Schroders TalkingPoint

Six questions for investors about China's future

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This month has seen the once-in-a-decade leadership transition in China, the world's second largest economy. This has taken place against a tough global economic backdrop and what we believe to be a bottoming in Chinese growth. Virginie Maisonneuve was asked the following six questions on what it means for the future direction of the country and what the top opportunities are for investors.

How will investors benefit from the leadership shuffle in China?

First, as we move forward with the new leadership team, a new impulse for economic guidance and leadership can take effect. The final year of a 10 year political tenure in China tends to be a transition year with muted drive. This time round, with the added global external pressure of the financial crisis, many investors have possibly mistaken this for a "hard landing".

Second, while Xi Jing Ping has been relatively quiet during the transition with regards to the direction he intends to move the country post March 2013, we believe his impact on the country will be positive. We believe he represents a new generation of Chinese leadership, although still aligned with the direction from the Deng Xiao Ping era. He is pragmatic and a diplomat and his role could be decisive in bringing the second largest world economy to a more prominent global geopolitical role, more in-line with its economic power. This might entail a change in foreign policy.

Which new reforms are you expecting from the new team and what would this mean for investors?

While we do not foresee any drastic change in tone regarding key reforms under the new leadership team, some emphasis might be different. Some of the priorities post-transition will most likely be financial reforms, pricing reforms – in areas such as gas, oil and power – state-owned sector reforms with a potential transfer of assets from companies in difficulty, and fiscal and tax reforms. The dual needs of more housing and "acceptable" property price increases may bring welcome land supply reforms and would impact developers and construction companies as well as commodities. Finally, a focus on urbanisation, which in China stands at around 35% if one excludes all the migrant workers from the statistics, could continue to be a driver of growth for many years to come.

Is the growing consumption enough of a reason to invest in China?

Consumption in China is an important mega trend that will continue to develop over the next three decades. Overall estimates show that Chinese consumer spending will rise from US$2tr to US$6tr in 2020. With estimates of total global consumer spending at US$40tr in 2020, this will put China at a 15% share versus 5% today.

As GDP per capita increases and the population matures, spending will move towards services as the impact of urbanisation deepens. Chinese consumption growth and the opportunity it opens should not only be considered within the framework of buying Chinese-listed equities, but also through companies all around the world which can tap into that growth. Investors should therefore focus on streams of earnings in global and local companies.

The strong growth in China didn't become sustainably noticeable on the Chinese stock markets. Why is this and is it likely to change shortly?

Macro-economic developments and stock market behaviour can become disconnected for periods of time. In the case of China over the past 12 to 18 months, several factors have made this the case. First, the strong belief by many foreigners that China was going to suffer a hard landing has kept them away from exposure to the local markets.

Second, while overall economic growth in China has been strong – especially given the difficult global economic environment – the government has in the past 18 months or so attempted to normalise the effects of the 2009 stimulus plan which was the strongest China has seen. This was necessary because of some of the negative secondary effects the stimulus plan had, especially regarding property price increases, underground banking and corruption.

While some of those measures were reversed more recently, signalling an end to the tightening, investors have waited to see when the impact of this stabilisation might be felt and have waited for the political transition to be over. Interestingly, global companies benefitting from Chinese economic demand dynamics, especially in the consumer areas, have done well.

What are the biggest challenges and risks when investing in China?

There are three main challenges to investing in China for global investors. First, understanding political dynamics and how they affect macro-economic direction in China is crucial.

Second, depending on whether investors are looking at A shares, H shares or Chinese shares listed abroad, different levels of disclosure and accounting standards might apply.

Third, while China has done so well so quickly (the country has doubled GDP per capita in 12 years, achieving what took over 100 years in Europe), there is a gap between China's economic prominence and its global political leadership role. The next decade in China could well be the turning point where we witness a change in foreign policy where China affirms itself. This could possibly come with changes in the role of the military when compared to the past 25 years and create new global dynamics from a geopolitical standpoint. The first step might already be underway and relates specifically to issues with Japan and the Philippines.

Which sectors in China look attractive for equity investors in the medium term?

Understanding key trends in China in the medium term is crucial to making successful equity investments. Such trends include demographic challenges (rapid population ageing, a work force that has already peaked), continued urbanisation, reform of the agricultural system, the growing role of consumption over fixed asset investment, and the impact of climate change on Chinese growth and opportunities.

We see strong growth opportunities in services in general and, particularly, insurance, retail and food (including restaurants). From a consumer angle we still like the luxury goods sector (including autos) as brand recognition gains traction in second tier cities. We also see opportunities in selected commodity areas given the continued prospects for urbanisation in China. Finally, as China has become the largest carbon dioxide emitter globally, climate change-related issues or investment will continue to be crucial. Opportunities in energy efficiency, water treatment – including sewage – and public transportation, for example, should be considered.

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