Is China Investible?

Since the end of the pandemic lockdown, our analysts and portfolio managers have gone back on the road, meeting with business owners, policymakers, suppliers, and consumers. Our first-hand observations of the economic and social climate strengthens the quality of our research and helps us generate insights. In this series, On the Road, we share the findings uncovered by our on-the-ground research.

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Members of our research team visited China for the first time since 2019, before the start of the coronavirus pandemic and China's move to more heavily regulate its technology sector. We aimed to gauge the medium- to long-term direction of the country to assess whether it is still an attractive investment destination for our Emerging Markets Growth (EMG) strategy.

We held more than 80 meetings with companies, experts, sell-side analysts, and buy-side contacts in the consumer, insurance, electric vehicle and batteries, industrials, and internet industries in 14 cities. We found evidence of many changes in the investment environment resulting from the economic impact of the pandemic as well as increased government regulation of businesses.

While we believe the opportunity set for growth investors in China has narrowed, we continue to see attractive businesses across sectors, and we are more constructive on areas such as renewable energy and industrial automation that are more aligned with the future policy and economic direction of the country. Overall, we believe that a nimbler and more selective approach to investing in China is required. This is consistent with an economy in transition that's prioritizing the quality over the quantity of economic growth.

Our questions about the viability of investing in the country have grown over the past two to three years as the risks and uncertainties of investing in the region increased meaningfully. A convergence of several headwinds, including regulatory pressure on the tech/internet sectors, mobility restrictions to contain the coronavirus pandemic, and deteriorating geopolitical relationship between china and the United States has negatively affected investor sentiment and contributed to a period of relative underperformance by the Chinese stock market. For better or for worse, China is a country that has a history of transformative changes, so we should remain engaged and constantly reassess our current position based on the facts on the ground and the broader global environment. Below we also share our views of the macroeconomic backdrop, which is important to consider when investing in emerging markets.

ASSESSING OUR EXPOSURE

China exposure in our EMG portfolio is about 16 percent (about 20 percent if we include our holdings listed in Hong Kong,) , well below China's 30 percent weight in the benchmark, the MSCI Emerging Markets Index. At the portfolio level, we are constantly reassessing three key questions: 1. Is China investable relative to our investment criteria? 2. What should our strategic allocation to China be? 3. If China is investable, which sectors and companies offer us the best growth opportunities and the greatest potential for positive investment outcomes over the next three to five years?

1. Is China investible? Yes!

China is a core part of the emerging markets opportunity set. Despite its ongoing challenges, it remains a large and flourishing economy. Visiting China in person let us see this dynamism firsthand.

Some highlights of what we saw: the accelerating pace of electrification in the auto sector; the growing aspirations of an increasingly affluent urban middle class with significant spending power; and the daring entrepreneurs looking for opportunities to expand their businesses despite many challenges.

In traveling across China by road, rail, and air, we experienced the world-class infrastructure that China has built over the past two to three decades. Infrastructure remains a source of competitive advantage for China Inc. in the global manufacturing and export markets. More importantly for our strategies, China continues to produce world-class businesses, in our view, such as consumer brands and companies in the electric-vehicle supply chain that meet our investment criteria.

2. What should EMG's strategic allocation to China be?

While we continue to think that China is investable, it is increasingly less attractive relative to India, Indonesia, and other emerging market (EM) regions. China is a country and an economy that is transitioning from a middle-income to an advanced economy, which requires substantive changes to the economic model that has been in place for the past 40 years. But changing domestic politics and worsening geopolitics complicates China's options and path toward achieving its long-term economic objectives. For example, the tech war with the United States will likely slow—even if it doesn't completely derail—China's ambition to become an advanced industrial nation. The challenges and uncertainties—for businesses and investors—created by China's ongoing transition are substantial and justify a strategic underweight in EMG, in our view.

3. In which sectors/businesses should we seek to invest?

Overall, we don't see a short-term need to make substantial changes to our China holdings in the EMG portfolio. The investing opportunity set has narrowed gradually over the last several years, with tech and internet, which was historically a big part of EMG China exposure and most other EM portfolios, now largely a matured and overregulated sector. We see potential investment opportunities, such as renewable energy and industrial automation, in the broader advanced manufacturing sector. We continue to see select opportunities in consumer staples, consumer discretionary, healthcare services, financial services, tech, and information technology. Some of these are businesses currently owned in EMG, or they are in our new opportunities pipeline. Generally, the Chinese state is using a heavier hand in allocating capital to favored areas such as artificial intelligence, high tech, and advanced manufacturing. At the same time, it is more willing to let sectors that have historically contributed meaningfully to gross domestic product

(GDP) growth–such as real estate—suffer. This reflects the economic policy shift toward high-tech industries and manufacturing away from highly leveraged and low-productivity legacy sectors.

OTHER OBSERVATIONS, CHALLENGES, AND OPPORTUNITIES

Mixed investor sentiment:

We have seen some global funds exit their China exposure, perhaps because they view China as uninvestable. Other emerging market growth managers have significantly reduced their position as well. Some global value funds view China as more attractive due to the significant valuation discount. Domestic funds generally sound more optimistic and are less worried about the situation. The onshore market is heavily retail-driven (70 percent of volume) and remains very oriented to the short term.

THE MACROECONOMIC BACKDROP

Slowing economic growth:

China's GDP growth will likely slow over the next few years compared with the pre-pandemic period. This slowing will likely result from a combination of government priority changes and structural challenges. The government's goal has shifted to "quality growth" driven mainly by consumption, services, and higher-skilled industrial/manufacturing instead of the investment-heavy and debt-fueled growth of the past. Accordingly, the government has removed GDP growth targets, tried to restrain excessive local government spending, and triggered a healthy—albeit painful in the short term—contraction and consolidation of the real estate sector. The country's leadership recognizes that it faces its greatest challenge since the start of the reform and opening era that has taken China from a "poor" to a "middle-income" country since about 1978. But advancing China from a $10,000 to a $30,000-plus per capita income economy—in other words, from a "middle-income" to a "developed" economy—will be more daunting.

A challenging road to "developed" economy:

The next phase of China's economic transition will be much harder because the country benefited from several one-time factors that accelerated the pace of economic growth over the last 40 years that are not repeatable—or can only make limited contributions—going forward. These include China's transformation from a mostly rural/agrarian economy to an industrialized/manufacturing economy helped by a population exodus from low-productivity agriculture to high-productivity industry, massive inflows in foreign capital (foreign direct investment, portfolio investments, technology, skill, experience, etc.), and the opening of various previously closed business sectors to the private sector. All of these contributed to a better allocation of labor, capital, and other resources, in addition to a steep and sustainable rise in productivity, higher wages (and per capita income), and a virtuous and self-sustaining cycle of higher consumer spending driving business expansion. But this phase of economic expansion has reached its limits, so China's future economic trajectory will require more innovation and advanced technology, highly skilled labor, value-adding manufacturing products, and greater incentives for entrepreneurs to take risks to improve productivity, employment, and global competitiveness.

In general, the China-based macroeconomic experts we met believe that the government's instincts are good but its ability to achieve the desired outcome is challenged by the realities discussed below.

Policy and regulatory environment:

We perceive that foreign investors in China have grown increasingly concerned by the centralization of political authority and the erosion of technocrats' role in policymaking. This perception, combined with greater regulatory scrutiny of several key business sectors, has raised doubts about China's status as a business-friendly environment.

We heard that sectorwide crackdowns are largely behind us, and regulatory intensity is unlikely to escalate. The Chinese government has consistently repeated that China is open for business and welcomes foreign investment. Tesla is an example of a successful foreign company in China that continues to grow and expand its operations in China even through the last three to four years of pandemic and geopolitical challenges. But other foreign businesses have complained about greater scrutiny and constraints on their day-to-day operations in the name of national security. The recent performance of Chinese investment assets indicates that foreign

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investors remain doubtful. It will take actions from policymakers, as well as supportive words, to relieve such doubts.

Structural challenges:

China faces structural problems, such as high unemployment, an aging population, and a low birth rate. An urgent and more pressing challenge is the high level of youth unemployment—about 20 percent—that is a drag on economic output and raises the government's anxiety about social stability. While these challenges are not insurmountable, they limit the policy options available to the leadership.

Geopolitics:

China's deteriorating relationship with the United States and its allies has heightened its national security concerns in domestic policies and international relations, which could complicate long-term economic and business priorities. This sometimes results in policy actions that seemingly work against the country's broader economic objectives. For example, the recent crackdown on foreign consulting firms in the name of national security happened around the time that China's leadership touted the country as being open for business and welcoming foreign investors.

Tech war:

The restriction of China's access to certain high-tech products (such as semiconductors) by the United States and its allies will inevitably slow the pace at which China is able to develop a high-skill-based manufacturing sector that can compete with those of developed nations. It is also likely to hurt China's ability to use higher labor productivity, higher wages (and per capita income), and higher consumer spending to escape the "middle-income trap" caused by higher wages.

Attracting foreign capital:

The risks inherent in China's changing domestic politics and an increasingly confrontational relationship with the West (the main source of foreign capital into China over the last three decades) are creating many uncertainties for international investors, in addition to making them increasingly more cautious toward investing in China—both in terms of portfolio investment and foreign direct investment. All of this is happening as China arguably needs foreign capital more than ever as it transitions its growth model to depend less on government-led investment. The international business community doesn't seem inclined to fully divest from China, but it also understands it must manage the geopolitical risks. Members are also hesitant about being too vocal about their support for China as that often doesn't play well in the domestic politics of their home countries.

Overall, this justifies a more cautious medium- to long-term outlook and the EMG strategy's strategic underweight to China. But the situation is still in flux and could change for the better or worse. We should be open to changing our position in either case. As things stand, the risks and uncertainties of investing in China are partly offset by a few considerations discussed below.

The social compact appears intact:

The legitimacy of the Chinese Communist Party and the Chinese government ultimately depends on the average Chinese citizen continuing to materially improve their living conditions. The Chinese people aspire to be as wealthy and advanced as citizens of Western nations or nearby Asian Tigers (Korea, Taiwan, Singapore). All the local experts and entrepreneurs we interacted with believe this social compact remains intact and that there is a deep commitment by the leadership to deliver on this. A note of caution, though, is that actions taken by the leadership in recent years indicate a willingness to forgo these objectives in the short to medium term as it addresses other priorities deemed more pressing. For example, recent harsh COVID-19-related lockdown policies prioritized saving lives and ensuring the leadership looks strong and effective rather than prioritizing economic growth. We also expect the leadership to deprioritize short-term economic growth in the face of what it might consider national security concerns. However, the rapid turnaround in coronavirus-related policies and the abrupt opening of the economy in December 2022 support the idea that the leadership can be pragmatic and receptive to popular opinion, especially when social and political stability is at risk.

Large upper middle class with considerable wealth:

China's high savings rate saw another 3 percentage point expansion during the COVID-19 lockdown, and it kept rising amid the government's recent easing of those measures. Chinese households accumulated 3 trillion yuan in savings during the pandemic, according to a Goldman Sachs estimate.[1] The upper class is generally doing well, despite layoffs from white-collar jobs. We saw long lines at luxury stores (Hermes, Chanel, Louis Vuitton) until 10 p.m. on a Friday. These are generally "gold collar" workers who could work remotely and whose income didn't suffer as much during the lockdowns. We even heard stories of such high-income workers paying off their mortgages last year due to a lack of investment opportunities. On the other hand, middle- to low-income people, particularly those in a service industry (restaurant workers, Didi drivers, hotel staff), have generally suffered. They had no source of regular income during the lockdowns but still had to pay for rent and other basic expenses, and there were no government-mandated rent relief programs. We are seeing an increasingly bifurcated economy that is not sustainable over the long term. However, in the short to medium term, it creates opportunities that address the aspirational urban middle class.

Durable competitive advantages for China Inc.:

China has several advantages that will help support its leadership in global manufacturing and exports. These are mainly infrastructure (transportation, telecommunication, etc.), an educated and skilled labor force (tens of millions of young people graduating college every year), a lot of accumulated wealth and entrepreneurship to support new growth industries, a highly technocratic and experienced civil service, and strong state institutions even if they are more centralized and differ from liberal democracies. The China electric vehicle supply chain is a good example of how China has harnessed these advantages to attain global leadership in one of the leading growth industries of the future.

[1] Goldman Sach, China Data Insights, FAQs in "excess savings" in China, February 7, 2023.

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