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Asset Management

ALTERNATIVE INVESTMENTS

The Chinese dragon: powered by consumers

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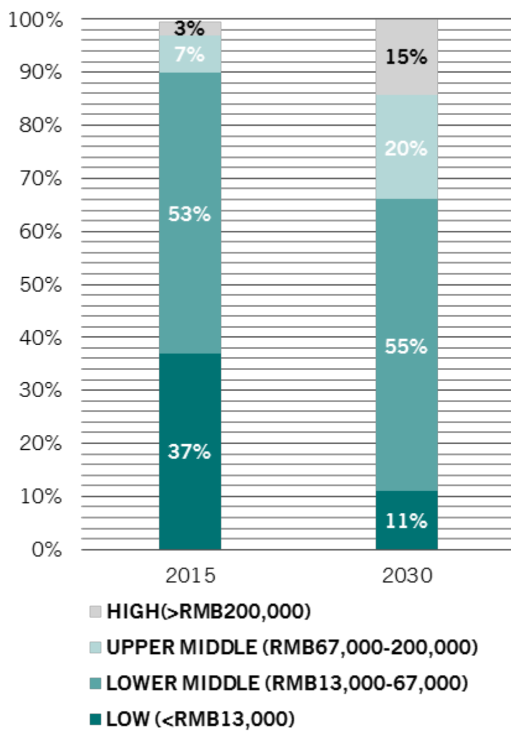
China's increasingly affluent and discerning consumers are opening up new investment opportunities. A long/short approach can help minimise risk.

It was once the world's primary source of cheap manufactured goods. But now, the Chinese economy is becoming a centre of technological innovation and one that's increasingly powered by domestic consumption. This transformation is creating winners and losers among Chinese companies, resulting in a deep pool of opportunities for equity investors in general and for long/short strategies in particular.

From cheap labour to discerning shoppers

ANNUAL DISPOSABLE INCOME PER CAPITA DISTRIBUTION
(% of total population, grey income-adjusted, constant 2015 prices)

Disposable incomes in China have more than doubled over the past decade. The proportion of



Source: The Economist Intelligence Unit: The Chinese consumer in 2030; November 2016

the population falling in the middle of its income distribution is expected to rise to 75 per cent by 2030 from 60 per cent in 2015, with some of the strongest growth seen in the higher income bracket, according to the Economist Intelligence Unit.

As a result, consumers are becoming far more discerning – 48 per cent now always buy the best quality and most expensive clothes that they can afford, compared with just 28 per cent in 2011.[1] The era of "one size fits all" cheap goods is over. Companies that can cater to these changing tastes could reap significant rewards. Spirits producer Kweichow Moutai, for example, is forecast to post revenue growth in the mid-teens for 2016, and to maintain that pace over the next two years.[2]

With greater prosperity, people have more money to spend on 'fun' services. They are travelling, eating out, buying online games, sending real and virtual gifts to Internet stars and investing in various financial products in a bid to compensate for the low interest rates on offer on traditional bank accounts.

Leisure activities are a feature of the long portion of our portfolio. One of our investments is a company involved in the gaming industry in Macau, an autonomous region on the south coast of China famed for its casinos. It is a cash business model, with operating cash flows supported by official restrictions on the number of gambling licenses granted.

Tech upgrade

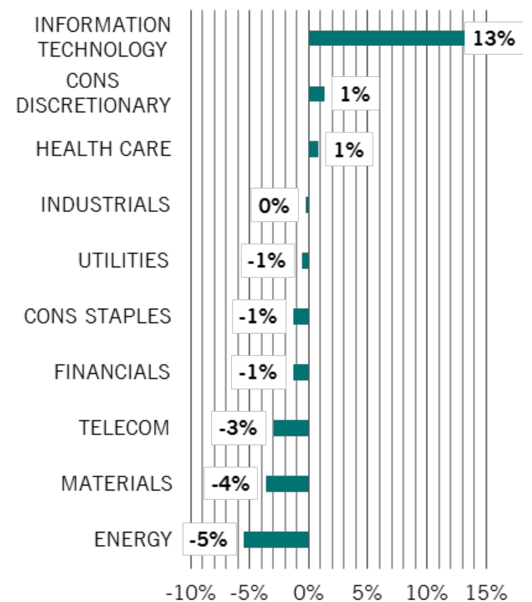
There is also radical change afoot in manufacturing. China is no longer focused on producing cheap textiles and shoes – much of that has moved to other places such as Vietnam or Indonesia. The new Chinese boom now is in technology, such as automation, artificial intelligence, smarter devices or e-commerce – major trends that we also seek to capitalise on in the long segment of the portfolio.

CHANGE IN MSCI GOLDEN DRAGON SECTOR COMPOSITION
December 2011 to December 2016

Chinese Internet giants Alibaba and Tencent, for example, were tiny a decade ago. Now, Alibaba accounts for a third of the world's e-commerce based on gross merchandise value (GMV).[3] The penetration of technology has been remarkable: in

2016, 200 million Chinese used their mobile to pay for goods – 46 per cent more than in the previous year.[4]

The tech boom has made Greater China's investment universe far more diverse. IT now accounts for 32 per cent of the stock market in China, Hong Kong and Taiwan, up 13 percentage points from just five years ago.



Source: Datastream, as at 31.12.2016. Note that Financials comprises Financials and Real Estate for comparison purposes; the MSCI Golden Dragon Index captures the equity market performance of large and mid cap China securities (H shares, B shares, Red-Chips and P-Chips) and non-domestic China securities in Hong Kong and Taiwan.

Beware of government-dependent sectors and outdated giants

On the short side, we don't like government-initiated sectors that rely on quotas and are not directly influenced by market demand. For example, we have been very sceptical about the business models of anti-pollution environmental companies. Although China clearly needs to invest to combat pollution, we think that businesses are more likely to spend the money on becoming greener if there are laws and/or government subsidies. Such sectors are therefore very vulnerable to any changes in government policy and tend to have low cash flow.

We are also cautious about companies in the old economy – the manufacturing giants who have not adapted to changing demand and continue to produce low-end goods that are now available cheaper elsewhere.

Trump compromise would avoid 'lose-lose' scenario

There are, of course, a number of clouds on the horizon, not least US foreign policy. We expect an escalation of tensions between the US and China should Donald Trump implement his campaign promises on trade. He has been very vocal in calling for an end to cheap imports from China and campaigning for manufacturing jobs to be brought back to the US. We don't know whether this is just rhetoric, but we do know that some of the people chosen for his new administration are hostile to China. In such an environment, it would make sense to avoid – or even short – companies that export a lot to the US and would thus be vulnerable to trade restrictions.

However, the consequences of any protectionist policies wouldn't be fully positive for the US either. If Trump delivers on his pledge to impose a 45 per cent import tax on Chinese goods, it would have a knock-on impact on US inflation and affordability. Although he is taking a hard line, we hope he will reach a compromise with China and avoid an outright trade war, which would be a 'lose-lose' scenario for both countries.

Debt pile: opportunity inside danger

The other major concern is China's debt burden – especially private debt. China's overall debt to GDP ratio is 250 per cent – high, but not as high as, for example, Japan at over 350 per cent. The worry is that, unlike in Japan, Chinese debt is mostly corporate. If the economy slows down, companies will struggle to repay loans and be forced out of business. That is one reason why Chinese banks are currently on such cheap valuations – investors are concerned about the scale of their non-performing loans (NPLs).

The onus is on the government to step in and resolve this situation. After all, most of China's banks are government-owned, and roughly two-thirds of the outstanding corporate debt is held by state-owned enterprises (SOEs).

We believe that 2017 could be the year of reckoning on the debt front – and potentially of great opportunity. Famously, the Chinese word for "crisis" is made up of one character meaning "danger" and another "opportunity". If the debt crisis is resolved, then we could see a very good year in Chinese equity markets, especially as corporate profits and industrial activity are showing signs of improvement.

In order for that to happen, we would need to see the government taking on some of the corporate debts, alongside continued monetary stimulus – but not so much as to cause inflation problems. For now, however, the debt situation remains a risk.

Barbell bets for a boom

To sidestep some of the risks and position for a possible boom, we have built a barbell portfolio. On the one hand, we are investing in the new economy, in sectors such as the Internet where companies are typically debt-free, cash-rich and enjoying structural growth. These stocks should do well regardless of what happens to the corporate debt pile.

We also have some beleaguered industrial companies and ports, which are at the bottom of their earnings cycles. If there are reforms, then these battered industrial companies should benefit. We think the risk reward is quite good – the potential for investment gains is considerable while the scope for a further fall in their share price is limited because they have already fallen so much. These are our call options on the possibility of reform.

At the same time, managing risk is top of our agenda. We constantly monitor overall market and macroeconomic risks and stand ready to adjust the net exposure of the portfolio to take advantage of opportunities or mitigate losses in down markets. The flexibility of being able to actively shift our positioning helped the portfolio over the past year – both during the sell-off in early 2016 and the rally in the third quarter.

An opportunity for long/short

Many people are understandably sceptical on China because they cannot understand how a country whose corporate debt burden has exploded can avoid a blow-up. We agree that there are some challenges – albeit ones that intelligent government intervention could effectively disperse. At the same time, however, China is an economy with close to 1.4 billion consumers whose disposable income is growing every year.

Correctly identifying the stocks that are likely to perform well or lose out amid the economic transformation, can be especially attractive in Greater China where the median returns dispersion of stocks in the MSCI Golden Dragon over the past 20 years stands at 19.5 compared with 13.5 for the S&P 500.[5] We believe that all adds up to create very fertile ground for bottom-up investment opportunities for long/short strategies.

[1] McKinsey
[2] Bloomberg consensus forecasts
[3] Pictet Asset Management, Alibaba
[4] eMarketer
[5] Pictet Asset Management, Thomson Reuters Datastream, MSCI. 20-year median of 3-month total return dispersion, measured as standard deviation of returns of index constituents as of 31.01.2017.

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