For professional investors and advisers only

Schroders TalkingPoint

China still offers up opportunities for long-term investors

Louisa Lo, Fund Manager, Greater China Equities

January 2013

Louisa Lo

As China's growth rebound continues, with improving fourth quarter GDP, there are still opportunities for investors to benefit from the 'China story'. Further recent data seems to have confirmed this. Improving manufacturing data, retail sales, trade figures and fixed asset investment (FAI) have all shown that a hard landing has been averted. Improvements in these key numbers have preceded a much-predicted pickup in GDP growth which has seen fourth quarter GDP come in at 7.9% - coming off a three-year low of 7.4% seen in the third quarter of 2012. The government will seek to maintain stability through a series of sustained economic and structural reforms as well as gradual liberalisation of interest rates, supported by continued investment in major infrastructure. However, we will not see a 2009-style mass stimulus, which is viewed as having been a mistake by authorities, as inflation problems came to the fore.

Growth to be supported by market reforms

The new Politburo Standing Committee, President and Premier, which were unveiled in November, are set to continue on a path of stability for the economy. FAI will continue to be utilised by policymakers if any further slack is seen in export demand. A reserve ratio requirement cut for banks is another measure likely to be used to boost growth and lending.

The policy of 'maintaining economic growth and social stability' will continue to top the agenda of the new leaders. In terms of the structural reforms the economy requires, we expect that these will be implemented in phases albeit with varying priorities. Already in the past year we have seen substantial increases in the Qualified Foreign Institutional Investor quota that foreign financial institutions can invest in the country's A shares market.

We believe the current path of reform will continue, as will liberalisation of interest rates – a major precursor to the eventual internationalisation of the renminbi. Further reforms will also support the broader development of capital markets within China.

Cautiously optimistic

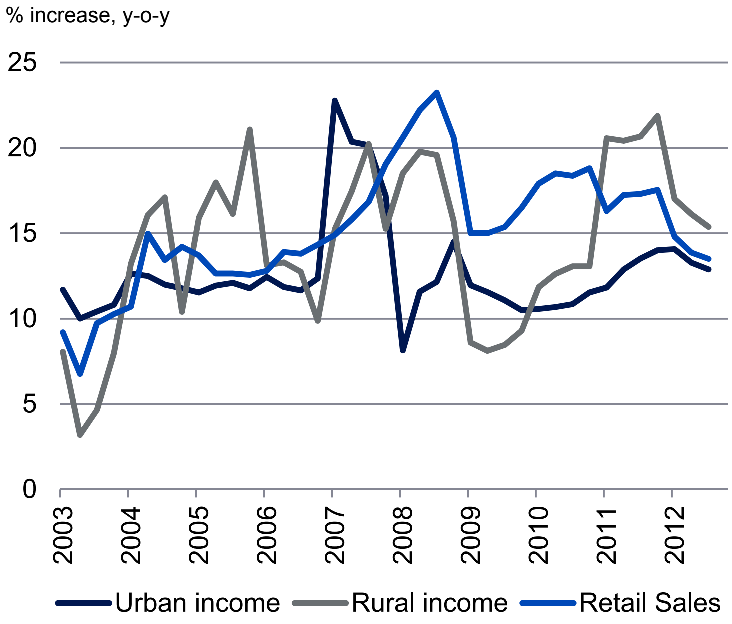
China's continuing urbanisation of the rural population, increased domestic consumer spending and large-scale infrastructure investment will drive China's growth in decades to come. The country's gradual transition from an investment-driven economy to one where consumer spending will dominate is a shift that will present investment opportunities.

Rising consumer spending, supported by increasing wages (see chart on next page), should ensure that the country moves in this direction, albeit at its own pace. With these changes and reforms set in motion, we see both opportunities and risks for investors, making the market more interesting and stock selection even more crucial.

> The policy of 'maintaining economic growth and social stability' will continue to top the agenda of the new leaders."

Schroders

We remain wary on several fronts though. In more recent developments, a weakening yen may also pose challenges to the export sector in China. Domestically, structural issues including the risks posed by non-performing loans, as well as wealth management products and concerns over its shadow banking system are other risks lurking for China. At the corporate level, we are cautious on the earnings risk over the next few quarters as negative operating leverage and poor demand are set to pose problems for companies' margins and bottom lines.



Source: CEIC, BofA Merrill Lynch Research, January 2013

Sector selection

Regarding sectors, we continue to favour consumption stocks that will benefit from the ongoing trend of longer term urbanisation and maturing consumer habits. Certain consumer discretionary names have been sold down on short-term disappointment and provide attractive buying opportunities for long-term investors. We also see value in selected internet companies that will continue to benefit from the growing advertising spend in China's burgeoning online media space. As the government loosens the reins on investment spending coming into 2013, the railway equipment sector is a likely beneficiary. With FAI picking up again, and the government's commitment to extending the national rail network, they will experience an improvement in equipment/rolling stock demand and order flows.

Investing for the long-term

China is very much a long-term growth story. As an integral part of Asia's dynamic appeal, the world's second-largest economy still has potential that will only be realised over decades – hence it is not too late to benefit from its success. In a market as diverse as China's however, stock selection becomes even more imperative. Not all sectors offer returns and earnings growth synonymous with the country's roaring economy. Our bottom-up approach focuses on tapping into the longer-term changes that are taking shape in China and ensuring exposure to companies that will most likely benefit from these. In addition, companies with professionally-run management teams and strong balance sheets offer better prospects for returns over the long-term.

Important Information:

Schroders