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SYNOPSIS

As US-China strategic rivalry drives economic and financial fragmentation, Chinese assets are becoming increasingly independent of US market cycles. Lower correlations – especially in China's domestic A-share market – can enhance global portfolio diversification by reducing concentration risk. While not guaranteeing superior returns, Chinese assets are evolving into a distinct strategic asset class worthy of renewed consideration.

COMMENTARY

For most of the past three decades, globalisation steadily integrated the world's economies. Trade expanded, multinational supply chains deepened, capital flowed freely across borders, and financial markets increasingly moved in tandem. Chinese equities were therefore largely viewed as part of the global emerging-market universe, with returns closely linked to international economic conditions.

Today, however, the intensifying geopolitical rivalry between China and the United States is fundamentally reshaping this relationship. Ironically, the ongoing economic and technological decoupling between the two powers may be making Chinese assets more valuable – not necessarily because they promise higher returns, but because they offer greater diversification benefits within global investment portfolios.

The principal driver of this shift is the growing divergence between the Chinese and US economies.

While the United States has experienced persistent inflation, high interest rates, and an investment boom driven by artificial intelligence and mega-cap technology companies, China has been grappling with property-sector weakness, subdued inflation, and slower growth.

In response, the People's Bank of China has pursued monetary easing, while the US Federal Reserve has maintained relatively tight monetary conditions. Consequently, US and Chinese equity markets increasingly respond to different macroeconomic forces rather than moving in tandem.

Beyond differing monetary cycles, the two countries are also pursuing increasingly distinct development models.

China's growth strategy is centred on advanced manufacturing, electric vehicles, batteries, semiconductors, robotics, renewable energy, and industrial upgrading, all under active government guidance.

By contrast, US economic leadership remains concentrated in software, cloud computing, digital platforms, AI infrastructure, and technology services.

As corporate earnings are increasingly driven by different industries and policy priorities, the earnings cycles of Chinese and American companies have become less synchronised, further reducing the correlation between their equity markets.

Geopolitical "de-risking" has reinforced this divergence. Export controls, investment restrictions, competing AI ecosystems, industrial subsidies, and efforts to secure domestic supply chains are gradually creating two partially independent economic systems.

While these policies increase geopolitical tensions, they also reduce the transmission of economic shocks between the two countries. As business cycles become less synchronised, investors regain some of the diversification benefits that globalisation had previously diminished.

China's capital controls provide an additional layer of insulation. Unlike fully open financial markets, China's partially closed capital account limits rapid cross-border capital flows, making its domestic A-share market less sensitive to fluctuations in US interest rates, global liquidity, and international investor sentiment.

Although capital controls may reduce market efficiency, they also shield Chinese markets from some global financial shocks, allowing them to behave differently during periods of volatility and thereby enhancing their diversification value.

These structural changes are increasingly recognised by global institutional investors. Major investment banks such as Goldman Sachs, Morgan Stanley, J.P. Morgan, and UBS have observed that Chinese equities remain under-owned relative to China's economic importance, trade at substantial valuation discounts compared with US equities, and offer growing diversification benefits due to their increasingly independent macroeconomic cycle.

Investor sentiment towards China has become more constructive, with many institutions viewing Chinese assets less as a tactical emerging-market allocation and more as a distinct component of global portfolio construction.

Not all Chinese assets, however, offer the same diversification advantages. China's domestic A-share market is primarily influenced by local liquidity conditions, domestic monetary policy, retail investor behaviour, and companies serving the domestic economy.

Hong Kong-listed H-shares, by contrast, remain much more exposed to international capital flows and global investor sentiment. Consequently, A-shares may provide greater diversification benefits because they are more closely tied to China's domestic economic cycle than to global financial conditions.

Importantly, diversification should not be confused with superior investment performance. Modern Portfolio Theory demonstrates that combining assets with lower correlations can improve risk-adjusted returns by reducing overall portfolio volatility and concentration risk, even when individual assets do not generate exceptional returns.

Given the heavy concentration of US equity markets in a handful of technology companies, allocating a modest share of portfolios to Chinese assets may improve portfolio resilience without replacing US investments.

Nevertheless, the case for diversification should not be overstated. During severe global crises, financial correlations often rise sharply as investors sell assets indiscriminately across markets. Moreover, China continues to face significant country-specific risks, including regulatory intervention, political uncertainty, demographic challenges, a prolonged property-market adjustment, and geopolitical tensions such as sanctions and cross-Strait risks.

Ironically, the same geopolitical fragmentation that enhances diversification also introduces new forms of strategic and financial tail risk that cannot be eliminated simply through portfolio allocation.

The broader implication is that China is gradually evolving into a distinct macroeconomic asset class. Its monetary policy, industrial strategy, technology ecosystem, capital markets, and investor base are increasingly independent of those of the United States.

Rather than operating within a single global business cycle, investors now face two partially separate economic systems with different policy responses and growth drivers. Future global asset allocation may therefore focus less on convergence and more on balancing exposure across these two increasingly independent economic ecosystems.

In conclusion, geopolitical fragmentation is reshaping global investing in unexpected ways. While US-China strategic competition has increased economic uncertainty, it has also reduced the correlation between Chinese and US financial markets. This lower correlation enhances the diversification value of Chinese assets, particularly domestic A-shares, by improving portfolio efficiency and reducing concentration risk.

Chinese assets should therefore be viewed not merely as an emerging-market growth opportunity, but increasingly as a strategic diversification tool. The key question for global investors is no longer whether Chinese markets will mirror those of the United States, but how much exposure they should maintain to an increasingly independent Chinese economic cycle.

Professor Tan Kong Yam is Emeritus Professor of Economics at Nanyang Technological University (NTU), Singapore. He was a senior economist at the World Bank's office in Beijing from June 2002 to June 2005. Before that, he was the chief economist of the Singapore Government. His research interests are international trade and finance, economic and business trends in the Asia Pacific region and economic reforms in China. Professor Tan is currently the NTUC Professor of International Economic Relations at the S. Rajaratnam School of International Studies (RSIS) at Nanyang Technological University (NTU).

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