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PRICE POINT
November 2015

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Economies and Markets.

CHINA'S "NEW NORMAL": OPPORTUNITIES IN A SLOW-GROWTH ECONOMY.

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EXECUTIVE SUMMARY

Headlines about China have grown increasingly pessimistic as the country experiences its weakest economic growth in many years. China-driven worries have recently fueled a renewed slump in commodity prices and an emerging markets sell-off, adding to long-held concerns that the country could experience a "Lehman moment" after a rapid rise in debt since the 2008 global financial crisis. While T. Rowe Price investment professionals do not think China is on the brink of a full-blown crisis, we believe that China's large debt level will weigh on its growth for many years. This slow grind scenario raises the likelihood that China is in for a long period of below-potential growth similar to Japan's lost decades starting in the early 1990s. Despite this bearish backdrop, we continue to see opportunities in select Chinese companies, many of which are adapting to slower topline growth.

WHAT IS CHINA'S "NEW NORMAL," AND WHY IS IT HAPPENING NOW?

In May 2014, Chinese President Xi Jinping announced that China was in a "new normal" of slower economic growth. The new normal comes as China's economy is shifting to new growth drivers and away from the old growth model that relied on manufacturing and investment. While the old growth drivers worked remarkably well for the past three decades, in recent years, China's GDP growth has slowed even as investment has increased. Because the old investment-driven model is producing diminishing returns, China's growth model had to change.

Manufacturing has long been China's growth engine, but the services sector is gradually taking its place. Moving away from a manufacturing-driven economy to one led by services and consumption is a long process that will take many years. This transition will entail a lower growth rate than the double-digit GDP expansion rates of previous decades.

A SPECTACULAR RISE IN DEBT

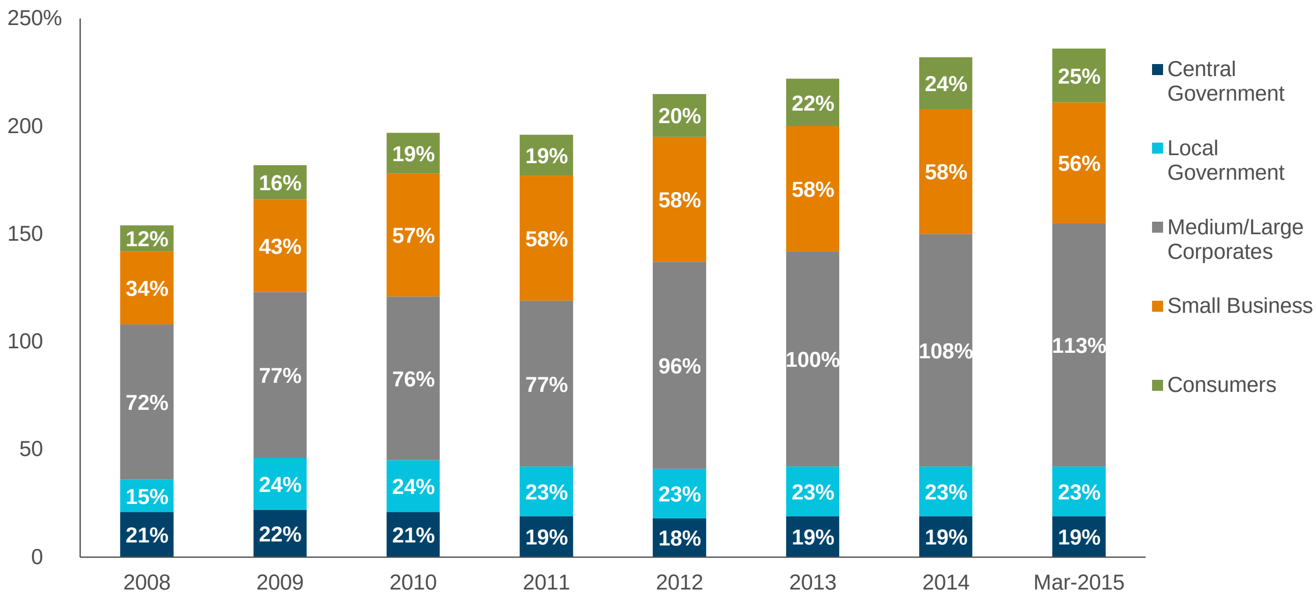
A big factor driving China's changing economy is that its old model was funded by debt—an unsustainable growth driver over the long run. China's debt level climbed rapidly following the 2008 global financial crisis after it announced a huge economic stimulus package.

Including corporate, household, small business, and government debt, China's indebtedness rose from about 150% of GDP in 2008 to roughly 240% of GDP in 2015—a spectacular increase by any global historical comparison. Such a rapid rise in debt has often led to a financial crisis, not only in emerging markets, but also in developed ones.

Much of the debt increase lies with medium-sized to large corporates, as shown below. This category includes many state-owned enterprises (SOEs)—typically, local government entities set up to fund infrastructure projects. Over time, however, many of these SOEs became "zombie" companies—unable to pay off their debt, yet kept alive by various local government subsidies.

Figure 1: **Where Is the Debt?**

As of 31 March 2015



Levels of debt rose rapidly after 2008, but the pace of increase has slowed.
Much of the corporate debt in China is at the SOEs and may be considered quasi-government.

Source: Morgan Stanley.

Uncertainty about the extent of nonperforming assets in China's banking system is a big concern. Our regular visits to China have found that smaller lenders in the inner provinces define nonperforming assets differently from a big bank in Beijing. Because of the varying ways that nonperforming loans (NPLs) are accounted for around the country, we believe that the level of NPLs in China's financial system is much higher than 1.5%, the latest figure provided by the central bank.

In fact, we suspect that much of China's credit growth in recent years has been driven by banks giving additional loans to troubled borrowers to allow them to pay off their existing debt. This "ever-greening" of existing debt is troubling, since it helped contribute to Japan's financial crisis in the 1990s.

NO LEHMAN MOMENT, FOR NOW

In contrast to the most bearish forecasts, we don't think that China is at risk of an imminent large-scale financial crisis. China has one of the biggest current account surpluses of any country on an absolute basis and is the world's biggest holder of foreign exchange reserves (roughly US$3.5 trillion as of the end of September). Both provide the country with ample resources to support its financial system.

As long as China's government can finance its banking system by maintaining some control over the capital account using liquidity from the current account surplus and has central bank reserves at its disposal, we believe it can avoid a crisis by kicking the can down the road—just as the European Central Bank did at the height of the euro sovereign debt crisis.

Unlike U.S. bank regulators who allowed Lehman Brothers to fail, policymakers in China are opposed to letting financial firms go under, since doing so would be too destabilizing. Similarly, cleaning up the NPLs in China's banks could produce negative GDP growth—an unattractive option for Chinese policymakers.

A LONG, SLOW GRIND AHEAD

Rather than a Western-style banking crisis, we think the most likely outcome is that China will see years of steadily slowing growth as it avoids the pain of deleveraging and sticks with its current "kicking the can" strategy. At the central government level, China still has low debt and deficit levels, giving policymakers the flexibility to support other over-indebted sectors.

Maintaining the status quo will allow China to forestall a Lehman-type crisis and avoid a painful deleveraging process. However, this is not a cost-free strategy in the long run. Misallocated capital, overcapacity in certain industries, and investment in projects with diminishing returns will continue to weigh on China's economy, resulting in GDP growth slowly grinding lower over time.

China continues to reform its economy, and the changes in some areas are encouraging. However, reforming the SOEs that make up a large part of China's economy is a long and complex undertaking that faces stiff resistance from competing interests. Whether or not these reforms will be successful is still uncertain.

Given China's ability to service its debt, unwillingness to let financial firms go under, and emphasis on stability, we believe that China could be in for a "lost decade" of below-potential growth, much like what Japan endured after its property market bubble burst in 1991.

WHERE DO WE SEE OPPORTUNITIES IN CHINA'S CHANGING ECONOMY?

We are finding pockets of opportunity in businesses that are taking share in their respective markets despite China's slowing economy. Technology companies, particularly some Internet names, and select consumer and services companies are still growing. Most of our research centers on private sector companies, where people are proving more adept at responding to the new environment.

In the consumer area, we're focusing on innovative businesses that are introducing new and different products, as Chinese consumers become more sophisticated in their preferences. In the services area, we think that health care and logistics are promising areas. The opportunity set in services is currently small but has a lot of room for growth.

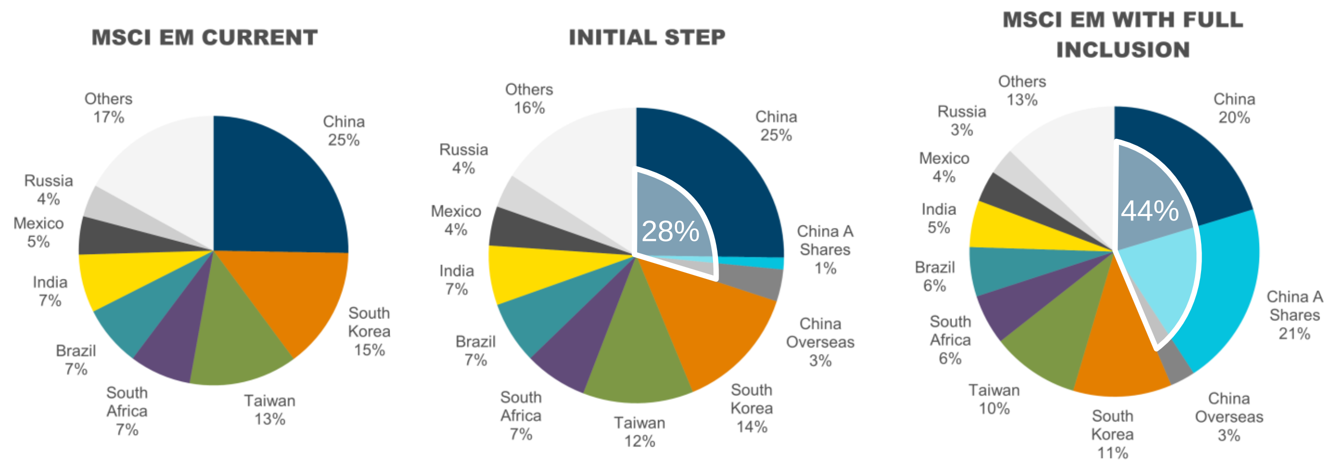
We try to seek out businesses that are adjusting to lower—even negative—topline growth. Many companies realize that the strong demand and cheap money of recent years is gone for good and have restructured their businesses to adapt to a tougher operating environment.

Longer term, we think that China's A share market will open up many opportunities. Right now, the A share market comprises over 2,000 Chinese companies whose shares are accessible to overseas investors only through limited quota systems. China's government is slowly opening up the A share market, which we believe will be fertile ground for stock selection in the coming years.

Currently, China accounts for just 2.7% of the MSCI All Country World Index. After the eventual inclusion of the A share market, however, the country's allocation could more than double to 5.9%. Given China's relatively low exposure in global equity indices, we believe that demand for Chinese stocks will inevitably rise as MSCI increases the country's weighting over time.

Figure 2: **China Will Become Larger Within Global Indices**

As of 31 May 2015



China weight in AXJ[1]	29.9%	China weight in AXJ	35.0%	China weight in AXJ	49.4%
China weight in ACWI[2]	2.7%	China weight in ACWI	3.3%	China weight in ACWI	5.9%

[1]MSCI Asia-Ex Japan (AXJ)
[2]MSCI All Country World Index (ACWI)

Source: MSCI.

CONCLUSION: STOCK SELECTION IS KEY TO FINDING OPPORTUNITIES IN CHINA'S NEW NORMAL

After decades of double-digit GDP growth rates, China's economy is at a watershed. The old growth drivers of manufacturing and investment are losing their effectiveness, forcing the government to bolster services and consumption as new growth engines while it grapples with a ballooning level of debt. Though we think a Lehman-style crisis jeopardizing China's financial system is unlikely, maintaining the current policy of supporting troubled SOEs and avoiding the deleveraging process will be reflected in slowing growth in the coming years.

This bearish scenario, however, does not preclude us from finding good investment opportunities in China. Many companies in the consumption and services areas continue to show solid growth even as China's GDP growth grinds lower. We are focused on finding companies that are showing innovation, restructuring their businesses, or taking other actions to help themselves adjust to the new normal.

Finally, we would note that several Japanese companies generated considerable value for shareholders even during the country's decades-long bear market. We believe that similar opportunities exist in China and that T. Rowe Price's research capabilities and careful stock selection will allow us to find these businesses despite weaker economic growth in years ahead.

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