China: The Investing Story Unfolding Before Us

In China, iconic investor Warren Buffett is known as the "god of stocks" and his image has adorned everything from mouse pads to phone cases. China's equity market is one of the world's largest by volume and total market capitalization. Yet China-listed stocks have remained largely a world apart for individual foreign investors. That's changing. Manraj Sekhon shares his thoughts on the big themes and bottom-up opportunities that are part of investing in China today.

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Q: What's your sense of the current investment landscape?

Manraj Sekhon: There are many drivers around Chinese equities right now.
For instance, we've been through a phase where the general backdrop has been positive, driven by the cyclical pickup in developed economies, particularly the United States. Within China, we've seen strong growth in some new-economy businesses such as information technology and consumer services. The generally easier monetary backdrop of the last few years has also helped. Obviously, that situation is reversing given the US Federal Reserve's interest rate increases.
We've also seen tightening domestically as China's authorities are pressing on the shadow-banking sector with its risky products and imprudent lending. Last, but not least, we have US-China trade tensions.

Q: What are your thoughts on the latter?

Manraj Sekhon: We've been struck, by what appears to be, the surprising flip-flopping out of Washington. The United States targeting China for perhaps more tariffs seems strange given the seemingly positive resolutions that took place in May.
From our vantage point, there are two main effects. One is obviously the short-term trade effect in terms of goods and services. The revenue impact, based on those Chinese products targeted by US tariffs as of June, is estimated to be 1.0% to 1.5%.

What's less clear is the indirect effect. As these measures potentially extend, what's the impact on trade between China and the rest of Asia? What's the impact on the industrial value chain to China and the pass-through implications for smaller companies? That's more difficult to ascertain. Lastly, there's the larger question: What do recent actions mean in terms of US-China political relations?

Managing portfolios in this time of unease, we try not to be overly influenced by short-term news. We focus on the fundamentals of businesses over the medium to long term. In a nutshell, we're watching the unfolding China-US situation closely, but it's currently not changing a lot of what we're doing.

Q: By October, over 230 large cap China-listed A-shares will be included on MSCI's benchmark Emerging Markets Index.[1] It's a first for MSCI and other indices providers have announced similar plans. How important is this transition?

Manraj Sekhon: Symbolically, it's very important. It's endorsing a lot of work that's happened in China in terms of transparency, improving corporate governance and improving foreign investor accessibility to their capital markets. Using MSCI's recent move as an example, the universe of investable companies will be much wider and a larger portion of the economy will be so-called Asian companies.
Indices providers are signalling their willingness to begin integrating Chinese companies into the world market.

A-share additions currently represent a small weighting in the MSCI Emerging Markets Index. But, keep in mind that

1. Sukumar Rajah, "Chinese A Shares Get MSCI Nod," Franklin Templeton Investments, May 30, 2018, http://emergingmarkets.blog.franklintempleton.com .

when institutional investors—pension funds, endowments and exchange-traded funds—"track" the index, China-listed stocks will be part of the mix. To give you a sense of scale, if the total A-share market were to be included at 100% market capitalization (as opposed to the current 5%), China would represent over 40% of the MSCI Emerging Market Index, at today's levels.[2] Will this happen overnight? No, but it's something to consider.

We're already seeing rising foreign capital inflows from the Hong Kong Stock Exchange to onshore China. The number has reached US$36 billion thus far this year as compared to US$30 billion in all of 2017. Investors have anticipated this shift and have already put the opportunity into play. We expect a lot more foreign capital to flow into China.

Q: Where are you finding opportunities?

Manraj Sekhon: We're seeing a lot of interesting opportunities in the broad technology space as e-commerce expands, and as services targeting increasing affluence among China's consumers grow. We're also seeing attractive valuations and strong growth related to consumer spending, especially in the automotive sector. We think there's a lot of long-term opportunity in some automotive companies in China.

Q: What's your sense of valuations?

Manraj Sekhon: Following the correction of the last few weeks, Chinese equities are looking pretty attractive. This trend will likely continue at least until the end of summer as people assess how long this episode of trade tension will take to play out.

Q: How do you view China's One Belt One Road megaproject, bolstering transportation infrastructure linking countries in North Africa, Europe and Asia?

Manraj Sekhon: It represents a long-term strategic political objective, involving immediate regions around China and further afield. With some countries, the aim is to build stronger economic interdependence with China. With others, it's to encourage economic dependence. The meaningful build-out of infrastructure and trade on the network will be played out over the next 10 to 15 years. From a public market perspective, we expect the short- to medium-term impact will be limited. Some unique companies in the private space will have positive exposure to the One Belt One Road project. Those are opportunities we'll look at over the next few years.

Q: Some investors own multinational company stocks as a way of participating in emerging markets. What about investing directly in China-listed firms?

Manraj Sekhon: An investor's approach hinges on their specific risk/return appetite. Many US multinational companies, for instance, have exposure to China. However, it's generally low relative to their exposure to the United States, Europe and Canada. For example, let's say 15% to 25% of a multinational's business is in China. It's not a given that their stock returns will reflect China's growth in that particular industry. It's important that return expectations reflect this reality. In my view, any investor truly wanting exposure to China should consider having direct exposure. That's where it's possible to see the most attractive return outcome for the risk assumed. As with any part of the world, there are some very well run and some poorly run companies in this market. An effective investment partner can help access attractive opportunities; however, China should be viewed on a long-term time horizon. It's not a one-, two- or three-year situation.

Q: What should investors keep in mind as China evolves?

Manraj Sekhon: In the '70s and '80s, many people viewed Japan as part of Asia. However, as Japan evolved into an economic powerhouse, there came a time when it warranted being treated as a stand-alone market. We're seeing some sophisticated institutional clients thinking about investing in China on a stand-alone basis. It's not happening yet, but it's a real consideration. Franklin Templeton Investments has a distinct history of investing in China and we're increasing our resource allocation to research and investing in the region.

China's impact on our lives—whether in terms of your portfolio, growth and trade, and geopolitics—is significant. And it's only going to increase. As complex and faraway as it may seem, I urge investors to be careful not to dismiss what's happening in China.

2. Rajah, "Chinese A Shares Get MSCI Nod."