Invesco Global Insights
Global Investors' Forum – China

The Investors' Forum brings together Invesco's investment professionals from around the world to discuss issues that are critical to global investors.

Investing in the beneficiaries of China's new growth drivers

Invesco's Global Investors' Forum held the first in a series of discussions on China. Investment professionals from around the globe engaged in an interactive discussion with their colleagues. Stuart Parks and William Yuen started the discussion by sharing their views on the latest macro-economic trends in China and the implications for investors. The conversation was then opened up to their fellow investors for a Q&A. Close to 100 investors across the firm called in to participate.

Contributors

Stuart Parks
Invesco Perpetual

William Yuen
Invesco Asia Pacific

Tell us about China's growth prospects. What should investors expect?

Unlike many major developed markets in the world, China's growth prospects across its regions are actually very different. If you tally up the top five or 10 provinces, they only represent a small percentage of the overall GDP of China. – W. Yuen

As seen in figure 1, the official China GDP for the first quarter of 2016 was 6.7%. However, the shaded provinces, such as Liaoning and Shanxi, are growing at much lower rates. In fact, some of them have registered negative GDP growth. Conversely, more prosperous regions like Jiangsu, the Pearl River Delta and certain Western China provinces have outpaced the official GDP rate. Given the scale of China's market, each region must be examined separately to fully understand it. – W. Yuen

Figure 1: China's growth prospects are different across regions

Sources: CEIC, Morgan Stanley Research, NBS and Bloomberg L.P., May 2016.

This white paper was generated in conjunction with Invesco's Global Investors' Forum, based on research conducted by Invesco's U.S. Product & Market Research group. The Global Investors' Forum brings together each of Invesco's 750-plus investment professionals from around the world to discuss issues that are critical to global investors.

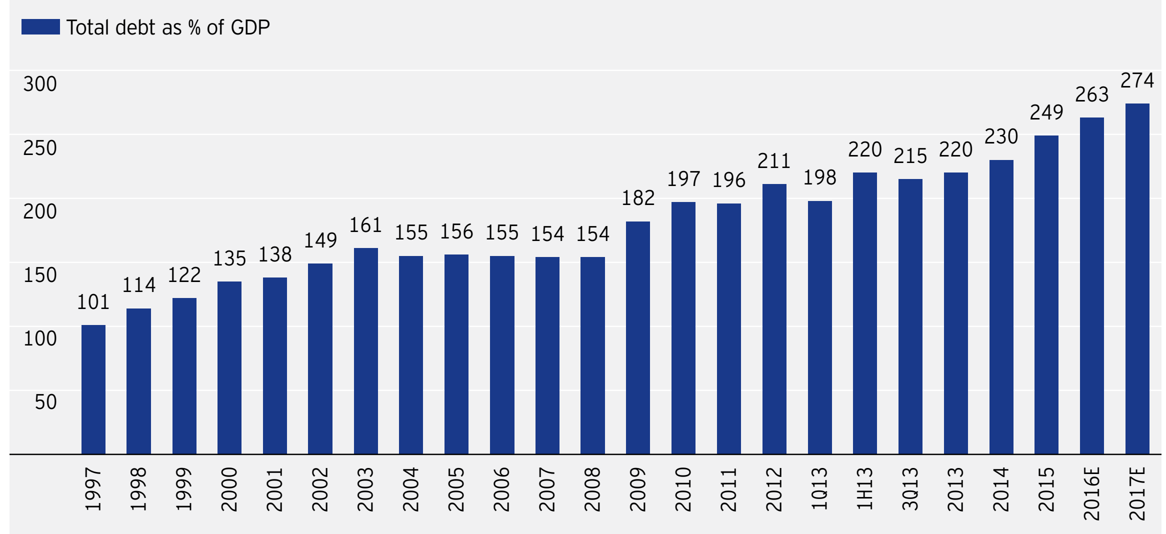
Should investors be concerned about the level of debt?

As a starter, much of the growth that we have seen over the past decade has been fuelled by a buildup of debt. It's obviously difficult to be precise about the debt-to-GDP ratio in China. Most commentators assume an approximate figure of 250%. Difficulty arises due to the rapid growth of the so-called shadow banking system which is extremely difficult to measure. – S. Parks

The rise of debt to GDP from about 150% in 2008 to close to 250% in 2015 is not sustainable. However, much of it was due to the stimulus package China introduced following the global financial crisis which went into excess-capacity industries. – W. Yuen

This is the sort of level at which other countries have seen their debt levels toppling over, leading to a collapse in growth. As such, history would say that at some point in the future there might be problems. Unsurprisingly, markets are concerned. – S. Parks

Figure 2: China's rising debt levels are concerning investors



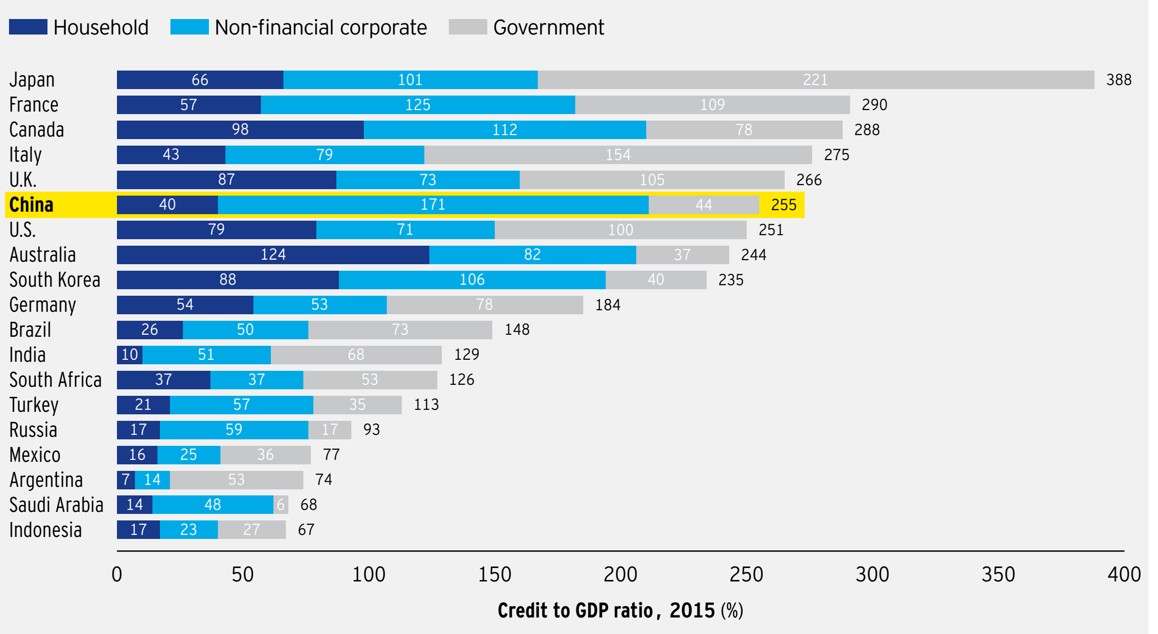
Source: Goldman Sachs, as at May 18, 2016. Note: E = estimates.

Tell us how China's debt compares to debt levels in other emerging and developed markets. Are there important differences investors should consider?

Figure 3 shows you that China's debt is actually very different from the mix in other G20 countries. Clearly, China's overall debt level is not the highest at this moment. Looking at the numbers in detail, we see that consumer debt comprises about 40% of the mix. – W. Yuen

The problem area is non-financial corporate debt, which is at about 170%. This is concerning and is mostly coming from lending related to SOEs (state-owned enterprises) that has gone bad in excess-capacity industries. Furthermore, when you look at the government's debt level, it's at about 45% which already includes local government debt. In short, when you look at the breakdown of China's debt, you will see that it is very different to the mix in developed markets and other emerging markets that led to the 2008-09 financial crisis. – W. Yuen

Figure 3: China's debt mix is different from other economies



Sources: Haver, Bank of International Settlements and Citi Research, June 2016.

Another important issue is that so much of this debt has actually been directed into areas of the economy that produce very low returns and, in some cases, even immaterial returns. – S. Parks

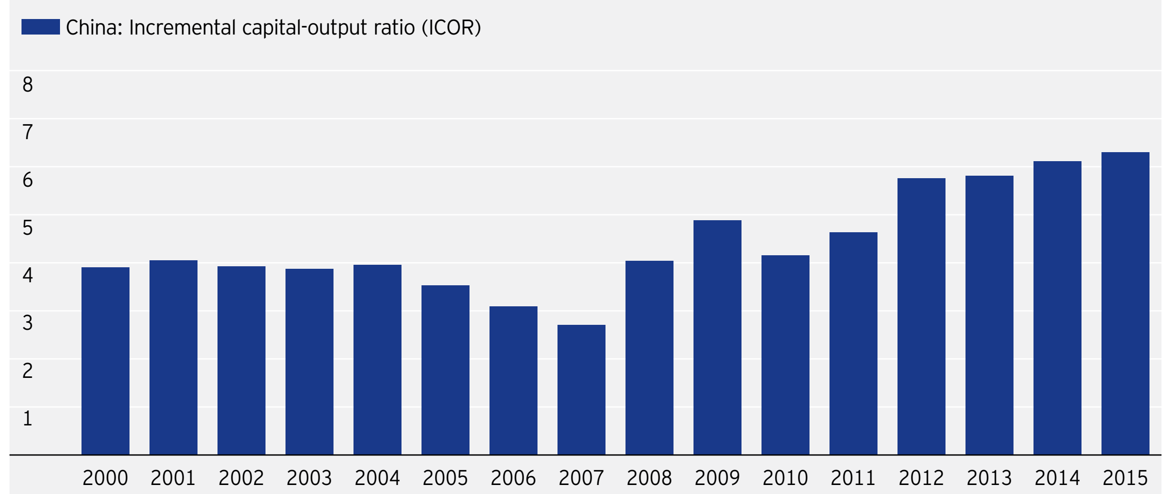
A lot of debt went into inefficient, low-productivity industries like steel and coal, and part of the property sector as well. What that means is that they have been investing a lot of money through debt into excess-capacity industries which is raising concern and putting pressure on the banking sector as a whole. – W. Yuen

How efficient is the allocation of capital? What implications does this have for China's economy?

Figure 4 shows China's incremental capital-output ratio (ICOR) between 2000 and 2015. ICOR is a fairly simplified way of measuring just how many units of capital you need to produce a unit of economic growth. As you can see, in the boom years of China in the early 2000s after its entry into the World Trade Organization, China was a highly productive place. – S. Parks

As we have exited the global financial crisis, while more and more capital has been used to promote infrastructure growth in China, the ICOR has risen, and as a result, we are getting high levels of debt which are not being used productively. – S. Parks

Figure 4: A higher ICOR ratio suggests a less-efficient use of capital



Source: Datastream, as at June 22, 2016. Note: ICOR is incremental capital divided by incremental real GDP.

What we need in China is for the allocation of capital methodology to change. We need more capital to go into the private sector, which, in general, is a highly efficient utilizer of capital when it's available, and less into the SOEs. There are signs of improvement already in this area, but I would say that a lot more needs to be done. – S. Parks

We've heard a lot recently about overcapacity in state-owned enterprises (SOEs). Is this something investors should be paying attention to?

One thing we have noticed is that the government has been very proactive in trying to scrutinize the effectiveness and productivity of some of the industries. While it takes time to reduce overall capacity, in the past 12 to 24 months, we have seen shutdowns in industries such as steel and coal because of the excess-supply issues that led to low global commodity prices in some of those sectors. – W. Yuen

Further, with respect to the overall debt situation, if you recall, the consumer debt in China is relatively low at about 40%. In my view, the government is trying to promote and leverage up the consumer sector while stabilizing the corporate sector. That's something we are monitoring quite closely, and we have seen some progress on that. – W. Yuen

Similarly, I'd like to stress that there has been genuine progress. In actual fact, some of the shutdowns have been deeply meaningful already in steel, coal and cement. – S. Parks

What do you think the most attractive opportunities are for investors today? Where should they be looking?

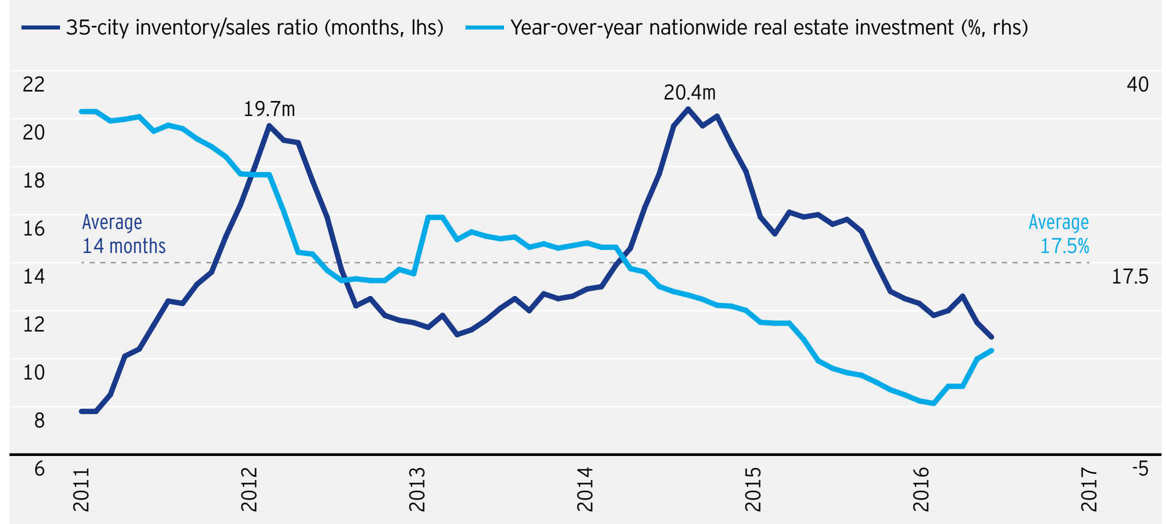
Why do we still believe there are opportunities? The first thing to say is that we don't see collapse as imminent. Foreign-exchange reserves are still plentiful, and the restrictions on the capital account are working. Also, the loan-deposit ratio of the banking system is probably still less than 100, and that means that the banking system is liquid. It is still able to support the debt that has been built up. – S. Parks

From our own investment perspective, very similar to Stuart's, we are largely focusing on the private enterprises, which are earning very high ROE, are privately and competitively run, and have very good margins, management, etc. – W. Yuen

A lot of investors are interested in the property market. How healthy do you think this market is in China today?

With respect to the property market and potential oversupply, figure 5 shows that there are early signs of recovery. The top-tier cities are progressing well, but we believe the excess inventory problem in lower-tier cities is unlikely to be resolved and is one of the concerns relating to problem debts in China. – W. Yuen

Figure 5: Property inventory vs. investment cycles



Sources: CEIC and Citi Research, June 2016.
Note: 35 major cities include four first-tier cities, 20 second-tier cities and 11 third-tier cities. The four first-tier cities are Beijing, Shanghai, Guangzhou and Shenzhen; the 20 second-tier cities are Changchun, Shenyang, Tianjin, Taiyuan, Jinan, Qingdao, Nanjing, Suzhou, Hangzhou, Ningbo, Hefei, Nanchang, Changsha, Fuzhou, Xiamen, Guiyang, Nanning, Xi'an, Nanzhou and Xining; and the 11 third-tier cities are Huainan, Maanshen, Jining, Yantai, Changzhou, Nantong, Wenzhou, Jiujiang, Jingmen, Maoming and Beihai.

Where should we expect the bulk of growth to come from going forward? What do you see as the primary drivers?

Where we are actually looking and investing is where we are seeing the beneficiaries of the new growth drivers of China, namely relating to the services front. Whether it's internet, health care, consumer services, etc., they seem to be growing very rapidly. If you're talking to and looking at these so-called industries (mostly in services) riding on the younger generations of China, the situation looks promising. If you're looking at the more traditional industries, though, that's a lot more bleak. – W. Yuen

It's important to track the breakdown of GDP growth going forward. Right now, the services component is already more than 50% of GDP. As long as you see that number continue to rise and the secondary and primary industries come down, it suggests that rebalancing of the economy is happening. – W. Yuen

Wage growth has been propelling the consumer sector which continues to be the major determinant of where growth in China is going to be in the future. If wage growth slows and becomes negative in real terms, then I think that is the time we should really worry. At the moment, wages are still growing, and the economy itself is still growing, if not as quickly as it once was. – S. Parks

Obviously there are areas where wage growth has stopped, and I think over time the introduction of automation is something that needs to be watched very closely in this context. There are large sections of the Chinese workforce that are potentially subject to dislocation as a result of increased automation. – S. Parks

Investors are intrigued by the opportunity of a more open market. Understandably, though, some are concerned the trend may not continue. Do you think the government will continue its commitment to more open markets?

I think China's government is rather pragmatic about all of this and that they would like to open up more. They have seen that opening up too quickly, though, especially in times of high volatility, can lead to quite a lot of foreign-exchange outflow which is problematic when there's a banking system that needs liquidity. – S. Parks

China's domestic financial markets and currency are still largely functioning in a closed system (mainly via capital control). We cannot expect them to open up overnight. However, if you look at more recent news and activities, China is trying to liberalize and internationalize itself. One such example is to encourage greater outbound investments. With internationalization, China is also expecting the reverse to happen – namely, attracting new capital flows to China. It should work both ways. – W. Yuen

Important information

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.