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Different Currents Affecting The Direction Of China

By Morten Springborg, Global Thematic Specialist

We visited China on two occasions this fall, and though the picture has been very mixed, the bottom-line is that the economy is doing what it's supposed to do – rebalance away from fixed asset investments and industrial production towards private consumption and services.

Obvious areas of challenges are in the manufacturing sector as well as the state-owned enterprises (SOEs), where reform is progressing too slowly – if progress is happening at all.

Real Estate markets are glowing hot in the major tier 1 markets, and flattening out here is to be expected while the bull market moves on to selected Tier 2 markets and below, driven by an obvious lack of alternative investment opportunities in an environment where the outbound investments from China are seeing more restrictions. The transition towards a private consumption driven service economy progresses fast – driven by impressive entrepreneurship and a "go-get-it" mentality amongst young people.

We believe the world underestimates the advancement of Chinese e-commerce and other internet platform companies and services, and continue to see good investment opportunities here.

In 1939, Winston Churchill formulated his thoughts about Russia in the following way: "I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest."

At that time, Russia was (together with Germany) the upcoming challenger power and a society very difficult to understand for the western powers. And although the situation back then was very different from the international environment today, Churchill's famous quote could easily be applied to China, as there are so many different currents affecting the direction of China today.

It is important to recognise that President Xi Jinping's end game is the great revival of the Chinese Nation after what he think was 100 years of humiliation following the opium wars and up to the Communist Party's take over of power in 1949.

Nationalism is core part of the policy and Xi Jinping considers it to be the duty of the party to lead this process. Thus, recent years have seen a tighter control of society, cracking down on foreign influence as well as a clean-up process attacking corruption in the system to increase the population's support of the one-party system.

The results of economic reforms have been mixed. While some success can be seen on the monetary reform side (interest rate liberalisation as one example), the reform of the SOE sector has been less positive, and in an environment where globalisation seems to be going backwards, China cannot any longer rely on fixed asset investments as a growth driver.

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Opposing Forces Affecting the Economy

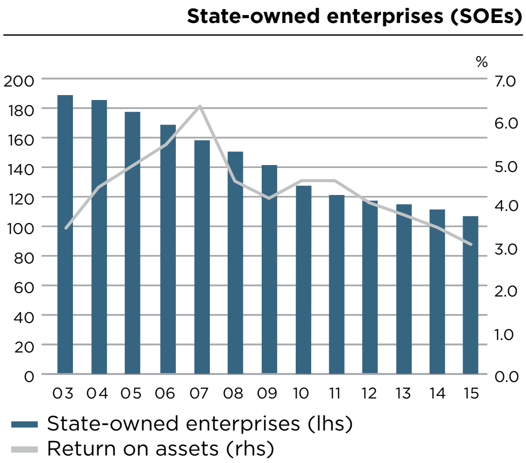
With this in mind, we visited China twice over the past few months. The economy continues to show steady growth and the main driver remains the housing sector and domestic services. It is easy to call an end to the latest increase in China's home prices, but the situation is probably far more nuanced. We talked to property investors in Shanghai, who had seen 30-50% price appreciation over the last year and who did not contemplate reducing exposure since it would be very problematic to find alternative investment opportunities, especially after the latest tightening of outbound investments from China. One comment was that the recent overheating of tier 1 property (Beijing, Shanghai, Shenzhen and Guangzhou) most likely would mature in the sense that investments would move to select tier 2 cities and cities below that in the quarters ahead.

While the housing market is doing well, the manufacturing SME companies (Small and Midsized Enterprises) are in general struggling. These companies are typically export oriented and therefore affected by the generally muted trade environment globally, while at the same time see rising wage pressures. On top of this, state banks are not extending credit to private companies. The effect of this is reduced profitability and lower investments, something that is critical for the longer-term competitiveness of SME's in China, as the country is supposed to climb up the value ladder. Ironically, weak manufacturing activity has not prevented blue-collar wages from increasing by approximately 8% year-over-year (YOY) as of now. This remains the case as the number of younger workers (aged 15 to 30 years) is now declining faster than ever (minus 4.5% per year). In this context, China's recent decision to finally alter the one child policy is long overdue, and in fact far too late per sources we met.

Many Chinese simply cannot afford to have more than one child (education fees are sky high), and the unreformed Hukou system is making it extremely expensive to bring up a family outside one's own area of registration.

The SOE reform is not progressing as one could hope. Most likely because reform would affect growth – and potentially social cohesion – negatively in the short term despite the obvious long term benefits of better resource allocation. In recent years, as can be seen in Figure 1 below, the number of state owned enterprises have been reduced significantly. Unfortunately, this has not been realised via closures of businesses but via mergers that have not reduced employment and overcapacity, but reduced return on assets of the state sector instead. SOE's account for around 30% of the Chinese economy and remain to be very significant low hanging fruits for any reformer in China, should the state one day decide to go for improvement in the quality of the Chinese growth. However, at the moment – and if the banks continue to fund poorly run SOE's in sectors with significant overcapacity – the quality of growth in China deteriorates by the day.

Figure 1



Source: The Economist

The New Economy is Growing in Size

In contrast to the dire outlook for both the manufacturing sector and the SOEs, entrepreneurship prevails in China. This is visible in the more advanced service industries, not least when it comes to internet-related services like social media, e-commerce and mobile payments. This is an area dominated by the likes of Tencent, Alibaba and Baidu. However, these mega caps are incubators for thousands of start-ups and smaller companies that thrive on the infrastructure of the large internet companies. In the years to come, Chinese growth will continue to migrate towards domestic consumption, and we believe there are major investment opportunities in this space.

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A great example is of course e-commerce in China, the most advanced e-commerce market in the world. We met with a developer and operator of shopping centres, who believed that growth in e-commerce will flatten out at 15% of total retail sales as consumers seek the entertainment angle in the shopping experience, which should play into the advantage of brick-and-mortar operated retail businesses that combine shopping with dining, cinemas etc.

We, on the other hand, got the impression that he was talking his own book and find it very difficult to see that e-commerce should peak out at 15%, when it is already above 13% and China's goal – per the 13th 5-year plan – is to achieve online sales of 20% of retail sales by 2020. Alibaba itself believes that grocery and rural e-commerce are new growth engines. China's rural e-commerce remains small at only 9% of total online sales today, but growth has accelerated and could increase 4-5 times by 2020 with rising 4G adoption (80% of Alibaba sales are done via smartphones), better purcharsing power, improving logistics infrastructure and favourable government policy.

To contrast the view of the shopping centre developer we met, Alibaba aims to double its gross merchant volumes by 2020, of which one third of the increase could come from rural. If that goal was to be realised, Alibaba would control 12.5% of all retail sales in China by 2020, leaving 7.5%-point to other e-commerce platforms in China.

WeChat (owned by Tencent) is another example of a service that is much more advanced than what is prevalent in western markets. WeChat users can do just about anything, including play games, send money to people, buy investment products and other banking services, make video calls, order food, hail a taxi (or more likely an Uber or Didi), read the news, book a doctor's appointment and more. It is basically China's version of Facebook, only much more advanced when it comes to the number of services attached to the platform.

WeChat Payment is a central part of the offering. It serves as both a payment platform and an instant messaging service. WeChat Pay can be used to pay in stores, on websites, WeChat shops and third-party apps, and its payment procedure is easier and simpler for both customer and company alike. Being able to pay through WeChat has revolutionised how retailers and customers interact and has the potential to reach – and make its payment method essential for – a huge number of customers because of their dependency on its social media and instant messenger service. It is therefore a very useful and effective marketing tool.

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The very large user bases of these companies have aggressively been leveraged to expand into financial services. Chinese consumers are hugely underserved with financial services, as the large banks historically have focused on corporate lending and more lately retail loans. This has opened up for a huge consumer finance market for disintermediation by technology companies.

Alibaba is the clear leader. Alibaba has consolidated its various financial service activities under one roof called Ant Financial. Ant Financial is now running Alipay and other services, such as the market fund Yu'eBao (which has grown very rapidly into one of the world's largest money market funds and today acts as a cash management tool for ordinary Chinese), online credit scoring service Sesame Credit, Internet-only bank MYBank and micro-loan provider Ant Micro. 2017 is an important year for Chinese fintech in general and for Ant Financial specifically, as it is expected that the company will make an IPO and thereby generate much more interest in a very important and fast growing part of the Chinese economy.

Conclusion

China is going through a gradual rebalancing of growth and incrementalism – in contrast to drastic reform, is the appropriate term for the process. The prime objective is to safeguard the power of the Communist Party and that objective overrules all other objectives. Therefore, SOEs will continue to be politely encouraged to improve performance while still being protected, banks will continue to accumulate dubious assets (with the ultimate backing of the state) and therefore there will be plenty of negative stories to tell about the unavoidable collapse of the Chinese economy, something we have heard now for many years. But what the bears on China fail to recognise is the entrepreneurship of the private sector, the "go-get it" attitude of young people in China and the enormous domestic market that offers some of the best opportunities for people with the right attitude to build their own future.

China continues to be a "riddle, wrapped in a mystery, inside an enigma", but China is also a good case in point of our main principle of not missing the full picture by looking at too many details. The big picture story on China is the continuous rebalancing of growth away from manufacturing towards consumption, and our recent trips to China convinced us this continues, while problems in the state sector is contained and can be managed over the longer term.