China

CHINA MISCONCEPTIONS: A CHINESE FUND MANAGER'S THOUGHTS ON BEING DOWN UNDER

Premium China Fund's **Jonathan Wu** explains the differences between Australian and Chinese perspectives on funds management.

AS FUND MANAGERS come to Australia to share their views on the markets they specialise in, it's always good to see as part of their travels how they view our market and in turn how being in Australia shapes their views of offshore markets and, in this case, China.

Renee Hung – deputy chief investment officer (CIO) of Value Partners Group in Hong Kong spent a week travelling in Australia in September and conducted this interview with me on her observations on how Australian advisers see China and how misconstrued news (or lack thereof) can shape investment decisions to the possible detriment of portfolios over the longer term.

Q: During your week-long travels in Australia, what is the most interesting observation you made?

A: This is the longest time I've ever spent in Australia in one trip and what I found consistent around the country was that general news feeds don't mention a lot about investing and if they do it is focused around Western markets with little mention of Asia or China. News also seems focused on lifestyle issues and sports which is fantastic and a reflection of the great Aussie lifestyle but I can now appreciate how investors do not understand China at all. This in turn leads to many questions which we certainly do not get from Asian investors.

Q: One of the most common questions we were asked during the recent national investment briefings were on growth and whether or not it is sustainable. Isn't this an old story already?

A: That's right, Chinese GDP growth levels are an old news story. China's goal of shifting away from high nominal figures is a five-year-old newswire. The growth story in China is wholly focused on increasing the living standards of its population. One of the weaknesses as shown in history is that when there were 12-13 per cent nominal growth rates in China, that real wealth growth effect wasn't felt that much in the middle class. But while living standards of Chinese citizens has grown significantly over the last few years, people in Australia don't necessarily feel it directly which is understandable. It seems that from my week in Australia, a lot of talk from Australian advisers was focused on the Chinese buying up local property. For us as locals, the transformation of the growth profile is drastic. Shenzhen's gross domestic product (GDP) is almost as large if not larger than Hong Kong already. In Beijing and Shanghai, most Fortune 500 companies have a presence and restaurants, which equal anything in Australia book out quickly due to sheer demand. One has to understand that the key area of growth in China is not labour deployment (i.e. finding people jobs) but more so productivity growth which is something the world has been lacking since the global financial crisis (GFC). When one moves from being a rural farmer to even a third tier city, productivity jumps anywhere from three to 13 times.

Q: So, with the growth in productivity, does that then fuel the growing consumption profile?

A: Exactly. In Australia, you have talked about the number of Chinese shoppers buying up top tier brands like Louis Vuitton, Gucci or Prada but that is not where the majority of shoppers are acquiring their goods. The story goes something like this: say for sports apparel, when they move from rural areas to say a third tier city, they can only really afford to buy local brands. When they then move to higher tier cities, they would buy high tier local brands like Anta or Li Ning. It is only once they hit first tier cities, then their brand of choice becomes Nike and Adidas because they can afford it. This is a trend that will continue for the next 10-20 years. Urbanisation occurs when you move from rural areas to even a fourth tier city. While that's great, it's only the start of the consumption upgrade cycle. The world clearly understands the power of the American consumer, and they have a population of 320 million people. In China going forward, every 10 years will bring another 250-300 million people into this same consumerism sphere. Just to re-iterate, this all comes from productivity growth which in turn drives income growth and therefore an upgrade in consumer tastes.

Q: The Chinese property market is always a point of contention when talking to advisers, they love to mention ghost cities. What do you make of this generalisation?

A: China is a big place with over 1.6 billion people and there are over 160 cities with a population greater than one million people. Logically thinking about it, if China were just a bunch of ghost cities, where would everyone live? Each country will have pockets where excess supply exists (I understand during the trip that South East Queensland currently has this issue) which outstrips demand. Over time, as demand increases to absorb supply, developers will start developing again. This is the same for China. In actual fact, it is very hard to buy property in tier one cities such as Beijing, Shanghai, Shenzhen and Guangzhou. If you work there, you can buy one but no more than that. There has been and there will continue to be a lot of pent up demand in these markets. How the government has been tackling this is to increase supply and open up tier three and four cities. These have far more potential as it's more affordable. The central government wants to take the focus off tier one cities over time because prices can spike over short periods. For example, in Q3 2016, the government announced a range of tightening measures for tier one cities because Shenzhen and Beijing property prices went up over 50 per cent in the preceding 12 months. Everyone has to remember that the key sustainable driver for property prices is that income growth is faster than property prices. This is occurring in tier three and four cities and hence why the government's focus has shifted.

Q: For those who have visited China, one of their first comments is the level of pollution across tier one cities like Beijing and Shanghai. Has China done anything about this?

A: Yes, it has been an issue for many years. Again, everyone should understand the source of this. China over the last 30 years has been the manufacturer to the world. The positive economic consequence is that the country has exported deflation which in turn has provided Western manufacturers access to cheap goods. The negative environmental impact is that fossil fuel consumption and emissions have hit record highs. Over the last 10 years, the government has shifted its focus to attacking pollution. A few measures that have been implemented is attacking steel manufacturers which breach government guidelines on emissions. This has stepped up in a big way in the last few years which forces many players out of the market but for the sake of its population as the government recognises the significant associated health costs over the long-term, it is aggressively shutting down many facilities. Furthermore, there are new waste to energy technologies being implemented in different parts of the country. This is a growing area for the private sector as you can derive high single digit stable returns via public/private partnerships (PPPs). As China's growth continues to transition from being one of manufacturing to one of services which in turn increases incomes for all, the broad level of pollution should also come down.

Q: Something that always makes investors uneasy about investing in China is related to corruption which could stall reform progress. What do you think of this being an investor in the region for the last 20 years?

A: Corruption is an unfortunate outcome of any capitalist society (which includes most countries across the globe). If you think about corruption in its simplest form, it is an artificial distortion of wealth which defies the natural laws of competitive advantage. Practically speaking, if one was to avoid investing in countries where corruption occurs, then the list of areas where one can invest is very limited if not zero. What investors should be focused on is on whoever is managing their money on behalf of them knows how to navigate the landmines related to corruption. As everyone knows, President Xi has been a big advocate for stamping out corruption at all levels within the Chinese government. Historically speaking, his approach has been the most effective which is reflected in the citizens of China being more confident that if they want to succeed in business, the journey is clearer. This is a positive for not only locals but also foreigners wanting to enter the ever-growing Chinese market.

Q: Do you have any parting words for Australian advisers and their investors?

A: The speed of reforms occurring in China are unprecedented and are being achieved much faster compared to 10-15 years ago. The last three to four years have been most noticeable especially in the areas of education, healthcare, finance, state-owned enterprises and power. This in turn provides us with many investment opportunities to look into on behalf of your investors. EPS [earnings per share] growth in China has also been strong at 20 per cent plus, compared to a year ago and the future is bright with a President leading a country with strong leadership qualities. MM

Jonathan Wu is executive director – chief investment specialist at Premium China Funds Management.