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Investment opportunities in China best not be ignored

Written by: Pieter Hundersmarck, Fund Manager at Flagship Asset Management

China's rising economic and political power requires a radical rethink of traditional global investment management

China has long been classified as an "emerging" economy characterised by high GDP growth rates and a growing middle class but lacking the robust institutions, governance and economic dynamism of the more established "developed" nations.

For a long time, this classification suited Chinese ambitions. China received outsize deference in its dealings with its neighbours and received meaningful global assistance to grow and alleviate poverty within its borders.

However, today, with the US looking increasingly feeble as a global leader, China is demonstrating that it is willing to invest in the necessary infrastructure and institutions to grow its economic might. Investors and savers underestimate the implications of this at their peril.

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
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Time to challenge beliefs

As the rest of the world struggles to contain the various COVID-19 outbreaks and restart their economies, China appears to be gaining potency. Chinese GDP expanded 6.5% in the fourth quarter of 2020 and 18.3% in the first quarter of 2021, an astonishing rebound which speaks highly of their societal resilience and deft handling of COVID. Economically, analysts predict that the Chinese economy will be the size of the US and Europe combined within the next ten years.

Despite its growing size and relevance, several entrenched beliefs stand in the way of acknowledging China's leading position in the global economy. These include:

- **Style of government**. China's communist and authoritarian system of government is considered incompatible with longer-term capitalist institutions, and vulnerable to unrest, as citizens ultimately seek to define how they are governed.
- **Debt**. Chinese over-indebtedness is considered risky, and how the debt has accrued, is incompatible with what is required for a flourishing long-term destination for capital. Because of this, Chinese institutions would struggle to maintain trust in the governance and accountability that shareholders seemingly have elsewhere.
- **Fraud**. Fraud involving Chinese companies are over-emphasized in Western media. Fraud involving Western companies rarely lead newspapers to say the same about their home countries.
- **One dimensionality**. China is considered 'only good at copying and not creating anything original. Many will recall the same thing being said about Japan and Taiwan, which now are seen as producing the most cutting-edge tools in semiconductors and robotics. Is it so hard to imagine that 'Made in China' will be a stamp of quality in 20 years?

Growth by leaps and bounds

China has achieved far more than Western nations have in recent years. Firstly, it has continued to grow at breakneck speed, while most economies have contracted. This growth was achieved off of a base that is by no means small and through crises (like the GFC and COVID) that floored other nations. Expectations are for the Chinese economy to be larger than the US and Europe combined by 2030.

China has a powerful business model. It exports more than it imports, running a current account surplus as opposed to most developed nations that run deficits. Its economy is moving away from government spending towards personal consumption, as many economies before it have done. As a country, this places it in a net creditor position, controlling its destiny and not beholden to external pressure.

Debt, although higher than it has been in many years, is less than or on par with the debt levels currently seen in the West. Importantly, debt is predominantly domestically held as opposed to lending practices elsewhere in the world.

The Chinese bureaucracy is still restrictive, but efficient, as evidenced by the leading Chinese businesses emerging as global players (Alibaba, Xiaomi, Tencent, Ant Financial).

Poised for tech greatness

On the research and developmental edge, China has also shown that it can be a leading innovator globally and domestically. China has made noticeable gains in four broad categories of innovation: manufacturing; digital platforms; the utilisation of apps and "super apps"; and R&D in fields such as computing and biotechnology.

According to the UN, China was the biggest source of applications for international patents in the world last year, pushing the US out of the top spot it has held since the global system was set up more than 40 years ago. China's figure was a 200-fold increase in just 20 years. China is also poised to overtake the US in the most-cited 1% of published AI papers by 2025 if current trends continue.

Though there are some questions about the efficiency and effectiveness of Beijing's push to become a leader in tech, it is undeniable that Washington and Tokyo face mounting competition in innovation.

Where is this innovation leading? In 2020, China's most valuable brands were worth a collective $1.4 trillion – taking the second spot globally.

Even before COVID-19, China was already a digital leader in consumer-facing areas, accounting for 45% of global e-commerce transactions. At the same time, mobile payments penetration was three times higher than that of the US. By early 2020, according to McKinsey, ecommerce had reached 24% of total retail value – versus 11% for the US and 9% for Germany – and the pandemic has undoubtedly increased this since then.

Expansion in many areas

Wherever you look, Chinese influence is growing. The largest alcohol brand globally, the greatest number of CFA's and engineers, the largest manufacturing base, the largest mobile phone market and the largest car market, are already all Chinese.

Whatever you may have thought about China, the truth is that their system is working, their economy is growing, and their institutions are moving forward.

Beware of the cultural lenses

As a global investor, rich pickings in the US markets have often meant you needn't invest in China to make good returns. As a result, Chinese assets are underrepresented in global investment portfolios across the investment spectrum. However, with its strong economic foundations and boundless equity market opportunities, it should be as natural a hunting ground for the global investor as any market.

There is no doubt the global balance of power is shifting inexorably. Time, size and momentum are on China's side. Yet our objectivity to China has been clouded by sentiment, fear and ethnocentrism. That needs to change. As investors, we need to ensure that we capture the best opportunities that China has to offer, while appropriately sizing it in our global portfolios.

Glacier Research would like to thank Pieter Hundersmarck for his contribution to this week’s Funds on Friday.

Pieter Hundersmarck

Flagship Asset Management

Pieter has been investing internationally for over 13 years. Prior to Flagship, he worked at Coronation Fund Managers for 10 years in the Global and Global Emerging Markets teams, and also co-managed a global equities boutique at Old Mutual Investment Group. Pieter holds a BCom (Economics) from Stellenbosch University and an MSc Finance from Nyenrode Universiteit in the Netherlands.