The Base Case for China

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Summary

We believe that the Chinese stock markets represent an attractive investment universe for active equity managers.

Thesis

Our investment thesis revolves around the following points:

1. Social transformation. China is undergoing a social transformation on a massive scale. The population is transitioning from rural areas to urban centers and from traditional agriculture to "modern" industry and services, a pattern previously observed in other "Asian tigers" such as Korea. China's urbanization level is only 55% today, and nearly 20% of its population is still employed in agriculture. It will take several decades before China's social structure evolves to match that of more developed countries. Thus, this social transformation should continue to fuel economic growth beyond our investment horizon.

2. Rise of consumption. China is still perceived as a country whose economy is solely reliant on exports, but the reality is different. Consumption rather than exports now drives economic growth. The rising urban middle class earns more and spends more, fueling the growth of companies providing them with goods and services. While China's private consumption has been growing at an annual rate of 14% over the past decade, it still represents a smaller portion of the economy than in developed countries. Thus, it has significant room to grow over the coming decades.

3. Growth of services economy. China is still perceived as a manufacturer of cheap plastic goods, but services rather than manufacturing now dominate the economy, representing more than 50% of GDP. Services sectors are less capital-intensive than industrial sectors, less tied to exports and their health often reflects growing consumer spending. Our managers find many investment opportunities in such sectors.

4. New technology-driven business models. China has advanced much beyond its traditional image as a copier of western intellectual property and is now increasingly developing and exporting its own technologies. The rapid adoption of the internet and the introduction of new business models by newly-created Chinese internet giants are raising productivity and growth. In turn, Chinese consumers are bypassing conventional stages of online commerce development and have overtaken the United States in areas such as online commerce. Mobile payments in China are 11x larger than in the United States!

5. Future international investor allocations. China's economy is more than half the size of the United States', yet the weight of China in the MSCI ACWI Index is very low, in line with the weight of smaller countries such as France or Switzerland. Chinese stocks are significantly under-represented in global indices and investor portfolios, and foreign investors account for only 3% of the A-shares market capitalization. We expect a significant tailwind of capital flows in the coming years as index providers such as MSCI adjust their constituent weights to more fairly reflect China's market capitalization and the size of its economy.

6. Attractive market characteristics. China offers a large and liquid market, with attractive pricing inefficiencies. There are more stocks in China than in the United States, but research coverage is much lower. Also, stocks are subject to significant volatility as retail investors represent more than 80% of trading. The lack of coverage and high volatility exacerbate pricing inefficiencies and create return opportunities for active investors. From a portfolio perspective, Chinese stocks offer additional benefits in the form of low correlation with other equity markets.

Conclusion

As of November 9, 2018, the MSCI China Index is down 17% year-to-date in U.S. dollars and trading at a 10.2x price to forward earnings ratio (12.2x ex-banks), below its 10-year average, with 11% expected earnings growth in 2019 (14% ex-banks)[1].

Investors are concerned about Chinese debt levels, cash outflows and currency depreciation, trade tariffs with the United States, social conflicts and geopolitical tensions. We will address these issues separately.

[1] Goldman Sachs Research (November 2018).