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Why China Should Be Part of a Long-term Investment Portfolio

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Investing in China is a controversial topic, with China bulls and bears almost as far apart as supporters of Clinton and Trump. Bulls and bears talk "at" each other, often with red faces and raised voices! Although the debate about China may be as polarized as the Presidential debate, it is possible to present an unbiased view that acknowledges both sides of the argument. Despite the significant challengers on the horizon for China, long-term investment portfolios should include investments in Chinese stocks.

Addressing the risks

Slowing GDP Growth: Many commentators cite the slowdown of Chinese GDP growth as a reason to avoid China. GDP growth according to official statistics, which was 11.4% in 2005 and in double-digit levels as recently as 2010, fell to 6.9% in 2015. Private estimates are for Chinese GDP to fall further in 2016 than official statistics would indicate, with consultancy Capital Economics projecting 5% growth. An important consideration, however, is the size of China's economy in 2016 relative to its size in 2005. China's economy is more than 5 times larger today, so 5% growth on a much larger economy base is still quite robust! In a recent speech Matthews Asia's Andy Rothman commented about the need to "get away from the obsession with China's GDP growth rate."

Debt: China's corporate sector binged on debt in recent years, in large part because of massive infrastructure spending initiated to stabilize the economy in response to the Global Financial Crisis (GFC). Private debt in China represents more than 200% of GDP, far higher than the peak of U.S. private debt before the GFC and approaching the high reached by Japan in 1990. The explosion of debt creates fear that China will face a banking crisis and hard landing, repeating post-bubble cycles experienced in the U.S., Europe and Japan.

The debt picture may be more nuanced than alarmist headlines would indicate. The central government is the largest shareholder in most of China's major banks, and a significant portion of the private debt was extended on behalf of the government as a form of fiscal stimulus. In the words of Rothman, "the potential bad debts are corporate, not household debts, and were made at the direction of the state, by state-controlled banks to state-owned enterprises." Although China's corporate debt is uncomfortably high, household debt is low and government debt is only 44% of GDP. China's overall debt, including corporate, household and government debt, is comparable to that of the U.S. and UK and considerably lower than that of Japan, France and Canada. That may not be unequivocally great news--as 255% debt/GDP ratio is still uncomfortably high--but it's important for context-setting. Perhaps most importantly, very little of China's debt is owed to external parties, so China (at least for the time being) has considerable latitude as to the approach and timing of structural change to reduce its private debt.

State-owned enterprises: China's leaders face a difficult balancing act: maintaining enough growth to preserve social stability while addressing the need to restructure debt-laden, money-losing state-owned enterprises. The slow pace of reform among state-owned steel, coal and electricity companies that dominate China's "rust belt" is a concern, but the stereotype of China as an export-focused, state-dominated economy isn't true anymore. Exports are a small part of China's economic output, and the private sector is the dominant economic engine for the country.

Embracing the opportunities

A "slower-growth" China accounts for about 1/3 of global growth, a higher proportion than was the case in 2010 when China's GDP growth was 10%! Private sector employment is more than 80% of total employment in China, and outside of the manufacturing sector there are more jobs than job seekers. China may be the best consumer story in the world, and the rise of the "consumer class" in China is very real. Real household income rose more than 130% over the past decade, a noteworthy advance compared to nearly non-existent income growth for developed market households. China's consumers are in good shape, with high savings, low debt, and rising household income. Retail sales in China gained 10.6% year over year in August, continuing a strong multi-year trend. The middle class, about 8% of the population today, is expected to triple to 300 million people by 2020 An aging population also provides opportunities, as 16% of the population (220 million) are age 60 or older today. Some of the most exciting opportunities are with the consumer-oriented companies that benefit from rising incomes, healthcare companies that support a more affluent (and aging) society and industrial companies helping to improve manufacturing consistency. Many of these companies didn't exist ten years ago!

Addressing China's structural problems, including high corporate debt and sluggish state-owned enterprises, won't be an easy process, but is likely to result in slower growth, pressure for currency adjustments and continued volatility rather than a crisis or hard landing. Despite the risks and volatile ride, China is likely to be an attractive investment destination for the patient investor.

Disclosures: