Investment Focus on China
December 2021

Much investor attention has turned to China in the past year, with increased foreign capital flowing into Chinese stocks. In our view it is worthwhile looking more closely at this to see what investors are focusing on.

China's economy has been rapidly expanding since 1978 when its government introduced structural and regulatory reforms to grow the economy and reduce the poverty level in the country.

Four decades later and China is now the second largest economy in the world. Since 1990, extreme poverty has dropped from 66% to 0.35% in 2019 (data from World Bank). However, despite this reduction in poverty, the rate of income inequality has grown significantly, with 70% of the population sitting in the low-income tier earning less than $233 per month.

The governments' goal is to shift 300 million people from this low income tier to the middle income by 2035. In order to do this, regulatory reforms in sectors such as technology and healthcare have been implemented. Although this has dented many Chinese equity valuations in the short-term, the long-term prospects look brighter as it shows the government is keen to address structural issues in the country which should benefit many companies.

That being said, economic growth and stock market growth are not correlated, particularly in emerging markets.

Investors are concerned as to what further regulations could be introduced and which sectors could be punished. Increasing state involvement could limit company growth and attractiveness and turn the country into a planned state again.

The case for investment in China

However, the Chinese government has said that "Common prosperity means doing a proper job of expanding the pie and dividing the pie. … We will not kill the rich to help the poor." This could indicate that the government is less interested in controlling the state and more interested in reforming the markets so that they work more efficiently. Equally, this could be a facade designed to cover increasing government control.

The introduction of antitrust regulations on technology companies may not necessarily stop innovation and limit growth. The largest e-commerce companies are no longer allowed to restrict merchants from opening stores on rival company sites. We have already seen new merchants at smaller e-commerce sites, including those that target lower income tier consumers. This should help to drive consumption by allowing merchants to offer lower costs (previously they had to pay the largest e-commerce sites high fees) and target a wider range of individuals.

On the other hand, larger online companies may be hampered by the increased regulation. The monopolistic power they held over smaller companies is fading, and the content restrictions over foreign content could deter consumers from using or viewing the sites, reducing any additional revenue the companies gain from advertising.

The government is also trying to reduce the cost of healthcare, making it more accessible to lower earners. High distribution costs are being eliminated by introducing a volume-based bidding system run by the Healthcare Security Administration, rather than the hospitals bidding directly with the distributors for medical devices.

The government is shifting the economy from an investment economy to a consumption and services-based economy. Lower income inequality in the country should help to drive up consumption and improve both the economy as a whole and individual company earnings.

At the moment the savings rate for China is 40% of GDP, the highest globally. This is mainly due to the fact that there is no safety net for low earners and high property prices. The reforms and structural changes should help to provide a basic level of welfare and therefore open up individuals' financial resources, increasing consumption in the economy.

The case against…

We have discussed several potential positives when looking at the future of the Chinese economy. There are also dangers to be aware of.

One key issue is the level of debt in the economy. The debt-to-GDP ratio is 300%. This is a big risk to the long-term growth of the economy. We have already seen the problems which huge leverage levels in the property sector can cause with the likely insolvency of Evergrande, the worlds most indebted property company. Although the knock on effects of this insolvency are unlikely to cause a crisis, there are still risks present.

The government has sought to combat the huge debt levels by imposing restrictions on credit in the property sector and has stepped to the side in helping failing companies. These restrictions are also imposed as the government is concerned about asset price bubbles in the property sector.

Another major issue is China's ageing population. This will be a major drag on the economy as there will be less workers providing the tax revenues needed to fund pensions for retired individuals and to pay for the social care needed. Fiscal stimulus will also be reduced as there will be less tax revenue for the government. This could see capital taxes such (the equivalents of UK Inheritance Tax and Capital Gains Tax) introduced.

Japan's population has been in decline since 2007 and is an example of the problems that could be faced. Deflation has plagued the Japanese economy and the level of consumption has not increased until recently.

Research by Jefferies suggests the population of China will peak in 2022, 10 years earlier than the UN currently estimates. Declining birth rates are dragging natural population growth down and it is now negative across much of China. Reports in the FT suggest Chinese producers are already shifting to take account of this ageing population (nappy producers are prioritising older customers rather than younger customers!). Private equity firms are investing in funeral and burial plot providers as the number of deaths each year is expected to increase.

Although on paper the regulatory changes may sound like they are providing the backdrop for economic growth, some investors are concerned the government may have stepped too far into the market economy. The government has seen what has happened in the past when the idea of a planned state failed and the devastation this caused. How far these regulations will stretch and when they will be changed is another uncertainty.

Chinese monetary policy is expected to be eased to help stimulate growth. Economists do predict that economic growth will slow in Q4 to 3-4%, down from 6% in Q2. Chinese equity valuations have declined and there is a possibility of a rebound in stock markets.

Covid as always proves to be a threat. At the start of the pandemic China was the quickest and swiftest to respond, and it was unsurprisingly the first economy to return to its pre-pandemic levels. However, any return to lockdowns globally (a likelihood if the Omicron variant takes hold) will hit economic growth and reduce investors' risk appetite especially if China chooses to close major ports (further exacerbating supply chain bottlenecks).

The lowering of interest rates will be important in relation to the country's ageing population as well. In order to meet its inflation target, consumption needs to be encouraged and savings need to be reduced. Currently the People's Bank of China interest rate is 3.85%.

In line with other global economies China has set decarbonisation targets. These include reaching its carbon peak by 2030 and being carbon neutral by 2060. In 2021 so far energy consumption has grown faster than GDP due to strong export demand and industrial growth. Low coal inventories meant that the government cut power supply in September to some manufacturing companies in order to achieve its energy intensity target, leading to major disruptions to industry.

Our conclusions

Overall, there is potential for long-term growth in small and medium technology companies, healthcare companies and consumption based businesses as the wealth gap is reduced and consumption in the economy increases.

There are many risks to the progression of the Chinese economy including high debt levels, ageing populations and a government which may have already overstepped its mark. Even if the Chinese economy continues to grow it does not mean the stock market will perform well.

In terms of investing in China, it is worth noting that the broad Chinese stock market indices are not attractive investments due to their indiscriminate inclusion of industries such as real estate, state owned banks, telecoms and utilities and mining companies. This makes any investment which simply tracks the Chinese stock market relatively high risk and unlikely to deliver outperformance.

As is often the case in emerging markets, in our view it is essential to look for an active fund manager who has good stock picking abilities, and to research the underlying holdings extensively before investing.

Robert Dougherty, December 2021.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.