



What to know about investing in China

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Are you invested in China? Get an update on the economy, growth potential and the possible effects of the U.S. tariff talks.

As the world's second largest economy, China represents a significant opportunity for investors. Chinese equity markets staged a strong rally in 2017, driven by rising corporate profits. Economic trends have been favorable, including the acceleration in growth of gross domestic product (GDP) and deceleration of credit growth, which has slightly eased short-term concerns about debt.

But people are still concerned about investing in China. Over the past five years, China's overall debt soared, driven by stimulus spending on infrastructure and rapid increases in corporate and mortgage debt. In 2017, credit rating agencies downgraded the country. More recently, President Trump has engaged in tariff discussions that have rattled markets.

I sat down with our head of emerging market equities, Dara White, for some insights on what he thinks about investing in China today.

William: What's your outlook for investment opportunities in China?

Dara: I think it's a mistake to hold a general outlook for China. China is really made up of two different economies. One is an old industrial economy, which is where we saw a lot of the debt concerns resulting in overcapacity and concerns about the banking system. But the other economy, which we tend to forget about, is services-oriented China and can be found mainly in the coastal regions. And it's very powerful.

If you think about a 25- or 30-year-old in China today who's participating in the service economy, and you consider their education levels, amount of income and lifestyle compared with that of their grandparents, it's a tremendous level of change. To make a generalization about Chinese housing prices, inventory levels or the economy as a whole is kind of like making generalizations about Detroit and applying them to San Francisco. It just doesn't make a lot of sense.



William Davies
Global Head of Equities

William: How would you characterize your view on China's two economies?

Dara: We used to have a lot of concerns with the industrial economy, including the debt concerns we already talked about. But now, supply-side reform is shutting down excess capacity in a lot of sectors. The companies that are surviving are returning to positive cash flow and then reducing debt levels, which has taken stress off the banking system. We're starting to feel more positive about the industrial part of the economy than we have in a long time.

In contrast, we've *always* been excited about the new economy. The lifestyle of a 30-year-old in China is a wonderful tailwind for consumption.

William: How can investors capitalize on the disruption in China?

Dara: After doing research on individual companies, we see a lot of opportunities in the services economy. The opportunity is particularly impressive when you compare it to U.S.-based counterparts. As you scroll through your Facebook feed, you're bombarded with up to 25 advertisements a day. Tencent, a Chinese multinational company offering internet, social media and mobile chat services in China, is still only serving up to one ad per day. Being in an emerging market with a growing service economy puts them very much in control of what they can monetize.

To look at another example, ecommerce superstore Alibaba has a significant presence with the Chinese population. Their ecommerce take rate, or the fees and commissions they collect on sales by third-party sellers, is currently about 2.9%. Compare that with Amazon's take rate of about 15%. It highlights an important difference in growth potential between U.S. and Chinese companies.

Some of these Chinese companies in the service sector are early in the process, but they're already generating really good earnings and cash flow. That's the type of growth potential we get excited about.

Q: How will the U.S.-imposed tariffs on Chinese goods affect China?

Dara: Even though the U.S. is imposing tariffs on goods imported from China, the effects are limited right now.

China has been dealing with industries leaving the country for some time now. Two industries that have slowly been moving from China to other countries are cell phone assembly and textiles and apparel. Samsung Electronics has invested billions to move production to Vietnam. And apparel manufacturing has been moving to Vietnam, India, Bangladesh, Pakistan and even Ethiopia. The catalyst for the move in both industries has been wage pressure in China. But the country has shown the ability to absorb the lost factories and replace these jobs with services and higher value-added manufacturing, continuing its growth trajectory of 6.5%.¹

The reality is that all the production will not move overnight — it will likely take a couple of years at the earliest. Our observation is that many Chinese manufacturers have established bases in countries with lower costs like Vietnam, India, Bangladesh and Pakistan, and they have the flexibility to manufacture and export goods to the U.S. from these production plants.

China's scale in many export industries (such as electronics and machinery) indicates that it's difficult to find replacements globally in the near term. Studies

found that price elasticity of China's exports are usually within the 0.25-0.5 range.² If we assume the worst price elasticity scenario of one (meaning replacements could easily be found, and a change in price would affect demand for the exports), a 25% tariff on \$60 billion of goods will cause a \$15 billion export loss to China. This would negatively affect China GDP by only 0.01% based on 2017 data.

Bottom line

Although investors may have concerns about China's debt load and U.S. tariffs on Chinese goods, we believe the growth potential in China is still the far more compelling story.

¹ National Bureau of Statistics of China.

² CLSA as of March 2018.

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