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INSIGHTS WEBINAR SUMMARY

China: Too Big to Ignore

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Chris Kushlis, CFA
Chief of China and Emerging Markets Macro Strategy

Wenli Zheng
Portfolio Manager, China Evolution Equity Strategy

Regulatory Actions are Well Intended, and Opportunity Lies in Their Wake

- Wenli Zheng, portfolio manager of T. Rowe Price's China Evolution Equity Strategy, acknowledged that the recent regulatory actions by the Chinese government had caused concerns among investors. However, he reminded the audience that these actions were part of a long-term plan to ensure a more equitable society, along with a desire to create greater competition and avoid monopolies.
- In particular, he mentioned the rise of online platforms and the intention for the creation of a more open ecosystem for all online platform providers, as opposed to affording mega-cap tech giants certain implicit protections. This would also help protect relevant stakeholders within the industry who usually have weaker bargaining powers versus these large platforms.
- In terms of investment implications, Mr. Zheng noted that the Chinese equity market was constantly evolving, citing several major shifts in the MSCI China Index. Twenty years ago, telecommunications firms accounted for over half of the index's weight, while financials dominated in the 2000's with nearly 40%. Today, internet companies comprise 40% to 50% of the index as China has evolved and innovated. Mr. Zheng advocated for the approach of seeking out emerging trends, rather than focusing on existing incumbents.
- He also noted the importance of aligning your investment strategy with the direction of regulatory reform. This is difficult due to a lack of transparency and communication in some areas. The pace of change has also increased. However, Mr. Zheng believes that, on balance, the government's regulatory agenda is both consistent and well intended. China has over 5,300 stocks in its liquid markets, so there is also plenty of opportunity to invest in other areas not impacted by regulatory change.
- In Mr. Zheng's view, China remains an attractive market. It provides access to what he believes are some of the best business models and growth opportunities, and can serve as a key source of diversification for global investors. He also believes China's relatively inefficient market may provide active investors the potential for sustainable alpha generation.

China’s Economic Trajectory and Credit Cycle

- Chris Kushlis, T. Rowe Price’s Chief of China and Emerging Markets Macro Strategy, shared that despite meaningful headline interest in China’s new regulatory policies, he believes the impact to the country’s long-term growth trajectory remains modest. Mr. Kushlis attributed China’s long-term growth prospects to two key structural forces: slowing demographics and its ability to move higher in the global value chain due to productivity gains.
- While the “demographic dividend” is fading, Mr. Zheng commented that advancements in education and engineering have started to shift China’s competitive advantage away from being a low-cost manufacturer and toward innovation.
- For fixed income investors, Mr. Kushlis cited China’s current deleveraging campaign as a focus point. China had ridden the credit wave to develop its property sector, but the country’s credit-to-GDP ratio had reached levels that had begun to raise concerns among financial regulators. As a result, regulators have proactively tightened credit facilities to avoid potential financial instability.
- Overall, Mr. Kushlis believes it is likely that China will need to recalibrate its long-term GDP growth expectations modestly lower: Its previous growth rate of 6% to 8% a year, will likely fall to around a 4% to 5.5% range over the next 10 years.

Investing in China’s Innovation

- Mr. Zheng encouraged investors to look beyond the Chinese mega-cap companies on the internet and health care sectors to other pockets of the Chinese economy with leading players in rich industries, as well as the rising companies in emerging sectors, such as renewable energy, electric vehicles, and semiconductors.
- Innovation is a major source of opportunities and wealth creation: If you look at just over the past three years, there has been a USD 2.5 trillion market cap increase from three sectors: internet, biotech, and electric vehicles. But innovation is not just limited to those emerging or new industries. Even in traditional sectors, China is quickly becoming a front-runner in adopting the latest technologies, which allows it to catch up on the value chain and to compete on performance, rather than purely on cost.
- In the consumer space, two major trends were noted: First, the rise of local domestic brands. Like South Korea and Japan several decades ago, China’s rising middle class is shifting preferences to domestic brands due to the disruptive power of social media and e-commerce. Second, a shift from spending on products to spending on services. Given most Chinese sectors are still highly fragmented, this tailwind provides huge consolidation opportunities for industry leaders in areas such as hotel chains, property service management, drugstores, etc.
- Long-term drivers for China’s economy include urbanization, infrastructure spending such as investing in the green transition underway, and consumerism with its rising middle class.

Investor Concerns Over ESG Factors, Accounting Practices, and ADRs

- Mr. Zheng emphasized the country’s meaningful progress toward green transition and underscored its commitment to environmental protection. Fundamentally, he noted that industry leaders which have embraced solid environmental, social, and governance (ESG) practices have emerged stronger.
- He did concede that Chinese companies can be weaker in terms of ESG disclosure, but many were becoming more receptive to perspectives and feedback from international investors on ESG. Engagement is a key component of his research process and allows him to develop a comprehensive view of companies, including their ESG credentials.
- In terms of accounting standards, despite some reports of fraudulent activity, Mr. Zheng believes that many Chinese companies have high accounting standards. China's generally accepted accounting principles are aligned with the International Financial Reporting Standards.
- On the topic of delisting American Depositary Receipts (ADRs), Mr. Zheng regarded this as a low-probability scenario, but not impossible. If this were to happen, Mr. Zheng reminded investors that they would be able to convert their ADR shares into Hong Kong-listed shares.

U.S.-China Geopolitical Tensions Remain Elevated but Stuck in a Holding Pattern

- The geopolitical landscape has become more complicated and harder to navigate over the last few years, in Mr. Kushlis’s view. Under President Trump, the relationship between the U.S. and China became more contentious. Under President Biden, there are signs that we may be heading toward a more conducive relationship where there is greater competition, but also efforts to avoid conflict.

- On trade policy, Mr. Kushlis does not believe that there will be major near-term shifts in the next six to twelve months as there is little desire to reduce tariffs by the US. However, he thinks it is likely that country representatives will negotiate over several longer-term trade issues, which should forestall further tariff increases at this time.
- When asked about the military risks surrounding Taiwan and China, Mr. Kushlis described the risk of a unilateral Chinese action on Taiwan in the next five to ten years as still moderately low. While the Chinese government still seems intent to pursue a peaceful path to unification, the U.S. appears increasingly worried that the military balance is moving against Taiwan. While he believes recent headlines are an attempt to signal redlines around moves toward recognizing Taiwan, he is watching developments closely in the near term.

China's Currency Position in Foreign Exchange Markets

- The renminbi (RMB) has outperformed significantly against a number of other currencies, supported by the rise in China's current account surplus over the last 18 months as China became the exporter to the world during the COVID-19 crisis. But Mr. Kushlis believes that we are likely to see some sort of depreciation from here, mainly because of the anticipated slowdown in China's economy.
- Long term, there is a push for the RMB to be recognized as a potential reserve currency globally. To foster this goal, Mr. Kushlis believes it will be important for Chinese officials to allow for more volatility in the currency. That means allowing market forces to drive valuations more than they have previously.