Innova Market Insights

Equity Associates Inc.

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Issue #40 – "From 'Made in China' to 'Bought in China'"

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"When our thousands of Chinese students abroad return home, you will see how China will transform itself."
- Deng Xiaoping

In 1979, the 'Great Reformer' Deng Xiaoping took the first major steps in converting the communist-style, centrally-planned economy of China into a market-driven one. Thirty-six years later, some would argue that the Communist party still retains its inept grip on the Chinese economy. However, few can doubt the free-market clout of the Middle Kingdom after the recent announcement of the planned inclusion of the Renminbi (RMB) into the International Monetary Fund's "basket of reserve currencies".

This basket, formerly called the Special Drawing Rights or XDR currencies, form the backbone of the world economy. Savings in these currencies are seen as the non-gold foreign reserves for a country's central bank. Impressively, the RMB will make up 10.92% of the basket, with 41.73% going to the US greenback, 30.93% for the Euro, 8.33% for the Yen, and 8.09% for the British Pound[1]. Between them, the Euro and the Pound gave up the largest portion of their weightings, due in large part to the perceived instability of the Euro and the falling importance of the British economy.

With the growing importance of the Chinese economy, the inclusion of the Renminbi will have important ramifications on world trade. China will no longer need to exchange funds to a reserve currency before engaging in material trade with other countries. If 1979 was the birth of economic reforms in China, it has just received its driver's license as it enters into its teenage years.

China's rise as a global economic player has been nothing short of formidable. Over the last 35 years, over 440 million[2] people have made the move from a rural (farming small plots of land) to urban (city) way of life. To put this into perspective, that means an average daily migration of over 34,000 people per day sustained for 35 years. This is especially striking when we think of the logistic and housing issues that Canadians are facing to bring in 25,000 Syrians over several months.

Accommodating these new city dwellers caused the largest boom in infrastructure building the world has ever seen. High-rises, schools, hospitals, train stations, power plants, shopping malls, airports, and highways were commissioned. Commodities from the world over were brought in to build this rapidly modernising country.

Apart from being the largest migration in human history, this shift also brought important changes to the economic earning power of the new city-dwellers. As of 2013, the working population of China stood at 770 million, approximately 5 times more than the United States[3]. The Chinese middle class outnumbers the entirety of the US workforce and despite their relatively low annual income per person of just under USD$12,00, they have become an economic powerhouse in their own right.

Never has this been more evident than on this past "Singles' Day", the day that the Chinese shower gifts upon the unmarried men of China. Celebrated on November 11th (11 – 11), Singles' Day is a consequence of the one-child policy in China and its sex-selective abortions that ultimately led to an imbalance between men and women. Men now outnumber women by almost 24 million[4], which is equivalent to the population of all the provinces in Canada combined excluding Ontario. Thanks to aggressive marketing from China's Amazon.com equivalent known as Alibaba, that one website alone processed more than 120,000 orders per minute. Their total registered sales exceeded USD$14.3 billion[5] in the 24-hour period, a new record for online shopping.

Despite the drastic difference in consumer spending power, this one website's one day sales tally represents almost half of the total retail sales across Canada for the entire month of November[6], both online and in-person.

Clearly, the shift from the majority of products being "Made in China" to them being "Bought in China" is underway. The transition from a manufacturing and construction based economy to a consumption based one is necessary for the Chinese economic engine to keep up growth and to raise the living conditions of the world's most populous nation. That shift is now well underway. China's total investment in infrastructure is forecast to drop by almost 1% of GDP per year[7], and along with it, the demand for building materials.

What does this mean to you?

The question is how do we, as Canadian investors, profit from this shift? Over the last two decades we were fortunate that the Chinese infrastructure boom led to a commodity super-cycle, which pushed the price of all basic materials well above all-time highs. As a resource-based economy, we were all too happy to oblige by digging new mines and shipping raw materials to Chinese construction sites. The current slack in demand has now caused a substantial oversupply issue in commodities, which has led to the 30% drop in stock prices of the mining sector as a whole.

As "Buffett"-style investors, we at INWB have shied away from investments in companies that cannot price their product and thus guarantee profitability at time of sale. When we remove materials and energy from the Toronto Stock Exchange, we are left with 2/3s of the index, half of which is represented by financials.

If you invest in Canada alone, you are actually missing out on more than 98% of the world's markets. Your investments would also be grossly underexposed to important growth sectors such as healthcare, information technology, and the all-important Chinese consumer!

Despite the weakening of the Canadian dollar, we believe continued over-exposure to the global economy is a key component of a long-term investment portfolio. Furthermore, a modest exposure to the Chinese consumer through direct investment in Chinese companies or, as we've preferred in the past, through multi-nationals with established brands sought by the Chinese consumer will continue to reward our investors with better returns than the Toronto Stock Exchange can produce on its own.

Despite their growth prospects, emerging market equities are currently trading at 30% discount[8] when compared to developed markets. In fact, they've only traded at these Price-to-Book ratios 5% of the time over the past 20 years, which includes the Asian Financial Crisis. For that reason, expect our January allocations to include exposure to these markets for clients who are comfortable with risk and have a long-term objective.

1. http://www.bloomberg.com/news/articles/2015-11-30/imf-backs-yuan-in-reserve-currency-club-after-rejection-in-2010
2. https://en.wikipedia.org/wiki/Migration_in_China
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