China – Growing Concern or Opportunity?

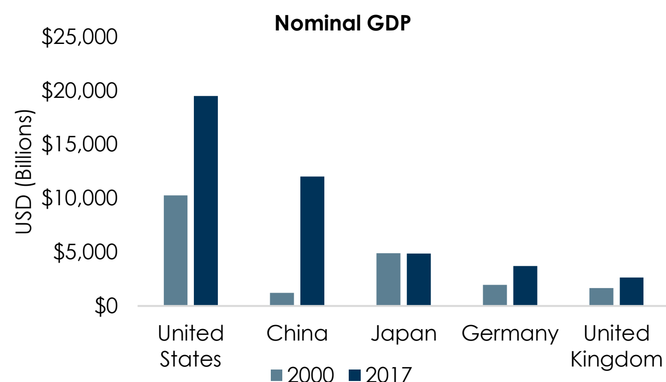
December 2018

OVERVIEW

- **China is the second largest economy (Gross Domestic Product) in the world**
- **China is evolving from a manufacturing/export-driven economy to a more consumption/service-driven economy**
- **China is currently underrepresented in global equity indices (currently 3.5% of the MSCI All Country World Index)**

Background

In 2000, China's economy was approximately 12% the size of the U.S. and the sixth largest economy overall. Currently, in second place, it is 65% of the U.S., surpassing Germany, the U.K., and Japan. Along with economic growth, per capita income in China has grown more than 800% since 2000. Over a similar period, U.S. per capita income grew by 65%. It is clear that the social and economic reforms in China have been beneficial to its economy and population.



Source: IMF WEO Database, October 2018

An Evolving Economic Composition

Coincident with China's growth has been a transformation of the makeup of its economy. China's economic growth has shifted from manufacturing and exporting, to domestic consumption, service-oriented industries and increased privately owned entities via entrepreneurship. These efforts are taking hold as the service sector now represents just over half of its GDP. Notwithstanding this shift, terms of trade with the U.S. and other countries remain a key risk.

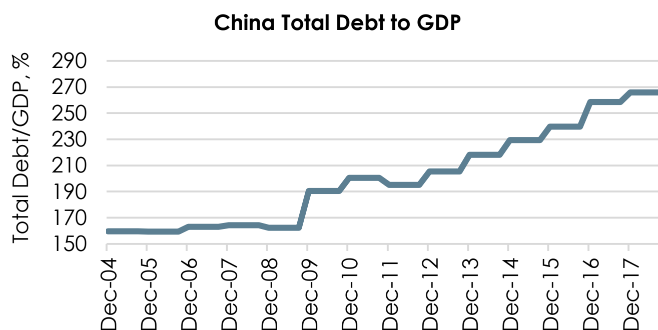
2017	Agriculture	Industrial	Services
China	7.9%	40.5%	51.6%
U.S.	0.9%	19.1%	80%

Source: Statista, CIA World Factbook, ACG

Deleveraging – A Looming Concern

A commonly discussed risk is China's use of debt to finance growth. While the economy has grown significantly, the Bank for International Settlements (BIS) recently reported that total credit to the non-financial sector as a percent of GDP was 260%, which is well above the 2008 level of 170%. This was the result of large domestic investment programs put in place to compensate for the decline in exports during the global recession of 2008-2009, as well as the more acute slowdown in 2015.

The challenge for China is to manage its debt levels in a manner that is least disruptive to both its economic growth prospects and its foreign exchange rates going forward.



Source: Bloomberg, ACG

Expansion of Investment Opportunities

Until recently, China has been a difficult market to access due to government restrictions on foreign ownership of Chinese financial assets. Historically, investors gained direct China exposure by purchasing equities of Chinese companies listed in Hong Kong (H-Shares). While many did list in Hong Kong, there are a number of equities only listed on the Shenzhen and Shanghai exchanges (A-Shares). In mid-2017, MSCI announced it would begin integrating A-Share companies into its indices. The full integration could take 10+ years depending on market accessibility improvements. Over time, China could comprise more than 45% of the MSCI EM Index, compared to its current 31% representation. This increased share of Chinese equities within the indices increases the potential exposure to companies in the faster growing healthcare and technology sectors.

ACG'S Position

China has thrust itself onto the global economic stage directly behind the U.S. economy, and has become an equally relevant investment theme. Through a re-shaping of its economy, this growth and evolution has led to an expansion of investment opportunities, but not without risks. MSCI's gradual inclusion of Chinese A-shares in its indices will incent active managers to expand their research to assure they are evaluating the entire opportunity set. For now, ACG continues to believe exposure to China can be effectively achieved through diversified EM mandates, and would caution against more volatile country-specific offerings.

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