

**Special Theme:**  
**The (Re)Rise of China?**  
**The Good, the Bad and the Ugly**

“Quantity has a quality all its own”

Mao Tse-tung

**CORESTONE**  
Investment Managers

## 1. The (Re)Rise of China

Quoting Mao Tse-tung<sup>1</sup> on the front page of a research paper of an investment manager seems odd – after all, China today is not what “the great leader” envisioned when he came to power or what he left when he died.

He has a point though and we will come back to the quote at the end of the paper.

Another odd thing is to quote a 1960s Italo-Western<sup>2</sup>. Not to imply that China is the mirror image to the wild west with no rule of law in vast areas of the US during that time.

However, when looking at China today, people familiar with the country do see the Good, the Bad and the Ugly in certain areas of life, sectors of the economy or politics. Reflecting on all three and putting them in perspective should give a better basis to assess and evaluate current economic and political developments.

Since most of recent news or research articles have focused (more or less undifferentiated) on the Bad and the Ugly – sometimes rightfully so and sometimes not (in our opinion) – we will start with these negatives and end with the more positive aspects of China’s re-rise.

Chinese people often tell us when we talk to them about the problems the country is facing: “China is a big country...and a big country has big problems but also big potential”.

In the following pages we will not be able to dive into every single detail of those problems or silver linings – the country is too complex for this. But we do hope to add a little bit more spice and insights to the ongoing discussion and encourage further investigation.

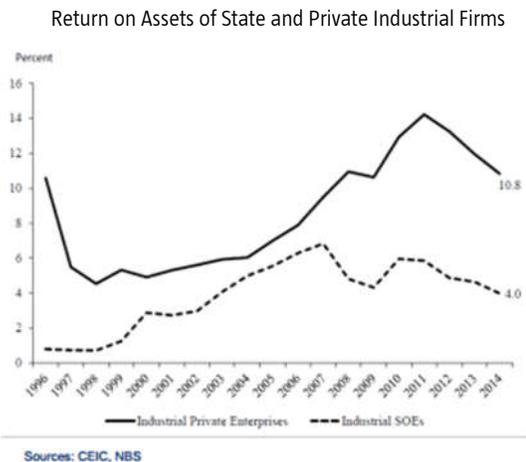
## 2. The Ugly

### 2.1. China’s SOEs

China’s State Owned Enterprises (SOEs), oh boy, where does one start. They are huge, they are slow, they are inefficient, they are political instruments and, they are corrupt. Those are just some, but most certainly not all attributes people ascribe to this part of China’s economy. And they are right in many ways – though not all to the extreme.

Chinese SOEs are large indeed. In 2000, they made out roughly 70% of industrial assets and employed more 55% of all employees. Since then, 15 odd years have passed and things have changed. Nowadays, these numbers are down to 40% of assets and 20% of employees, a fact that many pundits do not see. Nevertheless, they are still large – and inefficient.

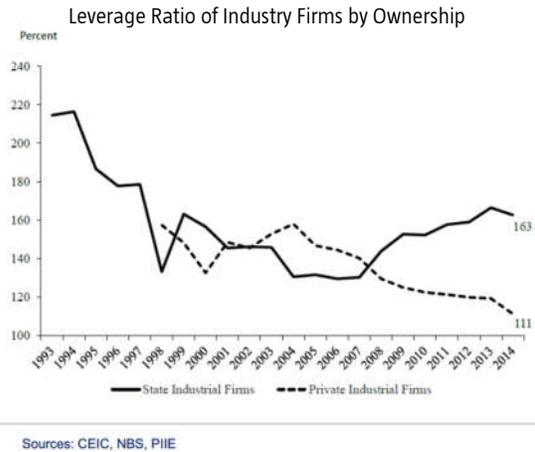
Looking at return on assets of state and private industrial firms between 1996 and 2014, it becomes evident that the private sector is dramatically more productive in comparison to SOEs.



<sup>1</sup> The quote was also credited to Stalin and Lenin

<sup>2</sup> The Good, the Bad and the Ugly (1966), <http://www.imdb.com/title/tt0060196/>

Furthermore, the leverage ratio of SOEs, most likely because of higher risk taking due to the implied government guarantee, is also substantially higher than for the private sector.



Politically, SOEs have always been the breeding ground for people with higher aspirations to rise within the communist party. Additionally, they have also been the place where to “promote” people to get them out of the political arena. As such, SOEs have always been also a political instrument to consolidate power within the ranks.

Contrary to most beliefs, SOEs are not owned by the central government but by the provinces. Hence, steering SOEs on a national level becomes even more challenging as different provinces might be more reluctant to implement certain reforms.

When Xi Jinping came to power in early 2013 he consolidated his political power much more quickly than people outside but also inside of China had anticipated. With this power consolidation came the crackdown on corruption within the political elite but also within the SOEs – a step necessary to rebuild legitimacy for the rule of the party.

Furthermore, the initial discussion on reforms also included SOEs and the implementation of a model similar to Singapore’s Temasek.

The plan suggested a rough vision in which government control of SOEs would shift to a kind of wealth-management approach in which government-run investment funds operated at arm’s length, trying to maximize the wealth the public held, through the government, in their SOEs. Hence, SOEs would be given greater autonomy and performance measures would focus on key indicators like RoE and Economic Value Added.

This reform, however has faced obstacles and cutting through all the differences among the various institutions, the small leadership group accepted proposals from the Ministry of Labor that tied the compensation of enterprise managers to that of government officials of the same bureaucratic rank. This significantly cut salaries, and abolished compensation schemes designed to encourage a better performance by the senior management.

In addition, Xi spoke in the past clearly in favor of maintaining strong SOEs, which he described as pivotal for Chinese Communist Party (CCP) rule and having “a dominant role in important sectors and crucial areas that affect national security and the commanding heights of the economy.”

As a result, the current status of SOE reform focuses mainly on mergers (orchestrated by the state-owned Assets Supervision and Administration Commission – SASAC). A Chinese proverb says “you can’t dry a wet dog with another wet dog” and the same holds true with merging the largest firms in the same industry with the hope to improve efficiency<sup>3</sup>.

<sup>3</sup> Examples are the takeover of the China International Travel Service Group Corporation by the China National Travel Service (HK) Group Corporation. Other recent mega mergers of state firms include China’s two largest train makers - CNR

Corp and CSR Corp; the two largest mining and metals companies China Metallurgical Group and China Minmetals

Additionally, there is disagreement on the highest level on the future role of SOEs. President Xi Jinping (a “princeling” with strong links with the military and SOEs) has made statements contradicting the party document by pledging to make SOEs “bigger, stronger and better” state champions while premier Li Keqiang (risen from the Communist Youth League and a “commoner”) said that: “SOEs should enhance their competitiveness and efficiency through market oriented reforms and reduce excess and backward production capacity to advance supply-side structural reform.”

Adding to the confusion, or better, providing a most recent view on SOEs came in March 2017, when Xi pointed out that “authorities must deal with zombie companies in a 'resolute manner,' offer laid-off workers new posts or vocational training opportunities, and ensure those who are unable to find a job are covered by the social safety net or other aids”. A more clear sign, that highly indebted and inefficient SOEs will face more pressure going forward.

Despite these recent announcements, a lot remains in limbo and the current state of progress is, from an efficiency point of view moving more backwards than forward. Given the sheer size of the SOEs, this is worrying and does not reflect well on the leadership’s willingness to reform relative to keeping or evening expanding their power base. One can only hope, that recent remarks actually represent a shift in fundamental thinking and approach to SOEs.

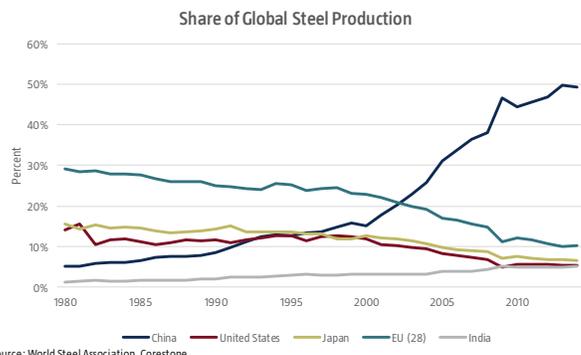
Investment view: After the above discussion, it is needless to say, that we are not big fans of investing in SOEs. Too many of them are inefficient, bloated and are mostly driven by political agendas rather than economic rationale. Hence, we would advise to stay away from these companies.

Having said that, on a highly selective basis, picking some SOEs which are set to be (fully or partly) privatized or have engaged in more market oriented behavior might have its merits. However, this requires extensive on the ground work and understanding of the companies to actively make choices in this sector.

## 2.2. The Old Economy

Another part of the economy which is truly worrying, and that includes obviously also the SOEs which are mainly located in this sector, is the “old economy” – the heavy industries and manufacturing side.

As an example, steel production is often used to visualize the problem (one could equally well choose coal by the way) the Chinese economy is facing in these sectors.



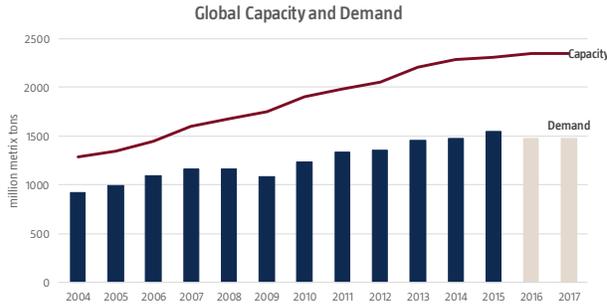
Over the last 35 odd years, as industrialization and urbanization increased, China built up a vast amount of capacity in the steel sector. As with most things in life, people tend to overdo it and end up well beyond where they supposed to end up. Steel production is no exception.

As a result, China’s share of global steel production increased dramatically, especially from the early 2000s onwards.

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Corp; and the two largest shippers China Ocean Shipping Group (COSCO) and China Shipping Group.

Due to weak national leadership by Hu Jintao and Wen Jiabo, SOEs expanded their production well above the needs of the domestic economy to show growth and increase the chances of senior management moving up the ranks in the CCP.



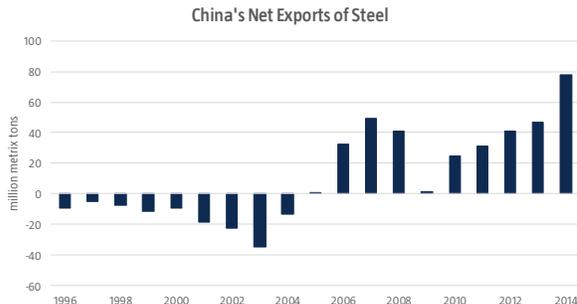
Source: OECD Capacity Figures, World Steel Association, Corestone

This flipside to expanding capacity is obviously demand which should ideally increase with the same speed. Needless to say that this was not the case with steel (or coal for that matter).

Over the last decade, while China's steel capacity kept expanding or, as in the last couple of years not decreased substantially, demand, while increasing, did not keep pace at all with the expansion of global capacity.

As growth in China slowed somewhat, so did the demand for construction materials and as such, also steel.

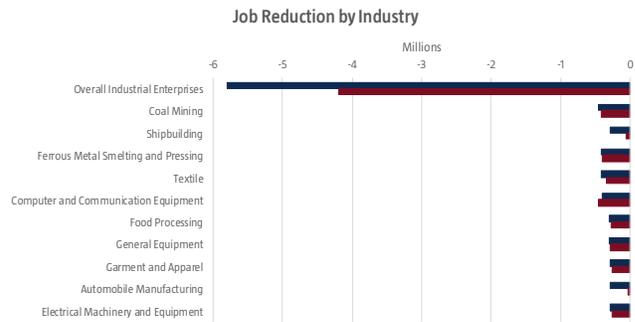
To cope with the excess capacity, Chinese steel exports increased substantially over the past years instead of cutting down on production, thus "sharing" China's steel output with the rest of the world.



Source: World Steel Association, Corestone

The overall picture seems to not have changed, but the details have. While productivity improvements made for example the steel production more efficient, labor intensity even in heavy industries decreased.

Not just in the steel sector, where roughly 1 million workers lost their jobs since 2015, but also in other industries.



Source: CEIC, Corestone

Over the last 18 months, more than 1 million workers were let go due to the drastic shutdowns of coal plants in Hebei province, north of Beijing.

Whoever has been to Beijing in winter welcomes these steps as emissions from these coal plants kept Beijing population literally "in the dark". From the point of view of those thousands of workers in the region, that's a different story.

But it's a story which poses significant dangers to the CCP going forward as it remains a huge challenge to find work for these people and to avoid increased social unrest and the rise of questioning the rule of the CCP.

Especially in the northern provinces which rely mainly on heavy industries.

Growth Rates by Province FOR GDP and Value-Added of Industry (VAI) in 2015



10 Million workers across several industries were laid off over the past quarters alone and finding adequate new employment for those displaced employees will not prove easy. Outside of China, a lot of people still seem to have problems grasping just the sheer amount of people being affected and the problems arising because of that but first steps towards the restructuring of SOEs and also heavy industries are underway.

We remain skeptical however that the central government is willing to take further steps to significantly reform the economic structure in those most hit regions and will most likely react more than act to change things.

Hence, in our opinion, things will get worse on this front before the government is forced to take more drastic, but then also much more painful and expensive steps in the right direction.

Investment view: As a result, the “hardcore” old economy is not one of our favorite investment themes. There might again be one or the other good and well-run company within this sector, but with the overall economic structure changing, these companies also will face bigger obstacles going forward. Future investment returns in this old-economy sector will in our opinion lag behind those

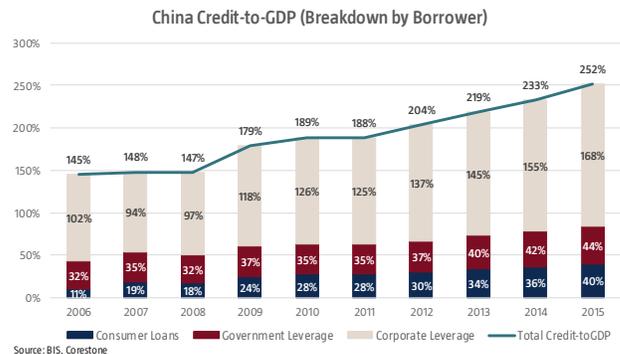
more dynamically growing sectors which are supported by structural shifts in the economy.

### 3. The Bad

#### 3.1. Credit & Capital Efficiency

Why is credit only “Bad” and not “Ugly”? Well, needless to say – it was a close call.

Overall, the credit picture looks bleak and the credit-GDP multiplier, i.e. how much expanding debt is needed to generate one additional unit of GDP has been increasing in recent years. To be fair, not only in China, but also in Europe and the US.



However, again the devil is in the details. Credit to GDP might have increased over the last couple of years but mainly driven by corporate leverage.

Furthermore, this increase was mostly driven by SOEs and to a lesser extend by private enterprises. From the household side, debt has also increased – mostly with respect to property purchases and less on the consumer loans side.

This is not surprising when looking at the asset breakdown for Chinese households.



Traditionally, households have a substantial wealth in cash and real estate in China as the social net has been historically weak. This has changed over the last decade.

Today around 900mn people have basic pension benefits (up from 220mn in 2005) and around 700mn have basic health insurance coverage (up from 150mn in 2005). These developments free up cash to be invested also in stocks and bonds over the long term.

Nevertheless, the buildup in credit remains worrisome. The BIS joined the World Bank recently in noting that China is facing a debt and/or banking crisis should the speed of debt increase not be stopped.

The only “upside” is, that as mentioned, most of the increased leverage is located in the SOE sector which is backed by the government. The “downside” is, well, that it is backed by the government and no real improvement will come unless the government decides to do something about it.

The risks are well understood in Beijing. The state-owned People’s Daily published a front-page interview in early 2016 from a “very authoritative person<sup>4</sup>” warning that debt had been “growing like a tree in the air” and threatened to engulf China in a systemic financial crisis.

The writer called for an assault on “zombie companies” and a halt to reflexive stimulus to keep the boom going every time growth slows. He went on to say that it is time to accept that China cannot continue to “force economic growth by leveraging up” and that the country must take its punishment.

The Chinese banking system is an arm of the CCP so any denouement will probably take the form of perpetual roll-overs sapping the vitality of the economy gradually.

The country was able to weather a banking crisis in the late 1990s but the circumstances were different. China was still in the boom phase of catch-up industrialization and enjoying a demographic dividend. Today it is no longer growing with past high growth rates and its work-force is shrinking.

Any adjustment will be painful. The more decisive actions are being delayed, the more painful future adjustments will be in our opinion.

### 3.2. Exports as an Engine of Growth

In the past, China was always considered the workbench for global manufacturing and exports contributed significantly to GDP growth over the past three decades. Besides supplying global consumers with low end manufacturing products, these trends in international trade were accompanied by low inflationary pressure due to low wages in China.

But also here, things have changed quite a bit over the last years. Chinese wages have increased substantially and manufacturing hubs in Cambodia, Bangladesh or Vietnam became the “new” places to manufacture high labor intensive goods for the western world. Not that these countries have the capacity (just in terms of the number of people) to substitute China on the global stage, but the effects can be seen in the export numbers.



Source: NBS

Corestone

<sup>4</sup> This is usually in China a reference to either the premier or the president himself writing and communicating “incognito”.

Clearly, the purely export oriented Chinese growth model is a thing of the past and laying off workers in these export oriented sectors will add to the social problems.

Export growth has been in decline for the last few years together with imports, which were affected by the general growth slowdown in China. Additionally though, import growth has also declined because of falling raw materials prices and the substitution of domestically produced products for international brands.

Future will tell if the lack of stimulus from exports can be offset by more dynamically growing internal demand. If not, market participants will have to get used to much lower overall growth rates and increasing frictions on the debt and leverage side.

Investment view: Given these developments, focusing on companies with a high export share and riding the “old” export driven China theme will not necessarily lead to negative returns, but we are convinced that this is not the place to be going forward.

### 3.3. Real Estate

Real estate – not a single sector has caught the focus of international pundits as much with the mentioning of ghost towns, exploding property prices and a new debt bubble.

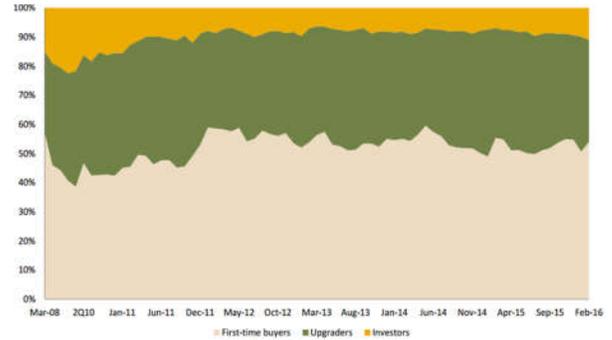
Last things first – a debt bubble in the real estate sector – at least the residential portion of it, is in our opinion unlikely.

As seen earlier, the net cash balance of households in China is still substantial.

90% of new home buyers are owner-occupiers, who use a lot of cash. Additionally, down payment requirements are quite restrictive in China and are used by the government to steer the market. Down payments of 30% for first time buyers or 60-70% for second home buyers, depending on the region and city are very common and are adjusted depending on the market environment.

Hence, even if prices were to adjust, it is unlikely that owner-occupiers would sell their apartments again and investors usually have such high equity in these apartments that forced selling is rather unlikely.

Breakdown of Property Sales by Buyer-type



Some price developments on the other hand seem more worrisome, especially in Tier 1 cities and one can understand why people outside of China focus on these figures.

While this is indeed an area to watch, we would caution people just to look price developments.

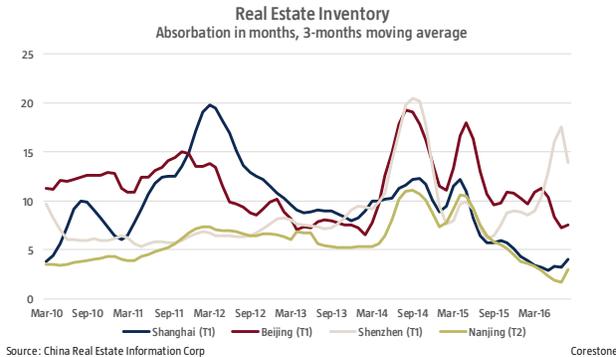
Real Estate Price Developments  
6-months moving average YoY-% Change



Source: China Real Estate Information Corp

Corestone

Adding the supply side to the picture changes the perception of a price bubble in general, a lot.



While there are Tier 1 cities like Shenzhen which fight a supply inventory of around 14 months worth of sales (the absorption period), Shanghai or Beijing only cope with an inventory of four and seven months, respectively. Not really a dramatic oversupply.

If you take New York as a counterpart example, per end 2016, the absorption period for Manhattan was around 7 months.

On the other hand, we have seen cities in China firsthand, like Ordos (Mongolia) or Urumqi (Xinjiang) where a lot of real estate was built in expectation of future demand. If this demand will materialize in full is still to be seen and we will keep an eye on those cities to see how things are progressing and revisit our views if necessary.

So there are cities where a lot of supply has been built in anticipation of future demand – Chongqing is a great example as we have recently been there and visited several real estate developments.

Will supply be met with demand? In the case of Chongqing we are confident – for Erdos or Urumqi we have mixed feelings.

Is there a general property bubble in China? In our opinion no. Are there bubbles in certain cities or regions? Most definitely.

But again, the same thing could be said about the real estate market in San Francisco when looking just at prices.

So where is the “Bad” ... The construction sector has been one of the driving forces of growth for inner China and regional governments rely heavily on the revenues from land sales.

These revenues are beginning to decline and put additional pressure on local and regional finances. Furthermore, we do see a shift of consumers towards different spending patterns as the “own apartment/house” as a nest egg for retirement becomes less necessary.

Seeing what large construction companies like Vanke and others still have in their land bank, we don’t see the real estate sector as one of the driving forces going forward, especially in Tier 3 cities. This could again lead to significant layoffs of less skilled workers and increased potential for social unrest in addition to lower contributions to or even drags on economic growth going forward.

Investment view: Currently, real estate companies are still “en vogue” and some stocks, like Vanke are additionally driven by takeover battles. We wouldn’t necessarily stay away from these well-run companies like Vanke or Poly Real Estate in general, but would caution as the political influence in these companies should not be underestimated. We would more focus on sound Tier 2 city construction companies where demand is still expanding.

### 3.4. The Stock Market

Being an investment manager, the stock market was and is, of course, of particular interest to us.

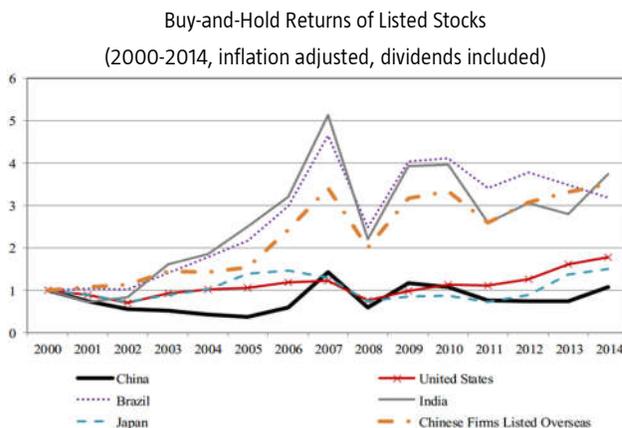
Most complaints we hear from investors are that the Chinese stock market is extremely volatile, unpredictable, that corporate governance is non-existent and the speed of sector rotation is just ridiculous. Furthermore, they are disappointed that their investments did not mirror the economic growth story they observed in China.

And true, while China’s GDP growth over the last three decades was extraordinary – Chinese GDP surpassed that of the US at the end of 2014 (in PPP terms as measured by the World Bank), the results of the Chinese stock market have been disappointing.

The stock market was started in 1990 to “help SOEs privatize and raise funds” and most Chinese companies today are traded at either one of the two domestic exchanges (the A-Share market) in Shanghai and Shenzhen. Additionally, some Chinese companies preferred a listing in the US or in Hong Kong (H-Shares) instead or in addition to the local listing.

A recent study by Allen, Qian, Shan and Zhu<sup>5</sup> sheds some light on the apparent disconnect between the economic progress and the poor performance of the Chinese Stock Market.

Looking at buy-and-hold returns of listed stocks in China in comparison to other large countries, the performance issues become obvious.



Between 2000 and 2014, any investment in such a strategy in China would have left the investor with basically no positive return at all.

The authors find that the 5-year correlation of economic growth and stock returns which holds true for most countries is for China basically non-existent.

Additionally, among other things, returns on assets are much lower for listed companies relative to their unlisted counterparts. Furthermore, returns on equity around the IPO of a company fall drastically after a domestic IPO and less so by firms seeking a listing in Hong Kong or in the US – a problem of the current IPO process which we will touch on below.

Another issue are Chinese stocks listed with the “ST”-addition, whereas ST stands for “Special Treatment”. These are usually companies in distress which stopped trading but remain listed and are a reflection of the underlying “problems” of the Chinese stock market.

So why do these companies remain listed? Well, to say the least, having an IPO in China takes a tremendous amount of time and once you’re in, even if the company is making losses, the corporate shell alone is worth so much more, that people are just reluctant to delist. Additionally, regulators still have to come up with a stringent process to force de-listings.

The current IPO-process in China is based on a registration system which is handled by the CSRC, the Chinese Securities Regulatory Commission, on a case by case basis. Hence, there is a long line of companies waiting for an IPO in this purely administrative process. Furthermore, any company seeking a listing must prove profits for the previous two years before listing – a reason why returns on assets are being pushed artificially high before on IPO, only to fall substantially in some cases after a listing.

A change of the registration system from an administrative to a more market-based process in

<sup>5</sup> F. Allen, J. Qian, S. Chenyu Shan, J. L. Zhu, “The Best Performing Economy with the Worst Performing Stock Market”, AQSZ, 2014.

addition to lowering performance hurdles for listings should prove helpful in smoothing the number of companies entering the market in a given month.

On top of all that, corporate governance still needs substantial improvement and the monitoring of controlling shareholders is still not sufficient to protect minority shareholders.

So were investments in the Chinese stock bound to disappoint? Well, yes and no.

If you expect China as one of the largest equity markets (in terms of market cap) in the world to behave like, for example the US market or Japan, then you will most likely be disappointed.

The Chinese equity market is mainly driven by retail investors and by mutual funds which face performance comparisons with their peers literally on a daily basis and as such behave basically in the same way as retail investors. Chinese equities have always been ridiculously volatile. Since 1994, there have been 32 bear markets in the A-Shares, compared to two in the S&P 500. Industry portfolio turnover on average is around a whopping 300% a year.

Another “yes”, if you just focus on the SHCOMP, the Shanghai Composite index as your investment universe. This index is unrepresentative of the Chinese economy in our view. It is overweight state-owned enterprises (SOEs), not the privately-owned firms that employ 80% of the workforce and create the vast majority of new jobs and wealth. It is also overweight the old economy, underweighting the biggest and fastest growing parts of the economy—services and consumption.

A resounding “no” is in place if you look at actively managed strategies focusing on privately held companies with proper management incentives and focus on the consumer side. Here, substantial value was created over the last 15 years.

Again, as with most markets, but even more drastically true in China (and other emerging

markets also for that matter), simple “buy-and-hold across the board” or passive index strategies are lacking the necessary flexibility to adapt to a changing market and economic environment.

Investment view: Passive investments in China are in our view bound to disappoint any investor for the above mentioned reasons. Buying an index like the Shanghai Composite or (even worse) the Hong Kong Based H-Share Index exposes you to large inefficient SOEs and the banking sector while leaving the dynamic parts of the economy on the consumer and service sector on the sidelines. Active management in the domestic Chinese stock market is in our view key for superior returns going forward. Having said that, the most recent emergence of passive products focusing on these more promising sectors could provide an alternative going forward.

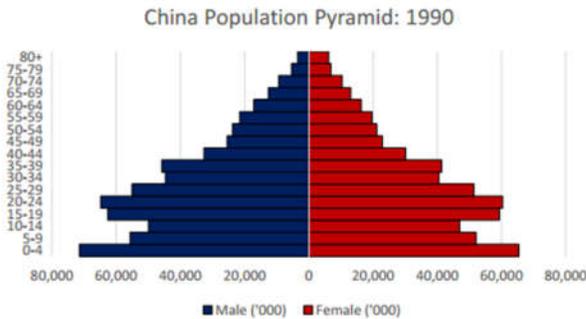
### 3.5. Population – The Long Run Problem

Besides changing market or economic environments, demographics also change, at a much slower but also much more predictable pace. Some people would consider this topic boring, but its long run implications are tremendous. Not just when looking at China but also for countries like Germany, Switzerland and others where an aging population poses problems which have to be addressed now even though they only very slowly emerge. The leverage of these problems is enormous.

China is a big country and usually this goes hand in hand with equally sized problems. When it comes to demographics this is even more true. The one child policy was exactly implemented because of the long term problems which would have arisen 20-30 years down the road.

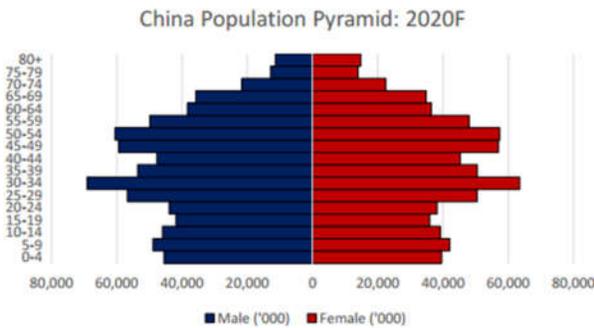
Now on the other hand, policy makers are relaxing this policy to cope with the same problem.

A comparison of the population pyramid some 25 years ago relative to 2020 clearly shows the distorting – even though well-meant – policy effects.

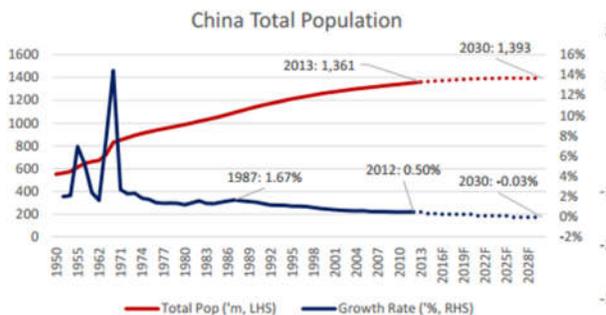


And 2020 is not really a forecast. Every single worker who will be entering the labor market, is already born.

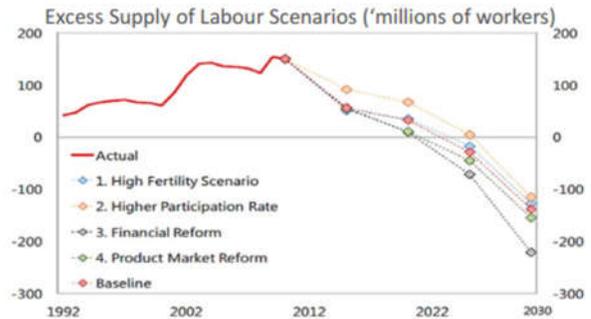
The deformation of the population pyramid is clearly visible and resembles more that of a developed market economy than that of an emerging market economy.



As a result, the Chinese population is projected to grow, but only marginally over the coming decades.



This slower population growth overall and the increased ageing of the population has direct effects on the excess supply of labor going forward. As of 2014, the total labor force is already decreasing and this trend will continue in the medium term.



Going forward this will lead to increased wage inflation – an effect we have already been observing in certain areas of the economy and regions of the country. Hence, the need for faster productivity growth becomes more and more important. In terms of robot density, China is still lagging and potential for improvement and innovation is substantial.

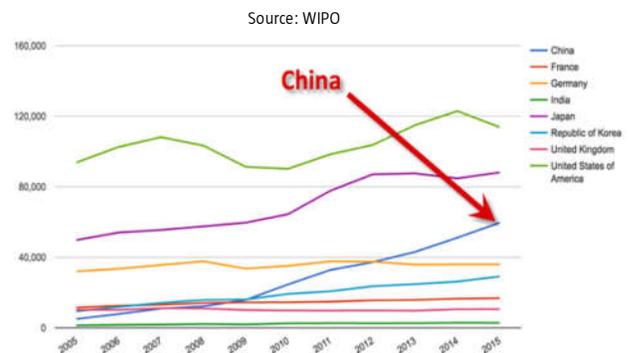
## 4. The Good

### 4.1. The Rise of the Private Sector – From Manufacturing to Innovation

This innovation is already observable and mostly driven by privately held companies in China.

In terms of factor productivity, the firms are highly innovative and the number of patents being filed is increasing.

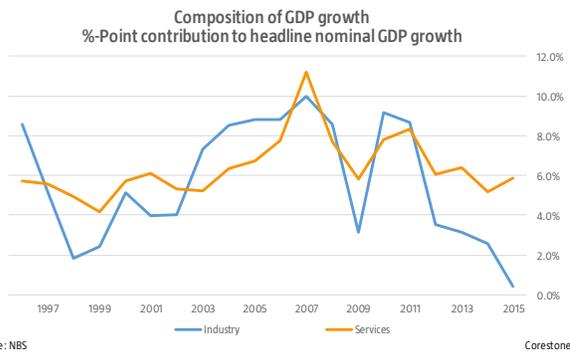
### Number of Patent Applications Files Under the Patent Cooperation Treaty (PCT)



Gone are the times when China was solely a low cost low skilled production hub. Companies like

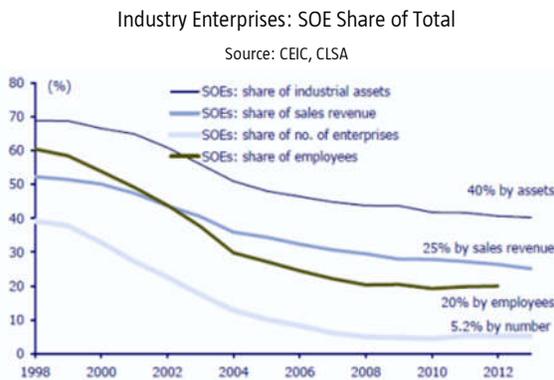
TenCents, Alibaba, Huawei, Xiaomi etc. are not only producing high quality products and services and moving up the value chain, they are also highly innovative.

Especially in the service-oriented sectors, private companies are not only employing the majority of people, they are also investing substantial amounts to satisfy increasing demand from the Millennials domestically but also increasingly from overseas markets.



Large, inefficient SOEs become less and less important.

Facts, which are often overlooked from abroad when just focusing on the economic structure of 10-20 years ago.



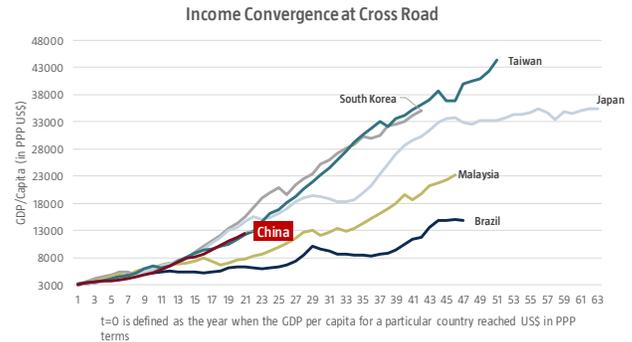
The growing importance of these dynamic companies cannot only be observed on the employment side but also when looking at the composition of GDP and growth contributions.

In 2014, for the first time, the service sector contributed more than 50% to total GDP, a trend which had been going on since the late 1990s and is a reflection of changing regulation to make it easier for private companies to operate but also of the growing and changing consumer class in the largest country in the world.

#### 4.2. The Rise of the Chinese Middle Class

This increasing middle class of consumers is in our opinion the single largest factor, which will drive Chinese growth going forward.

Looking at its current trajectory relative to other countries, China is still on track to follow in the footsteps of countries like Taiwan or Japan.



One of the main reasons people underestimate this factor is the fact that they focus on the official income numbers which show that private consumption is hovering around 40% of GDP – dramatically below the 70%+ for the US for example.

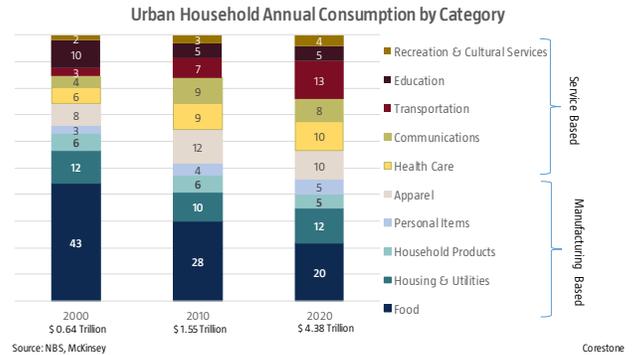
Looking at this data might be misleading. Even if people don't value the quality of Chinese statistics highly, this is still the one which is always quoted to show the high reliance on the government for growth.

The problem with Chinese income statistics is, that they are imperfect (like so many other statistics around the globe). The income statistics are based on survey data by the NBS (National Bureau of Statistics) and funnily, a lot of people do not tell the truth in these kind of surveys especially if they think that this data could be passed on to tax authorities!

To have a more informed view on this, Credit Suisse, along with the China Society of Economic Reform encouraged Prof. Wang Xiaolu to conduct a different survey<sup>6</sup>. With his vast network of people, the survey used interviewers who asked questions about income, spending and food consumption to 5,000-plus respondents whom they know personally. The assumption here is that given the interviewer knows the respondent personally, the respondent would feel more comfortable and would be willing to disclose his/her “true” income to the interviewer.

The results are intriguing and paint a more realistic picture in our opinion of the current income levels.

1550bn US\$ in 2010 and another forecasted expansion to 4.38 trillion US\$ in 2020 should not be underestimated.



2011 Household distribution	Per-capita disposable income (rmb)		2011 Distribution		Income CAGR (%) 2008-2011
	NBS data (1)*	Survey Estimates (2)*	2/1	of hidden income (%)	
Bottom 10%	6876	9026	1.3	1.2	19
10-20%	10672	12646	1.2	1	19.4
20-40%	14498	17048	1.2	2.5	12.5
40-60%	19545	27061	1.4	6.9	14.8
60-80%	26420	45250	1.7	16.4	18
80-90%	35579	79654	2.2	18.5	13.2
Top 10%	58842	188448	3.2	53.5	10.7
Average	21810	43663	2.0	100	13.7

\*NBS Data is based on the household income survey published by the National Bureau of Statistics  
Survey estimates are the estimates from Prof Wang's Grey Income Survey  
Sources: Prof Wang's Study (China Reform Foundation, 2012)

Corestone

As incomes might be underreported or underestimated, so can purchases of goods and services.

An indicator which is fairly reliable to grasp consumer confidence and income growth from our point of view are car sales. Firstly, buying a car is not cheap and hence only something to consider when the economic environment seems stable and secondly, every car is registered in China. Hence, as soon as one buys a car, it will show up in the statistic no matter if you paid for it in cash or via bank transfer.

As income levels change, so does the composition of consumption and the demand for certain products and services.

The sheer size of the expanding consumer base in terms of volume from 640bn US\$ in 2000 to

A lot of these developments are already observable in daily life in China, but also abroad.

Year-on Year Change	Event	Time Period
109%	Chinese visitor arrivals in Japan	January-November
99%	Apple's greater China revenue	3 months ending September
52%	SUV sales	2015
49%	Movie box office revenues	2015
49%	Express parcel deliveries	2015
48%	Chines tax-free shopping in France	October
33%	Nike shoe sales in Greater China	3 months ending November
16%	Furniture sales	2015
11%	Inflation-adjusted retail sales	2015
11%	Household appliance and electronics sales	2015
8%	Gasoline consumption	January-November
7%	New home sales	2015
7%	Passenger car sales	2015

Sources: Japan National Tourist Office, Company Data, Global Blue, CEIC, CNBC, National Bureau of Statistics of China, Corestone  
As of December 31, 2015

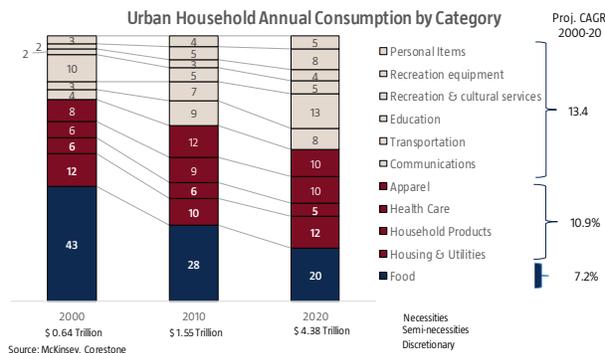
Alongside a growing middle class and growing incomes, also for the lower income quartiles, consumption patterns change as we have seen above.

However, these changes will affect the various sectors of the economy differently.

Whereas the more service based categories are expected to grow with more than 13% CAGR until 2020, food and manufacturing based categories will grow too, but will lag the dynamics of the service sector.

<sup>6</sup> Credit Suisse, Equity Research “Analysing Chinese Grey Income”, October 2013.

Hence, like always, the devil is in the details.



Just buying for example the SHCOMP index with the intention to participate in this growth story will lead to disappointments down the road in our opinion as it has done so in the past (see our discussion on the disconnect between index versus economic performance).

Two things are “wrong” with this thinking from our point of view, well, actually three things. Firstly, buying the index will give you exposure to ALL companies in the index and currently the majority are the before mentioned SOEs – we hope it became clear that this is NOT the place to invest.

Secondly, even though the whole economy is growing, selecting the most dynamic, well run and most innovative companies will lead to higher returns in the future.

And, thirdly, which should be clear by now, market cap weighted indices are inherently backward looking and buying past performance is never a good idea. By the time these companies make up a larger part of the index due to their superior performance, a large part of their growth story might already have played out. As always, the early bird catches the worm and the diligent early investor reaps the bigger fruits.

**Investment view:** Investing in China is investing in an Emerging Market. And most investment theses in this area are about the rise of the consumer. China

is no different in this respect, except for the sheer magnitude of changes happening within the country. We are a proponent of these long term trends towards a growing middle class and with it the increased demand for more services and higher value products. Finding and investing in companies which are bound to profit from these developments is key.

However, as with every emerging market, corporate governance might not be up to western standards and cultural as well as political differences can lead to sub-par returns or losses<sup>7</sup>. Hence, in-depth on the ground research and insights by people with the necessary cultural and language background are necessary to tap the full potential of these markets. This is true for China, but also for other countries like India, Russia or South Korea etc.

## 5. Quantity has a quality all its own

Looking at the past is sometimes necessary though to reflect on where things came from on how they have evolved over time.

China is, as mentioned, big – really big. So the numbers we are dealing with are equally big. Hence, saying that “quantity has a quality all its own” is especially true when looking at China.

Some 35 years ago, China was, in terms of GDP, not really important and was more or less on par with Mexico or New York state in the US.

GDP Size in 1980 (US\$ billion)

Country	GDP (US\$ bn, 1980)	Multiple of China GDP
China	303	1
India	190	0.6
Mexico	235	0.8
NY State	236	0.8
Tx & Illinois	348	1.2
Italy	470	1.6
Japan	1087	3.6

Sources: Worldbank, BEA, Corestone

<sup>7</sup> We would caution however praising western standards too far. Afterall, Enron or Worldcom are just two examples of

corporate governance failures in the most advanced economy in the world.

Things have changed since then - dramatically so.

We mentioned the 680mn people who gained access to basic pension benefits over the last ten years or the 550mn who now have basic health insurance coverage.

The increase in urban household consumption from 640mn US\$ to most likely almost 4.4trn US\$ within 20 years, the lifting of over 150mn people out of poverty and aiming to lift another 10mn per annum for the next 5 years are just mindboggling numbers.

To put this argument further and China's size in today's world in context – we thought the following table just puts things perfectly into perspective.

Assuming an annual increase of Chinese GDP by roughly a trillion US\$ per annum (the average between 2012-2014), within less than a year, the Chinese economy would add economic power comparable to Indonesia and every two years it would add the GDP of India or Russia.

China GDP Size (2015) = US\$ 11.4 trillion  
Annual Increase in China GDP Size= US\$ 954 bn (Average of 2012-2014)

Country	GDP (US\$ bn, 2014)	Number of Years for China to Increase by this GDP Size
Laos	11	0.01 (4.2 days)
Philippines	285	0.30 (3.6 months)
Singapore	308	0.32 (3.8 months)
Indonesia	889	0.93 (11.2 months)
Russia	1861	1.95 (23.4 months)
India	2049	2.15 (26 months)
ASEAN	2491	2.61 (31.3 months)
UK	2989	3.13 (37.6 months)
Japan	4602	4.82 (58 months)

Sources: World Bank, Corestone

Funnily, taking a long weekend and coming back might just add the country of Laos to your Chinese GDP.

We understand that people focus on growth rates and are concerned when China suddenly “only” grows with around 6.5%. Those are by the way the same people who said that the growth rates of 7-9% of the past were too high and things had to change.

And of course they are right – things and growth rates have to change – “big boys grow slower” and

they will change as China slowly adapts to a new economic structure.

Why slowly? Again, China is big. We just looked at the almost 10mn workers being let go over last 18 months in the industrial sector. These changes have to be done gradually to keep the national, political and social order intact.

We are convinced that the Chinese growth story will play out. If it happens in the same speed as we predict or at a slower or faster rate is up for discussion and we do see the issues left and right alongside the road.

We do see increased political tensions with neighboring countries – either because of territorial disputes or because of increased political influence in the region. The “one belt, one road project” is controversial to say the least as it expands well beyond China's borders. This project to unblock the road and rail networks between China and other nations while improving trade and exports for its over-capacity industries is naturally not welcomed in all neighboring countries as political influence increases.

Obviously, this topic alone has economic as well as political consequences and twists (some very interesting ones we might add) which go well beyond this paper and we will most likely dedicate one of our future special theme papers just to this project.

But again, size is important here too. This whole long term project which is just focusing on a small part of the overall Chinese infrastructure is estimated to be around 1 trillion US\$.

Sometimes indeed,...

*quantity has a quality all its own...*

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