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Matthews Asia Perspective

Quality of Growth Adds Stability to China's Economic Engine

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Fast economic growth can be volatile, with peaks and valleys along the way. China's policymakers are trying to tackle this issue. China's current economic framework seeks to foster sustainable, stable growth over the long term by focusing on the quality of its growth. Quality growth, in our view, requires a large, consumer-driven marketplace, businesses that allocate capital efficiently and workers who feel they are part of a system that provides potential for upward mobility. We believe this approach to growth can improve the quality of life for China's citizens, while also generating compelling opportunities for global investors.

Over the past 15 years, China's growth has far exceeded the global average. The profit-per-share growth of Chinese companies has kept pace with nominal GDP growth in U.S. dollar terms, as shown in Figure 1. The drivers behind this growth are easily identified. China saves a huge amount of its GDP, investing both in infrastructure and technology. The country has been open to trade and new ideas. China's government also has been changing its political, economic and financial institutions to support growth.

Figure 1. China Earnings Per Share and Economic Growth

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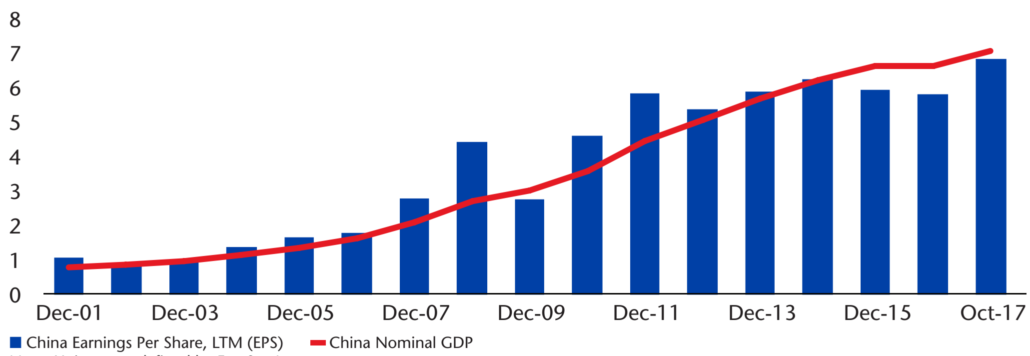
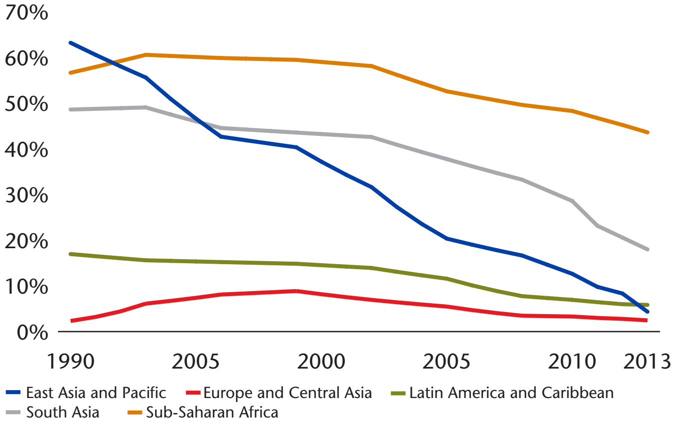


Note: Universe as defined by FactSet Aggregates
Source: FactSet Aggregates, MSCI, Matthews Asia; data as of November 6, 2017

Beginning with economic reforms in the late 1970s, China has made steady progress in its transition from a planned economy to a market-based economy. Today, more than three-quarters of urban employment is now created by private enterprise. While GDP has grown quite a lot in past years, the actual earnings-per-share growth in Chinese companies has been fairly flat, or stable, since about December 2011. This has been part of the Chinese government's desire to raise wages and by extension help to stabilize society. While challenges facing the working class in the United Kingdom and United States have resulted in political upheavals, including Brexit and the election of Donald Trump, China has made a focused effort to address key social issues, including improving quality of life for its large working class.

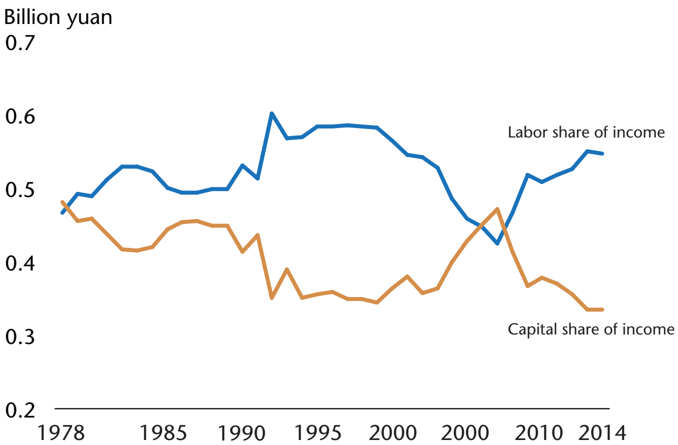
Consider the dramatic changes in household income over the past 25 years in Asia. In 1990, about 63% of households in eastern Asia, largely comprised of China, lived in poverty. Poverty is defined as earning US$2 or less a day. In 2013, the most recent year for which the World Bank has published data, China's poverty rate was less than 5% of its population. This is an unprecedented pace of change in people's lifestyles. (See Figure 2) Workers are also gaining a larger share of corporate profits. Following the global financial crisis of 2008, labor started to gain a greater share of income. (See Figure 3) To accomplish this, the Chinese government raised minimum wages ahead of rates of productivity and ahead of rates of nominal GDP growth. For the past couple of decades, this stabilized labor's share of income at average rates. This adds to debt in state-owned enterprises but also creates a more cohesive society, putting the country's growth under stronger footing.

Figure 2. Internal Stability: Poverty Rates at US$2 a day
% of population living in households with less than US$2 a day income



Sources: World Bank, POVCAL

Figure 3. Internal Stability: Mr. Worker and Mrs. Capitalist



Note: Capital Share and Labor Share of Gross National Income data from Asian Productivity Outlook (APO) and Matthews Asia calculations for China.

Sources: Asian Productivity Outlook (APO), Matthews Asia Calculations (Capital Share, Labor Share data)

Market-based economies are driven by consumer demand. Name brands are an important element for creating consumer demand. A name brand means a company is not just selling on the basis of price, but rather on intangibles, such as service, ideas of luxury and individual expression. Brands are about how a product makes people feel, as opposed to a strict cost/benefit analysis. The development of a robust marketplace for local brand names in China creates more opportunities for investing in businesses with the potential to survive for the long term while improving return on capital. When nondomestic brands enter the Chinese market, they often lose market share because they tend to misgauge local needs and tastes. As Chinese brands continue marketing to Chinese consumers, a truly consumer-driven marketplace has arisen. China's new economy mainly consists of information technology, health care, consumer discretionary and consumer staples. These sectors are direct beneficiaries of the growing purchasing power of China's new middle class.

For global investors interested in capturing the upside of China's growth potential, there are at least two pitfalls to consider. The first is that China's stock market is largely driven by retail or individual investors, so some high-flying stocks may see their prices driven up purely on market sentiment rather than the underlying strength of the company. The second is that it can be difficult for global investors to discern which companies are truly private enterprises, part of the more modern economy in China, rather than state-owned enterprises (SOEs), part of legacy systems.

Looking ahead, we believe the environment for growth in China is going to be one of better quality. Chinese domestic companies are developing robust consumer brands. In tandem, the Chinese government is focused on promoting higher quality management of businesses, while fostering more commercially and privately owned and operated organizations. As active investors, we focus on high-quality companies that we believe will survive and can grow sustainably over the long term. We believe the future of China will be built on a stable economic engine, driven by consumer demand, private businesses making efficient economic decisions and an engaged working class.