Letter n°26

Why invest in the future of China ?

« A journey of a thousand miles begins with a single step » Lao Tzu

Since the founding of the Chinese Empire in 221 BC, China has formed a multi-millennial civilization that has stood out in Asia. The compass, gunpowder and printing are but a few of the great inventions by the Chinese, which have had a huge impact to the world. Between the first century BC and 1500AD, China was already much more advanced than Europe in terms of metallurgy. Echoing ***Lao Tzu***, ***David Landes*** writes in his book "***The Wealth and Poverty of Nations***" that China has taken steps to become the second power in the world today, and perhaps the first one day.

Of all countries, China has recorded the strongest growth cycle since the start of the Industrial Revolution in Great Britain in the 18th century. Over the last 30 years, it has avoided crises and increased its share of world industrial production from 3% to nearly a quarter. Since joining the WTO (World Trade Organization) in 2001, China's export market share has increased from 4.3% to 14%, making it the world's largest exporter. At the same time, China's GDP has increased eightfold and its weight in the world economy is no longer 2%, but 15%.

Result of this growth is a catch-up to the American power. In 2001, China’s GDP of $1.8 trillion, represented only 13% of America’s GDP, which was then at $14.3 trillion; by 2020, it became a whopping $14.1 trillion, 70% of America’s GDP which came off 3.5% to $20 trillion.

After China’s supersonic GDP growth for nearly two decades, its annual growth slowed to 6.6% between 2016 and 2019. Faced with many internal and international challenges, China zoom in on a few strategic axes in an attempt to strengthen its technological independence, promote domestic consumption and try to bring the GDP/capita, from the category of middle-income countries (currently $10,000/capita which is less than a sixth of the American GDP/capita ($63,000)), to that of rich countries. Prior to 1820, China was the world's leading power, and it intends to regain that foothold.

If we think that China is capable of meeting these new challenges, then it is timely to look at the Chinese stock market and more specifically at the sectors and stocks that will carry its future.

1. Challenges :

The great English historian, ***Arnold Toynbee***, taught that every civilization is a response to a challenge and, more recently, ***Jared Diamond***, analyzed the decline, degeneration, extinction of civilizations that were unable to meet these challenges.

Among the challenges faced by China are several domestic and one international. An aging population and environmental issues fall into the first category, protectionism or more broadly, rivalry with the United States is in the second.

- Rising living standards and debt management in the face of the challenges of an aging population **:**

According to the Chinese Prime Minister, at an annual press conference in May 2020, the median annual income of the 300 million Chinese living in the coastal areas is €3300, in comparison to the income of the middle class in the EU, as well as the additional 600 million inland Chinese earning less than €125/month.

China's labor force is about 800 million workers, a number higher than the total labor force of OECD countries, However, in recent years, the labor force in the 20-65 age group has been decreasing by 0.5%/year and according to China Daily, the percentage of the population that is over 60 years old will increase from 20% to 33% by 2050.

If, apart from Africa and India, ageing is a universal problem, then this problem is exacerbated for China by the one-child policy implemented between 1978 and 2015, leaving a population unequally covered by pension systems.

As in many countries, this ageing process is compounded by the problem of a rapid increase in debt, from 175% of GDP in 2011 to 290% of GDP in 2020, of which 157% is for companies, 84% is for the State and 49% is for households.

To manage the debt, reduce poverty and raise living standards in a context of aging, we draw parody to ***Napoleon*** when he noted "My power is in my glory and my glory in my victories" in that the government is pursuing a proactive policy in growth and high value-added sectors and the investor on the stock market must give priority to these sectors.

- The environment :

Pollution of land, water and air, is an issue. China being a signatory of the Paris Agreement consumes more coal than all the other countries combined. If the Americans are the biggest polluters per inhabitant of the planet, China is the biggest emitter of greenhouse gases, but it is also the biggest investor in renewable energies because it wants to reduce its dependence on coal, which is the source of two-thirds of electrical energy today.

China has only 8% of the world's water reserves but consumes a quarter of them and must therefore invest to alleviate this problem. It must also fight against soil desertification and pollution of arable land and therefore invests to this end. For solar cells, 6 out of the top 8 groups in the world are Chinese, along with one American and one South Korean. For wind energy, 5 of the top 10 equipment producers are Chinese that collectively install half of the world's wind turbines. Four Europeans producers remain, Denmark's Vestas, number 2, Germany's Siemens and Enercon, Spain's Gamesa and America’s GE. For electric batteries, 5 of the top 10 producers are Chinese, 3 are Japanese (including Panasonic ranked top) and 2 are South Koreans.

As can be seen, the environment in China is a promising stock market investment theme.

- The international :

Moving on from these two major domestic challenges, let's analyze the international challenge that China faces. Exports have been a driving force behind China's takeoff but in recent years, China's weight in global exports of goods has stabilized at 14% against 2% in the early 1990s. This is the result of rising production costs, competition from low-cost countries such as Bangladesh and Vietnam, the appreciation of the Yuan and, perhaps tomorrow, relocations by Western firms, who may prefer the proximity of Eastern Europe or Africa to supply their domestic markets. China is taking notes from these developments, recognising the need to specialize in products with higher added value and greater technological substance.

The second aspect of the international challenge is the tensions with the United States; the impact of the measures taken by Trump. Let's not go back to the customs duties imposed by the United States on three-quarters of the goods coming from China because, as we have repeatedly pointed out, they penalize the purchasing power of the American consumer more than China and they have not avoided a worsening of the American trade deficit by almost 18% in 2020 to $678 billion, of which $317 billion came from the bilateral deficit with China.

As ***Stiglitz***, winner of the Nobel Prize in Economics, aptly explains in his book "***People, Power and Profit***", the percentage of Chinese exports which are indeed manufactured in China is much lower than the percentage of American exports produced in the United States. One dollar less in China's exports has a weaker effect on the economy than one dollar less in U.S. exports on the U.S. economy. In addition, China being a managed economy can more easily help impacted companies. Finally, in the event of a supply chain withdrawal, U.S. companies would become less competitive.

The customs duties imposed by Trump on Chinese solar panels presents an illustration to underline the failure of American protectionist measures. Even though they benefit from the tariffs imposed, this industry has not been allowed to develop in the United States, instead it has made solar panels more expensive, which slows down the installation. As a result, the number of jobs in solar energy installation is more than double the number of employees in American coal mines.

Admittedly, under American pressure, Huawei has been pushed out of 5G by Singapore, Vietnam and perhaps by Brazil and India, but Africa remains open. Admittedly, Japanese, Korean and Taiwanese groups are repatriating production capacities from China, but the presence of international firms, attracted by the size of the Chinese market, remains.

In substance, many of the American measures can penalize China in the short term, but in the medium term, they only add to China’s motivation to achieve its technological independence. Two examples include the impossibility for some Chinese companies to list on the US stock exchange or to remain on the Nasdaq, and the threats to semiconductor sales.

The Trump administration passed a bill prohibiting Chinese companies who lack transparency, from being listed in New York. This worked to the benefit of the Hong Kong Stock Exchange as it drove Chinese companies to list in Hong Kong instead. According to Congress, in January, there were more than two hundred Chinese companies listed in New York with a capitalization of $2.2 trillion. For a long time, these companies were able to raise funds in the US even though Chinese companies did not allow US auditors to audit their accounts in China. Today, the policy is the opposite and 35 Chinese companies linked to the army are excluded from the American indexes. China Mobile, China Telecom and China Unicom have dropped off from the stock market, but this is temporary. Alibaba, Tencent, Xiaomi and the oil giant CNOOC are also listed in Hong Kong and this helps compensate.

China produces only 16% of the semiconductors it needs and its main company is lagging behind but, as the Boston Consulting Group (BCG) pointed out in a recent study, the American threats and the suspension by TSMC of its chip sales to Huawei, only serve to accelerate the race for Chinese technological independence. This in itself is an investment theme in the Chinese stock market since we can trust the resolve of the authorities on this subject.

2. Strategic Responses :

In recent years in China, there has been a reduced dependence on exports, a promotion of large state-owned enterprises to form large internationally competitive groups and the technological breakthrough of many private companies.

Exports, which accounted for a third of GDP ten years ago, was only 18% of GDP in 2019. In reaction to Tencent’s subsidiary - Wechat’s ban on TikTok (by Bytedance), the government is focusing on the domestic economy. China is determined to promote technological independence and, as ***Philippe Aghion***, professor at the Collège de France, notes in "***The Power of Creative Destruction***", in order tofoster innovation, we must promote competition and invest in higher education.

- ***The quest for technological independence :***

For a long time, China was able to benefit from access to Western technologies and was satisfied with the development of sectors with low added value such as textiles. Today, China still accounts for 40% of global e-commerce; and while it seems to still be catching up in some sectors, it is in the forefront for several sectors.

In the high-tech sectors, China is no longer satisfied with the role of an assembler. The "China 2025" program initiated in 2018 planned to invest €2 trillion in 10 sectors of the future, such as robotics, autonomous cars, electric vehicles, chips... China wants to see these 10 sectors become world leaders in their respective industries in order to increase local production of these key technologies to 40% in 2020 and 70% in 2025.

To achieve this, research spending has increased. According to World Bank statistics on research and development spending worldwide, China is in second place with $304 billion spent in 2018, behind the United States with $584 billion, ahead of Japan's $162 billion and South Korea's $123 billion.

China plans to invest €480 billion in infrastructure development to facilitate the deployment of 5G and the growth of electric vehicles. In artificial intelligence, China has spent $20 billion in 2020 and plans for $60 billion in 2025.

As ***Joseph Stiglitz*** writes, China has two technology clusters in the world's top 5 - Shenzhen-Hong Kong-Canton and Beijing, while the United States has Silicon Valley. In 2020, China ranked 14th in the global innovation index by the World Intellectual Property Organization, WIPO, not far behind Israel and France. China also has started to invest in 6G, a much more powerful technology than 5G, a magnetic suspension train running at 600 kilometers per hour, and quantum computing.

China already has big companies: in online commerce, Alibaba and JD.com have 75% of the market and Alibaba controls 20% of retail sales in China while Amazon has only achieved 5% in the United States. In social networks, Tencent is the Chinese Facebook. In search engines, Baidu is the Chinese Google. In online payments, WeChat, a subsidiary of Tencent has 60% of the market. To add, NetEase in games, SenseTime and Megvii in facial recognition and artificial intelligence, Hikvision in video surveillance equipment.

Many of these companies take advantage of the size of the Chinese market but still only have a small share of their sales abroad - about 10% for Alibaba, 5% for Tencent, 1% for Baidu. There is therefore a potential that will be exploited in the coming years.

For semiconductors, a sector of $450 billion globally, is expected to grow another 8% in 2021 after a 15% growth in 2020. The focus is on two of the big players, SMIC, HiSilicon and a few other local players such as Tsinghua Unigroup.

- ***Investment in education :***

Every year, China has nearly 5 million university graduates with a science degree. This is 10 times more than Americans. The country also has more engineers per year than in Europe. China has a much higher average level of educated population than India or Brazil. According to UN figures for 2018, 78% of Chinese over 25 years of age have received secondary education compared to 59% for Brazilians and 51% for Indians. In higher education, according to UNESCO, in 2020, only 6.1% of the working age population has completed tertiary education as compared to 28% in the United States. The country is engaged in a catch-up policy and it is another investment theme. In the top 50 world universities, United States has half of them and China has two, but this should change.

According to a study by Verluise and Bergeaud, if since 1990, nearly 70% of the patents relating to the editing of the genome have been granted to American, 11% to Chinese, 8% to Japanese, 3% each to German, French and British applicants; for the year 2018 alone, China represents nearly 20% of the patents granted in this field, a clear evidence of progress made.

- ***Robotisation :***

To offset rising labor costs and remain competitive, Chinese industrial companies have multiplied the number of robots. China wants to catch up from only 36 robots/10,000 inhabitants in 2018 against 315 in Japan and 478 in South Korea. Thus in 2019, China installed 140000 industrial robots, this is more than other countries.

- ***The internationalization of Chinese companies :***

Along the Silk Roads or outside China, Chinese companies have become important players. At the end of 2019, there were 27500 Chinese companies in 188 countries, looking for resources, markets and productivity gains.

- ***The development of the Stock Exchange and the promotion of digital stocks :***

In 2019, the Shanghai Stock Exchange created a "Chinese Nasdaq". In 2020, the stock exchanges of Hong Kong, Shenzhen and Shanghai have shown great dynamism, raising $120 billion in IPOs, or more than 40% of the world total. 2019 saw Alibaba listed in Hong Kong followed by JD.Com, a major e-commerce company in 2020, NetEase, a video game developer and many others.

We know that China has 3 major players in video sharing: ByteDance with its subsidiary Douyin in China and its subsidiary TikTok internationally, Bilibili and Kuaishou. Kuaishou, China's second largest video sharing company with some 300 million daily users, was able to raise €4.5 billion during the IPO in Hong Kong and triple its share price on the first day, despite significant losses of $12 billion in the third quarter. This is the largest IPO since Uber in New York almost two years ago.

This year's IPOs are expected to include Vipshop, an events sales site, Didi Chuxing, the "Chinese Uber", Bilibili, a livestreaming website valued at nearly $50 billion on the Nasdaq, Tencent Music and the Baidu search engine.

Similarly, we can expect a bright future for companies such as ZhongAn, Ping An, Good doctor, Youdao, TongCheng, because the Chinese government intends to promote alternatives to the oligopolies of Alibaba, Tencent, Baidu, Xiaomi and Jd.com to facilitate innovation.

Conclusion: "*Capable, appear incapable; ready for battle, do not let it be seen; near, seem far away; far, seem near. Attract the enemy with the promise of an advantage*." Kong Tse

With the United States, the rivalry is bound to last, but China is too powerful to be ostracized, and one would do well to meditate on the words of ***Kong Tse***, a Chinese thinker of the 4th century BC as it sheds lights on the skillful Chinese diplomacy. Economic ties are too strong to explore a path other than multilateralism. It should be remembered that China is, the first country for savings, 27% of the world total, the first for the accumulation of foreign exchange reserves, $3 trillion, the second after Japan for holding American public debts, $1.08 trillion against $1.250 trillion by Japan.

The country has evolved a lot in recent years, becoming less dependent on the outside world, less dependent on industry, with an emphasis on services, technology and consumption. China is 20% of the world's population but only 11% of global consumption while the United States, with 4% of the world's population, accounts for 27% of global consumption and herein lies some potential to be studied on the stock market.

Today, the country is dealing with an accelerated ageing process, a structurally weaker growth from 10%/year 10 years ago to 6% in recent years. This will likely slow down to 2 to 3%/year in the next 10 years. There are also unknowns, possibly a decrease in imports as percentage of GDP if the government promotes local production, possibly a decrease in the savings rate if a development of social protection reduces the need for precautionary savings to finance education, health care spending and pension coverage.

All of these state-planned developments present revelations in investment themes and equity market trends to be captured if past success of the last few decades is able to be replicated. With only 3% of its debt in foreign hands, China wants to open its market and strengthen the international role of the Yuan. Represented in only 40% of the MSCI Emerging stock market index, China should see its share increase in the coming years, given China's average equity market appreciation of merely 2.6% on an average 9.1% annual GDP growth fares far higher than that the 10% market cap expansion on 2.4% GDP growth of the United States.

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Bruno Desgardins

Bruno Desgardins
CIO
Switzerland

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@sing-alliance.com

SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@sing-alliance.com

SingAlliance (Hong Kong) Ltd
1205, 12/F Bank of America Tower
12 Harcourt Road, Central
Hong Kong
T: +852 3611 7790
E: info.hongkong@sing-alliance.com