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Asian takeaways

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"The World Bank recently raised the country's growth forecast for 2024 to 4.8% on the back of economic bright spots, including strong exports and increased manufacturing and infrastructure investment."

Our last few visits to China, since the start of the year, have exposed a story of two halves. Reflecting on our learnings from years of investing in the region, we re-iterate that when it comes to China's equity market, things are never as good as they look, but also never as bad.

The first half of the story is the narrative that is widely reported of China's economic slowdown, negative consumer and investor sentiment, and a crumbling property market. The second half, which very much lies in the shadow of the former, is of China's continued relevance in a global context when it comes to contributing to global growth, and its ongoing importance in international supply chains. The World Bank recently raised the country's growth forecast for 2024 to 4.8% on the back of economic bright spots, including strong exports and increased manufacturing and infrastructure investment[1].

On the ground, there is evidence of both. Travelling around Beijing and Shanghai in April, it was encouraging to witness a genuine sense of energy. The streets were bustling with cars, bikes and pedestrians, and restaurants and coffee shops had no shortage of patrons. However, as we travelled further out of the city centres, half-finished large scale building projects were a stark reminder of the ongoing property crisis, which has sent ripples across various industries and the economy as a whole.

Meetings with corporates echoed this duality, with management teams overall bearish on the country's macro trends but indicating areas of more resilient demand. This was particularly evident during our attendance at a Shanghai-based conference in June, where pockets of positivity in sub-sectors such as international travel and shipping, as well as areas such as exports, are helping to balance weak spots elsewhere in the market.

[1] World Bank Group, 14 June 2024.

The domestic landscape

On the back of a weak property market, culminating in a negative wealth effect and deleveraging across the sector, domestic consumption remains sluggish. Sentiment continues to be weak and needs more time to recover, although we have not yet written off the possibility that we could see a bottom to this this year. However, even in this environment, we are seeing resilience in certain areas.

Pioneering Chinese tech names, for example, have continued to hold up well despite broader macro issues, growing via disruptive innovation and benefitting from a lack of correlation to property prices (Figure 1).

Discussions with tech companies during our visits pointed to increased demand against this challenging backdrop, leveraging broader macro headwinds in order to grow penetration. An online headhunting platform, by way of example, indicated its ability to grow market share in a more volatile business environment, whilst a property transaction and services platform pointed to the hedging effects that its business model has from a property downturn; the worse the market, the more property developers need help from this type of platform to sell.

Certain pockets of consumption have also demonstrated more resilience, namely experience-based consumption. Dining and travel have witnessed a more robust recovery since China's reopening, something that it is easy to see first-hand whilst travelling around the country.

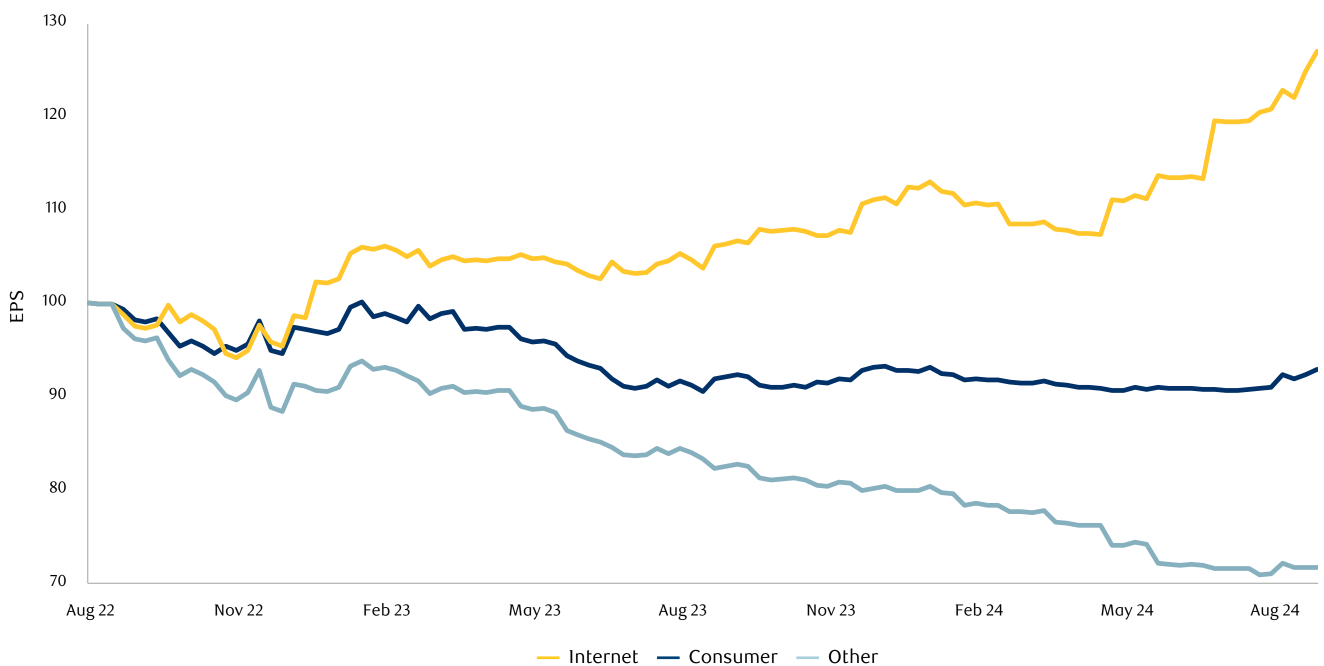
Despite being off-peak, we saw decent shopper traffic looking for bargains on everyday staples in Shenzhen.

A recent visit to Shenzhen demonstrated the draw that mainland China poses for Hong Kong residents in the current environment. We noted an influx of visitors from Hong Kong, looking to maximise on cheaper prices, namely in restaurants, a trend that we would expect to accelerate on the back of any further yuan weakness.

Meetings with travel companies seemed to support this narrative, with businesses in this area experiencing strong demand for both internal domestic travel, and international travel within Asia. Indeed, for mainland China residents, the recent popularity of domestic travel has been so strong that consumers are looking further afield for their trips in order to find cheaper options, as prices within the country for flights and hotels have been driven up.

Figure 1: Tech companies have witnessed earnings strength against broader market weakness

MSCI China sectors 2024 EPS consensus: index-weighted EPS evolution



Source: IBES, MSCI, Datastream, UBS, as at March 2024.

Exports in an evolving global market

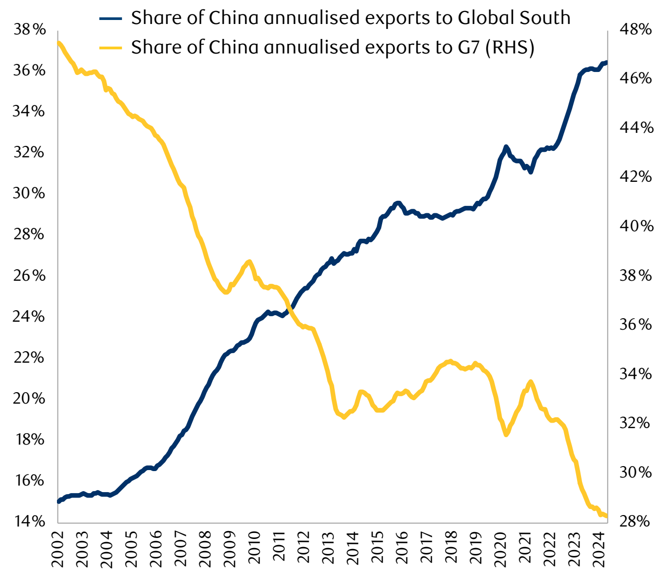
Beyond the brighter spots that we are seeing for China's domestic market, exports have also been surprisingly strong year-to-date. This is particularly interesting in the current global context of the move towards "China+1", as international businesses look to diversify supply chains away from the country.

There are notable headwinds for China's export market in the form of geopolitical tensions and the impact of the upcoming U.S. election, however it is interesting to note that the country's export strength is becoming increasingly less reliant on the U.S. and other G7 countries (Figure 2). The Global South is now responsible for over 35% of China's total exports, whilst G7 countries have reduced their share to around 28%.

We have also seen China's manufacturing trade surplus with countries beyond the U.S. increase between 2019 and 2023, including markets such as Mexico, and ASEAN where the trade surplus almost doubled over the period[2]. What this tells us is that, whilst the U.S. has been reducing its share of imports from China and looking to diversify across other markets, the markets in question are increasing their own trade with China and becoming more economically dependent on the country. This offers support to China's export market, and we would expect this to continue in the current macroeconomic environment.

Industries such as machinery and electronics, particularly high-tech products, have been drivers of this export growth in the first half of 2024[3]. China's unique scale, supply chain strength, and competitive domestic market have helped industries such as these to bolster productivity and increase global market share, with China's annual investment in advanced manufacturing (or "new productive forces" as named by Xi Jinping) reaching USD1.6 trillion. This now equals one-fifth of all investment in the country and is double what it was five years ago, in nominal terms. This new figure is equivalent to 43% of all business investment in America in 2023[4,5].

Figure 2: China's exports are growing with or without the U.S.



Source: CEIC Data, General Administration of Customs, Jefferies, as at April 2024. Global South = ASEAN, Africa, Latin America, India, Pakistan, Saudi Arabia, UAE and Turkey.

> **"We have also seen China's manufacturing trade surplus with countries beyond the U.S. increase between 2019 and 2023."**

The widening trade surplus also points to a shrinking import market, and whilst some of this must be attributed to weaker consumption, localisation efforts are also likely playing a part. High quality businesses are emerging across sectors and can compete with global peers on product quality and price, whilst offering the edge of more readily available product or customer servicing, when compared with their international competitors. We met with one such company in the healthcare space that manufactures state-of-the-art medical equipment and is a strong competitor in the domestic market, alongside global players such as Siemens and GE Healthcare.

"Kicking the tyres" at a mechanical parts company site visit.

Cutting edge medical equipment designed and manufactured in China offers a competitive local alternative to global brands.

[2] ITC, Comtrade, June 2024.
[3] China Customs, WIND, Macquarie Macro Strategy, July 2024.
[4,5] The Economist, Xi Jinping's misguided plan to escape economic stagnation.

China's "overcapacity"

Hand-in-hand with discussions on China's export market comes the question of its "overcapacity", a strongly debated topic, perhaps in part fuelled by U.S. Treasury Secretary, Janet Yellen, calling for the U.S. and Europe to respond to the country's industrial overcapacity in a "strategic and united way"[6].

As there is no ultimate measure of overcapacity, it can be hard to quantify, but if we look closely at the data, there is certainly some evidence of this. For example, industry utilisation rates in China today are near its historical lows of 2015-16 (Figure 3), and inventory levels have not yet recovered to pre-pandemic levels (Figure 4), likely exacerbated by overall weakness in the economic cycle, as well as soft domestic consumption.

> **"Industry utilisation rates in China today are near its historical lows of 2015-16, and inventory levels have not yet recovered to pre-pandemic levels."**

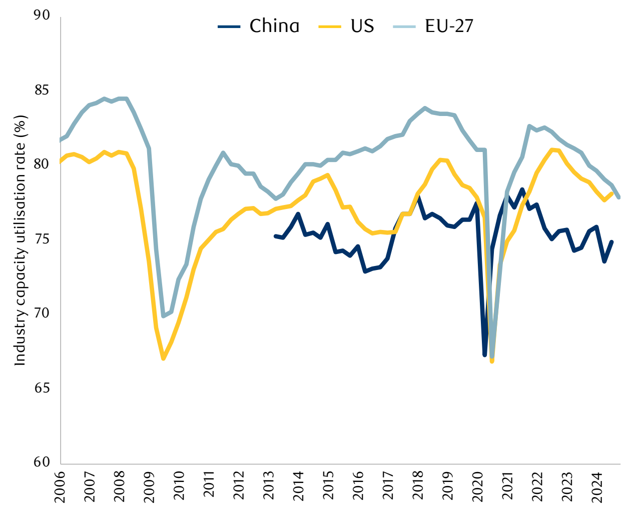
The auto industry is a notable example that has come under fire for overcapacity problems, with some estimates indicating that its utilisation rate is well below the average, at just 65%[7]. Interestingly, whilst government policies have likely led to overcapacity in industries such as steel and solar, where state-led efforts play a greater role, for the auto industry, foreign mass brands and EV startups (including Li Auto, Nio, and Xpeng) appear to have been the major drag on industry utilisation rates (Figure 5).

Test driving new models from one of China's auto manufacturers.

[6] Reuters, *Yellen pushed for joint G7 response to China's industrial overcapacity*, 21.05.2024

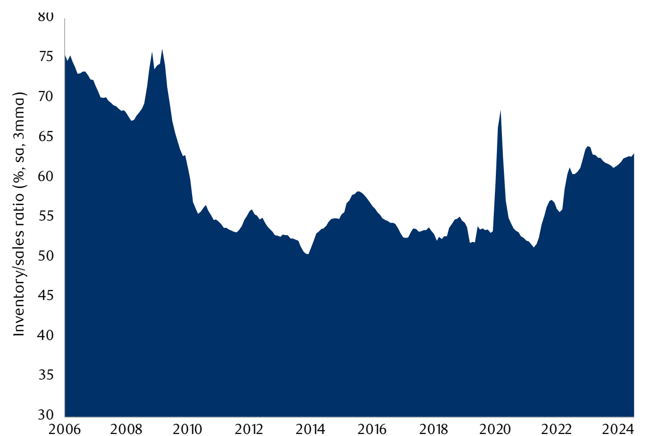
[7] UBS, China *EV Sector: the overcapacity myth*, April 2024.

Figure 3: China's industry utilisation rates are nearing historic lows



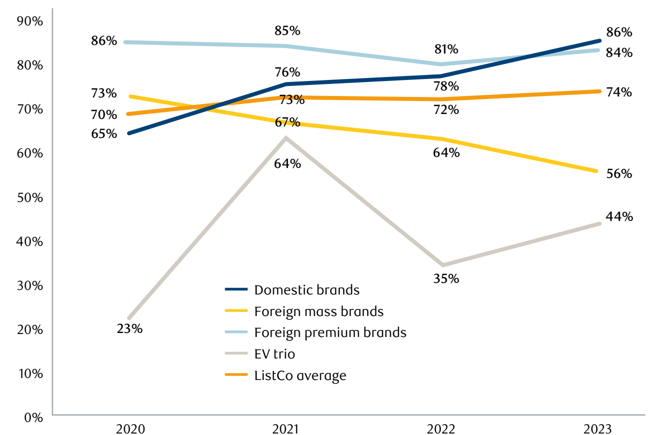
Source: CEIC, UBS estimates.

Figure 4: Inventory levels also point to evidence of an overcapacity problem



Source: CEIC, UBS estimates.

Figure 5: Utilisation rates across the auto industry



Source: Company data, UBS Research. EV Trio refers to Li Auto, Nio, and Xpeng.

In spite of the apparent problems here, China's auto industry continues to be highly competitive, and is another significant contributor to export growth. Visiting EV and EV parts companies in March this year, it was clear that the domestic market for both remains intense, with companies outcompeting not just on cost but also on product (we explore this further in our note China's clean, green electric machines on page 17 of our ESG Report). This fierce competition in the domestic market is driving innovation and, in turn, leading to competitiveness in the overseas market. Indeed, China has recently overtaken Japan to become the world's top auto exporter in 2023, and close to 10% of China's total trade surplus comes from this industry[8].

"Trade war 2.0"

However, even with these pockets of strength across exports, another major global event on the horizon is creating further uncertainty for China's recovery and overall economic health – the U.S. election.

Whilst the outcome of the election remains uncertain, the possibility of another trade war feels more likely regardless of the results. Higher tariffs, potentially in the realm of 50-60%, seem to be a bipartisan priority for both Harris and Trump, and whilst China's share of U.S. imports has come down significantly since the "trade war 1.0", contributing 13.9% share of U.S. imports in 2023 compared to 21.6% in 2017, it continues to run a material trade surplus with the U.S.[9].

Given that China is likely to continue pushing manufacturing and exports as its main growth engine, a conflict with U.S. trade policies appears inevitable and imminent. That said, for bottom-up investors such as ourselves, we continue to see opportunities against this environment.

We're seeing export-oriented Chinese firms looking to relocate plants offshore to ASEAN or Mexico, a trend that we would expect to accelerate moving forwards. By way of example, Shenzhou, the largest apparel supplier to Nike, Adidas and Uniqlo, now has 52% of its production outside China, and continues to build out its global footprint and ability to move up the value chain[10].

However, this approach will not suit companies across the board, and it doesn't offer protection in the instance that the U.S. raises tariffs more broadly across other nations alongside China. It also poses the likelihood of higher production costs for most industries as component sourcing and overall supply chain efficiency becomes less streamlined. What we may see as a result is industry consolidation as a weak economy and necessity to relocate plants places pressure on certain companies.

However, it simultaneously emphasises China's continued edge and integrity in the global supply chain when it comes to cost advantage and resource availability. Regardless of changes in global trade relations, we believe that China's manufacturing industry will continue to remain relevant and should not be dismissed.

What's next for China?

China still has a long road to recovery, but we believe that the changes in global dynamics will help the country to reconfigure its growth model. Whilst it was previously heavily dependent on the property market, the government may feel that the opportunity to become the "world's factory" could reduce the emphasis on this sector, instead doubling down on its commitment to manufacturing and exports. As discussed in this note, this can be to the U.S., but also to the many countries beyond this that are becoming beneficiaries of "China+1".

"Whilst we cannot predict what will happen over the coming months, we are focused on strengthening out our portfolio's positioning against any outcome by investing in high quality businesses."

In addition, whilst domestic demand continues to lag, localisation and self-sufficiency will become more of a focus, and in light of this, we would expect China's trade surplus to widen.

As bottom-up stock pickers, this environment creates select but compelling opportunities. Whilst investor sentiment remains muted, we're seeing high quality companies with decent growth rates being punished alongside the broader negative macro narrative. This creates attractive entry points, particularly in areas of resilience, as well as those that we would expect to succeed in the evolving global landscape. Whilst we cannot predict what will happen over the coming months, we are focused on strengthening out our portfolio's positioning against any outcome by investing in high quality businesses across structurally winning industries. We believe that patience will be crucial for investors in the region, as the coming months unfold.

[8] NBS, CEIC, Citi Research, as at December 2023.
[9] US Census Bureau, Citi Research.
[10] Company report.

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