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## China Equities

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

### KEY POINTS

- China currently finds itself at an uncomfortable juncture, troubled by slowing growth and elevated debt and locked in an ongoing trade dispute with the U.S.
- While headwinds clearly exist, China continues to provide compelling investment opportunities, in our view. Equity market inefficiency and low valuation levels give us good reason to be upbeat.
- China A-shares represent a deep opportunity set with many attractive companies, a number of which remain undiscovered by foreign investors.

Faced with slowing economic growth, protectionist trade policies, and an uncomfortably high debt burden, some are suggesting that China is at risk of becoming “yesterday’s economic success story.” This raises questions about what the future holds for China and, similarly, for investors in China.

### GDP GROWTH IS KEY, BUT MAYBE NOT THE KIND YOU ARE EXPECTING

The macro outlook in China continues to dominate investor thinking, with concerns laser-focused on the country’s slowing economic growth. China’s economy is currently growing at a little over 6% p.a. While it has decelerated from the double-digit growth of a decade ago—levels unlikely to be seen again—it is still solid from a global standpoint.

However, what matters most for many domestic stocks is not so much national GDP growth, but the GDP growth of households. Here, data shows that disposable household income has increased significantly over the past 10 years, despite the slowing

economy (Figure 1). There are two reasons for this: demographics and policy. In terms of demographics, the pool of working age people in China has been stagnant for some years, but spending by this group continues to grow. China factory owners, for example, are contending with progressively higher wages every year, to attract, and then keep, new recruits.

On the policy side, the government has made a priority of delivering meaningful wage increases every year over the past decade, across every province in China. The approach is not popular with businesses, but the government’s aim is to deliver more money into the hands of minimum wage earners and thereby help to underwrite a consumption boom.

The income growth contributes to improved affordability for working-class families across a range of consumables, including holidays, insurance, health care, and medical services. And this increased spending is exactly what is happening across a demographic of hundreds of millions of people.

**THE TRADE NARRATIVE HAS SHIFTED, AND NOT IN CHINA'S FAVOR**

The China/U.S. trade war remains a key concern for investors in China, and prospects of improvement appear slim, certainly for the remainder of the Trump administration. Over the last six months, the narrative from the U.S. has shifted markedly. Originally simply seeking a better deal, and being apparently open to negotiation, the U.S. has more recently taken a harder line, notably extending sanctions to the “China 2025” industries, i.e., the high-tech sectors at the heart of China’s plans to become a developed, self-sufficient country.

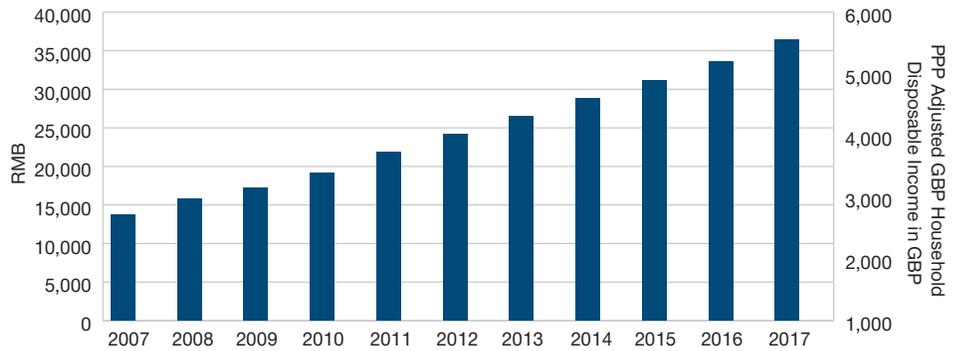
It is highly unlikely that China will want to be subordinate to a western power intent on containing its modernization progress. It may well be hoping that the Trump presidency lasts only one term and, thus, be prepared to wait. However, in the meantime, there appears little scope for the current trade tensions to ease.

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<sup>1</sup> 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. The Chinese government also has numerous levers at its disposal, such

**FIGURE 1: China’s Household Income Continues to Rise**

As of December 31, 2017



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

“[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.”

as industry subsidies and tax rebates, 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, nonfinancial 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. Ten years ago, the corporate borrowing rate was in double digits. Today, it is between 4% and 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 anytime soon. There are no signs of inflation currently, and the impact of tariffs is likely to be deflationary. All of which suggests that the level of debt is not yet a major concern.

**THE INEFFICIENCY OF THE CHINA A-SHARES MARKET APPEARS COMPELLING**

While Chinese equities have underperformed all other major markets, year-to-date, in 2018,<sup>2</sup> there is a lot to be excited about in this market. Valuations look very cheap, which is partly a reflection of the slowing growth/trade sanctions headwinds. However, a quick comparison shows the MSCI World Index<sup>3</sup> 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.

<sup>1</sup>The trademark displayed is the property of its respective owner. T. Rowe Price is not endorsed, sponsored, or otherwise authorized by or affiliated with the trademark owner represented by the trademark displayed herein.

<sup>2</sup>Source: FactSet, as of October 20, 2018.

<sup>3</sup>Source: MSCI, as of October 20, 2018.

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“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.”

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. There are a lot of very good companies, but many remain 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 2). This represents a great environment for finding mis-priced opportunities.

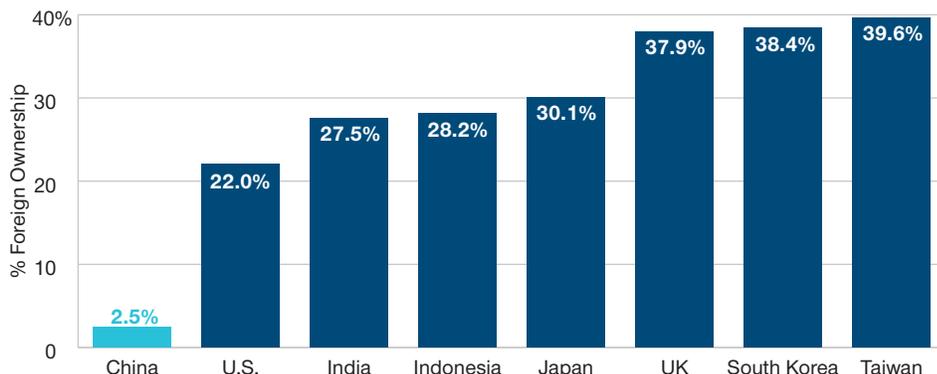
Of course, poor quality companies in the A-shares market are present, particularly down the market cap spectrum. However, it is possible to find blue chip companies, growing by around 15% a year, at very reasonable valuations. This level of growth may be less attractive to local investors, but for the astute investor these are quality companies, with sound balance sheets and good dividend profiles.

**“CHEAP MANUFACTURED GOODS AND COPIED INTELLECTUAL PROPERTY”**

This is another misconception that no longer describes modern China. As

**FIGURE 2: China A-Shares Represent a Huge Opportunity Set to Explore**

As of June 30, 2018



Source: BofAML.

wages have risen, China has become less competitive and has moved out of a range of manufacturing areas. Much of the manufacturing capacity concentrated in Southern China, for example, has been either closed or moved away. China is now moving up the value chain, with a growing amount spent on research and development (R&D) in high-tech areas like artificial intelligence. R&D expenditure has risen to OECD levels of 2%–2.5% of GDP.

Electronic payments is one area that China is making great strides in terms of innovation and progressing up the value chain. Few people in Beijing or Shanghai now carry cash, with mobile devices the preferred mode of payment, via service providers like Alipay and Tenpay. China has effectively skipped the credit card phenomenon and gone straight to electronic payment processing. As a result, the progress in this area is well beyond many major markets, including the U.S. This represents a powerful trend that can be directly accessed by investing in the parent Internet companies of these

service providers, such as Alibaba Group and Tencent Holdings.

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.

**CRISIS-LEVEL EQUITY VALUATIONS**

I continue to believe that growth in China is still strong. And if you look at household GDP growth, it is still very strong. Meanwhile, from a market perspective, valuations are not only undemanding, they are currently at crisis levels where the domestic A-shares market is concerned. That is not to say that they can't go lower still, but when I look at the Chinese A-share market today, I see some of the greatest inefficiency I've ever seen.

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