September 2018

China as an investment destination

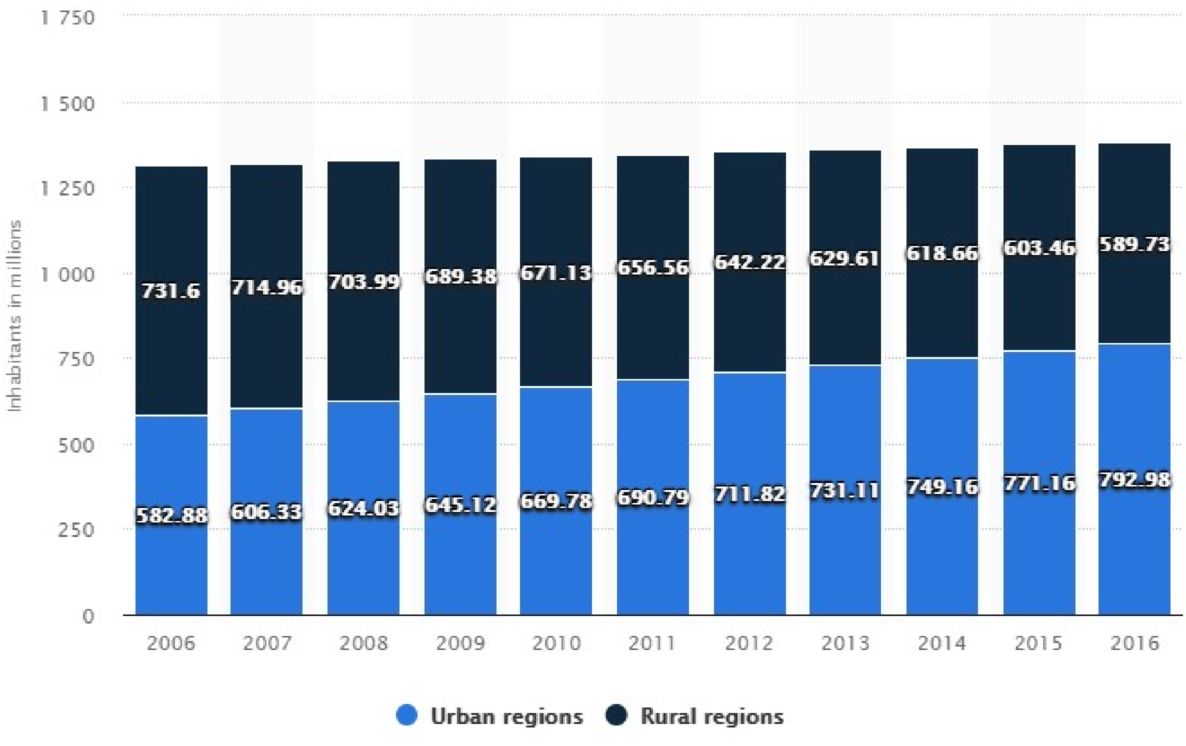
The rapid rise of the Chinese economy over the past 20 years is quite remarkable. From being an economic backwater a generation ago, China has become a global powerhouse of manufacturing, largely thanks to its relatively lower wages and highly productive workforce. Despite this strong economic growth however, most foreign investment in China has been through direct investment into physical assets, like factories and assembly plants, while financial investment into Chinese equity markets has been negligible. The reason for this is that a large segment of Chinese investment markets is closed to foreign investment, and the segments foreign investors can invest in are tightly regulated by the Chinese government. Global investors therefore approach investment opportunities in China with some scepticism. But many of these restrictions are being relaxed, and as China continues to grow the question has become whether it is becoming a more attractive investment destination.

An investable destination should provide investors with strong growth prospects on their investments, a transparent and efficient market and the protection of property rights. Below we'll consider some evidence regarding how China is satisfying these requirements.

1. Positive demographic trends

China has over 1.4 billion inhabitants, making it the most populous country on the planet. To put this into perspective, China's population exceeds the second most populated country, India, by the entire population of Germany. This population is becoming increasingly mobile and participative in the Chinese economy. The chart below shows the rapid growth of the urban Chinese population over the last 10 years. About 800 million Chinese, or 57% of the population, currently live in urban areas, and another 350 million, are expected to migrate to urban areas within the next 20 years. Despite the national population growing relatively slowly, there is massive movement of people from poorer rural areas to richer, more dynamic urban areas.

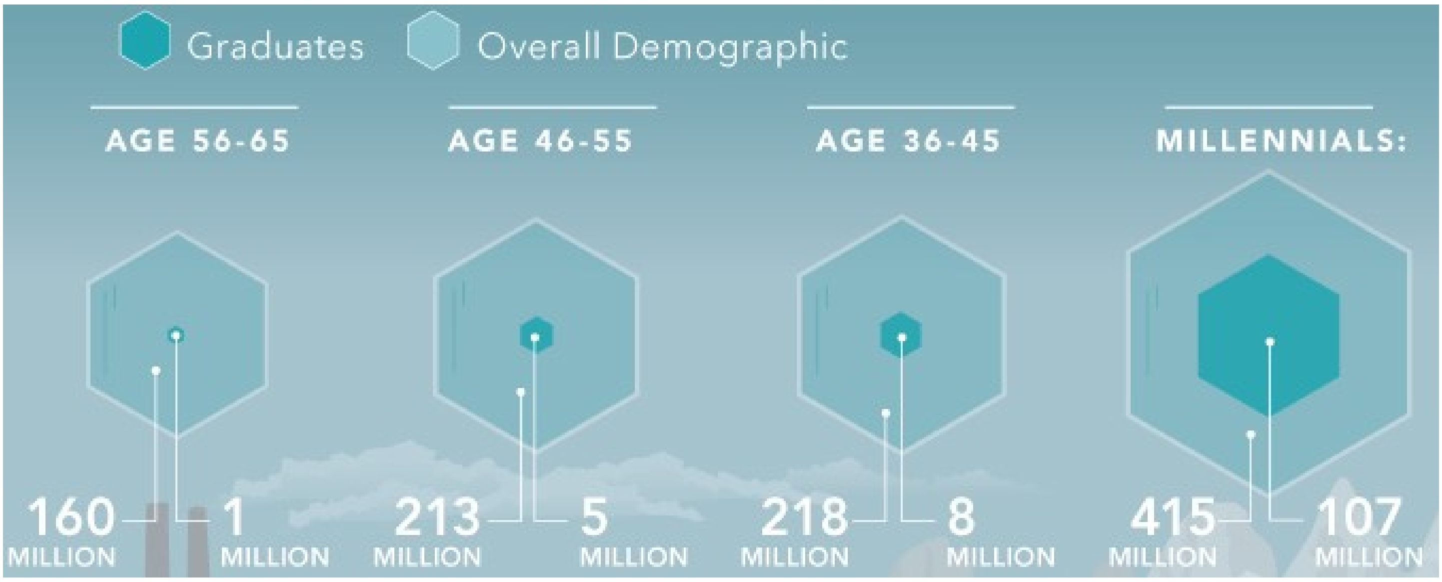
Chart 1: Urban, rural and total population changes in China, 2006-2016:



Source: Statista

The education levels within the Chinese populace are also increasing, with the Chinese government spending over USD700bn on education every year. Their investment is bearing fruit as demonstrated in the chart below, showing the number of university graduates by age group. Whereas only 1 million out of 160 million (0.63%) of Chinese between the age of 56 and 65 have graduated university, around 26% of the millennial population (aged 25-35) have.

Chart 2: University graduates by age group in China:



Source: Visual Capitalist

Chinese consumers are also getting richer. Where 17% of urban households were identified as being upper middle income or affluent with annual incomes of R230 000 or above in 2012, 63% of the population is expected to fall into these groups by 2022. The combination of a rapidly urbanising population, with higher levels of education and disposable income suggests massive growth in demand for more sophisticated consumer goods and services, and for the companies that cater to these needs.

2. Economic resilience

The Chinese economy is the second largest in the world after the United States, generating about USD11.2tn in output every year, and has shown astounding resilience in its ability to grow at high rates despite its large size. Consider this: to generate growth rates of 6-7% today, the Chinese are adding the equivalent of the entire South African economy to their GDP[1] every 5 months. One of the reasons they are able to achieve this is because they still lag developed nations on a relative per capita[2] basis. While Chinese GDP per capita is growing around three times faster than US GDP per capita, Americans still generate around 7 times as much economic output per person as the average Chinese every year. In fact, China is only now catching up to South Africa in terms of GDP per capita.

Chart 3: Chinese GDP per capita (compared to the US, Japan and South Korea):

Source: Visual Capitalist

3. Moving up the value chain

Chinese products haven't historically had a reputation for quality. Instead, China has typically been seen as more of an assembly plant of goods designed in developed nations and therefore an adopter of foreign technology rather than an innovator. This is changing, with Chinese manufacturers moving up the value chain and producing more advanced, higher quality products. Evidence of this can be seen in the number of high-tech firms listed on Chinese stock exchanges. 60% of the firms listed on China's second largest exchange, the tech-heavy Shenzhen Stock Exchange, operate in high-technology industries. Of the 20 largest high-technology firms by market capitalisation in the world in 2013, only three were Chinese. By 2018, this number had grown to eight, see the chart below. Chinese companies now spend more on research and development than all firms in the European Union combined.

Chart 4: World's largest technology firms by market value, 2013-2018:

Source: Visual Capitalist

4. Market Penetration

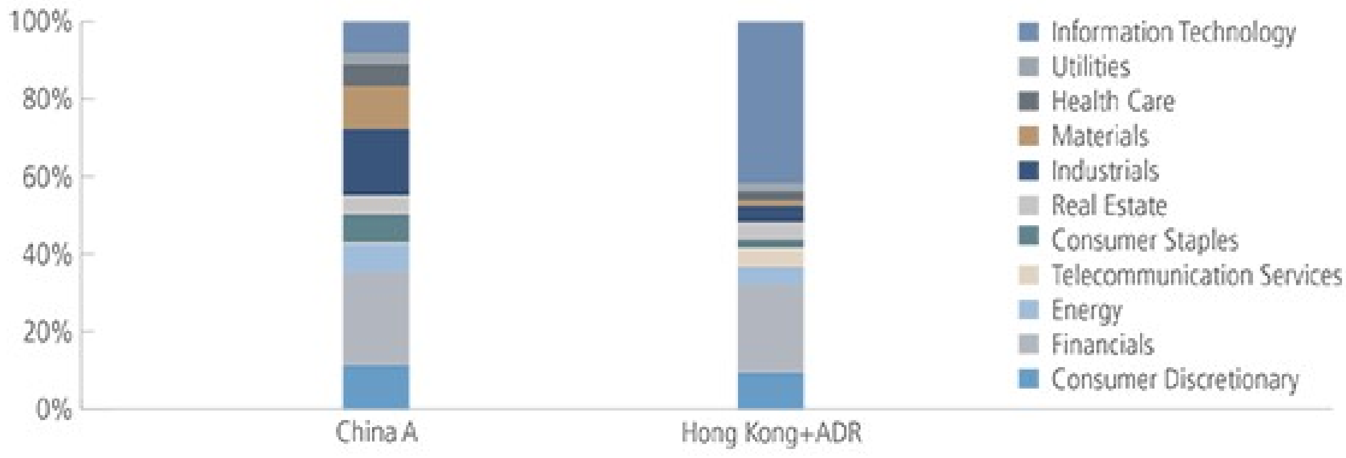
Foreign ownership of capital is tightly controlled by the Chinese government, with the limits varying depending on the importance of an industry to national interests. Consequently, Chinese equities are divided into different share classes depending on where the shares are traded, and who can buy it. The two most common types of shares are A-shares and H-shares. A-shares are companies that are incorporated in China, listed on either the Shanghai or the Shenzhen stock exchanges and trade in RMB[3]. H-shares are incorporated in China but trade on the Hong Kong Stock Exchange in HKD[4]. Before 2003, A-shares were completely off limits to foreign investors, who were restricted to H-shares if they wanted to get Chinese exposure.

Over the last few years there have been several changes to the benefit of investors seeking exposure to mainland China:

- Firstly, the government relaxed regulations to make foreign ownership of A-shares less restrictive. Foreign ownership is still limited to 30% of a company's shares, but restrictions on moving capital in and out of China have been relaxed.
- Secondly, access to A-shares listed in Shanghai or Shenzhen can now be traded directly via brokers based in Hong Kong.
- Lastly, the MSCI[5] started slowly including A-shares in its indices. This means that passive funds will need to start investing in A-shares in their aim of replicating the index.

The obvious benefit of the Chinese mainland market opening up is the sheer range of opportunities available to investors. There are almost 3400 A-shares trading on Chinese exchanges, in comparison to around 900 H-shares that foreign investors traditionally had access to before. A-shares are also diversified over a broader range of business sectors, whereas H-shares are dominated by technology stocks like Tencent, which South African investors already have access to via Naspers. The chart below shows the industry diversification of A-shares, compared to H-shares.

Chart 6: Sector exposure of A-shares and H-shares.



Source: Wind. The chart shows free-float market capitalization.

Source: Neuberger Berman

5. Property Rights

A risk that investors still worry about is that China remains a socialist state and that property rights aren't protected. The argument that is used against this concern is that the Chinese government realises the need to open up their markets to foreign investment and that they are committed to becoming a global investment destination. As a result, the likelihood of foreign property being nationalised is low. These commitments can only be taken at face value and will depend on investors' confidence that their property isn't more at risk in China than it is in Brazil or Russia.

China is expected to generate over 35% of total global growth over the next few years. They have an enormous population, which is increasingly participating in the economy, becoming richer and more educated in the process. Arguably, the country is now on a more sustainable growth trajectory that is supported by stronger domestic consumption and high value manufacturing, in contrast to the export-lead low margin manufacturing they were dependent on before. The market is opening up to foreign investment which should facilitate a more efficient investment environment going forward. There are country-specific risks that investors have to consider, as with all foreign investments. But, in terms of China growing as a global investment destination – my money is on red.

[1] Gross domestic product, which is a measure of the value all the goods and services produced in a country in a year.

*[2] Per person *

[3] Renmimbi is the Chinese currency

[4] Hong Kong Dollar

[5] MSCI creates global investable indices to benchmark performance against

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BESPOKE FINANCIAL SERVICES

September 2018

data provided by Reuters and Datastream

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.2%	-3.8%	3.3%	6.7%	8.0%	12.1%	10.5%	13.6%
FTSE/JSE SA Listed Property	ZAR	-1.0%	-22.2%	-15.7%	-1.4%	6.8%	13.5%	13.6%	13.7%
SA All Bond Index (ALBI)	ZAR	0.8%	4.8%	7.1%	7.6%	7.1%	8.5%	7.7%	7.3%
SA Cash Index (SteFI)	ZAR	1.7%	5.4%	7.2%	7.3%	6.8%	6.8%	0.2%	0.4%
Balanced Benchmark	ZAR	0.3%	1.3%	5.2%	7.5%	9.1%	11.7%	6.9%	8.5%
SA Inflation (1 month lag)	ZAR	1.1%	3.5%	4.9%	5.2%	5.3%	5.3%	1.3%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	5.1%	5.9%	11.8%	14.2%	9.9%	9.2%	9.6%	15.4%
Emerging Markets Equity (Datastream EM)	USD	-0.9%	-7.4%	-0.4%	12.8%	4.0%	5.8%	14.7%	21.2%
Global Bonds (Barclays Global Bond Index)	USD	-1.6%	-2.5%	-1.5%	1.7%	0.2%	2.2%	5.2%	6.4%
Global Cash	USD	0.6%	1.6%	2.0%	1.2%	0.8%	0.7%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.2%	-3.8%	3.3%	6.7%	8.0%	12.1%	10.5%	13.6%
Global Equity (Datastream World)	ZAR	8.5%	21.0%	17.2%	15.1%	17.6%	15.2%	14.5%	14.5%
Emerging Markets Equity (Datastream EM)	ZAR	2.3%	5.9%	4.3%	13.6%	11.3%	11.6%	12.9%	14.8%
SA All Bond Index (ALBI)	ZAR	0.8%	4.8%	7.1%	7.6%	7.1%	8.5%	7.7%	7.3%
Global Bonds (Citigroup)	ZAR	1.6%	11.4%	3.2%	2.5%	7.3%	7.8%	13.6%	14.9%
COMMODITIES									
Gold (US Dollars)	USD	-4.8%	-8.6%	-7.2%	2.3%	-2.2%	3.1%	13.3%	17.8%
Gold (Rands)	ZAR	-1.7%	4.5%	-2.7%	3.1%	4.7%	8.8%		
CURRENCIES									
Rand / Dollar	ZAR	3.2%	14.3%	4.8%	0.8%	7.1%	5.5%	14.9%	16.8%
Rand / GBP Pound	ZAR	2.0%	10.2%	1.9%	-4.1%	2.5%	2.3%	16.0%	15.8%
Rand / Euro	ZAR	2.7%	10.6%	3.0%	2.1%	3.8%	3.5%	13.9%	13.6%

Spot Rates		28-Sep-18	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	14.15	13.71	13.53	10.24	7.69	5.88
Rand/GBP	Rand	18.45	18.10	18.19	15.84	14.03	9.99
Rand/EUR	Rand	16.44	16.00	15.95	13.50	11.31	-
RATES							
Libor 6m $	US$	2.60	2.50	1.51	0.39	3.12	5.25
Repo Rate	Rand	6.50	6.50	6.75	5.00	12.00	21.86
Prime	Rand	10.00	10.00	10.25	8.50	15.50	25.50
All Bond Index Yield	Rand	9.65	9.44	9.39	8.49	-	-
COMMODITIES							
Gold ($/oz)	US$	1,191.49	1,251.13	1,285.10	1,397.63	834.60	294.95
Platinum	US$	815.00	851.00	918.00	1,514.00	1,479.00	350.00
Oil (Brent Crude) $	US$	82.79	79.44	57.86	116.20	113.45	14.82
INFLATION							
SA Inflation	%	4.9	4.6	5.1	6.4	12.0	-

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