Post-Brexit China: The Silk Road Opens Again

The pace of China’s transformation from a centrally planned to a semi-market driven economy has been incremental and impressive — 40 years and counting. The Chinese mantra for the scale of growth and expansion during this lengthy process, however, seems to be “Go Big or Go Home!” As other powerhouse economies, like the U.S. and U.K., begin to rethink their approaches to global trade liberalization, China is preparing to expand its financial and political sphere by liberalizing its currency, maximizing partnership opportunities and increasing innovation.

CURRENCY LIBERALIZATION: THE CHINA PARADOX
A country’s economic and political standing has historically been reflected in the currency realm. A currency gains international prowess based on its:

• Ability to store and retain asset value
• Usage in trade: What percentage of invoices for imports and exports can be paid with the currency?
• Popularity as a reserve currency (i.e. Do central banks and other major financial institutions hold it in their reserves to pay off international debt obligations or to influence their domestic exchange rate?)

The World Bank expects GDP to grow:
• 3.8 times faster than the UK and the Euro Zone
• 3.1 times faster than the U.S.
• 2.4 times faster than the combined world economy.

The economy enlarged by 25,000% since 1980 and with this expansion, the incomes of 800 million people was raised above the poverty level.¹

² Ibid.
Despite having the world’s second biggest (and fastest growing) economy, China is still regarded as a developing nation largely because of China’s currency, called the renminbi, current limitations on these three fronts. These limitations stem from policies, such as pegging the renminbi to the dollar, market intervention, and restrictions on China’s capital account, which China has been progressively relaxing. Examples include:

• China is now emerging as a formidable exporter of foreign direct investment (FDI), thanks to its “Going Out” policy, aimed at promoting Chinese investments abroad.

• The China Securities Regulatory Commission (CSRC), relaxed limitations for the Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) programs, which allowed qualified foreign investors, such as financial institutions and asset managers, to exchange designated types of securities in China’s capital markets.³

The People’s Bank of China (PBOC):

• Provided a bit of transparency for the previously mysterious China Foreign Exchange Trade System (CFETS) RMB Index, a gauge that Chinese central bankers use to monitor the yuan’s movement against a basket of currencies. As of January 1, 2017, the dollar has reportedly been diluted and 11 new currencies were added.⁴

• Extended a currency swap agreement with the European Central Bank (ECB) (in place since 2013), up to 350 billion Rmb/€45 billion, essentially bolstering a “backstop liquidity facility to address potential shortage of renminbi for euro area banks” in September 2016.³

PARTNERSHIPS

One Belt, One Road (OBOR)

In 2013, the Chinese proposed a $900 billion foreign policy and economic strategy named “One Belt, One Road” (OBOR)⁶, intended to revive the “Silk Road” between Asia, Africa, the Middle East, and Europe, by constructing new roads and railways. Four years later, in May 2017, China and Kenya announced the launch of an integral part of this effort, a $3.3 billion railway project that will ultimately link Nairobi with the Indian Ocean.⁷ A $4 billion railway between Djibouti to Addis Ababa, Africa’s first transnational electric railway, is already in service.

We believe that OBOR is geared to have a massive long-term impact not only on China’s currency but the international community’s view of China as a global power.⁸ Estimates indicate the infrastructure project will involve approximately 65 countries, 4.4 billion people, and about 40% of global GDP. The core goals outlined by the Chinese government involve:

1. Policy coordination
2. Facilities connectivity
3. Unimpeded trade
4. Financial integration
5. People-to-people bonds.

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In a May 2017, OBOR summit, President Xi announced China’s pledge of $124 billion.\(^9\) China aims to complete the trade agreements with 40 percent of Belt and Road participants by the end of 2017.\(^10\) The project entails “creating new markets for the country’s construction companies and exporting its model of state-led development in a quest to create deep economic connections and strong diplomatic relationships” across four continents.\(^11\) OBOR has attracted comparisons to the Marshall Plan, which, by the way, was only 1/12 the size.

BREXIT: CHINA IN THE MIDDLE

China may seem caught between one of its biggest trading partners (the EU) and a loyal ally in the global financial system (the U.K.). We believe that China may have hedged its post-Brexit future by increasing stakes in both partners.

European Union

Trade relations with the EU have been complicated historically, and we believe that they have become even more strained recently, in matters regarding China’s 15-year quest for Market Economy Status (MES).\(^12\) MES implies World Trade Organization (WTO) member states accept that the nation’s prices are set by the open-market, not government intervention, and agree not to impose protective tariffs.

There have been no “trade wars” per se between China and the EU, but there have been notable skirmishes.\(^13\) The EU has accused China of dumping and officials from member states have voted against MES status. In December 2016, China accused the EU and the U.S. of unfairly initiating anti-dumping investigations and tariffs based on inapplicable pricing models.\(^14\)

The Asian giant has employed a tactical strategy to optimize its access to the 500 million consumers in the European Union. In 2016, Chinese FDI in the EU jumped 77 percent year-on-year to over 35 billion euros ($39 billion), according to a study by the Berlin-based think tank Mercator Institute for China Studies (MERICS) and Rhodium Group.\(^15\) China seems to be laying the groundwork to exceed that in 2017 by:

- Taking over Syngenta AG for $43 billion via China National Chemical Corp., (China’s biggest foreign deal ever).\(^16\)
- Snatching up 13.6 million square meters of European real estate by buying Logicor (pre-IPO) from Blackstone for $13.8 billion.\(^17\) This purchase,\(^18\) reportedly the largest private equity real estate deal on record in Europe, establiishes China as a major contender in the private equity sector.\(^20\)

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UK

The UK is not China’s top trading partner, nor has the pound sterling gained prominence equal to the euro (or the dollar) in China’s RMB Index. London, however, is the financial epicenter of Europe — the city serves as the European clearinghouse for 18 globally dominant currencies — and a major global financial hub. The United Kingdom has historically attracted more Chinese investment than any other European nation. Recent deals could signal China’s intent to center the U.K. as its European offshore hub.21

In 2015, Peoples Bank of China (BOC) floated five billion yuan-denominated bonds and the state owned Agricultural Bank of China sold $1 billion in dual currency bonds in London. The Chinese conglomerate, CITIC Group, Inc. is set to partner with developer giant ABP to invest £320 million in the £1.7 billion London Royal Albert Docks project that could bring 30,000 jobs to the area.

Chinese authorities have worked closely with U.K. government to create an extensive and pioneering strategy of financial cooperation, the London-Shanghai Stock Connect.22 The initiative entails the development of multiple points of unprecedented access and foreign direct investment (FDI) increases between the economic giants, including:

- Licensing of select British banks as lead underwriters of China-based panda bonds
- Allowance for increases in foreign ownership of China’s life insurance firms
- Commitment to a number of initiatives on green finance

Chinese investment on British soil extends beyond London. Several Chinese companies are involved in nearly two dozen notable projects across the U.K., including a $9 billion purchase of a 33.5% stake by China’s General Nuclear Power Corporation in Britain’s Hinkley Point nuclear power plant.23 China is also expected to invest in Britain’s Northern Powerhouse Investment Portfolio, thirteen large-scale property and infrastructure development projects, each worth more than £100 million.24

The U.K. government has been historically more supportive of China’s efforts to advance to market economy status than either the U.S. or EU. The U.K. joined China as a top supporter of the Asian Infrastructure Investment Bank (AIIB), committing £40 million to fund programs across developing nations in Asia, thereby, bolstering China’s economic status in the region. Due to the regulatory implications of Brexit, there are speculations that the days of London’s status as a global financial hub are numbered. There is also risk that the U.K. withdrawal from the EU could cause the U.K. economy to decline and accordingly, diminish the value of Chinese investments. Nonetheless, China’s big bet on its partnership with the U.K. can pay off in soft political power and economic advancement.

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United States
The economic powers of China and the U.S. have historically been the most linked among all of China’s advanced economy trading partners. The iPhone, the iconic symbol of U.S. technology and innovation, could not be produced without the core components from China, which, in turn, provide jobs for up to one million Chinese. China’s need for certain U.S.-made high technology and agricultural items, such as Boeing aircraft and soybeans, helps millions of U.S. workers also make a living. U.S. opposition to China’s bid for MES standing can therefore play out with significant economic pains, long and short-term, for both sides.

INNOVATION: TECHNOLOGY AND RENEWABLE ENERGY
Can China pivot from a comparative advantage in cheap goods and component materials to infrastructure, machinery, and high-technology (also core essentials for OBOR)? As the nation’s exporting becomes less reliant on manufactured goods and begins to increase exports from high-tech infrastructure and renewable energy, MES may become less economically important.

After building the world’s largest high-speed rail network in less than 10 years and creating globally competitive rail companies, China has garnered contracts to build subway and transport infrastructure in several major U.S. cities and transportation hubs. COMAC (Commercial Aircraft Corporation of China, Ltd.) and Russia’s UAC (United Aircraft Corporation) are working to develop aircraft that could compete with the similarly sized Boeing 787 and France’s Airbus A330neo.

Laying new roads and railways requires extensive technical expertise beyond massive infrastructure equipment, like switching technology. The Chinese government is seeking to improve its frequently criticized low R&D spending rate (as a percentage of GDP). China has given birth to its own technology companies, however, like the top five smart-phone maker, Xiaomi, and the Chinese challenger to Uber, Didi Chuxing.

In fact, China may not be investing in “research” but it is becoming a major funder of “development” through investing in up-and-coming tech firms. Midea, a Chinese company, obtained access to critical high-end technologies by buying German robotics firm Kuka last year for 4.6 billion euros.

China’s BAT tech trinity — Tencent, Baidu, and Alibaba — have rivaled legendary venture capital firms like Sequoia in funding and hosting some of the world’s biggest “unicorns” (startups with valuations reaching into the billions) across Asia.

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According to World Bank studies, completed in conjunction with Chinese officials and researchers, pollution as far back as 2007 has been costing China a percentage of GDP as well as human capital and key natural resources. China’s main economic rival, the U.S., seems resolved to resuscitate the coal industry. China’s National Energy Board plans to dedicate at least $360 billion and create 13 million jobs by 2020 to address the mitigation of global warming and make China a frontrunner in the renewable energy sector.

And, as with any technology-based sector, advances in renewable energy can set the stage for other growth opportunities. The Chinese Academy of Aerospace Aerodynamics (CAAA) developed the CH-T4, a 130-foot, solar-powered drone designed to deliver critical applications for not only in the military sector, but also important civilian benefits such as providing broadband to rural China.

CONCLUSION
China achieved prodigious growth as a leading manufacturer of labor-intensive and export-driven cheap goods. No longer content with providing 50% of the world's steel, the nation has begun a transition whose goal is to become a leading exporter of high-technology and capital. As of October 2017, FlexShares has six exchange traded funds that offer exposure to China:
• FlexShares Morningstar® Emerging Markets Factor Tilt Index Fund (TLTE)
• FlexShares International Quality Dividend Index Fund (IQDF)
• FlexShares International Quality Dividend Defensive Index Fund (IQDE)
• FlexShares International Quality Dividend Dynamic Index Fund (IQDY)
• FlexShares STOXX® Global Broad Infrastructure Index Fund (NFRA)
• FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR)

Investors considering China as a worthy risk may want to examine the industries and initiatives that would allow the economic giant to fulfill its vision. China’s willingness and capacity to fill gaps left by key changes in the global world order may yield unprecedented economic opportunities for its advancement.

FLEXSHARES CAN HELP
We believe our strategic beta ETF strategies here at FlexShares are among the most innovative in the industry. FlexShares Exchange Traded Funds offer focused ETF strategies that seek to help investors achieve real-world goals, by providing solutions that empower advisors to construct, allocate and manage outcome-oriented portfolios. We would be happy to share our insights on how investors and their advisors can help preserve, protect and grow investment portfolios. Please visit flexshares.com.

Written in conjunction with Tasha Williams utilizing Contenly. Tasha is a former banking risk analyst who has written about ETFs, social impact investing and fintech.

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Rapidly emerging as a major player in high-technology, venture capital, private real estate equity, and renewable energy sectors

World’s second largest provider and the top receiver of foreign direct investment (FDI)

Global leader in development finance, surpassing US in some regions

Trade within Asia is the 2nd largest intra-regional flow of goods

Some currency limitations persist

Concerns about existing debt and potential increases for OBOR and other initiatives

Strained trade relations with EU and US could impede MES goal

Environmental degradation from meteoric growth extracts GDP, human capital, and natural resources

Facilitate more cost effective trade in general on 4 continents

Strengthen position in hightech infrastructure and related sectors

Withdrawal of US from Paris Agreement opens door for domination in renewable energy

OBOR may solidify China’s power in Asia region, which collectively has trade surplus with many major world markets

Ability to optimize these opportunities may nullify China’s need for MES

Uncertainty tied to Brexit and related political concerns, however, could lead to depreciation of existing assets and delay pending economic cornerstone projects

Breakdown in trade relations with U.S. or EU could lead to economic trouble

Fears within Asia of China’s political expansion and environmental concerns may lead to roadblocks for OBOR
IMPORTANT INFORMATION

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus and a summary prospectus, copies of which may be obtained by visiting www.flexshares.com. Read the prospectus carefully before you invest. Foreside Fund Services, LLC, distributor.

FlexShares Morningstar® Emerging Markets Factor Tilt Index Fund (TLTE) is subject to concentration risk. The Fund’s investments are concentrated in the securities of issuers in a particular country, market, industry, sector or asset class. The Fund may be subject to increased price volatility and may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class. The Fund may also invest in derivative instruments. Changes in the value of the derivative may not correlate with the underlying asset, rate or index and the Fund could lose more than the principal amount invested.

FlexShares International Quality Dividend Index Fund (IQDF), FlexShares International Quality Dividend Defensive Index Fund (IQDE) and the FlexShares International Quality Dividend Dynamic Index Fund (IQDY) are passively managed and use a representative sampling strategy to track their underlying index. Use of a representative sampling strategy creates tracking risk where the Fund’s performance could vary substantially from the performance of the underlying index. Additionally, the Funds are at increased dividend risk, as the issuers of the underlying stock might not declare a dividend, or the dividend rate may not remain at current levels. The Funds are also at increased risk of industry concentration, where it may be more than 25% invested in the assets of a single industry. The Funds may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class. Finally, the Funds may also be subject to increased volatility risk, where volatility may not equal the target of the underlying index.

FlexShares STOXX® Global Broad Infrastructure Index Fund (NFRA) is subject to infrastructure-related companies risk and MLP risk. Risks associated with infrastructure-related companies include: realized revenue volume may be significantly lower than projected and/or there will be costs overruns; infrastructure project sponsors will alter their terms making a project no longer economical; macroeconomic factors such as low gross domestic product (“GDP”) growth or high nominal interest rates will raise the average cost of infrastructure funding; government regulation may affect rates charged to infrastructure customers; government budgetary constraints will impact infrastructure projects; and special tariffs will be imposed.

FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR) is subject to the global natural resource industry. As the demand for or prices of natural resources increase, the Fund’s equity investment generally would be expected to also increase. Conversely, declines in demand for or prices of natural resources generally would be expected to cause declines in value of such equity securities. Such declines may occur quickly and without warning and may negatively impact your investment in the Fund.

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