging Market Equities

**Emerging market earnings update**

While the fourth quarter earnings reporting season is virtually over for domestic, publically traded companies, emerging markets (EM) are only slightly less than half way through their season, as just 48% of companies have posted results thus far. The bulk of EM earnings reports historically have come well after those in the U.S. Currently, our analysis suggests the MSCI Emerging Markets Index offers the best potential return of the major equity indices that we closely track over the balance of this year. The MSCI Emerging Markets Index is currently trading a touch over 7% below the mid-point of our year-end target range.

As we interpret the results in terms of regions, the largest capitalization region, Asia/Pacific ex-Japan, has been the biggest drag on overall EM results. As the table below illustrates, this region has posted a 17.6% decline in earnings thus far versus the year-ago period. Companies who are large technology exporters in countries such as South Korea and Taiwan have suffered as trade frictions continue to affect demand in China and around the globe.

So far, the overriding story during this EM earnings reporting season is that companies are putting big-ticket purchases of technology goods on hold to a meaningful degree. China's economy is slowing as suggested by their government lowering the 2019 gross domestic product (GDP) growth target to 6% - 6.5%. Overall global economic growth ex-China is slowing as well. On a positive note, earnings growth may be slightly positive in the first quarter and improving over the balance of this year.

**Key takeaways**

- » Emerging markets are only about halfway through their fourth quarter earnings reporting season.
- » So far, results have been hurt by concerns that trade frictions will lead to a further slowdown in global growth.

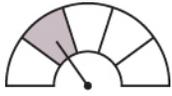
**Fourth quarter emerging markets earnings highlights**

	Reporting (%)	Growth (%)	First quarter 2019 consensus growth estimate (%)
<b>MSCI Emerging Markets Index</b>	47.6	-2.9	1.4
<b>Africa/Middle East</b>	75.0	18.0	8.5
South Africa	71.4	67.8	N/A
<b>Asia/Pacific ex-Japan</b>	40.4	-17.6	-1.1
China	8.1	5.5	5.2
India	100.0	-2.7	28.3
South Korea	79.1	-34.2	-29.8
Taiwan	54.7	-21.9	-19.3
<b>Europe</b>	61.6	3.5	0.6
Russia	65.2	40.2	7.6
Turkey	72.2	13.9	-49.6
<b>Latin America</b>	77.8	30.1	26.1
Brazil	66.0	14.9	37.9
Mexico	100.0	81.2	14.9

Sources: FactSet, Wells Fargo Investment Institute, as of March 5, 2019. Note: Not all countries represented in the MSCI Emerging Markets Index are listed. MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. An index is unmanaged and not available for direct investment.

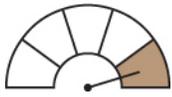
**Luis Alvarado**

Investment Strategy Analyst



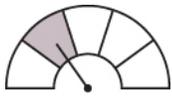
Unfavorable

U.S. Taxable Investment Grade Fixed Income



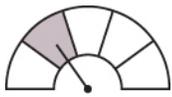
Most Favorable

U.S. Short-Term Taxable Fixed Income



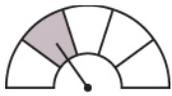
Unfavorable

U.S. Intermediate Term Taxable Fixed Income

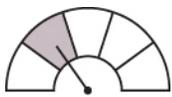


Unfavorable

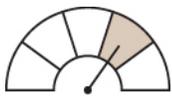
U.S. Long-Term Taxable Fixed Income



Unfavorable High Yield Taxable Fixed Income



Unfavorable Developed Market Ex.-U.S. Fixed Income



Favorable Emerging Market Fixed Income

**Taking on duration risk**

Duration (in years) is used by investors to estimate the potential price impact from a change in interest rates, while also taking into account maturity and coupon effects. For example, a bond with a five-year duration is expected to rise or fall approximately 5% in price for every 1% decrease or increase in market interest rates. Long-term bonds are more sensitive to changes in yields than short-term bonds, as it takes longer for investors to recover their initial investment. This was true throughout most of 2018, when 10-year Treasury yields climbed from 2.41% on January 2 to 3.23% on November 8, prompting long-term bonds to lose 7.6% and short-term bonds to gain 0.47%.

After four rounds of rate increases in 2018, the Federal Reserve (Fed) has signaled it will pause on rate hikes and will evaluate further increases based on how the economy and financial markets evolve. For the moment, we are not expecting a rate increase at the March meeting. With many inflation measures in check, we expect the Fed to remain “on hold” in the first half of the year, with one additional rate hike before year end. Despite rates moving lower over the last few months, we remain unfavorable on duration, but we are looking for opportunities to increase exposure to duration risk—should longer-term yields move closer towards our expected year-end targets.

(Fed Funds Rate: 2.50%-2.75%; 10-year Treasury: 2.75%-3.25%; and 30-year Treasury: 2.75%-3.25%).

**Key takeaways**

- » We do not recommend extending duration risk at the moment, as we expect U.S. Treasury yields to continue to climb towards our year-end targets.
- » We remain most favorable on the short-end of the curve and recommend investors to be selective on credit quality.

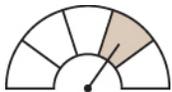
**Long-term bonds suffered over the last year as rates climbed**



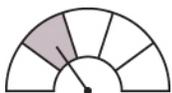
Sources: Bloomberg, Wells Fargo Investment Institute, as of March 4, 2019. Daily data: January 1, 2018 - March 4, 2019. For illustrative purposes only. Yields and returns represent past performance and fluctuate with market conditions. Current performance may be higher or lower than quoted above. **Past performance is no guarantee of future results.** Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market. An index is unmanaged and not available for direct investment.

**Austin Pickle, CFA**  
Investment Strategy Analyst

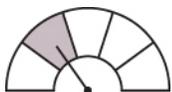
“Three rules of work: 1) Out of clutter find simplicity; 2) From discord find harmony; 3) In the middle of difficulty lies opportunity.”  
--Albert Einstein



Favorable  
Commodities



Unfavorable  
Private Real Estate



Unfavorable  
Public Real Estate

### Beware the REIT rally

We downgraded real estate investment trusts (REITs) to unfavorable last October. And so far, REITs have not cooperated. With REITs performing well and our 10-year Treasury yield forecast having recently been lowered, some have asked “should we upgrade REITs?” Today, our answer is no.

At the time of our downgrade, global growth concerns had not yet metastasized; equity return forecasts were elevated; and our 10-year Treasury yield forecast midpoint was 3.5%. Soon after our REIT downgrade, the equity market meltdown began. Investor skittishness and collapsing long-term interest rates (the 10-year Treasury yield dropped from 3.24% to 2.55% in two months) helped REITs outperform. Since that time, our equity, economic growth, and long-term interest rate forecasts have been slashed. Just last week, we took our 10-year forecast midpoint rate down to 3%. So, why haven’t we changed our unfavorable REIT view?

REIT fundamentals are decent, but we don’t see room for much *improvement*, which is generally what drives outsized returns. Gains in net operating income, commercial property prices, and occupancy have been slowing—and valuations are not cheap. Additionally, late cycle dynamics do not typically favor REITs. Equity investor skittishness and falling interest rates propelled REITs to all-time highs (see chart below). And now, we believe REITs are primed to lag, as that skittishness fades and interest rates resume their march higher. (Our new 10-year forecast is still a good bit higher than today’s rates.) We do not feel the risk is worth the reward here, and we remain unfavorable. Beware of jumping on the recent REIT rally.

### Key takeaways

- » We believe REIT performance will lag, as investor skittishness fades and long-term interest rates climb higher.
- » We remain unfavorable towards REITs.

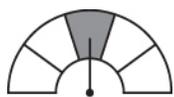
### Global REIT Index



Sources: Bloomberg, Wells Fargo Investment Institute. Daily data: January 1, 2015 - March 6, 2019. Global REIT Index is represented by the FTSE EPRA/NAREIT Developed Index. For illustrative purposes only. FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

**James Sweetman**

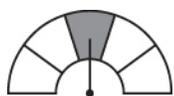
Senior Global Alternative Investment Strategist



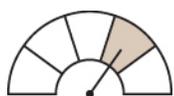
Neutral  
Private Equity



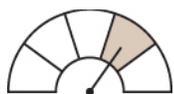
Neutral  
Hedge Funds-Macro



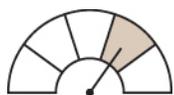
Neutral  
Hedge Funds-Event Driven



Favorable  
Private Debt



Favorable  
Hedge Funds-Equity Hedge



Favorable  
Hedge Funds-Relative Value

*Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not suitable for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.*

### Growing hedge fund exposures in China

Excessive pessimism over the U.S.-China trade dispute and the health of the Chinese economy led the Chinese stock market to suffer steep declines in 2018 (CSI 300 Index<sup>1</sup> down -25%). For global hedge funds, this actually created a unique opportunity. Global hedge funds actively increased their China exposure and benefited from a rebound in Chinese stocks, which were up 27.8%, year-to-date (YTD) through March 5. China-based shares have seen a large uptick in net exposure (YTD), as global-focused hedge funds have continued to buy A-shares throughout the course of the year—pushing net exposure to A-shares to the highest level since 2010 (see chart below).<sup>2</sup>

The Chinese stock market resurgence (YTD) was driven by the dissipating fears of a global trade war between the U.S. and China. However, the recent announcement that MSCI Indexes will grow the weight of China A-shares from 5% for large-cap stocks to 20% by year-end may also add to the momentum. Market estimates predict that the increase in the benchmark positions means as much as \$67 billion of active and passive investments could flow into mainland China equities.<sup>3</sup> We believe raising the level of A-shares would underscore China's progress in opening up its markets, while also deepening the investment opportunity for global hedge funds. This could create a more fertile investment landscape for "fundamental-based" strategies (such as Equity Hedge) in a Chinese market that historically has been dominated by retail investors, attracting those institutional investors eager to invest in the world's second largest economy.

### Key takeaways

- » It is becoming increasingly difficult for global hedge fund managers to ignore China. We expect recent changes to the MSCI Indexes may drive increased exposures.
- » In our view, a rise in exposure to China-listed stocks, as opposed to Hong Kong Exchange-listed and American Depositary Receipts, may create a fertile investment environment for global hedge funds in 2019.

### Net exposures continue to rise in China



Sources: Morgan Stanley Prime Brokerage, data as of Feb. 22, 2019.

<sup>1</sup> Bloomberg. The CSI 300 Index is a free-float weighted index that consists of 300 A-share stocks listed on the Shanghai or Shenzhen Stock Exchanges. An index is unmanaged and not available for direct investment.

<sup>2</sup> China A-shares are shares of mainland China-based companies traded on the Shanghai and Shenzhen stock exchanges.

<sup>3</sup> Forbes, "Dear Global Investors, You Will Own China Like It Or Not," March 4, 2019.

## Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

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