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ASK FORSTRONG: SPECIAL REPORT

POSTCARD FROM CHINA

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Introduction

I first travelled to China in 1993 (full disclosure: I was a trumpet nerd on tour with my school's concert band). Back then, it was a blur of bulldozers, a dizzying amount of people and some ill-timed food poisoning … serious culture shock for a small-town kid from British Columbia.

In hindsight, I was witnessing a tectonic shift. China was about to embark on one of the greatest economic transformations in history. And they weren't alone. Other developing countries were also opening to the world. Borders were falling. And, if you squinted hard, glimpses of rapid globalization could be seen. Some 3 billion new consumers, producers and savers were just emerging from isolation.

What set off this dynamic super trend? Mainly the interaction of three significant events — the dissolution of the Soviet bloc, the end of cold wars between communism and capitalism and, importantly, the opening of China (with 2001 as the landmark year when they finally gained accession to the World Trade Organization). The result was that almost the entire world's population found their lives being guided by the invisible hand of market forces instead of the iron fist of communism or feudalism.

Arriving into Beijing's bustling international airport last week (this time without the band and trumpet), the point was again driven home. Evidence of progress and modernization is everywhere. The statistics speak for themselves: since China emerged from its near-death experience in 1989, it has been the world's fastest growing economy for three decades.

Yet the country is now at a crucial inflection point. The trade war's tariffs have reduced external demand and sent broader shock waves across global supply chains. Domestically, the country must deleverage but maintain reasonable levels of output. And growth is steadily slowing.

Contrary to a long running consensus, none of these are existential risks. In fact, the most important facts about China today are not problems of slowing growth and high leverage. Rather they are the shift away from exports and massive infrastructure spending to consumer-led growth, improving margins and financial liberalization. We are only in the foothills of a long journey.

In this special report on China, we respond to the most relevant questions from our clients. Our investment team met with dozens of policymakers, economists, government officials, leading companies and institutional investors across the country. As always, we invite further questions from our readers.

What are your big China observations?

Where to start? At the risk of stating the obvious China is massive. And very diverse. Our high-speed train trip from Beijing to Shanghai was a journey that seemingly took us from monochrome to technicolor. Beijing, brimming with history, was orderly and functional but somewhat homogenous in its landscape. By contrast, Shanghai clearly refuses to color inside the lines — a sprawling city so vibrant and lively that the energy seems to pass directly into the bloodstream (perhaps the way I once felt about NYC). It is a truly global city, gesturing to a new direction for the entire country. But there are over 160 cities in China with more than 1 million people. For scale, Canada has 5.

Secondly, China gets stuff done. Now, right up front, there can be much room for misunderstanding here. Everyone has their China biases — even macro geeks. But the facts, as best as we can tell, are as follows. Yes, China is still ruled by a so-called communist party and top-down policy control has arguably increased under President Xi Jinping. But check your preconceptions at the door — things are moving quickly in China. While state-owned enterprises still exist, bottom-up capitalism dominates. Even foreigners are impressed. Tesla's Shanghai Gigafactory was just set up in record time, taking them just 168 working days to go from permits to a finished plant.[1] Everywhere we went, we heard similar stories.

This may be controversial but I believe that the people are happier than commonly thought. 40 years ago 88% of the Chinese population lived in poverty. Today that figure is less than 1%.[2] That means more than 850 million people have experienced a quantum leap in their standard of living.

One financial professional we met was one of these people. Born in a tier 4 Chinese city and now working in the US, he told us the story of his family and how grateful they were for the increased standard of living. Their lives had been completely transformed. In an era defined by global gloom and deep negativity (where pessimism is the common language), this is a refreshingly positive story.

Many Chinese brands are also doing well. Some may think this has been fueled by rising nationalism as a result of the trade disputes. Perhaps. But domestic companies have been steadily gaining market share long before any eruptions in trade spats. Many Chinese companies now perform at the same level as their Western counterparts. In 2019, Huawei and drone maker SZ DJI Technology Co. lurched ahead of once-untouchable American companies like Apple and Nike to make the list of China's 10 most favorite brands (according to San Francisco-based consulting firm Prophet).

This is where it gets interesting for the "I-get-my-global-investment-exposure-from-US-multinationals" camp. Yes, the US sells an enormous amount to China (almost $120 billion of goods in

2018, only behind Canada and Mexico). And, yes, US companies have expanded in China and overseas to capitalize on new opportunities. For example, GM Motors (whose Shanghai plant we toured) now sells more cars in China than in the US.

But globalization is a double-edged sword. International expansion doesn't guarantee fatter margins. Quite the opposite. As the world flattens (to borrow Thomas Friedman's phrase from a few years back), US companies face new competition — at home and abroad.

Finally, the Chinese are acutely aware that big economic risks lie ahead: uncertainties in global demand, required deleveraging, elevated property markets, protests in Hong Kong and those pesky trade wars — to name a few. "No one thinks the economy is doing great," remarked one Chinese portfolio manager, running out of time in her two-part presentation to move from the "risks" to the "opportunities" section.

The mood is one of hustle and heavy lifting ahead. In May 2019, President Xi made a highly-publicized visit to a memorial of the Long March, the Red Army's fabled retreat from nationalist forces during China's civil war. His message of a "new Long March" was widely taken as a signal that he is preparing for a protracted standoff with the US. However, it was almost certainly meant to be more. The President has long promoted four transitional imperatives: the shift from export and investment-led growth to an economy driven increasingly by domestic consumption; the shift from manufacturing to services; the shift from surplus saving to saving absorption in order to fund a broader social safety net; and the shift from imported to indigenous innovation. No doubt, a daunting list for any country. We will be monitoring all of these closely.

China is slowing. How bad is it?

"China's GDP Growth Grinds To 30 Year Low" screams a headline last week. The article breathlessly lists all the possible risks and — don't wait for it — suggests an imminent arrival of a China crash. This has almost become a cliché.

We get it. China is slowing. The country's GDP growth averaged 11% in the 2002-2011 decade. It's now at the bottom end of their official range of 6%-6.5% and further moderation is near certain in the years ahead.

But let's separate fact from fiction. A fixation on GDP growth rates misses the mark. Measured in US dollars, the Chinese economy is 30 times larger than 30 years ago. Even at the slower GDP rate, China's contribution to global growth (approximately 21% this year) is far higher than at any time in history and higher than any other economy in the world.

What's more, much of China's slowdown has been coordinated by policy. In the boom years, many starry-eyed China watchers previously predicted real GDP growth of 10% plus indefinitely. But there are limits to linear thinking. While trends can stay in place for some time, lines often bend, or even break and gallop off in new directions.

One senior Chinese executive joked (pointing upward), "we used to be able to see the economic index in the sky." More smog equaled higher GDP. Today, the air is much cleaner (at least in tier 1 cities, no doubt the result of some careful window-dressing). But he went on to tell the story of a steel production facility in Beijing that had transitioned to a luxury race track. The new economy is outpacing the old.

More broadly, investors should not confuse current cyclical weakness with the powerful secular story. China's new path is driven by broad recognition that the growth model of the last 30 years is neither balanced nor sustainable. The new model must rebalance away from export and investment-led production toward private consumption. "Made in China" and Western consumerism can no longer be intimately linked. This is a necessary shift if China is to avoid the so-called middle income trap, which ensnares most emerging economies that rely on cheap labor for growth. And it is entirely consistent with former Premier Wen Jiabao's critique, who famously warned in March 2007 that China's economy was becoming increasingly "unstable, unbalanced, uncoordinated, and unsustainable."

GDP per head in China has just surpassed USD $10,000. To move sustainably higher, policymakers know productivity must dramatically improve. That requires a litany of change — reduced corruption, changes in social welfare and an improved operating environment for the private sector. A critical next step is to establish a robust social safety net and thereby reduce fear-driven high household savings rates (which still hover around 45%). This will lead to a virtuous cycle of consumption, job growth and, ultimately, higher real wages and corporate profits.

China is also moving from the rapid industrialization stage of growth (where the main objective was to build up infrastructure and heavy industry) to the resource efficiency stage (where the main goal is to maximize the return on investment). For the last three decades China has overinvested in manufacturing capacity, securing global market share by keeping prices low.

This has now changed. At the 19th National Congress in October 2017 in a marathon speech lasting 3.5 hours, Xi Jinping confirmed the new direction: companies and local governments must now focus on the quality of growth. Supply-side structural reforms are clearly the highest priority of Chinese policymakers, with an emphasis on productivity, innovation, environmental protection and moving up the value chain in manufacturing and services. The days of bloated capacity are fading. Therefore, over the next several years China will see reduced capital waste and improved profitability. That means slower but higher quality growth.

What's the latest with the trade war? Will there be a deal finally?

"The trade war," according to one Chinese economist we spoke with "is the most over-studied macro issue today." We agree. Tariffs are economically illiterate, prescribing bilateral remedies for more complex problems. Consider that America's colossal trade deficit reflects imbalances with over 100 countries. In a world with globalized supply chains, slapping tariffs on China simply diverts trade to higher-cost foreign producers — the equivalent of a tax hike on US consumers.

Tariffs are also blunt instruments. To be fair, economic policies never work in linear fashion. Unintended consequences are the rule rather than the exception. But targeting bilateral trade ignores underlying causality. Linkages among ballooning budget deficits, low savings rates, consumption bubbles and the resulting trade imbalances receive almost no profile in these discussions.

Where to next? My colleague (and trusted globe-trotting travel partner), David Kletz, wrote an article in September 2019 entitled "Peak Trade Wars?". It was a prescient piece. An interim deal was announced on October 11 (although admittedly a watered-down "phase one" accord). Trump clearly wants to bag a political win ahead of next year's election and move on. That means macro risk from US-China trade conflict has ebbed dramatically.

But longer-term damage has been done. Trump has taken a wrecking ball to the US-led post-war world order and America's longstanding alliances (including immediate neighbors, Canada and Mexico). The larger costs will ultimately accrue from the pivot of America's trading partners. A Chinese government official we spoke to was clear here: "this is no longer a trade issue but a deep philosophical and sentiment issue". He is right. There is now a longer and more strategic reorientation at play: many countries have re-evaluated their view of the US as a reliable place to do business.

From here, deeper integration among countries outside the US will happen. They will begin to develop alternative systems to reduce their exposure to the US. This allows for the emergence and even acceleration of new leadership. That means more free trade zones without the US, more payments and settlements outside the US banking system and, ultimately, other institutions for global governance without US veto powers.

All the above means China must work hard to shore up its global image. Access to foreign markets is crucial for its continued economic ascent. The

US administration is correct that many Chinese practices require a fundamental overhaul. Promoting intellectual property rights, stopping forced technology transfers and opening up the financial sector are all priorities.

A predictable and fair operating environment is key. Some progress has been made here. For example, Premier Li Keqiang has repeatedly required local governments to stop forced technology transfers in dealings with foreign investors. China recently allowed foreign financial institutions to establish wholly-owned banks and insurance companies in China. Restrictions on foreign institutional investors' access to Chinese onshore financial markets have been substantially reduced. But more work needs to be done. The pressure is on Beijing to make it happen.

What about all the debt on China's balance sheet?

It cannot be ignored that China has an eye-watering amount of total debt, reaching the vertiginous height of 259.4% of GDP by the first quarter of 2019 (according to the Bank for International Settlements). But the fundamental reason behind this credit surge is rooted in its high savings and banking-centric intermediation system. Chinese households have long been the primary providers of savings in the economy and their assets are far larger than liabilities. Thus, viewed from a balance sheet perspective, the net debt situation is much less dire than commonly perceived. Further, the bears ignore that most debt has been used for infrastructure buildup rather than funding consumption (imagine that in any Western country!).

Isn't China sitting on a demographic time bomb?

Labor force growth in China is indeed slowing. However, about 40% of China's labor force is still employed in the rural sector which will continue to be urbanized and industrialized. Urbanization, not organic population growth, has been and will continue to be the main driver behind China's labor force growth.

Is China's policy reflation enough? It doesn't seem to be gaining widespread traction.

To date, trade wars have largely overshadowed the onset of China's policy easing. Yet reflationary efforts — cuts in the reserve requirement, followed by personal tax cuts and easing credit policies over the past several months — are now showing up in the data. Business activity has stabilized. And underneath the soft top-line GDP figures, higher frequency data such as manufacturing PMIs, retail sales and even electricity consumption have recently accelerated. Yet it is too early to declare victory. A broad rebound similar to 2016 is not yet in the cards. Rather, the outlook is one of stabilization.

More reflation is now required. Evidence is surfacing that this will happen. One local portfolio manager we met with argued that monetary policy was well behind the curve in China. She then proceeded to show us more than eighty slides to prove her point (to be sure, a thoroughly enjoyable indulgence for chart junkies like this author).

We would add more context to the above: China still runs relatively traditional monetary policy. The list of countries doing so has dramatically shrunk since 2008. Advanced economies like the US and the Eurozone are well into a type of monetary dark age. In recent years, science and technology may have hurtled forward, but money and banking have stumbled backward. This is a long way from the golden age former Fed Chair Greenspan presided over.

Investors should pause and reflect on the above points. As the developed world's bond markets have been sucked into a black hole of negative interest rates, here is a country that has more policy levers than growth headwinds. This remains their ace in the hole. With ample room for further monetary easing, infrastructure spending, and other forms of fiscal stimulus, Chinese authorities are far less concerned about a sudden growth downturn than the common narrative would lead one to believe.

To be sure, challenges remain. Chinese policymakers will need to carefully manage the balance between cyclical growth and tackling longer-running structural issues. The deleveraging campaign that started in 2016 created a larger-than-expected slowdown (and, contrary to consensus views, was more important in reducing growth than trade wars). Current policy reflation is a direct response to the credit crunch caused by these initiatives.

But any policy flip-flops will create higher macroeconomic volatility and increase the risk of a policy mistake. If growth accelerates too much into 2020, Beijing could return to tightening just as quickly as reflation occurred. Our investment team will be monitoring these dynamics closely.

Should I be invested in China's markets?

You wouldn't know it, but China's broad stock indices have soared in 2019 outpacing even the US's stratospheric lift. What gives? The collective sigh amongst China doomsters is almost audible. The common narrative is that it's bound to be yet another episode of speculative activity lacking any observable fundamental drivers and a deep correction awaits.

Actually, history would be on their side. A quick look back at China's stock market history supplies excellent material for the thriller section of your local bookstore. The most recent boom-bust episode ending in mid-2015 saw a rapid 150% rise in the local index, only to be short circuited by clumsy policy intervention (involving widespread stock suspensions and state-owned purchases). Hardly a comforting view.

Allow us to provide some context. Our last day in China included a visit to the Shanghai Stock Exchange to meet with their management team. Many points were made but what is striking is the wide-ranging nature of their proposed reforms. No one is in denial that serious change is needed. They spent 90 minutes detailing a series of concrete measures to deepen capital markets and boost confidence in their domestic financial institutions.

Reform is swiftly underway. But the makeup of China's stock market is also rapidly changing. Consider the IPO market in China. It is booming. The upshot is that the Chinese stock market will come to more closely resemble the underlying economy as a whole, rather than being dominated by state-owned enterprises. MSCI's steady increase in the weighting of Chinese A-shares in its flagship emerging markets index is icing on the cake.

Currently, equity valuations of both onshore and offshore Chinese stocks remain near the lower range of historical norms. Bank stocks are deep value plays. And, contrary to the feverish sentiment and high valuations reached in 2015, retail leverage, transaction volumes and investor positioning all remain relatively muted.

Of course, markets are made at the margin. What catalysts could drive sustainable returns in the coming years? The Trump-Xi summit next month could lead to a breakthrough on the trade front. But we never bet money on the US president getting up on the right side of the bed.

In the medium term, growth momentum should be triggered by policy easing. From there, the economy is likely to develop a virtuous cycle of improving business confidence, private sector investment and, ultimately, higher corporate profits. Policy reflation will evolve into a more sustainable earnings-driven theme. The China stock market is in a sweet spot right now.

Looking out further, the ascent of China as an independent economic center of gravity is a boon for investors. With diverging economic trajectories and monetary policies (especially from the United States which, in the post-war period, has functioned as the de facto leader of world order and economic stability), macro trends in China are highly diversifying. Chinese assets reflect this showing low correlation to rest-of-world stocks and bonds.

In recent years, however, there has been limited urgency to diversify geographically, especially for those overweight US assets (read: almost everyone). But as China's market opens and becomes more accessible — in part facilitated by the development of China-focused ETFs — these diversification benefits become more important.

Yet Chinese assets remain deeply underweight amongst global asset allocators. Investors should consider where the smart money is heading. Canada's Pension Plan Investment Board (arguably Canada's most well-resourced fund) plans to more than double the proportion of assets it allocates to China in the next seven years (from about 8% of its assets to 20% by 2025). Don't miss this trend.

Footnotes:

1.https://www.bloomberg.com/news/articles/2019-10-23/elon-musk-opened-tesla-s-shanghai-gigafactory-in-just-168-days

2. Figures from the World Bank.