



CHINA: YESTERDAY'S STORY OR MORE COMPELLING THAN EVER?

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Faced with slowing economic growth, protectionist trade policies and an uncomfortably high debt burden, some are suggesting that China is at risk of becoming an economic success story of the past. But while headwinds clearly exist, we think China still offers plenty of compelling investment opportunities.

GDP GROWTH IS KEY – BUT NOT THE TYPE YOU EXPECT

The macro outlook in China continues to dominate investor thinking, with concerns focused on slowing economic growth. However, what matters most for many domestic stocks is not so much national GDP growth, but the GDP growth of households.

Data shows that disposable household income has increased significantly over the past 10 years, despite the slowing economy. The income growth contributes to improved affordability for working-class families across a range of consumables including holidays, insurance, healthcare and medical services. And today, we are witnessing increased spending across a demographic of hundreds of millions of people.

HOW DAMAGING IS THE TRADE NARRATIVE REALLY?

The China/U.S. trade war remains a key concern for investors in China, and prospects of improvement appear slim at present. Despite this, it remains an ongoing misconception that China's economy is dependent on exports. Indeed, net exports accounted for only around 2% of total GDP last year.

This is largely because the “value-add” in China is surprisingly quite low. The iPhone is a great example of this: while the phones are manufactured in China, only about 4% of the value-add happens there. Most of the components come from elsewhere and the profit is largely captured by Apple in California.

Significantly, China trades far more with other emerging market countries than it does with the G3 (Europe, Japan and the U.S.). As such, the U.S. has less leverage today than it did 15 years ago when trade was heavily-weighted to the G3. This mitigates the pressure on China to react, while the Chinese government also has numerous levers at its disposal to help soften the impact of trade tariffs.

CHINA'S “DEBT MOUNTAIN” NEEDS TO BE VIEWED IN CONTEXT

Investors also see China's substantial debt stockpile as a primary risk. It is true that, over the past 10 years, non-financial corporate debt-to-GDP in China has risen from 100% to 165%, with some commentators nervous that this level is simply unsustainable. However, it is crucial to keep in mind that interest rates in China have plummeted over the same period.

“The China A-shares market is trading at 12 times earnings. This represents crisis-level valuations for an economy that is still growing faster than most places in the world.”

Ten years ago, the corporate borrowing rate was in double digits. Today, it is between 4-5%. Corporate interest relative to GDP, which is the key systemic risk indicator, is currently at 7%, the same level it was 10 years ago.

As the rate cycle turns, China is likely to feel the stress but, unlike some other major markets, there is no pressure to raise rates any time soon. There are no signs of inflation currently and the impact of tariffs is likely be deflationary – all of which suggests that the stock of debt is not yet a major concern.

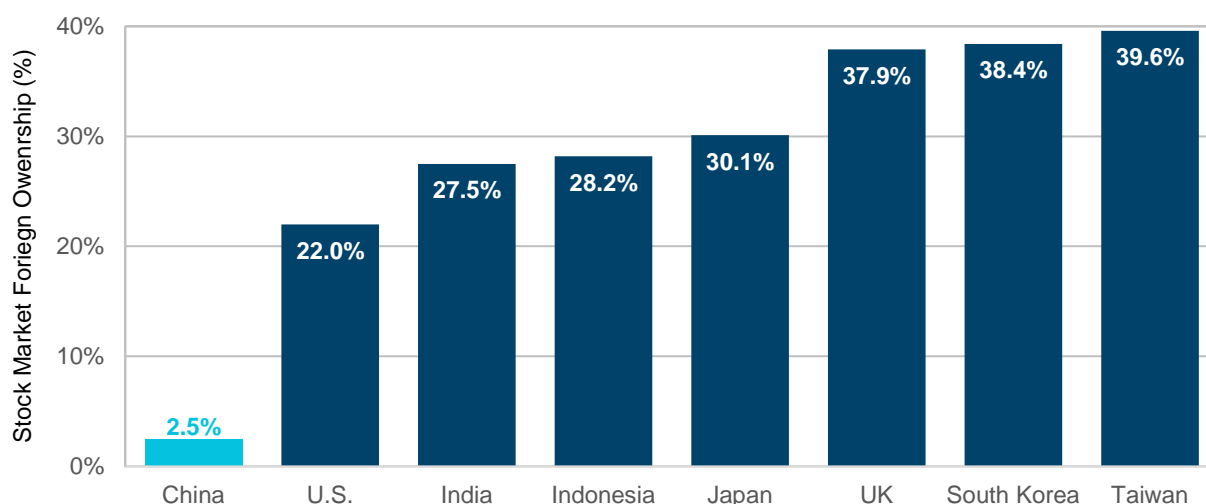
THE INEFFICIENCY OF THE CHINA A-SHARES MARKET IS COMPELLING

So against this backdrop, where are investors looking?

While Chinese equities have underperformed all other major markets year-to-date, there is a lot to be excited about. Valuations look very cheap, which is partly a reflection of the slowing growth/trade sanctions headwinds. But by comparison the MSCI World Index is currently trading at a price/earnings ratio of nearly 20 times, well above the China A-shares market at 12 times earnings. This represents crisis-level valuations for an economy that is still growing faster than most places in the world.

Figure 1: China A-Shares Represent A Huge Opportunity Set to Explore

As of June 30, 2018



Source: BofAML.

In the 15 years that I have been investing in emerging markets, I have never seen greater inefficiencies than I see in the China A-share market today. This is partly due to it being a very deep market, with plenty of good companies hidden from the gaze of foreign investors. As a retail-driven market, information is not often published in English, nor are investor roadshows a feature of corporate activity, meaning that only a small percentage of the market is owned by foreign investors (Figure 1). This represents a great environment for finding mis-priced opportunities.

A stock I have recently added is Sichuan Swellfun, a white spirits company that makes Baijiu, a type of Chinese vodka. When I first started looking at this company several months ago, there was no information available in English. There are also larger, higher profile, spirits companies in China so it was not very well known among foreign investors even though it is controlled by global drinks giant, Diageo. At the time I bought it, Diageo owned a 40% stake, now they have upped this to 60%. It is a well-positioned local company with western-style corporate governance, a disciplined and experienced management team, and a clear go-to market strategy.

“CHEAP MANUFACTURED GOODS AND COPIED INTELLECTUAL PROPERTY”

This is another misconception of China as a manufacturer of cheap goods that no longer describes the country today. As wages have risen, China has become less competitive and moved out of a range of manufacturing areas. It is now moving up the value chain, with a growing amount spent on research and development in high-tech areas.

And when it comes to applying new technologies, China is a fertile testing ground, as new ideas and products can be rolled out to millions of people in a relatively short time. Good ideas quickly stand out and are widely adopted, while the bad ideas disappear just as quickly.

We believe that, despite ongoing investor concerns, growth remains strong and valuations look cheap. China is now more compelling than ever – if investors know where to look.

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