A PARADIGM SHIFT
Capture Opportunities in the New Chinese Economy
A Paradigm Shift — Capture Opportunities in the New Chinese Economy

China’s economic foundations are shifting, and so are its investment opportunities. In this series, we will take an in-depth look into the changes taking place in its US$13.4 trillion economy, exploring the underlying factors that are driving them and where they may lead the country in the future. Through it all, we will study the opportunities being created and how investors can benefit.

China’s Macro Shift: Towards a Self-Sustaining Giant

For the past 40 years, China’s economy has developed at an unprecedented rate. Since its government implemented economic reforms in 1979, significantly freeing up markets, the country has seen real annual GDP growth average 9.5%. The World Bank has described this dramatic evolution as: “The fastest sustained expansion by a major economy in history”. The result of this growth is clear – its US$13.4 trillion economy is now the world’s second largest.

For most of those 40 years, however, this enlargement was mostly attributed to large-scale capital investment, financed from both international sources and substantial domestic savings. Another contributing factor was the rapid productivity increase brought about by market liberalisation, exposure to competition, and the import of efficiency-boosting technologies and processes via foreign direct investment (FDI).

The historical drivers that have contributed to China’s economic growth have diminished. In other words, China’s growth story has changed.

The Rise of Domestic Private Consumption

As China’s economic drivers have evolved, international trade and investment have taken a back seat, and private consumption is now behind the wheel. Since 2013, it has surpassed the others to become the main force of growth.

Data shows that private consumption accounted for at least 60% of GDP growth in 11 out of the 16 quarters since 2015. For the 2017-2018 period, this figure rose to 76%, and in the first half of 2018, its share increased further to 80%. Meanwhile, China’s net trade surplus keeps falling, from an estimated 8% in 2008 to 1.3% in 2018 – less than South Korea or Germany. In fact, net trade made a negative contribution to GDP for the 2017–2018 period.

Furthermore, as private consumption snaps up an every-higher share of the Chinese economy, China’s international relationship dynamics have also altered – China is reducing its exposure to the world.

Indeed, the data reveals that China is becoming increasingly insular. McKinsey’s China-World Exposure Index measures the relative exposure between China and the rest of the world on three fronts – trade, technology, and capital. From 2000 to 2017, the index value representing China’s global exposure declined from 0.8 to 0.6. However, for the opposite scenario, it increased from 0.4 to 1.2 over the same period.
The Power of Higher Incomes

The main reason for this macro shift toward consumption is rising household incomes. In the late 1980s, average household incomes stood under US$3004. In December 2018, this figure had increased to almost US$4,000. This stronger purchasing power has naturally led to higher spending in the search for a better quality of life.

To put this in perspective, retail sales alone totalled US$5.5 trillion by end-2018 — comparable to that of the USA and over 15 times larger than China's entire GDP 30 years ago.

A Government that Actively Supports Economic Rebalancing

The Chinese government has also been a supporter and driver of this shift toward domestic consumption. This backing has typically been in the form of demand-side stimulus and credit expansion. From time to time, credit loosening was also used as a tool to stimulate economic growth.

For instance, between 2009-2014, there were appliance and rural auto-purchase subsidy programmes. More recently, in January 2019, China's State Council, together with ten other ministries, issued the 2019 Domestic Consumption Policy Package. In March, more detailed policies, such as VAT cuts, were released. Total tax and fee cuts are set to reach approximately RMB2 trillion this year, substantially higher than the RMB1.1 trillion for 2018. The ultimate goal of these fiscal and monetary measures is to lift business and consumer confidence and reduce the impact of short-term economic hiccups.

Is the Current Macro Shift Only the Beginning?

While statistics, such as private consumption driving 60-80% of GDP growth can make it seem as if China's macro shift is nearing an endpoint; the truth is it is still in its relatively early stages. Consider the developed economies of the US and Japan. In the US, consumption makes up almost 70% of total GDP. In Japan, which formerly held China's spot as the number-two economy in the world, it's about 55%.

By comparison, China's consumption share of GDP still stands at a relatively low 40%, inferring that China's macro shift still has a long way to go before it reaches parity with the developed world. Despite the size of its economy, GDP per capita is still low, and household incomes still far below those of advanced countries.

China also has significant room for further urbanisation. The rapid growth of its cities was a notable contributing factor to rising incomes, but as of 2018, its urbanisation rate stood at 58.5%, up from less than 18% in 1978. Again, the figures in the US and Japan are far higher, standing at over 80% in the former and over 90% in the latter. By 2027, China's urban expansion rate is estimated to hit 70%.

The Evolving Nature of Chinese Consumption, Products, and Services

While the China growth story has now been happening for 40 years, the shift in growth drivers implies a corresponding change in investment opportunities as well. The rise of the Chinese consumer class as the driving force of its economy means the firms that serve the domestic market are well positioned to benefit from a growing addressable market. These companies could be foreign or local; what matters is if they have the right know-how in engaging with Chinese consumers.

China's macro economic shift, rising household incomes, and its changing demographics are all interlinked. Our research team always tries to approach the consumption growth stories in different ways to better quantify the growth potential.
DEMOGRAPHIC TREND #1:  
The Growing Chinese Middle Class

The rise in household incomes over the past few decades has led to a growing and increasingly influential Chinese middle class. By 2027, it is estimated\(^1\) that this segment of the population will have expanded to about 65% of households. This could drive an average consumption growth of 6% per year to US$8.2 trillion over the same period.

It should be noted that the definition of ‘middle class’ is not a static one. Official Chinese statistics place this number at almost 400 million. Others, using a description of a net worth between US$50k to US$500k, a reasonably high standard, put this figure at under 110 million\(^\text{13}\).

Regardless of whether a lower or higher threshold is applied, the data shows that perhaps, contrary to popular perception, the proportion of the Chinese middle class is still relatively small. Yet, they have still been able to drive a sizeable macro shift toward consumption. As this group continues to expand, this transition will likely become even more pronounced.

DEMOGRAPHIC TREND #2:  
Consumption Upgrade by Income Group

Different sets of angles can be used when approaching consumption growth opportunities in China. GDP per capita is a commonly used measure to capture the quality of life of a population. However, in a country with such a huge population, the number becomes less insightful. It might be more useful to divide the 1.4 billion population into three large crowds: GDP per capita at below USD 5,000 (440mn population), between USD 5,000-10,000 (560mn population) and above USD 10,000 (390mn population). The consumption need, though supported by a consumption upgrade of any form, is different in each group. The first group is still mainly driven by volume growth from zero-to-one ownership; the second group’s consumption is highly influenced by brand, and third group’s spending is more about quality and experience-led consumption.

DEMOGRAPHIC TREND #3:  
A Cohort Analysis of Consumption

Another way of discovering investment opportunities is by segmenting Chinese population by age (or decades). China is, perhaps, the only country which demographers separate generational cohorts by decade, as centuries of economic and cultural change have been compacted into a relatively short period of time. Moreover to this, one generation in China can be equivalent to the entire or combined population of many other countries. Hence, understanding the baseline and discovering the evolution of behavioural change by generation can help in finding investment ideas.

By 2027, the proportion of little emperors, which refers to those born in the 90s and 00s, is expected to comprise 15% of the Chinese population, and the latter, an even greater 21%. As consumers, this demographic is markedly different from previous generations. They grew up in a period characterised by swift improvements in quality of life, increasing digitisation, and received financial support from their parents. They can be categorised under a separate segment, as they are the first in China’s history who are less concerned with needs and more concerned with wants – they were born consumers.

As such, companies that depend purely on volume growth will be structurally challenged while companies that have strong value-add proposition to parents will benefit. Private education sector is a clear beneficiary from the trade-off between offspring quantify and quality.

Not dissimilar to many countries, China is grappling with the challenges of an ageing populace. By 2027 it is forecast that 324 million people, equating to about 22% of the population will be 60 or older. As such, demand for products and services tailored to the needs of the elderly will increase. The healthcare sector, which includes areas such as senior care, dietary supplements, medical treatments (drugs) as well as health insurance, will benefit.
The New Mainstream – Personalisation and Innovation

As the size of the Chinese consumer class continues to grow, together with its purchasing power and expectations, further segmentation will be required. Companies will place people into progressively more targeted niches, leading to the gradual disappearance of the stereotypical ‘Chinese consumer’ as a monolithic and homogenous persona.

Offering personalised products and services to such a large market, however, is only possible with the use of big data analytics and technology. Hence, Chinese companies which can access, or own consumer data, are those that will benefit from this move toward a more personalised space.

Changes in China’s Capital Market

China’s economic repositioning also has important implications for future financing structures. Before, government investments, especially in infrastructure and manufacturing/exports were the primary economic fuel. All of this required an asset-heavy business model, which meant a heavy reliance on bank financing.

But with the continuing transition in China’s growth drivers, upgraded consumption trends, and more investments in the technology-supply chain, the government is providing these innovative companies with access to domestic capital market for funding. The STAR board, (Science and Technology Innovation Board), a new Nasdaq-style tech board, launched this year, is a beginning.

From a global perspective, China’s capital market, already the world’s second largest, has also taken on a larger importance. The Chinese A-Share market, previously limited to domestic investors, has been gradually opened to foreign investors. Global index provider MSCI is planning to quadruple the weighting of Chinese mainland stocks in its global benchmarks, which might draw US$80 billion of foreign inflows. On top of that, it plans to add Chinese mid-cap stocks by the end of 2019.

A Future Global Technological Powerhouse

The ascent and evolution of Chinese consumption is moving in tandem with China’s advancement toward a global technological powerhouse. In fact, the two are irrevocably intertwined. Several factors play into this interlinking.

Productivity Powered by Big Data

We are now in the ‘data age’ – data is the new oil. In the USA, the five most valuable listed companies, Alphabet (Google), Amazon, Apple, Facebook, and Microsoft, are all tech companies. Technology allows companies to deliver better product and services and increase productivity. AI supported by big data could be a solution.

Already the world’s largest population, China’s consumer-class boom, despite being still in its early stages, has precipitated a move toward a ‘big-data economy’. This isn’t a pure private-sector-led effort – the government, recognising its importance as part of the broader macro shift, is taking an active role in this transformation. Its Ministry of Industry and Information Technology (MIIT) has an explicit big-data development programme as a component of its current five-year plan. Most of the tech giants in China, both public and private, have already spent billions of dollars in research and development to boost their data analytics capabilities, with a strong focus on artificial intelligence (AI).

Full Speed Ahead Toward Winning the AI Race

AI may be a buzzword that has been around for a while, but the significance of this technology is very real.

One negative comment about this technology is this - AI’s enhancement of automation capabilities may only widen the inequality gap and further displace the power of labour.

We disagree. Our belief is that AI is poised to be the ‘jet fuel’ for economic growth – increasing the productivity factor, which has seen a slowdown in growth in recent years. While there is some variance in the estimates, there is a consensus that AI would be the catalyst for a surge in global output of USD13 trillion or more between 2019 to 2023, equating to at least a 14% boost in gross GDP growth.

In the AI race, the US and China are neck-and-neck at the head of the pack. In 2017, the government launched the New Generation Artificial Intelligence Development Plan, aimed at making China a global AI innovation hub by 2030. It is already delivering strong results. Tellingly, the adoption of AI in China is not limited to select industries but is far more encompassing – a by-product of its industrial diversity, something dubbed ‘economies of scope’.

In the research arena, China’s output is also considerably outpacing that of the US in terms of sheer numbers. Some
critics have justifiably pointed out that quantity does not imply quality, and there is data indicating that the quality of Chinese research output is lacking. Yet, even going by a different metric - the number of papers cited - China is still poised to overtake the US.

Toward a Consumption-Driven Digital Economy

As China’s macro shift continues, the country’s rising technological prowess in big data and AI, coupled with the evolving nature of Chinese consumers themselves, are propelling China toward a consumption-fuelled digital economy.

Consider that in 2005, China accounted for a mere 1% of global e-commerce transactions. In 2016, that figure was 42%. China also has the highest rate of fintech adoption in the world – 69% compared to the global average of 33%. This embracing of fintech is like the grease in the wheels of the digital economy, letting it power forward at an accelerated pace. To top it all off, China is also set to become one of the world’s leading technological innovators.

A Future Technological Innovator

China has been viewed as a ‘technological follower’ rather than an innovator or pioneer, but this may soon change, especially with the with the adoption of 5G technology. The government is playing an active role in driving this move, from its 5G, big data and AI development plans to its ‘Internet Plus’ plan for integrating traditional industries with the web – with applications from IoT to cloud computing to smart cities.

With the aggressive and earlier adoption of 5G in China market, the implication is that the country will be ahead of the curve in the new new ecosystem.

Demographic trends are also supportive. In 2016, Chinese graduates in Science, Technology, Engineering, and Mathematics (STEM) numbered 4.7 million – over eight times greater compared to the US. By 2030 China and India could account for 60% of global STEM graduates, compared with 4% in the US and 8% in Europe. In terms of the raw number of university graduates, China is already number one in the world.

A Few Final Words on China

For years, many investors perceived investing in China as more of a passive option. Things have since changed, as China now has over 129 companies (including three in the Hong Kong market and ten listed on the Taiwan exchange) making it to the Forbes Global 500 list in 2019. It is now the top ranked country, with the USA trailing behind at 121 businesses.

But while Chinese companies can be huge in revenue size, supported by their advantages in demographic and network scale, profits do not necessarily follow. This is an area where firms are continuously working on, and they are aided by the government’s reforms in accelerating market consolidation. Productivity improvements and upgrading industries will also be key points of focus in the next decade. Meanwhile, its geopolitical decisions will also be crucial in influencing how the world cooperates and works with them.

All these mean that while Chinese equities represent a considerable opportunity for investors, there are also commensurate risks. There will be winners, and there will be losers, and a rigorous equity selection process will be essential.

Our Investment Process and Stock Selection Methodology

Before going into our investment process and stock selection methodology, we need to talk about passive (or active-passive) investing, and why investors looking to gain from Chinese equities might be wise to tread carefully.

In recent times, passive investment strategies have been gaining in popularity, particularly in the US where assets under management have now reached parity with active assets. Leading investors have strongly recommended this approach when it comes to US equities, and the theory behind it is sound. Over the long-term, the US stock market has indeed made decent returns for investors, who also benefit from the low-fee nature of passive investing.

However, that strategy is not optimal for the Chinese stock market and specifically Mirae Asset China Growth Equity Fund. There are several reasons for this.
Less Robust Governance and Regulations

It's no secret that the Chinese market still has some catching up to do to reach Western institutional standards in governance and regulations. While H-Shares or American Depository Receipts, which are Chinese companies listed in the New York or Hong Kong markets, must abide by strict rules, mainland-listed A-shares face significantly looser regulations, leaving minority shareholders with much weaker legal protection.

An Unevenly Weighted Index

Financial and industrial shares are heavily weighted in Chinese equity indices. Conversely, high-potential sectors, like healthcare (which will benefit from an ageing population), are underweighted. While these may have been appropriate in the past, they no longer reflect the reality of China's future. While these may have been appropriate in the past, they no longer reflect the reality of China's future. Also, passively investing in a China index fund means losing the ability to only capture the country's best growth opportunities.

Our Eight-Stage Stock Selection Methodology

At Mirae Asset, we believe that fundamental analysis is key to navigating the Chinese market, and that is why we are strong advocates of achieving excess returns from bottom-up stock-selection strategies. Beginning with a total investment opportunity set of well over 5,500 stocks (A-shares, H-shares, Chinese ADRs and IPOs), we use a stringent quantitative screening process, filtering it down to a more defined investment universe of about 2,000 stocks based on their liquidity, financial, and business risk.

From there, we apply meticulous qualitative screening, analysing each potential stock at the fundamental level, from its key growth drivers and management quality to its position in the competitive landscape and what makes it different from the consensus. Here, we also put them through our independent valuation models. We do not rely on analyst coverage for information – instead, we carry out numerous company and site visits supported by on-the-ground research teams.

This narrows our potential portfolio down to a focus list of 200 – 300 stocks. That focus list now must go through a recommendation list and enter our model portfolio, where our Investment Committee selects only the highest conviction ideas. At the end of the process, we invest in fewer than 30 stocks in our China Growth Equity Fund with a two to three years, if not longer, investment horizon in mind.

The strength of this approach is the quality and quantity of research we conduct on each stock that goes into our final portfolio. Our experienced on-the-ground teams are keenly aware of the pulse of the market—they go out to see first-hand the economic, demographic, and technological changes going through the Chinese economy, obtaining data that they then incorporate into our detailed analyses.

This is a demanding process, but it gives us confidence when managing our clients' money, and why we have been so successful.

Your Gateway to Investing in Sustainably Competitive Chinese Companies

The Chinese equity market holds substantial opportunity. However, it is also an opaque one, and investors should be aware of this before they take the next step. Our China Growth Equity Fund, built upon our rigorous analytical and selection process, is your gateway to investing in sustainably competitive companies that can participate in and benefit from the rapid shift in China's economic foundation.

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