INSIGHTS

EMERGING MARKET EQUITIES

CHINA'S NEW PHASE OF GROWTH & THE ROLE OF ACTIVE INVESTMENT

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Since joining the WTO (World Trade Organisation) in 2001, China has enjoyed various tailwinds to economic growth, driving a multi-year investment expansion and world leading GDP growth rates. These positive drivers of investment are in some cases peaking and require China's economy to rebalance towards consumption in order to support future growth. Amongst the key tailwinds have been:

- **Export-led corporate investment** – the combination of access to international markets, relatively low labour costs and supportive policy enabled China to develop its industrial base and effectively export disinflation globally for many years.

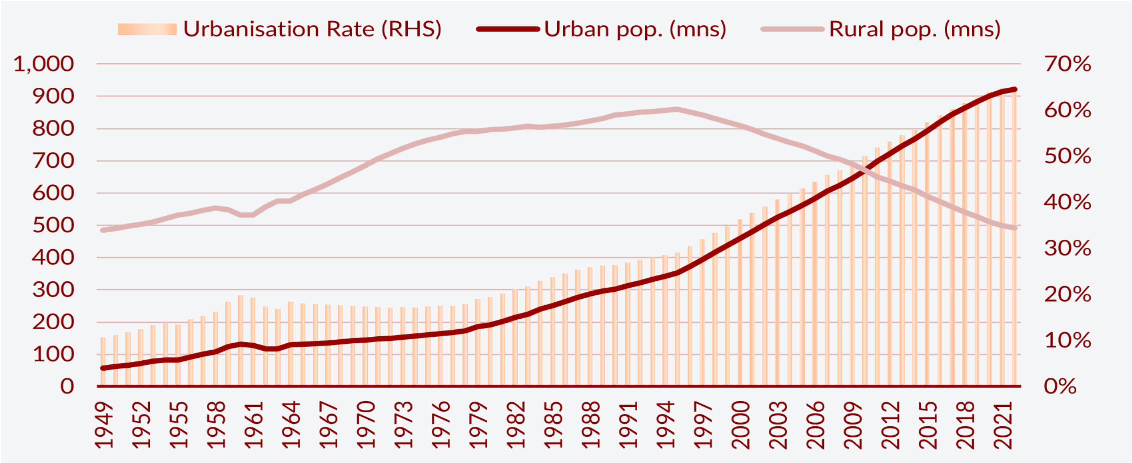
- **Urbanisation** – the huge population shift from the countryside to cities, with access to higher-paid and more productive jobs, as well as driving demand for housing investment was a key driver of GDP growth. China's urbanisation rate has grown to around 62%[1] and is slowing due to natural base effects and a declining pace of capital investment.

- **Demographics** – a young and increasingly productive population supported economic growth. The working-age population has peaked, although productivity still has room to improve.

- **Infrastructure investment** – China invested heavily in its domestic infrastructure and despite drivers such as its shanty town rehabilitation programme, is limited in its ability to add substantially from here.

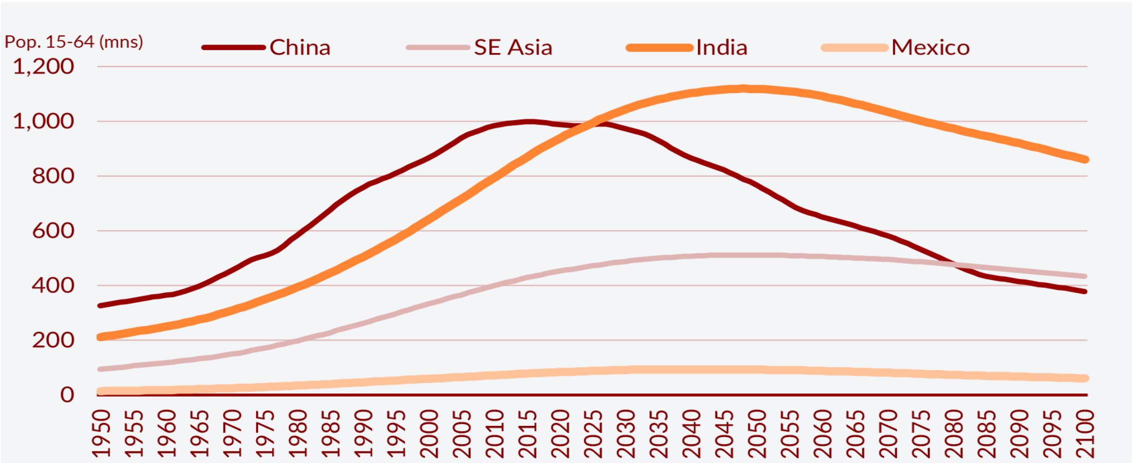
[1] CLSA Consumer Reality Research, September 2023

URBANISATION IN CHINA OVER TIME



Source/China Reality Research, NBS, May 2023

CHINA'S WORKING AGE POPULATION (15-64 YRS) IS BEING SURPASSED BY INDIA



Source/China Reality Research, UNSD, World Bank, Euromonitor, NBS, May 2023

It's worth pointing out, however, some straightforward interventions could reinvigorate some of the above tailwinds and not all have peaked:

- Urbanisation, whilst slowing, has now yet reached international standards, so should have room to increase further.
- Labour force productivity has huge headroom to increase towards global standards, which should help offset the declining absolute numbers in employment.
- China's retirement age is amongst the lowest in the world, at 60 for men, 55 for white-collar women and 50 for blue-collar women. This is set to increase gradually, which should support labour force growth, or at least go some way to offsetting its decline.
- There are still limits to urban expansion in the form of China's Hukou system and home purchase restrictions. The adjustment or removal of these would provide a further boost to urbanisation and investment.

- Improving state healthcare provision over time should enable households to divert an increasing proportion of their earnings from precautionary savings towards consumption.

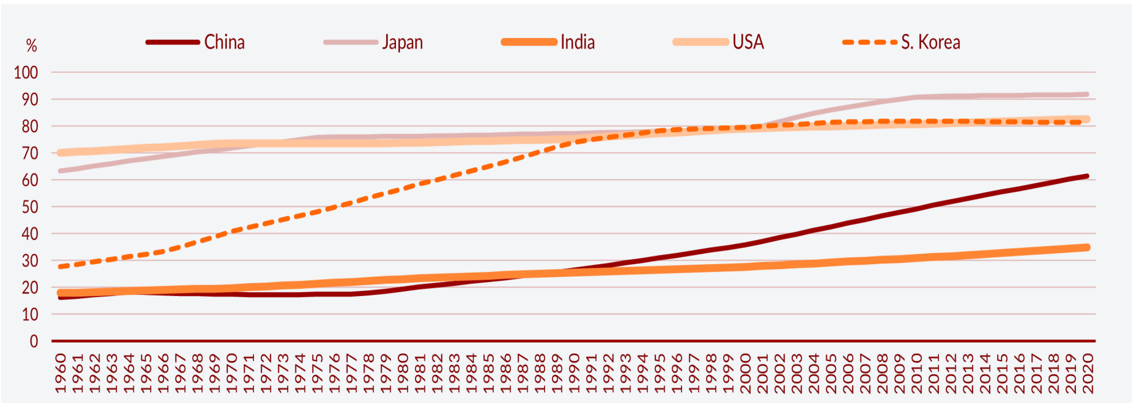
- The relatively high youth unemployment situation could be partially alleviated by changes to the system whereby job applicants require a specific degree to apply.

An additional positive is that China is generating approximately 11.6m new graduates each year to the workforce[2]. Aside from the challenge of providing sufficient decent job opportunities, this is a new tailwind to growth in itself.

Additional new challenges to growth come in the shape of less open global markets and political hostility from the US and the EU, in particular. Whilst these are genuine cause for concern, given the depth of supply chain integration and China's significance on the global stage, we believe their impact can be managed.

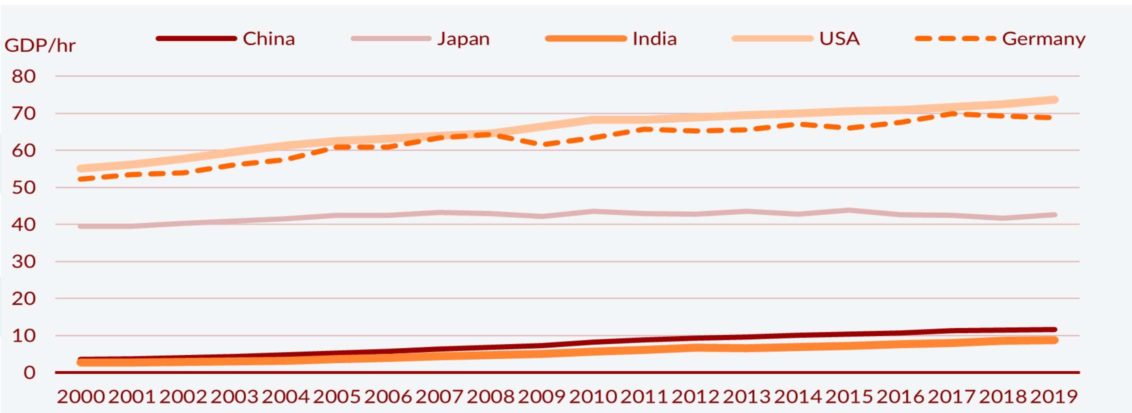
[2] South China Morning Post, July 2023

URBANISATION RATES AROUND THE WORLD



Source/China Reality Research, Our World in Data, World Bank, Global Data Lab, May 2023

LABOUR PRODUCTIVITY AROUND THE WORLD



Source/China Reality Research, Our World in Data, World Bank, Global Data Lab, May 2023

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FROM INVESTMENT TO CONSUMPTION

China's stellar growth of the past 20+ years has been primarily driven by investment. Due to natural base effects and shifting tailwinds, it needs to rebalance towards consumption in order to support future growth. Household consumption only represents 37.2% of GDP and increasing this to support overall activity will require a different approach from the government – something it is now embracing.

A strength during China's investment-led phase has been the ability of a command economy to direct investment. Although sometimes inefficient in terms of capital allocation, it has been effective. But it has limits and detracts from shareholder returns when taken too far. Take the solar industry for example, which has grown to dominate globally due to scale and supply chain integration translating into a cost structure far beyond the reach of any other nation. The government's role in influencing companies' capex plans, whilst successful at creating these scale benefits, eventually led to overinvestment and declining returns on capital, a negative for shareholders.

On policy, we are encouraged by signs that China's government is embracing the shift towards consumption and adapting accordingly. Having seen repeated high-level directives in support of consumption in recent months, we expect to see more specific policy actions over the months to come.

ADDING VALUE THROUGH ACTIVE MANAGEMENT

We believe the rising tide of the past two decades has become more nuanced. Investing in China now requires a more detailed approach to company and industry analysis, particularly given the opaque nature of government policy and sometimes low company disclosure, together with the negative potential effects of inefficient capital allocation.

Take the example of overinvestment in the solar supply chain. As active investors, we firmly believe in the long-term renewables theme and have realised gains from investments throughout the China solar supply chain. More recently, we have been able to pivot to areas where returns are still positive (from solar glass, modules, cells and wafers towards inverters and energy storage systems) and towards companies able to deliver more shareholder friendly outcomes. We attempt to positively influence company management teams where we see poor or misaligned corporate behaviour, but exit or avoid those investments where we see no evidence of improvement.

We are in the midst of a significant rebalancing of drivers within China and the broader EM, with new and changing tailwinds, geopolitical shifts & opportunities for investment.

We believe there are also other advantages of active management in China, from within the broad emerging markets (EM) and Asia funds, specifically:

- An EM or Asia portfolio can apply a broader view with comparisons and experience of well-run companies across other countries.
- EM and Asia portfolios can tactically under and over-weight China reactively and have a relative view on which to base that decision.
- Dedicated and experienced EM investors benefit from having witnessed many cycles across multiple markets in a way that those without the broader view may be unfamiliar with.
- International investors may be in a better position to ask the difficult questions of management, which can prove difficult for locally affiliated organisations.

IN SUMMARY

We are in the midst of a significant rebalancing of drivers within China and the broader EM, with new and changing tailwinds, geopolitical shifts and new opportunities for investment. As an industry we are also seeing some shift towards Asia ex-China and locally run China mandates. The above points remind us of the benefits of an integrated approach and highlight the increasing importance of active management.

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