



China's Long-Term Opportunity Remains Compelling

Beyond near-term trade tensions, positive fundamentals underpin China's long-term outlook.

September 2019

KEY INSIGHTS

- The growth case for China is well established: Its share of global GDP remains substantial while the economy continues to outpace most of the world, underpinned by strong domestic demand.
- Trade tensions between China and the U.S. represent a headwind in the near term. While a protracted trade war is not in either country's long-term interests, a quick resolution also appears unlikely.
- Meanwhile, the positive long-term investment thesis for China remains unchanged. The fundamentals underpinning China's domestic equity and credit markets remain compelling.

For some five decades, economic growth in China has handily outpaced global growth. Rapid productivity growth, rising wealth, and robust domestic demand have all fueled the China economic "miracle." More recently, however, slowing growth; rising debt; and, latterly, trade-related uncertainty have dominated the narrative. Just as China is opening up its domestic equity and bond markets, creating vast new opportunities for foreign investors, some are beginning to question China's investment potential. However, we believe the long-term investment case remains compelling.

The Macro View

Chris Kushlis

*Emerging Market Sovereign Analyst,
T. Rowe Price*

China's Economy Remains a Powerful Engine

China has been such a strong driver of global growth for so long, it is not hard to see why its slowing economy is worrying for many investors. Crucially, however, as China's weight within the global economy has increased in recent decades, so too has its overall contribution to global growth. China now contributes roughly 1% of total global growth, which is currently 3% to 3.5%. So even though China's aggregate growth rate has slowed to around 6% to 6.5% per annum, it continues to provide a substantial contribution to global gross domestic product (GDP) growth.



Chris Kushlis

*Emerging Market Sovereign Analyst,
T. Rowe Price*



Sheldon Chan

*Portfolio Manager, T. Rowe Price
Asia Credit Strategy*



Eric Moffett

*Portfolio Manager, T. Rowe Price
Asian Opportunities Equity Strategy*

1/3

China's approximate contribution to total global GDP growth.

Meanwhile, as China has become fully integrated into the global goods and trading system, income levels have largely converged to the global average, with China now essentially a middle-income country. Yet, there is still some way to go before it catches up to the world's wealthiest nations. So despite being the world's second-largest economy, there is still a great deal of relative wealth improvement potential. To put this in context, if China's relative wealth was to converge with U.S. levels, for example, its economy would balloon to roughly four to five times the size of that of the U.S.

However, making this jump is easier said than done, and China must overcome various structural challenges if it is to reach that next plateau of relative wealth equality.



The Shift to Sustainable Growth

From around 2006, the Chinese government began trying to rebalance the economy, moving away from a predominantly export-driven model, toward a more domestic-based model—a move that was accelerated by the global financial crisis. This shift is aimed at engineering more sustainable, long-term growth. Further slowing in the rate of growth is likely as this transition continues.



The Accumulation of Debt

As part of the economic transition process, the Chinese government has embarked upon a vast program of domestic investment to replace the decline in export demand, which has been largely funded by debt. As a result, China's debt-to-GDP ratio has soared to around 250%, raising questions about sustainability and potential risks. Authorities have recently moved to arrest the ballooning level of debt and have at least succeeded in stalling the pace of growth without inducing any serious financial market dislocation. There is still more to do, but progress has been made.



Shifting Demographics China's changing demographics also pose a structural headwind. The country's working age population (15–64 years) started falling around 2012, while the

dependency ratio (number of people over 65, compared with number of 15- to 64-year-olds) started to rise. The decline in the working age population is still relatively moderate but is expected to accelerate over the coming decades.



Commitment to Reform

Questions have been raised about how committed President Xi Jinping is to reforming China's economy, versus aligning more closely to a statist model. The consolidation of state-owned enterprises (SOEs), for example, seems to support the latter view. Given that SOEs tend to be less efficient and deliver lower relative rates of return, their growing prominence within the economy represents a potential drag on growth. Conversely, China's focus on innovation and developing new technology are policies that should ultimately support a longer-term shift from a middle- to a high-income country.

China's Bond Connect System Is a Major Development

A major development in global bond markets recently has been the opening up of China's domestic bond market to foreign investors. Historically, it was very difficult for fixed income investors to access China's bond market due to strict capital controls and quotas. However, the creation of the Bond Connect system in 2017 has allowed foreign investors to invest seamlessly in the onshore bond market, and paved the way for China's inclusion in the Bloomberg Barclays Global Aggregate Bond Index in April 2019. China will ultimately make up a 6% weighting in the index at full inclusion, completed over a 20-month period.

Meanwhile, in September 2019, J.P. Morgan announced plans to include China in its emerging market local bond index, capping its weighting at 10% (phased in over a 10-month period). The total size of China's onshore bond market is closer to USD 13 trillion—an amount roughly equivalent to all euro-denominated securities—if it were to be fully represented in the index.

What's Driving China's Investment Markets?



The Credit Market View

Sheldon Chan

*Portfolio Manager,
T. Rowe Price Asia Credit Strategy*

The Rise and Rise of Asia Credit

There has been tremendous growth in the Asia credit asset class over the past decade. Since 2010, the universe has been growing at a rate of 15% a year, and today there is more than USD 1 trillion in outstanding debt stock.¹ What's more, we think that this double-digit growth can be comfortably sustained moving forward. U.S. dollar bonds remain a very small part of the overall funding mix for Asian corporates and, so, could continue to increase as companies look to diversify their sources of capital.

The market offers a broad and diversified credit profile, and appetite for new issuance should remain strong. The high savings rate in China and other key markets creates a powerful structural demand from within the region for income-generating investments, with local investors accounting for around 88% of corporate debt ownership in Asia.²

Fundamentals Are Improving

Despite headline uncertainties tied to U.S.-China trade tensions and the impact on global growth, the Asia region still boasts the fastest economic and demographic growth, globally. China's economic influence has been well documented, and we expect it will remain so. Policymakers are working to reduce reliance on export-led growth, increase foreign currency reserves, and improve the transparency of the markets.

Country fundamentals across the region have improved steadily over the past decade, with all the major countries graduating to investment-grade status. Deleveraging policies and increased regulation in recent years have also imposed new discipline and forced poorer-quality firms out of the market—all of which augurs well for the longer-term stability and growth of the asset class.

Financial Health Remains Key

The most important attribute for credit investors is the health of the balance sheet—a feature strongly demonstrated by many Asia corporates. Looking at Chinese internet companies, for example, a number of these businesses boast healthy, net cash, balance

“Deleveraging policies and increased regulation in recent years have also imposed new discipline and forced poorer-quality firms out of the market...”

— Sheldon Chan
*Portfolio Manager, T. Rowe Price
Asia Credit Strategy*

¹Source: J.P. Morgan as of August 31, 2019.

²Outstanding debt in Asia ex Japan, J.P. Morgan, as of October 31, 2018.

sheets. The strong financial position of these companies makes their bonds potentially attractive while, in contrast, the equity stock might look less so given the volatility in earnings seen in these businesses over the past year.

An Attractive Risk/Return Profile

Asia credit has demonstrated an attractive track record of risk-adjusted returns over an extended period. With an average credit rating profile of BBB+ and 30% of the J.P. Morgan Asia Credit Diversified Index benchmark coming from developed countries, it is noteworthy that Asia credit has generated stronger long-term returns versus U.S. investment-grade credit, but with a similar level of volatility.

Currently, we prefer Asia investment-grade bonds, as well as maintaining a higher quality bias for our Asia high yield exposure. A prolonged U.S.-China trade war and the threat of broad-based economic slowdown would likely see high yield credit spreads remain at elevated levels. That said, we do see selective opportunities in China high yield real estate and consumer sectors, but also stress the need for bottom-up, fundamental analysis to pick the winners.

The Equity Market View

Eric Moffett

Portfolio Manager, T. Rowe Price Asian Opportunities Equity Strategy

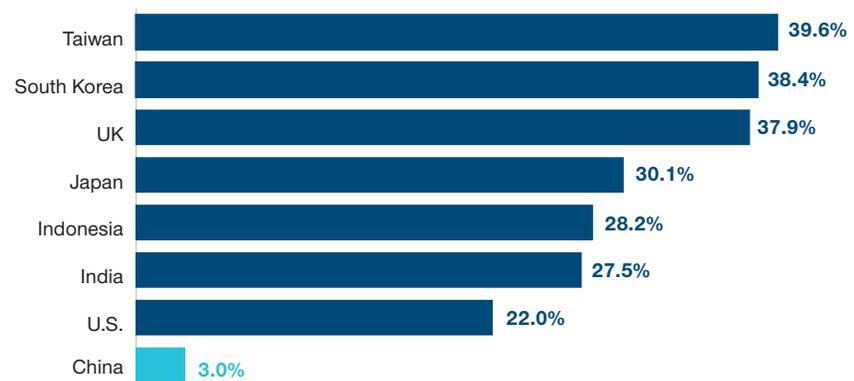
China's Domestic Equity Market—Large, Diverse, and Inefficient

From an equity market perspective, there is no doubt that the China A-shares market represents an exciting long-term opportunity. The domestic market remains highly inefficient, dominated by retail investors, and still significantly underpenetrated by foreign investors. Foreign ownership of China A-shares, for example, remains around just 3% while, in comparison, other Asian markets, like Taiwan and South Korea, are around 40% foreign owned (Fig. 1).

Over the last five years, global investors in China have largely targeted the growth-oriented names, particularly in the higher-profile technology/internet-related areas. However, interest is starting to broaden beyond the tech sector alone, with consumer-oriented areas, for example, attracting increasing investment. As foreign investor interest

(Fig. 1) Foreign Ownership of China A-shares Remains Extremely Low

Foreign ownership of world stock markets
As of March 31, 2019



Sources: Haver Analytics, Goldman Sachs, BofAML.

Household income in China continues to rise, particularly across the working class, growing at around 10%, annually.

— Eric Moffett
Portfolio Manager, T. Rowe Price
Asian Opportunities Equity Strategy

and investment continues to grow, this will not only underpin long-term returns, but also drive improvement in market regulation and transparency.

GDP Growth Matters, but This Growth Matters More

While all the world's focus is on China's slowing rate of GDP growth, a more important growth metric for many domestic companies is the growth in household wealth. Household income in China continues to rise, particularly across the working class, growing at around 10%, annually (Fig. 2). There are two key reasons for this: demographics and policy. Regarding the former, with China's working age population in decline, workers are seeing a degree of pricing power, leading to upward pressure on wages.

On the policy side, the government has prioritized delivering meaningful wage increases for workers each year for the past decade. In doing so, the government is effectively underwriting the boom in Chinese consumption—across a demographic of hundreds of millions of people.

In this way, the story of the Chinese consumer remains one of the most exciting in the world and, potentially, has decades still to run. More and

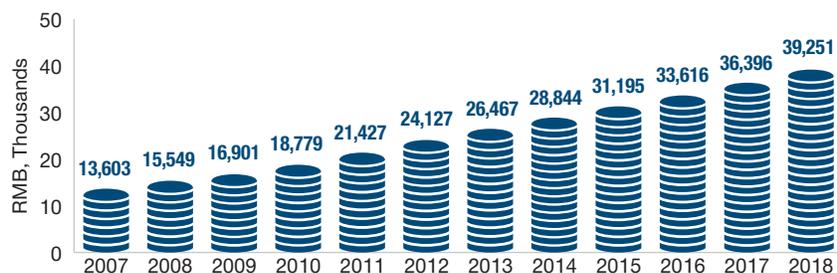
more Chinese households are buying products that are prominent in the western world such as cars, electronics, cosmetics, and health insurance, as well as spending increasing amounts on food, holidays, and entertainment. “Product premiumization” is also a big theme, as Chinese consumers are increasingly demanding higher-quality products.

Moving Up the Value Chain

China is also moving up the value chain, progressively moving away from its history of low-cost export production. Rising wages mean that China has become less competitive as a cheap source of labor and so is progressively moving out of some of the lower-skilled manufacturing industries. Similarly, China is also investing significantly in research and development (R&D) in areas like mobile payment processing, artificial intelligence, robotics, and 5G technology. No longer content to simply copy the technology of others at a cheaper price, the Chinese government has made innovation a core component of its future economic strategy. And the investment is paying off with Chinese companies starting to take market share from some of the leading global companies. In cutting-edge areas like facial and speech recognition, China is already the recognized leader.

(Fig. 2) For Many Chinese Companies, Household Wealth Matters Most

Household disposable income—urban
As of December 31, 2018



Sources: Haver Analytics, China National Bureau of Statistics, OECD.

Near-Term Headwinds Must Be Negotiated

That said, the breakdown in trade relations between China and the U.S. is a clear headwind in the near term, and a quick-fix solution does not appear likely anytime soon. However, amid this uncertain backdrop, valuations in China have fallen significantly over the past year to crisis-like levels. And while some companies undoubtedly warranted being derated, many good-quality companies have also been sold off alongside the bad. Rarely have we seen local investor sentiment as negative as it is today, and while this creates near-term market uncertainty, it also presents opportunities to buy good companies at heavily discounted prices.

In Conclusion

The growth case for China is well established: Its global share of GDP remains substantial, while its economy continues to grow at a faster rate than most anywhere else in the world. These trends are underpinned by solid growth in the middle class, robust domestic demand, and the region's growing influence on the world political stage.

The ongoing U.S./China trade dispute is a source of near-term uncertainty. While it is not in either country's long-term interests to see a protracted trade war develop, a solution does not seem close. That said, with an election year looming in the U.S., President Donald Trump will be mindful of any policies that could materially impact growth in the runup to November 2020.

Meanwhile, Chinese authorities also have stimulative levers available to them, as they feel necessary. Indeed, it looks like the economy has slowed to the point where we are now seeing authorities return to some of these stimulative policies. And the positive effects are already being felt in some of the manufacturing industries.

The positive long-term investment thesis for China remains unchanged, in our view. The fundamentals underpinning the domestic financial markets remain compelling, and foreign investors have only just scratched the surface of what is China's large and diverse opportunity set.

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.



Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2019 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.