Investment Insights

Invesco Emerging Markets Select Equity

China is embarking on a new stage of growth

Jeff Feng, CFA®
Senior Portfolio Manager,
Invesco Hong Kong Ltd.

Andrew Herron, CFA®
Portfolio Manager

Key takeaways

+ China's growth story isn't over — in fact, there is the potential for strong, better-quality growth in the short, medium, and long term
+ Interior provinces are developing infrastructure and striving to catch up with first-world standards in Beijing, Shanghai, and Shenzhen
+ The vast labor force is becoming even more productive thanks to robotics, automation, education, and training
+ Consumption by the growing middle class is insulating the local economy from external shocks and attracting foreign multinational corporations
+ Financial reform and innovation are increasing saving opportunities and making loans more widely available to small businesses

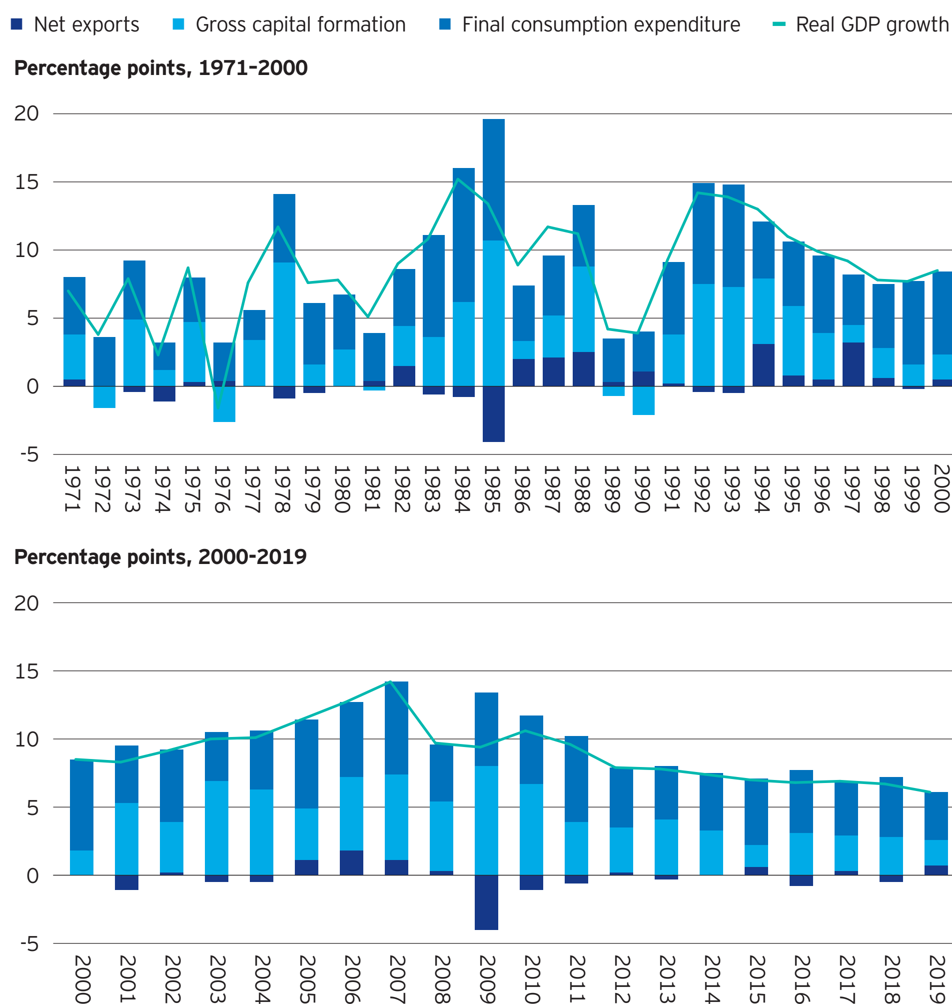
China is entering its fifth decade after the first reforms of the Deng Xiaoping era, and the conventional view among global investors, even emerging markets specialists, is that the economy is mature and growth avenues are mostly exhausted. The argument is that "miraculous" growth (to borrow former US Treasury Secretary Lawrence Summers' term), driven by a favorable demographic engine and credit-fueled investment in housing and infrastructure construction, is unsustainable and even has to be "paid back" with depressed growth levels going forward. While there are elements of truth to this perspective, it is too simplistic and can lead investors to miss important long-term opportunities. A holistic view shows that robust, higher-quality future growth may be achieved through a better balance between trade, domestic consumption, and investment.

Economic growth in terms of gross domestic product (GDP) and GDP per capita has slowed compared to earlier super-cycle[1] years. This is not surprising since the pace of China's growth since 1978 has been unprecedented, particularly for such a large country. China's GDP per capita in the late 1970s was about 1/40th that of the United States and 1/10th that of Brazil. After growing at an average annual rate (in real terms) of about 8%, GDP per capita is now almost 1/5th that of the United States and about 1.2 times that of Brazil. The picture is even more favorable in light of purchasing power, with positive implications, particularly for the growing middle class (see Figure 1).

1 Extended periods of high economic growth.

This marketing document is exclusively for professional clients and qualified investors (as defined in the Important Information at the end); in the USA for institutional investors; In Canada, the document is intended only for accredited investors as defined under National Instrument 45-106. It is not for consumer use — please do not redistribute.

Figure 1: Contribution of expenditure components to GDP growth



Source: Knoema, as of April 17, 2020.

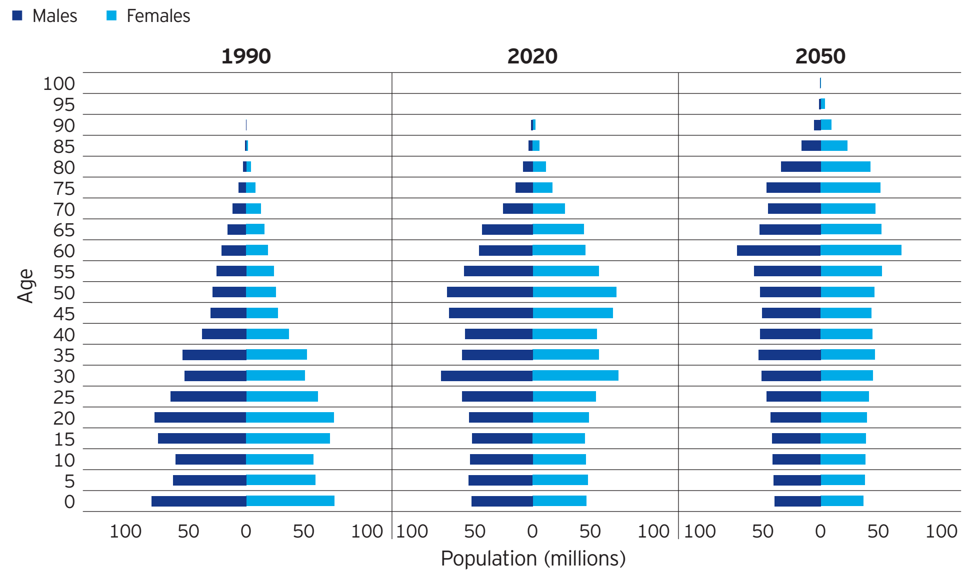
This can provide opportunities for careful investors who spend time identifying businesses with sound and stable competitive advantages that can capitalize on three factors:

+ Improving productivity resulting from investment in human capital – for example, through education and vocational training
+ Growing domestic consumption from a massive and expanding middle class, as well as low penetration rates for many consumer goods and services
+ Reforms to the financial markets and institutions that enable more efficient allocation of capital and better savings returns for the middle class

Maintaining global competitiveness

A key factor contributing to rapid growth in China was the "demographic dividend" from enacting the "one-child policy" (actually a patchwork of policies enforced to varying degrees). This allowed the country to grow its working-age (age 15 to 64) labor force as a share of the total population (see Figure 2). These workers, without large numbers of children to support, allowed China to become the "world's factory," with hundreds of millions of cheap manufacturing laborers attracting foreign capital. The peak was in 2003 when the country added 17.7 million people to its working-age population. A deficit began in 2015, however, and the working-age population has been declining since then.

Figure 2: Population



Source: United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, Volume II: Demographic Profiles (ST/ESA/SER.A/427).

Following this pattern, real wages in urban areas have grown by about 10% annually since 2005, outpacing even the country's exceptional growth in GDP. Local governments supported this trend by raising minimum wages in their respective provinces. The earliest manufacturing centers of Guangdong (north of Hong Kong) and Zhejiang (south of Shanghai) had statutory monthly minimum wages of 450 CNY and 380 CNY at the end of 1999 (US$54 and US$46, adjusted for their contemporary exchange rates). These have grown to 2,100 CNY and 2,010 CNY today (US$319 and US$305), and real wages for semi-skilled and skilled labor have outpaced this growth of about 8% per year, reflecting both declining labor supply and greater productivity.

This growth in wages has superficially made China less attractive for investment. Manufacturing labor costs (including non-wage benefits) per hour are indeed higher than those in earlier "Asian Tiger" outsourcing destinations such as Malaysia and Thailand, to say nothing of less-developed economies such as Bangladesh, India, Indonesia, and Vietnam. However, simply comparing these nominal costs ignores three important things.

1. Potential benefits from relocating capacity domestically to cheaper interior provinces

Ease of access to existing ports made coastal provinces such as Guangdong and Zhejiang the logical sites for factories from the beginning. As logistical infrastructure improved and operations became more efficient, Chinese manufacturers were able to offer global clients both inexpensive labor and rapid order fulfillment that lowered inventory requirements. In addition, these incremental savings on working capital carrying costs at least partly made up for increased labor costs.

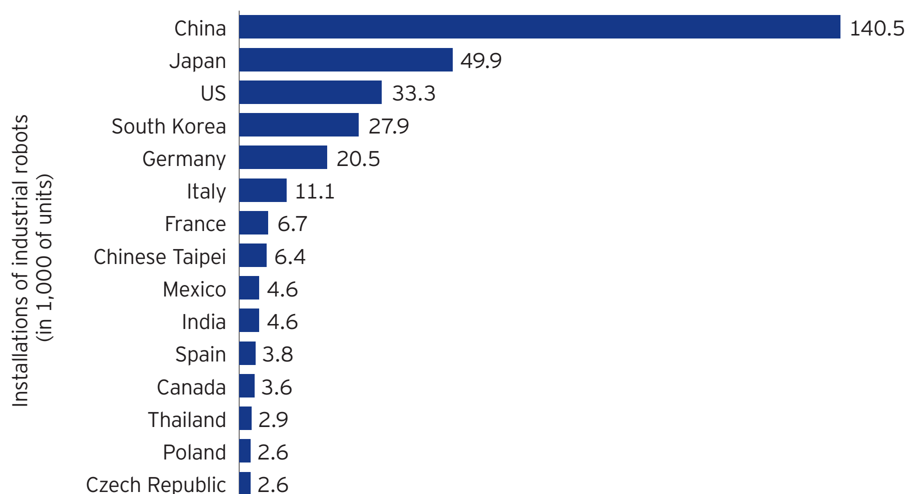
Now, after several years of focused investment by the Xi Jinping government geared towards developing interior provinces' infrastructure, factories in places such as Anhui, Chongqing, and Sichuan can offer much lower wages with limited loss of lead times. As an example, Chengdu (Sichuan), Zhengzhou (Henan), Chongqing, Xi'an (Shaanxi), and Urumqi (Xinjiang) are hubs for the China-Europe Railway Express service connecting to Duisburg, Germany, through Central Asia and Eastern Europe and built as part of the New Silk Road program.

China Railway, the country's state-owned railway operator, is developing a network of high-speed freight railways similar to the one built for passenger transportation. Freight transport in China is currently about twice as expensive as in Japan and the United States, reflecting under-capacity. Investment in an advanced control system and dedicated rail paths could increase the share of goods either moved directly to Europe on the China-Europe Railway Express or moved to ports for transport as ship cargo. This would resolve high logistics costs and also help the environment by getting polluting trucks off the road.

2. Chinese labor is highly productive and supported by capital investments in robotics and automation

Technology improvements now make investment in robotics and automation practical both as an alternative to human labor and as a productivity enhancement for workers. According to the International Federation of Robotics, Chinese factories installed 140,500 units in 2019 — by far the most in the world (Japan came second with about 50,000) (see Figure 3). Despite representing more than 30% of the incremental installed base, at 187 per 10,000 workers in terms of density (robots per 10,000 workers), China still lags behind countries such as Japan (364), Germany (346), and South Korea (855). As collaborative robots, or "co-bots," enter the market, there are more and more opportunities to make even workers performing lower-end tasks more efficient and productive.

Figure 3: Annual installations of industrial robots, 15 largest markets, 2019



Source: IFR — International Federation of Robotics.

Looking beyond robotics and automation, governments at the central and local levels have put in place grants, subsidies, and other supportive measures to create a globally competitive semiconductor industry. Local foundries (final manufacturers of semiconductor chips) have developed 14-nanometer processes, matching global competitors such as Intel and Global Foundries (which are not holdings within the Invesco Emerging Markets Select Equity strategy) and narrowing the gap with technology leaders in Taiwan and South Korea. In integrated circuit (IC) design for applications such as artificial intelligence and autonomous driving, some Chinese companies have themselves become world leaders and attracted global technology companies to China to hire the best engineers. The government has implemented similar programs for electric vehicles and renewable energy, particularly solar, that have propelled China to the lead in those fields, too.

3. There is potential for further increased productivity through education and training

The third key area for maintaining and improving productivity and competitiveness lies in human capital. China has made significant strides in educational attainment since the 1970s. Today, the country's reported Program for International Student Assessment (PISA) scores[2] are the highest in the world in all three categories of reading, math, and science. In fact, China is in a unique position globally as the younger end of its working-age cohort has higher educational attainment and specialized training than retiring workers, more than making up for lost productivity from contraction of the labor pool. This has allowed the country to move aggressively into valuable high-tech industries, such as high-speed rail, semiconductors, specialty chemicals, electric vehicles, and even space technologies. That has a twin benefit of moving into these richer markets for exports, but also reducing or eliminating China's requirement for their import.[3]

Still, while China has made progress, there is much room for improvement that can fuel continued growth. For instance, the country's urbanization rate remains only about 60%, though government policy continues to increase this ratio. The average educational attainment among rural laborers moving into the formal workforce through urbanization is only 8.25 years (reflecting nine years of compulsory education in rural areas), compared to the full 12 years of compulsory education that is nearly universal for urban workers. Furthermore, fewer than 2% of rural workers have education at or above the junior college equivalent, compared to about 20% for urban workers.[4] The government recognizes the importance of matching the educational attainment to that of wealthier countries to boost productivity and remain competitive. Likewise, employers recognize the need for stronger vocational training. This has created a policy environment friendly to private education at secondary and post-secondary levels.

2 Note that China only reports scores from students in Beijing, Shanghai, Jiangsu, and Zhejiang.

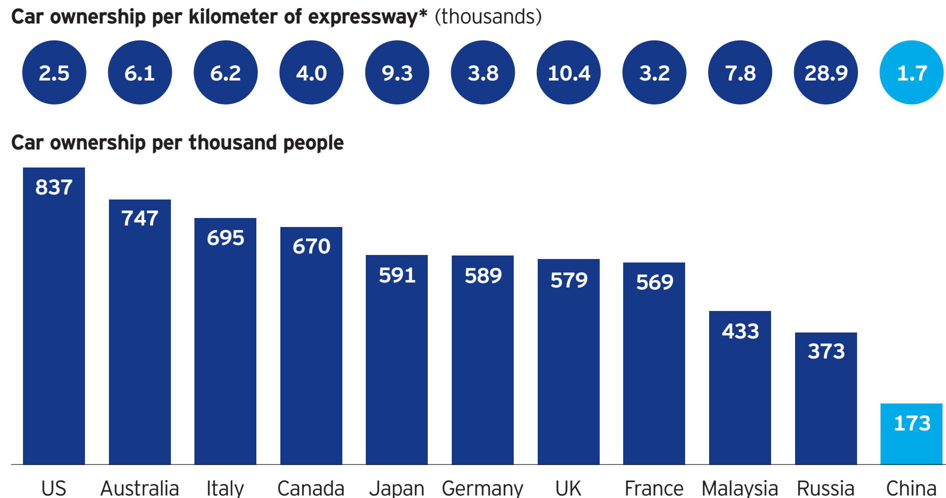
3 Song, Fang, and Johnston, "China's Path Towards New Growth: Drivers of Human Capital, Innovation, and Technological Change."

4 Cao, Yu, Wu, Wang and Mi, "The Educational Level of Rural Labor, Population Urbanization, and Sustainable Economic Growth in China."

Expanding consumer class and trade independence
Although the pace of China's economic growth has moderated, the economy has reached a scale where domestic consumption and investment can drive further growth. The country is much less dependent on foreign trade as a growth engine today. While exports are not immaterial, at about 18% of GDP, net exports (subtracting imports) now only contribute about 1% to 2% of overall growth, according to the World Bank. China has reached an economic level where it can be internally self-sustaining and much less vulnerable to external shocks and volatility, leading to a more robust economy and higher-quality growth.

This is most apparent in household income and wealth/assets. In 2019, median household income reached about 26,500 CNY. Half the population has reached the middle class, compared to about 3% in 2000.[5] Spread across such an immensely large population, this has created a middle class equal to the population of many countries. Online sales in 2019 reached 10.6 trillion yuan.[6] Automobile penetration has increased to 173 per 1,000 people, compared to 373 for Russia, 433 for Malaysia, and 591 for Japan, and is well below developed countries in Europe like Germany, and the United States, with 589 and 837, respectively (see Figure 4).[7] Smartphones are nearly universal now, but home internet access remains below peer economies such as Japan, Korea, and Taiwan. More shopping in formalized hypermarts rather than wet markets means more polyethylene bags. While increased petroleum imports are a balance of payments headwind (China has been in a net deficit for oil production since 1993[8]), China is moving along the competence curve for more advanced specialty materials ranging from active pharmaceutical ingredients to crop protection.

Figure 4: Car ownership in China remains relatively low



Source: World Bank, McKinsey China Auto Consumer Insights 2019.
* Data for China, Russia, and Germany from 2018; the UK and the US from 2017; France, Malaysia, Italy and Canada from 2013; Japan from 2012; and Australia from 2011.

Government consumption has also increased. As municipal, provincial, and national governments have modernized, they have both required larger spending budgets and become more sophisticated in deploying funds. As an example, health care spending by the government increased from US$42 per capita in 2000 to more than US$650 in 2019.[9] This funding has been directed towards personnel and capital investment — for example, modernizing existing and new hospital stock. This, in turn, supports a growing domestic pharmaceutical industry, as well as medical equipment and disposables.

As much as the size of China's domestic market is increasingly insulating the local economy from external shocks, the scale of the market and the fact that it is still growing makes exposure to the market critical for foreign multinational corporations. Some foreign automobile manufacturers can attribute more than 100% of their volume growth to China in recent years. Although births have been flat or have even declined, parents' demand for higher-quality milk powder, diapers, and more has grown significantly. There are pitfalls for foreign brands as well. A leading South Korean electronics company's smartphone sales in China plummeted following political conflicts between China and South Korea, as well as quality improvements by domestic Android-based smartphone brands.

5 China Power, as of October 29, 2020.
6 National Bureau of Statistics of China, as of January 19, 2020; Statista, as of December 17, 2020.
7 World Bank, McKinsey China Auto Consumer Insights 2019.
8 The Brookings Institution, as of September 1, 1999.
9 China Daily, as of December 25, 2019.

Amplifying wealth through financial reform and innovation
While China has grown and developed in many ways, its financial system remained relatively unsophisticated until recent years, and even today has significant room for further opening and reform. On the other hand, the fact that certain parts of the financial infrastructure have not been set down yet has allowed government regulators to learn from the experiences of developed economies and also to let certain innovative technology-based products evolve without having to contend with an entrenched legacy system. These are providing opportunities for the Chinese, who have a historically high propensity to save, to deploy wealth to financially and economically beneficial uses. It is also enabling investors to find unique companies.

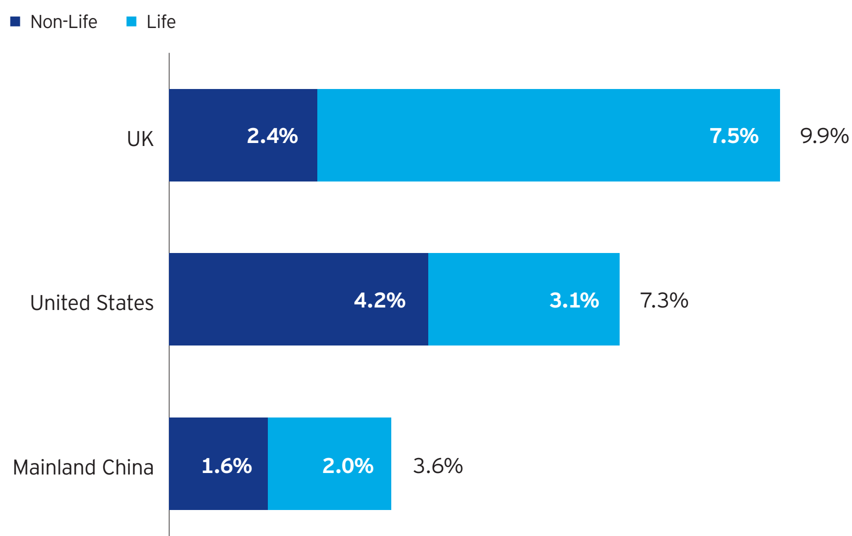
Into the 2010s, the Chinese banking system remained very simple. The "Big Four" state-owned banks held the bulk of the assets, which were mostly loans to state-owned enterprises, with some commercial loans to non-state businesses and for mortgages. Funding came largely from those state-owned firms with conservative capital structures and from private savers. Since banks were mostly engaged in regular banking activities, non-interest income was minimal while interest rates were tightly regulated and allowed banks to enjoy higher net interest margins than banks in other markets. The cost of this, particularly for those larger state-owned banks, was lower asset quality, partly because they had less discretion about whether to offer credit to other state-owned firms and also because of how incentives for bank managers were set, focused on asset growth rather than risk measures and profitability.

Financial constraints from misallocation of capital by an inefficient banking sector and immature non-bank financial industries limited growth as the super-cycle ebbed. Understanding this, the government under Xi Jinping has pushed new reforms designed to ease access to funding for productive industries and to cautiously wean lower value-added firms and industries from the curse of nearly-free capital. This has included introducing risk to certain financial products that previously had implicit government guarantees, such as "shadow finance" trust loans held off balance sheet by banks.

As China's demographics trend older, one of the chief concerns of the government, the future of the elderly and their children, is providing for their standard of living and health post-retirement. The central and local governments can only do so much through the social security system and also do not want the entire burden to fall on adult children during their most important working years. To ease this problem, the government has put in place friendlier regulations in the insurance and wealth management industries to create savings, health insurance, and other investment products so savers can earn reasonable risk-adjusted returns and prepare for retirement. They have also opened up access to new boards on the Shenzhen and Shanghai stock exchanges and generally improved retail investors' access to the equity markets.

At this point, products that are very common in developed markets, and even some peer emerging countries, still don't exist. Commercial health insurance penetration rates are still very low, in the lower single digits, which is about as low as they were in Southeast Asia 25 years ago (see Figure 5). There is a safety net from a national insurance scheme, but the level of care is not always up to consumers' standards, and the long-term financial burden could become very heavy for the government if it is not supplemented with a private insurance system. Likewise, tax-advantaged individual retirement accounts such as retirement savings plans simply do not exist in China, and yet there is a clear need for more robust retirement savings as the country ages.

Figure 5: Insurance penetration in China still lagging



Source: Oliver Wyman, 2016. Insurance penetration is measured as premiums underwritten as a share of GDP and is used to indicate the development of the insurance sector within a country.

Some of the most intriguing developments have been in the "fintech" space, or perhaps more accurately in the "techfin" space. China has become the innovation leader in mobile-based cashless payments, for instance. Essentially skipping over physical credit cards as a cashless medium, Chinese consumers can now use payment platforms from tech giants like some of the larger Chinese technology conglomerates to pay for almost any good or service directly from their phone, either through e-commerce or in physical stores. The platforms also allow users to invest their cash balances in savings products. Since using the platform makes small store owners' cash flows transparent, they can build a credit profile and access loans that were previously very difficult to get at non-extortionary rates, given banks' bias towards large firms and lack of credit data for small ones.

Conclusion

China will not grow again as it did in the 1990s and 2000s, but it is almost certain that no other country has the same growth potential over such a large economic base in the short, medium and perhaps long term. The country still has unmet potential from catching interior regions up to the first-world standards seen in Beijing, Shanghai, and Shenzhen. To find investment opportunities in this context, it is necessary to spend time in some of these next-generation regions, be aware of government policy priorities and how they can create tailwinds for certain industries, and dig deeper into management teams' track records as they approach a new era of growth.

Spotlight on Invesco Emerging Markets Select Equity

What differentiates the Invesco Emerging Markets Select Equity team and investment approach?
It starts with our team of analysts and portfolio managers — either we were born in an emerging market or grew up there, or our families did, and we speak the local language. That deep-rooted familiarity contributes to our insights. There are eight professionals on our international team, with five of us specializing in emerging markets. Each of us on that team of five has more than 10 years of experience investing in emerging markets, as well as a direct personal connection to these markets.

In terms of our investment philosophy, we emphasize high-quality companies, meaning companies generating a high return on capital and have strong growth prospects and a capable and honest management team. Those traits are important everywhere but particularly critical in emerging markets, where there are often no strong corporate governance structures, and even the legal systems can be challenging to understand.

Perhaps our most distinguishing feature, though, is that we run a highly concentrated portfolio — typically owning just over 30 names — allowing us to do very thorough research. In a normal year, we visit dozens of countries and conduct at least 500 meetings with companies in which we hold a stake or are considering investing. While travel has been limited this year due to COVID-19, we're managing interactions through Zoom and Skype. Research doesn't stop because of the pandemic. Again, this is important for emerging markets because disclosure practices are not as strong there as they are in developed markets.

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

As a large portion of the strategy is invested in less developed countries, you should be prepared to accept significantly large fluctuations in value.

The strategy invests in a limited number of holdings and is less diversified, and therefore this may result in large fluctuations in value.

Investment in certain securities listed in China can involve significant regulatory constraints that may affect liquidity and/or investment performance.

Important Information

This document is intended only for Professional Clients in Continental Europe (as defined below), Dubai, Jersey, Guernsey, the Isle of Man, Ireland and the UK; in Switzerland for Qualified Investors; and the USA for Institutional Investors. In Canada, the document is intended only for accredited investors as defined under National Instrument 45-106. It is not for consumer use — please do not redistribute.

For the distribution of this document, Continental Europe is defined as Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Norway, Liechtenstein, Spain, Sweden. It is not for consumer use - please do not redistribute.

This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities. The opinions expressed are those of the author, are based upon current market conditions, may differ from those of other investment professionals, are subject to change without notice and are not to be construed as investment advice.

This document contains general information only and does not take into account individual objectives, taxation position or financial needs. This should not be considered a recommendation to purchase any investment product. This does not constitute a recommendation of any investment strategy for a particular investor. Investors should consult a financial professional before making any investment decisions if they are uncertain whether an investment is suitable for them. Please obtain and review all financial material carefully before investing. Neither Invesco Ltd. nor any of its member companies guarantee the return of capital, distribution of income or the performance of any fund or strategy.

This document is not an invitation to subscribe for shares in a product nor is it to be construed as an offer to buy or sell any financial instruments. As with all investments, there are associated inherent risks. This document is by way of information only.

Asset management services are provided by Invesco in accordance with appropriate local legislation and regulations.

By accepting this document, you consent to communicate with us in English, unless you inform us otherwise.

This article is issued: In Canada by Invesco Canada Ltd., 5140 Yonge Street, Suite 800, Toronto, Ontario, M2N 6X7.

In Austria, Belgium, Denmark, Dubai , Finland, France, Germany, Ireland, Jersey, Guernsey and, the Isle of Man, Liechtenstein, Italy, Netherlands, Spain, Sweden, Switzerland, Luxembourg, Norway and the UK by:

Invesco Asset Management Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK. Authorised and regulated by the Financial Conduct Authority; Invesco Management S.A., President Building, 37A Avenue JF Kennedy, L-1855 Luxembourg, regulated by the Commission de Surveillance du Secteur Financier, Luxembourg. Invesco Asset Management Deutschland GmbH, An der Welle 5, 60322 Frankfurt am Main, Germany. Invesco Asset Management Limited, PO Box 506599, DIFC Precinct Building No 4, Level 3, Office 305, Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority; Invesco Asset Management (Schweiz) AG, Talacker 34, 8001 Zurich, Switzerland.

In the US, by Invesco Advisers, Inc., Two Peachtree Pointe, 1555 Peachtree Street, N.E., Suite 1800, Atlanta, GA 30309.

II-EMECHI-INSI-1-E 01/21 GL21-27