CHINA EQUITIES

IS CHINA STILL INVESTABLE?

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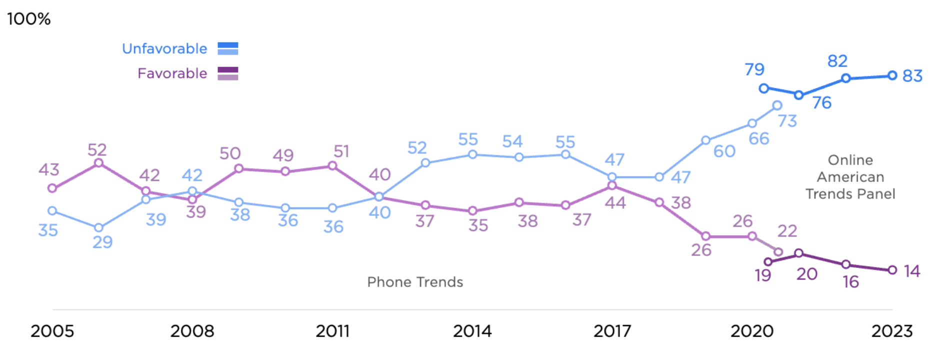
China's late September stimulus measures, including cuts to its benchmark interest rate and funding to boost share buybacks, surprised many investors. Misperceptions and fears have convinced many that China is no longer an investable market. Beyond the macroeconomic challenges and headlines, we believe that China remains a great hunting ground for quality growth companies.

Since China's reopening following the COVID-19 pandemic, the country has faced a sluggish economic recovery.[1] Investor sentiment has soured due to the government's tepid measures to boost capital markets, compounded by rising geopolitical tensions (see *figure* 1), demographic pressures and signs of a worsening real estate market.[2] Concern has also grown over the active role played by Beijing in shaping economic policy[3] and whether tit-for-tat trade measures will continue to define US-China relations in years to come.[4] For many investors, this macro environment has proven too much to handle with some investors significantly underweighting – and, in some cases, fully exiting – their positions in China.[5]

Figure 1. Breakdown of Americans' opinion of China



Source: Comgest, PEW Research Center. Note: Those who did not answer not shown. Survey of U.S. adults conducted 20/26-Mar-2023.

[1] Li, Xiangyuan, and Haizheng Li. "The COVID-19 Pandemic's Impact on the Chinese Economy." China Research Center, 4-May-2023.
[2] Yuan, Li. "What a Viral Post on Giraffes Says about China's Fed-up Investors." *The New York Times*, 15-Feb-2024.
[3] Yu, Sun. "US Private Funds Struggle to Cash out from China." *Financial Times*, 15-Mar-2024.
[4] Bremmer, Ian. "How China Chooses to Deal with the U.S. Election Will Have Massive Implications." *National Post*, 8-Aug-2024.
[5] Mark, Jeremy. "China's Stock Market Collapse Is the End of the Road for Many Foreign Investors." Atlantic Council, 21-Mar-2024.

Despite these macro challenges, our Comgest China Equities strategy continues to unearth quality growth opportunities. Market commentary involving China often focuses on politics and geopolitical competition over company fundamentals. As long-term, quality growth investors, we seek companies with competitive advantages, high barriers to entry and pricing power that we believe makes them capable of sustainably growing their earnings.

Based on our experience, these companies are typically well positioned to face macro challenges and benefit from long-term secular growth trends. In China, we believe that there are several growth opportunities related to the country's transition from an export-driven economy to one driven by domestic consumption. As the world's second-largest economy, China continues to offer innovative, world-leading companies operating across a wide variety of sectors, from green technology to retail brands.

CHINA'S STIMULUS SAVIOUR?

With growth slowing due to a property crisis, local government debt, weak demand and unemployment, the Chinese government unleashed its largest stimulus plan since the pandemic.[6] Announced by government leaders at the end of September, the package includes cuts to the country's benchmark interest rate and establishes a lending pool to support the equity market. The coordinated policy response by the People's Bank of China, the National Financial Regulatory Authority and the China Security Council also reduced the minimum down payment for housing purchases and existing mortgage rates, which were lowered for the first time.[7]

Markets reacted swiftly to Beijing's initial support package. Chinese stocks experienced their best week of performance since 2008. The MSCI China index of large- and mid-cap sized companies rallied 28% between 23 September and 2 October, accounting for most of its +36% year-to-date performance.[8] Much of the rally was fuelled by bets on what sectors of the Chinese economy would benefit the most from the new stimulus package. Investors used this as an opportunity to shift away from traditional state-owned enterprise sectors, such as banks and telecom companies, to the more private-sector industries of healthcare and consumer retail.[9]

Since then, the Ministry of Finance announced that it would raise the debt ceiling and issue bonds to help local governments buy back idle land and unsold housing inventory.[10] The government also detailed plans to issue special-purpose bonds aimed at providing banks with more capital so that they can lend more.[11] In our view, these policies will likely create a base to support the ongoing deflation cycle. Despite recent market volatility, we believe there are still long-term growth opportunities in China.

[6] Inman, Phillip. "China Unleashes Boldest Stimulus in Years to Boost Ailing Economy." *The Guardian*, 24-Sep-2024.
[7] Hoskins, Peter. "China Unveils Raft of Stimulus Measures to Boost Flagging Economy." *BBC News*, 24-Sep-2024.
[8] Source: Comgest/FactSet financial data as of 8-Oct-2024.
[9] Rovnick, Naomi. "Global Investors Gear up to Go Back into China." *Reuters*, 1-Oct-2024.
[10] Suzuki, Wataru, and Stella Yifan Xie. "China's Finance Minister Says There Is 'large Room' for Fiscal Stimulus." Nikkei Asia, 12-Oct-2024.
[11] Cheng, Evelyn. "China's Ministry of Finance Is Taking Aim at Local Debt Problems before Tackling Broader Economic Challenges." *CNBC*, 14-Oct-2024.

WHY CHINA?

> In our view, investors may lose sight of potential growth opportunities by focusing too much on the macro risks associated with China.

While Comgest is cautiously optimistic about Beijing's stimulus, this announcement does not change our long-term investment strategy. In our view, investors may lose sight of potential growth opportunities by focusing too much on the macro risks associated with China.

China's investment landscape has always been complex and notoriously hard to predict. Since 1978 when the country started its economic reforms and opening-up, GDP growth has averaged 9% per year, lifting almost 800 million people out of poverty.[12]

Few predicted 40 years ago that China would transform itself from a largely agrarian command economy into the world's second-largest economy with several of the most innovative and recognisable global brands.

When it comes to China – or any market for that matter – there is no crystal ball to reveal how the market will respond to stimulus announcements, GDP growth forecasts, inflation, or monetary and fiscal policy. Rather than spending our time predicting China's highly unpredictable macro environment, we tend to focus on what matters to us the most: company fundamentals.

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Beyond the prevailing headlines about China's demise, we have observed encouraging trends from the companies that comprise our Comgest China Equities strategy. In recent years, China's global export rate increased from 13% during the 2018 US-China trade war to 15.7% during the COVID-19 pandemic.[13] Today, China's export rate has remained consistent at around 15%.[14] While exports to the US have declined, China has expanded its export market globally, particularly in sectors such as electric vehicles, lithium batteries, solar cells, furniture and home appliances.[15]

Despite investor concern over domestic consumption, there are several sectors that have experienced growing consumption since the start of the year. During first nine months of 2024, electric vehicle sales in China have surged by 35% year-on-year[16], while air conditioner and washing machine sales both rose by 11%.[17] Excavator sales also saw a 21.5% year-on-year increase as of September, signalling that construction projects could be experiencing a rebound.[18]

LONG-TERM TRANSFORMATION

The companies that comprise our Comgest China Equities strategy have already weathered many of the macro challenges facing China.

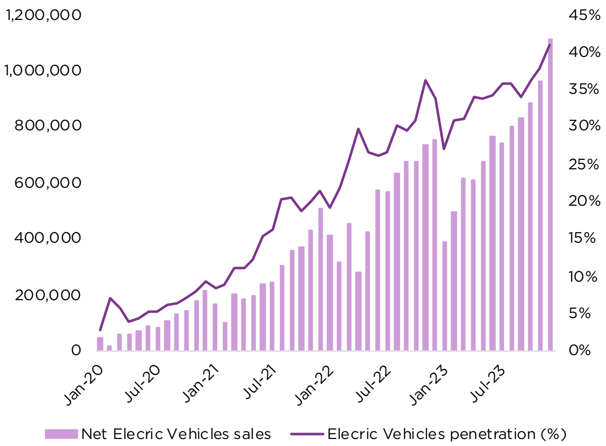
We look for companies that have built deep competitive advantages based on longevity, visible growth, robust free cash flow, barriers to entry and a strong corporate culture. In our view, these companies tend to be well positioned to overcome short-term volatility and grow over time. Our strategy typically avoids sectors that are more susceptible to macro-

12 "China Overview," World Bank, April 2024.
13 Source: Comgest, Haver Analytics, IMF
14 Source: Comgest, Haver Analytics, IMF
15 Leahy, Joe. "Chinese trade rebounds on electronics and exports to Russia." *Financial Times*, 7-Mar-2024.
16 Source: China Passenger Car Association
17 Source: ChinaIOL
18 Source: China Construction Machinery Association

economic twists and turns and instead focuses on sectors with long-term secular growth trends.

Many of these trends can be tied to China's transition from an export-driven economy towards a more domestic consumption-based model. After nearly four decades of export-fuelled growth, China has established an enormous domestic market of 1.4 billion people featuring an abundant middle-class with high savings and rising wages.[19] In our view, there are several undervalued quality companies with deep-rooted competitive advantages that are well positioned to benefit from this domestic consumption.

Figure 2. Electric Vehicles Sales Volume



Source: Flight Master and Goldman Sacks estimates. Latest data as of 28-Jan-2024, 7-day average.

We believe that China's inward-facing transition, which we refer to as "Transformational China," is poised to unlock several long-term growth opportunities across many consumer categories, including sportswear, travel, home appliance, gaming, and electric vehicles (as shown in *figure* 2). The consistent investment in innovation and strong entrepreneurship designed to boost domestic production efficiency is likely to serve as a catalyst for companies operating in key industries, like automation and healthcare, and semiconductor in the coming years.

A SIGN OF THINGS TO COME?

Despite initial enthusiasm about the stimulus, Chinese stocks dropped after reopening from a week-long public holiday on 7 October.[20] Investors were anticipating additional stimulus measures, but as of the writing, Beijing has not signalled any additional fiscal spending to boost markets. During a press conference on 8 October, NDRC chairman Zheng Shanjie reaffirmed the government's confidence in achieving their full-year economic growth target without announcing any additional stimulus measures.

We anticipate that Chinese markets will continue to experience ups and downs in the coming weeks driven by investor expectations over potential stimulus measures. At Comgest, stimulus speculation will not keep us up at night or cause us to reconsider our patient approach. As bottom-up, quality growth stock pickers, we prioritise long-term growth drivers and company fundamentals over short-term market fluctuations.

Geopolitical tensions, real estate woes and stimulus measures are likely to continue to grab headlines and the attention of short-term investors. In contrast, we tend to ignore any hype around macro developments or government policy, preferring to remain steadfast in our long-term, responsible investment approach. Moving forward, we believe that the "Transformational China" story will continue to present world-leading companies with innovative products and services. Investing in China not only opens doors to these innovative companies but also enhances portfolio diversification, mitigating risks associated with market volatility.

[19] Jun, Zhang. "How China Creates Its Own Market: By Zhang Jun." *Project Syndicate*, 4-Dec-2023.
[20] "China's stock rally hits Speed Bump as investors await more stimulus." *Reuters*, 9-Oct-2024.

With this perspective, our priority remains clear: identify the quality growth opportunities that rise above the noise of macroeconomic headlines and trends. Leveraging our on-the-ground expertise in the world's second largest economy, our focus is capturing the opportunities that we believe can deliver the sustained, long-term growth investment approach that Comgest seeks for all of our clients.

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- Investing involves risk including possible loss of principal
- The value of all investments and the income derived therefrom can decrease as well as increase
- Changes in exchange rates can negatively impact both the value of your investment and the level of income received
- Because the portfolio invests in a single country, its performance could be more volatile than the performance of more geographically-diversified portfolios
- The portfolio invests in limited number of securities and may therefore entail higher risks than those which hold a very broad spread of investments
- Emerging markets may be more volatile and less liquid than more developed markets and therefore may involve greater risks
- Investing directly or indirectly (through participatory notes or low exercise price/call warrants) in China A-Shares involves additional risks.

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