

## China – economy’s evolution creates new opportunities for investors

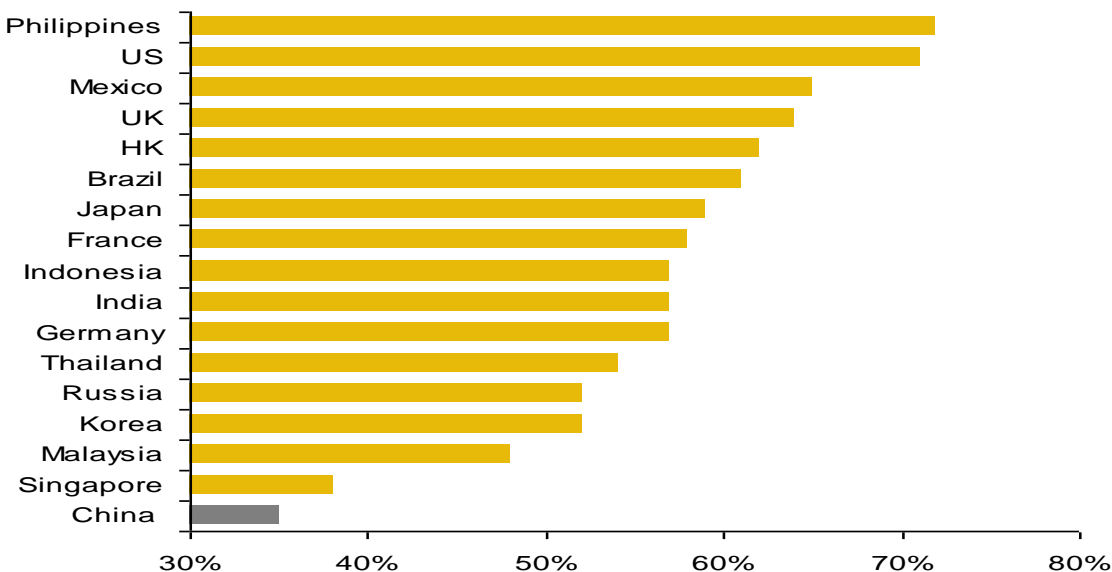
### Key points

- China’s economic slowdown is simply a move to a more sustainable level and we don’t expect a hard landing
- Domestic demand is increasing, fuelled by wage hikes, urbanisation and a widening of retail networks
- The shift from an export-led to a domestic demand-led economy is a more balanced model
- Property price rises are not a cause for concern as household debt remains low, employment rates high and demand outstrips supply
- We are optimistic about China’s long term economic outlook given looser monetary policy, financial sector reforms and compelling equity valuations
- Stock picking will be essential to maximise returns; we favour companies which have proprietary technology, are exposed to domestic consumption, have strong franchises or generate strong cash flows.

### **Domestic demand set to increase**

Investors have recently questioned whether China’s rapid economic progress of the past two decades can continue. Economic growth is undoubtedly slowing but we believe it is simply moving to a more sustainable level as China makes the transition from an investment and export-led economy to a more balanced model in which domestic demand is the key driver of growth. At present, consumption accounts for just 30% of GDP in China, whereas in developed countries, such as the US and the UK, it accounts for between 60% and 70% of economic activity.

**Figure 1: Domestic consumption has huge growth potential**  
**Consumption structurally low as % of GDP ...**



Source: BNP Paribas as at 31 March 2012

Sharp increases in pay, along with urbanisation and the widening of retail networks, are helping to fuel consumption growth. These wage hikes are affecting China's competitiveness in terms of basic manufacturing. However, in higher value-added areas, productivity gains and increases in economies of scale are offsetting the impact of the pay rises, and China needs to move up the technology ladder if its economy is to advance. Many other emerging economies, including Singapore, Korea, Malaysia and even Hong Kong, have experienced a similar evolution over the years.

In terms of recent developments, we have a positive view of the interest rate cut in June – the first since 2008 – because it demonstrates that policy makers have responded proactively to the economic slowdown. More interesting is Beijing's simultaneous decision to widen the band by which lending and deposit rates can be set. For many years, China has suffered from a mismatch between loan supply and demand, with banks eschewing loans to higher risk areas such as SMEs, preferring to lend to cash-healthy, state-owned enterprises that do not need these loans. As a result of interest rate deregulation, risks can be more accurately priced by banks, and credit should flow to areas where it is most needed. This illustrates the willingness of policy makers to address underlying structural imbalances. Consequently, we remain sanguine on China's longer term growth potential.

In terms of short-term prospects, we believe that the outlook for the second half of the year is brightening. Following a marked slowing in investment spending, the Chinese authorities are slowly shifting to a more accommodative policy stance, as evidenced by a pick-up in loan growth. Strong consumer demand will also continue to underpin the transition to an economy driven by domestic demand.

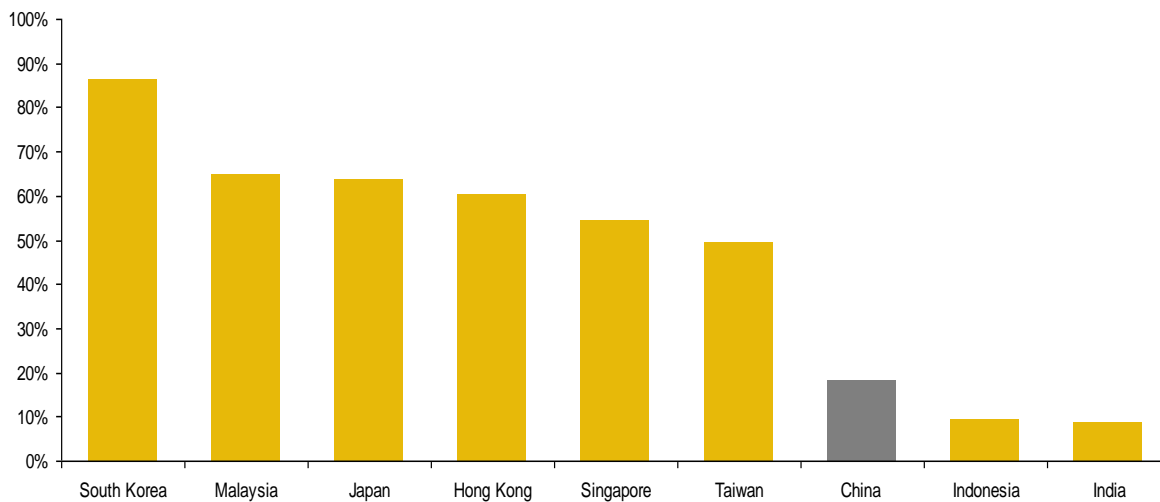
### ***Property market no cause for concern***

Surging property prices in China have also troubled a few analysts, some of whom have even made a comparison with the housing craze in the US that precipitated the global financial crisis. However, we believe that there are critical differences between the situation in China now and in America in the last decade. Critically, the US boom was driven by overlending with many people receiving mortgages even though they could not afford to repay them. Rising unemployment left further swathes of the population unable to finance their housing debts. Neither of these factors is present in China, where labour shortages are powering the aforementioned hikes in wages, and where most people either pay cash for their new homes or put up very large deposits. Indeed, only a relatively small proportion of Chinese have mortgages.

Moreover, asset prices in emerging economies almost always run ahead of fundamentals as people anticipate a dramatically-improved outlook for their lives. This optimism is usually expressed in their willingness to pay more for assets than they are really worth. In addition, despite an element of overbuilding and speculation in the high-end sector in cities such as Shanghai and Beijing, there is still huge untapped demand in the mass-market segment across China. Indeed, more than 300 million Chinese are expected to migrate to cities by 2030. The numbers of people involved in this movement is a bigger number than the entire population of the USA. In fact, not enough homes are being built to meet demand for mass-market, affordable housing. In addition, the authorities have already taken significant steps to cool the housing market. Indeed, the impact of these measures partly explains why the economy is now slowing.

**Figure 2: Consumer debt is not an issue**

**Household debt as % of GDP**



Source: BNP Paribas as at 31 December 2011. South Korea as at 30 September 2011 and India 31 December 2010.

***Eurozone crisis unlikely to have a significant impact on China***

The eurozone crisis is also unlikely to precipitate a hard landing or dramatically impact upon earnings growth in China. For while the eurozone is the country's largest trading partner, China's trade with the developed world (as a proportion of its total trade) has been decreasing. At the same time, trade with the fast-developing economies of Asia, Latin America and Africa is increasingly significantly. Indeed, intra-Asian trade is the biggest growth area as exports and imports from the likes of Singapore, Malaysia and Indonesia expand rapidly. It is also important to note that trade is not the only driver of the economy. Domestic demand, as we have seen, is of growing importance.

We believe the main threat from the eurozone crisis is that it will dampen risk appetite. Indeed, our biggest concern is that if the situation in the eurozone deteriorates drastically, a massive sell-off in global equities may ensue. This is what happened in 2008 following the collapse of Lehmans when emerging markets such as China were particularly badly affected by a flight to so-called safe haven assets.

Yet ironically, China and other emerging economies in Asia are arguably built on much more solid foundations than many of the developed economies. Europe, for example, is home to heavily-indebted governments, highly-leveraged companies, and debt-laden consumers. By contrast, Asia is characterised by governments, companies and consumers with very healthy balance sheets.

***Attractive valuations and strong earnings, but good stock picking essential to maximise returns***

Overall therefore, we believe that while growth is slowing, China will not experience a hard landing. We are optimistic about the long-term economic outlook given the positive impact of a looser monetary policy and financial sector reforms, which should boost lending to the most productive sectors of the economy. Moreover, following a prolonged period of underperformance versus global markets, Chinese equities are trading at compelling valuations. We believe that there are a number of sectors and companies in Greater China with strong earnings growth and reasonable valuations.

Stock picking, however, is likely to prove critical if investors are to profit fully from the market's potential. Over the next few years, China will experience more structural changes as the economy matures and these developments will unleash much more of the country's potential. However, some sectors will suffer as this process unwinds and thus investors need to focus on individual companies. We anticipate a volatile environment over the next three to five years but investors who can weather the storms and place the right bets will be more than adequately rewarded for their patience.

### ***Stocks that we favour***

Unsurprisingly, we favour businesses exposed to domestic consumption, partly because of the long-term trends outlined above and also because Beijing is likely to adopt more stimulus measures to kick-start growth, which will boost consumption in the shorter term. In the current environment, we also like companies that generate strong cash flows, as well as those with their own franchises and that have proprietary technology or are moving up the value chain.

Examples include the PC maker Lenovo, which has been gaining market share from the world's top PC maker Hewlett-Packard. Belle International, the leading women's shoe retailer, is another favoured holding. This very well-run company benefits from good inventory management and strong bargaining power with its suppliers. It has multiple brands, an excellent franchise and healthy cashflow-generating abilities.

We also like some of the Chinese internet companies such as Baidu and Tencent. The valuations of Chinese internet players have declined sharply, while earnings continue to grow at a fairly rapid pace. As China's largest internet portal and instant messaging provider, Tencent, with its stable cash flow, is almost like a telecoms proxy, while the country's dominant search engine Baidu is benefiting from increasing advertising spending. Meanwhile, Hong Kong-listed AAC Technologies, which makes acoustic components for smartphones, has been a huge beneficiary of soaring sales of Apple iPhones and Google Android phones. It has profited from miniaturisation and advances in consumer technologies.

### **Gigi Chan is fund manager of the Threadneedle China Opportunities Fund 23 July 2012**

#### **Important Information**

Past performance is not a guide to future performance.

The value of investments and any income from them can go down as well as up.

Threadneedle Specialist Investment Funds ICVC ("TSIF") is an open-ended investment company structured as an umbrella company, incorporated in England and Wales, authorised and regulated in the UK by the Financial Services Authority (FSA) as a UCITS scheme.

TSIF is registered for public offer in Austria, Belgium, France, Germany, Hong Kong (some sub-funds only), Italy, Luxembourg, the Netherlands, Spain, Switzerland (some sub-funds only) and the UK. Shares in the Funds may not be offered

**For investment professional use only**

to the public in any other country and this document must not be issued, circulated or distributed other than in circumstances which do not constitute an offer to the public and are in accordance with applicable local legislation.

TSIF is registered with Danish Financial Services Authority for marketing to professional investors only. The Funds may not be offered or sold to retail investors in Denmark.

TSIF is authorised in Spain by the Comisión Nacional del Mercado de Valores (CNMV) and registered with the relevant CNMV's Registered with number 481.

Het compartiment is op grond van artikel 1:107 van de Wet op het financieel toezicht opgenomen in het register dat wordt gehouden door de Autoriteit Financiële Markten. / Pursuant to article 1:107 of the Act of Financial Supervision, the subfund is included in the register that is kept by the AFM.

This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services.

Subscriptions to a Fund may only be made on the basis of the current Prospectus and the Key Investor Information Document, as well as the latest annual or interim reports and the applicable terms & conditions. Please refer to the 'Risk Factors' section of the Prospectus for all risks applicable to investing in any fund and specifically this Fund. The above documents are available in English, French, German, Portuguese, Italian, Spanish and Dutch (no Dutch Prospectus) and can be obtained free of charge on request from - in Austria: Raiffeisen Zentralbank Österreich AG, Am Stadtpark 9, 1030 Wien (TIF and TSIF), and Erste Bank, Graben 21 A-1010 Wien (TFIF); in Belgium: J.P. Morgan Chase Bank Brussels, 1, Boulevard du Roi Albert II, 1210 Brussels; in France: BNP Paribas Securities Services, 66 rue de la Victoire, 75009 Paris; in Germany: JP Morgan AG, Junghofstr. 14, 60311 Frankfurt; in Ireland: J.P. Morgan Bank Administration Services (Ireland) Limited, J.P. Morgan House International Financial Services Centre, Dublin 1 in Italy: State Street Bank S.p.A., via Col Moschin 16, 20136 Milano; in Luxembourg: State Street Bank Luxembourg S.A., 49 Avenue J. F. Kennedy, 1855 Luxembourg; in the Netherlands: Fortis Intertrust, Rokin 55, 1012 KK Amsterdam; in Spain: any appointed distributor listed on the Spanish Financial Regulator's website ([www.cnmv.es](http://www.cnmv.es)); in UK: Threadneedle Investments' Client Services department P.O. Box 1331, Swindon SN38 7TA.

The mention of any specific shares or bonds should not be taken as a recommendation to deal.

The research and analysis included in this document have not been prepared in accordance with the legal requirements designed to promote its independence and have been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed.

Issued by Threadneedle Investment Services Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Authorised and regulated in the UK by the Financial Services Authority.

To the extent that this document contains financial product advice, that advice is provided by Threadneedle International Limited. Threadneedle International Limited is exempt from the requirement to hold an Australian financial services licence under the Corporations Act in respect of the financial services it provides. Threadneedle International Limited is regulated by the Financial Services Authority under UK laws, which differ from Australian laws.

Threadneedle International Limited. Registered in England and Wales, No. 2283244. Registered Office: 60 St Mary Axe, London EC3A 8JQ. Authorised and regulated in the UK by the Financial Services Authority. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.