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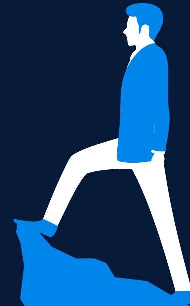

Investing in China means embracing discomfort

From the Field
January 2024

Key Insights

- Sentiment toward China is negative amid a weak macroeconomic outlook and geopolitical concerns, but there are opportunities for investors willing to seek them.
- The next phase of China's growth is likely to be "going global" as Chinese firms increasingly seek to challenge overseas competitors.
- There will be winners and losers in this process, making an active investment approach essential for capitalizing on dispersion and disruption.

Justin Thomson
Chief Investment Officer
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Throughout my career of more than 30 years as an international equity investor, I have consistently been captivated by China's remarkable growth. And despite current geopolitical tensions, a weak macroeconomic outlook, and poor investor sentiment, China's market remains a very important one.

During a recent three-week stay in Hong Kong, I had the privilege of engaging with prominent investment leaders in the region at T. Rowe Price's Asia Investment Forum. I emphasized the crucial importance of embracing uncertainties when investing in China, echoing the words of Howard Marks, one of my investment heroes, who famously said that the most successful investors are "comfortable being uncomfortable." I firmly believe that the best investment decisions are often made when one feels the most discomfort.

China currently looks very different from a macro versus micro perspective. At a macro level, the faltering property sector and the attendant deleveraging cycle will continue to cast a shadow over the economy. This is being registered through lower economic activity—building China (fixed asset creation) has been a major driver of the economy for decades, and the negative wealth effects of lower property prices will impact the Chinese consumer.

China needs to find a new growth model, but it would be a mistake to conflate gross domestic product (GDP) growth with asset returns. We took 47 of our investors to China in September, the first

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gathering of our emerging markets team since the pandemic. We saw that business leaders have adjusted to the new reality with a focus on the need to cut costs and restructure. China's industrial base continues to benefit from significant technological and productivity upgrades. Although foreign direct investment is currently down, the competitive advantage in the quality of supply chains means that China will likely remain the manufacturing base of choice for multinationals for many years.

Opportunities are there for the "carefully contrarian"

At the micro level, however, we believe China offers some very compelling opportunities. And for "carefully contrarian" investors who are willing to look past the negative sentiment toward the country, valuations are very favorable.

The carefully contrarian stance is supported by field research conducted by our investment professionals. In September, I joined a group of 47 T. Rowe Price portfolio managers and analysts on a research trip to China, the first since the pandemic, to gain firsthand insights into dynamics of Chinese companies and the market. During the week-long trip, we engaged with companies spanning the consumer, technology, and auto industries, all of which displayed acute awareness of the geopolitical situation and the macro weaknesses resulting from property deleveraging. We observed that Chinese firms have been increasingly proactive in managing their businesses to cope with reduced demand.

Global investors remain underweight Chinese stocks, and there are likely to be selective idiosyncratic opportunities in companies with strong fundamentals. The A-share market remains highly inefficient, but there are deep pockets of opportunity there, particularly in areas benefiting from the technological upgrade of China's industrial base, as well as innovative areas such as the electric vehicle ecosystem.

Chinese tech firms seek global expansion

Looking ahead, I believe that the next phase of China's growth is likely to be "going global." For example, China's quality supply chains make it the preferred manufacturing base for many multinational companies, and its lead in battery tech and electric vehicles (EVs) positions the Chinese auto industry to expand globally.

These technologically advanced Chinese EV companies are also challenging traditional automakers in Europe. While Western consumers have traditionally been hesitant to consider Chinese automotive brands, the rise of EVs may change that. In fact, China has already become the world's largest auto exporter, with more than 2.1 million units shipped in the first half of 2023,[1] driven by demand from emerging markets. Identifying the future beneficiaries in this rapidly evolving space will require careful stock selection.

Exciting investment opportunities can also be identified in other areas of the EV ecosystem, including Chinese companies at the forefront of powertrains, fast charging, autonomous driving, auto component supply chains, and industrial equipment manufacturing. Particularly, those poised to benefit from volume growth and content gain stories hold significant potential.

China's broad and deep equity market has undergone significant evolution over the past two decades, and we believe this transformation is likely to continue. Everyone came away from the research trip to China with a clear conclusion that there's much alpha to be made in China. But there will be winners and losers, making an active, bottom-up investment approach crucial for capitalizing on dispersion and disruption to generate substantial alpha. I also think asset allocators and institutional investors may consider allocating a portion of their diversified, long-term portfolios to China, positioning themselves for a time when sentiment eventually turns more positive, and capital flows back into the market.

2.14 million

The number of cars exported by China in the first half of 2023.

[1] Source: China Association of Automobile Manufacturers, 12 July 2023.

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