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China Research Trip: Key Discoveries

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It seemed clear from our recent research trip to China that the country's economy has slowed, but that doesn't mean we can't find compelling opportunities there.

We met with 16 companies across a range of sectors, including technology, healthcare, consumers, communication, and automotive. That was a good representation of the economy, with the exception of broad industrials.

At our meetings, the resounding themes were concerns about China's weak property market, slowed credit growth, tightened liquidity (especially among small and midsize enterprises as a result of deleveraging), and trade wars hurting confidence.

This is consistent with our view: As the Chinese economy is shifting from fixed-asset, investment-driven growth to domestic-consumption-driven growth, it has and likely will continue to implement economic rebalancing and structural reforms.

Continued Reforms

The economic rebalancing and structural reforms should help address the structural challenges the Chinese economy faces and help the country achieve better-quality sustainable growth—but they could also lead to a slowdown, as we have recently seen.

The government's measures to calm the red-hot property market and clamp down on easy credit are two examples. They have led to slower growth, but at the same time, they have supported the health of the China economy structurally.

Then there's infrastructure investment, which has also slowed materially this year to low single digits from the mid to high teens, as a result of the rebalancing and reforms.

After a 12-month pause on major infrastructure projects, and with consumer spending low due to rising personal debt and higher housing costs, the government has now returned to selective infrastructure investments to help shore up growth and counter the adverse effects of deleveraging and a trade war.

The Chinese government has approved a $1.3 trillion infrastructure spending plan, mainly in rural areas and lower-tier cities, where infrastructure is still lacking. This should get infrastructure growth back to the mid to high single digits.

However, the funding of this infrastructure stimulus has not been dispersed. Therefore, we continue to see weak order growth from construction and engineering companies. Companies we spoke to reported this as a driver of negative sentiment.

To combat the slowdown, China has also announced a stimulus package in the form of cuts to income value-added taxes. These tax cuts are designed to encourage consumption. The question is whether and how much these tax cuts will help boost consumption given current weak consumer sentiment.

The consensus we gathered from our trip is that the Chinese government will implement sensible fiscal stimulus without adding more stress to the property markets and credit system structurally; it will also focus on supporting consumption.

In the meantime, the Chinese government is likely to use flexible monetary policies instead of large-scale monetary stimulus to ensure liquidity. We believe this is an appropriate approach, although whether these measures are enough to stabilize growth in the near term remains to be seen.

Trade War Adds to Uncertainty

The trade war adds to the uncertainty, we learned.

There is widespread agreement among the companies we spoke to that a deal would be ideal, but the United States controls the situation with a politically driven agenda, and there's no clear time frame for a result.

This has led to a decrease in corporate sentiment, which has trickled down to individuals worrying about losing their jobs.

While the negativity about the uncertainty is prevalent, there's also a sense among the corporations we spoke to that they can deal with it.

Key Questions

With the Chinese economy facing these challenges, investors are asking if we'll see a repeat of the 2002, 2011-2012, and 2015 downturns. We think that's unlikely. In 2009, there was a massive stimulus package, and from 2013 to 2015, significant overcapacity was created.

The current down cycle is a result of China needing to reign in that overcapacity. But China's fundamentals are better than they were during previous downturns after the successful supply side reform in recent years.

So is the Chinese equity market at or near its bottom? That's unclear. Current growth, low valuations, and the markets being down 30% might suggest so. However, the risk to the U.S.-China relationship remains a major overhang on both fundamentals and market sentiment.

We are also concerned about the further downside of corporate earnings. If they decline, we could see another market downturn, even though valuations may have largely reflected the decline.

Where We See Opportunities

The upside: There are still opportunities for active managers.

Positives in China are sportswear, apparel, and shoe companies. Suppliers in this industry have seen acceleration flowing from U.S. demand, which is tightening supply and improving margins across the board for the sector.

Another reason for the acceleration has been a tailwind from the government promoting and encouraging outdoor sports. So companies in this sector reported strong, sustainable growth.

There are also several positive long-term trends presenting a compelling opportunity for quality growth managers in China: a growing middle class and growth in healthcare spending .

We believe fundamental research with a quality focus is key to exploiting these attractive opportunities while limiting some of the risks inherent in the asset class.

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