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China's Relevance for the Global Investor

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China's Relevance for the Global Investor

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Key Takeaways

- China has a strong investment potential and is a frontrunner for the developments in other emerging market countries. China has rapidly transformed the country's global position – from a backward feudal society suffering widespread poverty until the 1980s, to a nation that 40 years later is a formidable and influential global competitor economically, politically and also militarily. China has a population of around 1.4 billion and is currently the world's second largest economy after the US.

- Chinese companies comprise roughly 45% of the investments in our Asian equity portfolio and 32% in the Emerging Markets portfolio. Over the years, we have repeatedly experienced that the key to achieving success as a long-term equity investor is to align stock exposures with the agenda of the Chinese government. Understanding the complexity of the country and the visions that President Xi Jinping and the Communist Party are pursuing is essential. The purpose of this paper is to identify the measures and regulations that are crucial for long-term investors to understand in the coming years and thus provide insight into China's geo-economic strategy and policies across various sectors as the country heads towards its modernisation goal, its so-called Vision 2049.

Vision 2049

In 2012, the Chinese government incorporated two overarching goals to the programme of the Communist Party – two goals that would shape China's long-term economic plans and define the country's approach to everything from geopolitics to climate change solutions. The first goal was to build a moderately prosperous society with an emphasis on fighting poverty by 2021.

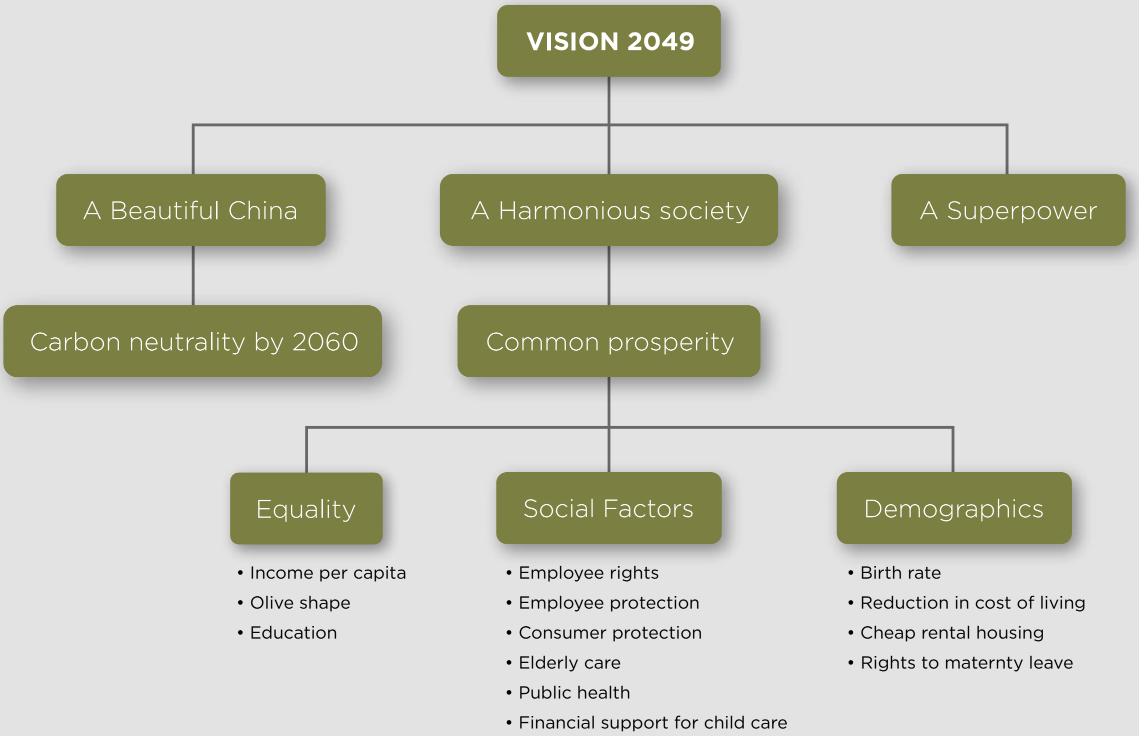
The second goal was to build a modern socialist China that is prosperous, strong, culturally advanced, and harmonious by 2049. The goals mark the centennial for the establishment of the Chinese Communist Party and The People's Republic of China, so the importance of this vision should not be underestimated – not least, when Xi Jinping and China face a presidential (re-)election in 2022, which we expect will accelerate efforts to achieve medium-term milestones.

Vision 2049 is essentially comprised of three parts – see figure 1 on the following page: "A Beautiful China", "A Harmonious Society" and "A Superpower".

A Beautiful China

As part of "A Beautiful China" an important initiative is the goal of becomming carbon neutral by 2060. To this end, the government is supporting green energy, such as solar farms, wind energy and carbon trading, where companies are financially compensated for reducing their CO2 emissions. A key initiative is that 25% of all cars sold in China must be electric cars by 2025 – a target that had already reached 20% by August 2021. Improved soil and air quality are other key goals, but as

Figure 1: Vision 2049



Source: C WorldWide Asset Management, as of October 2021

air pollution presents the greatest challenge, we expect the government will prioritise this area.

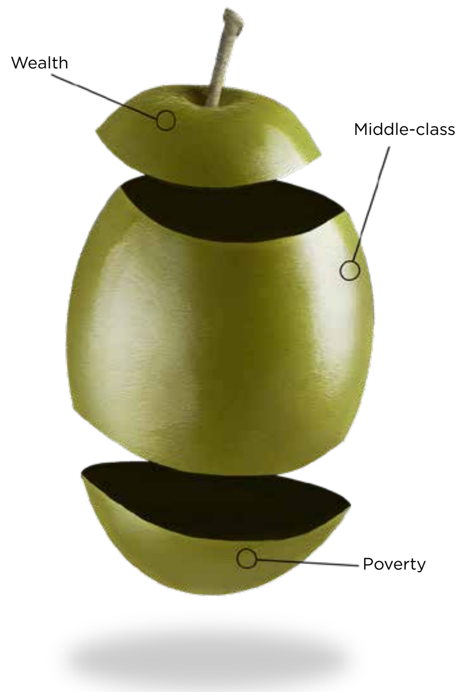
A Harmonious Society – from pyramid to olive

"A Harmonious Society" includes the goal of "Common prosperity", and under this is the ambition to create greater equality, expand social initiatives and develop its demographic profile.

While the expression "Common prosperity" is not new and was previously used by Mao Zedong, it has often been mentioned by President Xi Jinping, especially this year. A Bloomberg report from August 2021 states that the expression "Common prosperity" has appeared 65 times in Xi's speeches and meetings this year, but just 30 times in all of 2020. Furthermore, in a speech from 17th August 2021, Xi urged high-income groups and companies to give more back to society. Many investors have interpreted this as a signal of forthcoming regulation and redistribution policies. Indeed, several of the government's thinktanks are advocating for an olive- or spindle-shaped distribution of income, referring to some of the more developed economies, where most of the population can be defined as middle class, such as in Japan, Germany, Scandinavia, and the US.

> **"The government's thinktanks are advocating for an olive- or spindle-shaped distribution of income.**

The expression "Common prosperity" is in some ways a central aspect of socialism, but in Vision 2049 it is viewed in a modernised form with an emphasis on a higher quality of common prosperity, a more equal distribution of the wealth-creation and an ambition to eliminate poverty. The vision includes a doubling of GDP per capita by 2035 to around USD 20,000 per capita annually. Over the past 15 years China has seen a gradual 'Americanisation', which Xi represents as a pyramid, where the wealthiest owns a large share of the assets in society and a considerably larger proportion of the population at the bottom of the triangle owns almost nothing. Xi wishes to transform the pyramid into an olive shape which illustrates China's desired income distribution structure, where a substantially larger group in the middle owns the majority.



According to the National Bureau of Statistics (NBS), China's middle-income population is defined as a family with income of USD 16,000 – 80,000 a year. This applies to around 400 million or 29% of the total population in 2017 (latest available data and only a 2017 snapshot). The share of families in this income group has increased since 2017 but not enough to reach a level that defines an olive-shaped society. Meanwhile, around 600 million people, more than 40 % of China's population, continues to earn less than USD 2,000 a year.

While there are no official figures showing the proportion of wealthy Chinese, a study by the China Institute for Income Distribution (CIID) estimates that in 2019 there were just 9 million Chinese with an annual family income of more than USD 57,000 – this figure is based solely on income and does not reflect assets.

The study also estimated that around 964 million people earned less than Rmb 72.000 (around USD 11.200 a year in a family of 3) – in the figure shown as the level from 72-0. Based on this data, we can classify China's population into three categories according to disposable income: around 432 million people are in the middle-income group, fewer than 9 million are in the high-income and the remaining low-income group is of 964 million people, see figure 2 on the following page.

A superpower

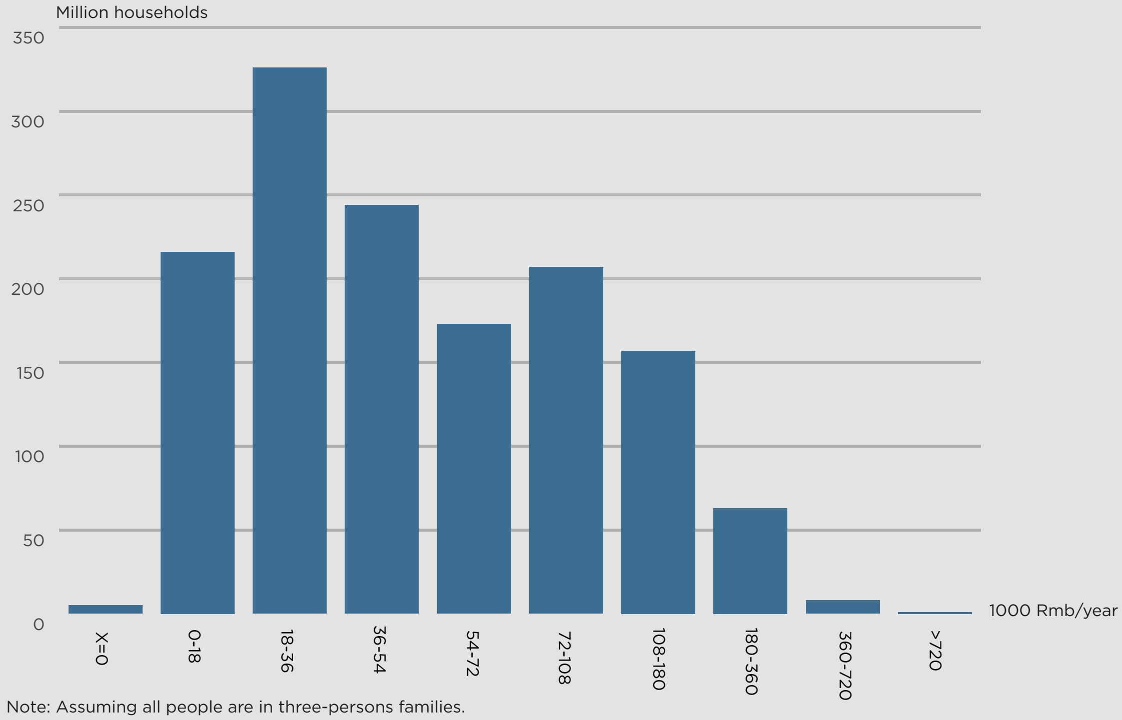
There is no doubt that China has ambitions of becoming a superpower, including enhancing the technological capabilities of its military and modifying rights in relation to, for example, Taiwan, the Senkaku islands with respect to shipping lines in the South China Sea. But a potential reunification will unlikely happen by a military intervention as China will prioritize diplomatic solutions.

China is in our view inclined towards cooperation which would be mutually beneficial for both itself and the countries with which it is boosting its economic partnerships. This has set the framework for other states to follow the same path of cooperation and try to minimize conflicts. Only through cooperation, can the prosperity and peace be ensured which would eventually serve all interests.

Chinese consumers in focus

China is striving for a better balanced and more socialist-based market economy and will stimulate the development of small and medium-sized enterprises (SMEs), for example by containing the power of monopolies. Meanwhile major companies, such as consumer-based internet platform companies exhibiting pricing power will be faced with regulation to cut or curb prices. Recently, Tencent and Alibaba announced that they would invest USD 16bn in areas related to Common prosperity, from addressing rural poverty to investing in

Figure 2: China Population Breakdown by Annual Household Disposable Income



Note: Assuming all people are in three-persons families.

Source: Credit Suisse, CIID, as of September 2021

healthcare and educational facilities in underdeveloped regions.

The consumer is at the crux of this initiative and the cost of living should support a normal, average Chinese family being able to raise children. The high cost of living in the cities are a reason for the low birth rate. The biggest expenses are rent, childcare, education, and healthcare, which is why these are being regulated and subsidised with the promotion of equal rights to education, elderly care, etc.

> **"The high cost of living in the cities is a reasone for the low birth rate.**

Demographic developments include the goal of "expanding" the middle class and creating opportunities for more low-income groups to prosper. As mentioned, the middle class currently comprises around 400 million people and the goal through 2035 seems to be to include an estimated 300 million additionally. Hence, there is good reason to link this initiative to the ambition of greater equality. The rollout of legislation of workers' rights and minimum wages will protect the average Chinese consumer, while citizens with higher incomes will face higher taxes, as China is urging high-income groups and profitable companies to "give back to society". Financing is the core of the modern Chinese economy, and efforts to avert large financial risks are implemented in accordance with market principles and government decisions as we have seen with the property developer China Evergrande Group.

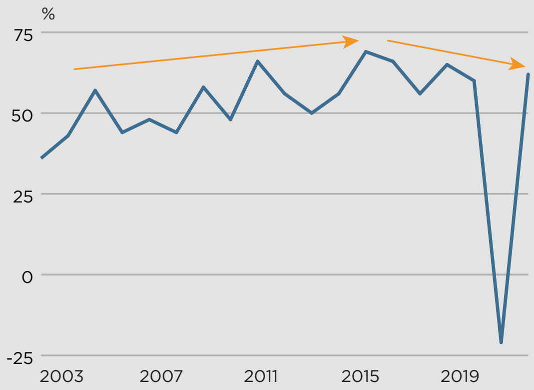
We note that Xi's focus on "Common prosperity" is more egalitarian than previous initiatives. Nevertheless, we believe the goal of "increased growth" will take precedence over the goal of "Common prosperity". The escalating rhetoric around "Common prosperity" likely also reflects China's concern about the widening wealth gap in the country since 2016. This appears to have dampened consumption growth thereby postponing the time when China overtakes the US as the largest consumer market in the world.

> **Xi's focus on "Common prosperity" is more egalitarian than previous initiatives.**

Handling wealth inequality is a challenge facing many countries, especially in the wake of the Covid-19 pandemic, which seems to have exacerbated the problem – and has subsequently given rise to social and political discontent. China is also exposed to this challenge, although the public's support for the Chinese Communist Party is generally solid and probably reinforced by its efforts to tackle Covid-19. In our view, China will most likely see the wealth gap as more of an economic risk than a political one.

With most of the population, around 70%, still in the low-income group, a redistribution of wealth via higher taxes would not be enough to resolve China's wealth gap. Instead, China will likely focus on initiatives to support a stable economic growth trajectory and support for job creation to reduce poverty and expand the middle class. In this light, China's transformation will depend on going from an investment-led to a consumption-led economy. In 2003, consumption accounted for 36% of Chinese GDP growth, but reached approx. 69% in 2015. However, since then, consumption growth as a percentage of GDP growth has fallen to around 60%, see figure 3.

Figure 3: Pct. of GDP Growth Contributed by Consumption Growth



Source: Credit Suisse, Wind, as of September 2021

From vision to market regulation

While vision gives direction, mission creates meaning. The vision declared by the Chinese government should result in a "beautiful", "harmonious" and "strong" – loosely translated – globally dominant China. The mission and its implementation will likely be achieved through regulation in the period up to 2049.

We see government intervention as particularly significant in the following three areas for the long-term investor: 1) Consumer protection of personal data (anti-trust), 2) regulation of content on internet platforms and 3) the government's assessment of unsustainable business models.

As an example of the protection of personal data, China is demanding that companies which operate with personal data improve/invest in new software solutions and infrastructure so heavily that their margins will be pressured. Therefore, before investors become too positive on the Chinese software sector, they must understand how and where the government's consumer protection strategy will crystalise. Adding to the complexity of this sector is the penetration of cloud-based services that disrupt the old business models.

We also find an example of the government's power and regulation in the gaming industry, where there is a desire to reduce the potential addiction of children and young people to computer-based games. However, this regulation has less impact on our investments than personal data protection, as a company like Tencent, for example, only generates 3-5% of its total earnings from games for children and young people under the age of 18. Nevertheless, when investing in companies that supply gaming or related companies, one should keep this in mind.

The third form of regulation focuses on the business models that conflict with Vision 2049. This could be the private education sector, where some companies are being forced to close their business.

Understanding political tendencies

When China implements their initiatives, it happens extremely quickly compared to the democratic procedures in the Western world. What takes the US or the EU five years to agree upon and implement just takes months in China! We saw this with the rollout of the personal data legislation. Hence, one should not doubt China's efficiency when it comes to implementing the government's initiatives. Consequently, China can change the sector outlook dramatically for better or worse within a short time period, so to find the right companies that can compound earnings year after year requires one to think in line with the government's vision, understanding the country's political and legislative effectiveness and the subsequent structural changes in demand. We have witnessed that Chinese equities have performed quite well in recent years despite the trade war with the US. This is primarily due to China's ability to support and stabilise its economy. More technically, this involves the control of interest rates, currency devaluations and targeted lending activity to prioritized sectors.

As an active investor, it is imperative to invest in line with the government's vision and the politically stated goals. When policies change, the structural growth outlook for some investment themes can also change and new investable themes will emerge. One example is the technology sector, where China is working towards independence from the US technology sector and building local know-how and production capabilities. With Vision 2049 in mind, themes such as Healthcare and the Environment are becoming more interesting together with domestic consumer brands that supply high quality products at low, consumer-friendly prices. A prime example of the latter is Li Ning which produces athletic clothing of essentially the same quality as Nike. The supplier to both Nike and Li Ning is the same, namely the Shenzhou Intl. Group – and we have both companies in our Asia and Emerging Markets portfolios. In contrast to Nike, Li Ning sells its products roughly 20-30% cheaper. The company is therefore aligned with China's focus on better affordability for consumers.

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However, when it comes to investing in the healthcare sector, there is a huge difference of where in the value chain to invest. For example, a research company that offers testing and development of active ingredients for major pharmaceutical companies can be significantly less risky than an innovative pharmaceutical company, as the research company receives payment prior to market rollout and is not dependent on the pricing of the pharmaceutical product or the future market situation. Themes that we expect will experience structural headwinds due to Vision 2049 include the gaming industry, companies within private education and the real estate sector in the medium term.

We foresee increased geopolitical risks as China pursues its goal of becoming an even bigger global superpower. One present conflict is the situation around Taiwan, where China will likely never abandon its claim on the island, which was originally part of China. If Taiwan were to declare independence from China through a referendum, turmoil and unrest would be expected. Trade-wise this is not a viable option for Taiwan, so this will probably never happen. In the current situation, the status quo in the China-Taiwan relations will likely remain the same. Coincidentally, the Taiwanese company TSMC, which produces semiconductors for the global tech industry, may also turnout to be a stabilising factor. Any supply issues from TSMC would be a major setback for both China's and the world's technological progress. However, despite all this, Xi Jinping wants a resolution around Taiwan before 2049.

Given the current changes as described, we advocate a more risk adverse stance with less tolerance if the fundamentals of a sector or company changes. This may potentially lead to a need for higher portfolio turnover. This underlines the importance of solid investment experience in China as intuition will play a more important role when analysing future government initiatives that might affect business conditions within certain sectors.

> **President Xi Jinping will achieve most of the stated ambitions in Vision 2049. China's firm ambitions to move-up both the industrial and social value chain have important investment implications.**

China's investment landscape going forward

We have more than 20 years' experience of China's complex investment universe and have closely followed China's development journey from President Hu Jintao to President Xi Jinping.

China as a growing global superpower with an expanding consumer market and not least a clear technological potential, has been widely perceived as an investment opportunity for decades. Historically, China has achieved its ambitious goals, and it is likely that China under President Xi Jinping will achieve most of the stated ambitions in Vision 2049. China's firm ambitions to move-up both the industrial and social value chain have important investment implications. The leading Western companies will eventually face massive competition as Chinese companies with a strong foundation from a huge domestic market seek to expand internationally. In this respect, it is important to understand that China's worldview differs significantly from that of the West's, which is a key consideration when implementing a successful investment strategy in China.

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