TD Greystone Asset Management

China, Playing the Long-view

Macro to Micro

Part One: Compelling Reasons to Look at Chinese Equities

"The stock market is a device for transferring money from the impatient to the patient".

- Warren Buffett

With equity markets ending 2018 on a negative note, the economic outlook for 2019 is mixed as global economic woes heighten, particularly as they relate to China. With a population of over 1.3 billion, China is the second largest economy in the world and has been a significant contributor to global GDP growth since 2001, according to the IMF. In 2001, China's share of global GDP growth was 17%, and the United States was 14%. At the end of 2018, China's share of global GDP growth increased to 28% while the United States declined to 13%. The geopolitical risks facing Chinese equities today could easily dissipate through compromise, as political leaders have acknowledged that global trade barriers aren't productive for any country. Resolution of trade deficits are likely, while more structural issues could be resolved over time. Nonetheless, current conditions seem favorable for long-term investors to invest today.

In our two-part series on Chinese equities, we will address some of the key concerns related to investing in China, such as:

- Why invest now? Is it better to wait for the economy to bottom first?
- How to invest in China using an active management approach.
- TD Greystone Asset Management's approach to investing in Chinese equities.

In this article, Part One, we provide our perspective on the first question related to the Chinese economy and the stock market. We discuss how our long-term positive outlook on Chinese equities remains intact, principally around the Chinese consumer, and how fiscal and monetary stimulus measures will support the economy and the stock market.

In the second part of this two-part series, we will provide an overview of the TD Greystone Asset Management approach to investing in Chinese equities, specifically, A-shares, and discuss why we believe that an active approach to investing in China A-shares is preferred to a passive approach. **Over the 4-year period ending December 31, 2018 our China Income & Growth Fund achieved an impressive 15% annualized return through an active approach while the CSI 300 index return was negative.**

Performance (%)

			Annualized		
December 31, 2018	**1 Yr**	**2 Yrs**	**3 Yrs**	**4 Yrs**	**Since Jan-15**
Greystone China Income & Growth	-14.7	16.0	8.5	15.3	15.3
CSI 300 (Net)	-21.2	-1.3	-7.3	-0.6	-0.6
Difference	6.5	17.3	15.8	15.9	15.9

This figure shows the performance of the Greystone China Income & GrowthFund in C$. Includes cash. Gross of investment management fees. May be subject to rounding. International funds and CSI 300 benchmark performance is net of foreign dividend withholding taxes.

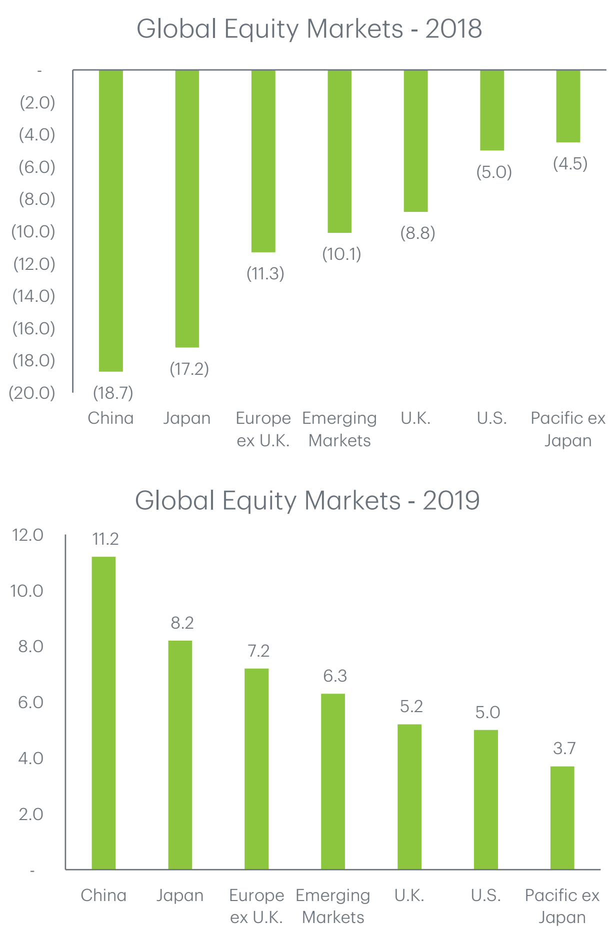
Why invest in China today? Is it better to wait for the economy to bottom first?

We are long-term focused in our investment approach, and we see value in Chinese equities today based on the following:

1. The absolute decline in equity prices over the last 12-18 months (Figure 1);
2. The valuation discount, which suggests sentiment and expectations are low (Figure 2);
3. The lagged effect of fiscal and monetary stimulus measures (and perhaps more to come) should begin to show up in the economic data and have a positive impact on equities; and
4. The continued rise in demand for Chinese equities by foreign investors following the inclusion of China-A shares into the MSCI EM index and MSCI ACWI Index beginning in 2018.

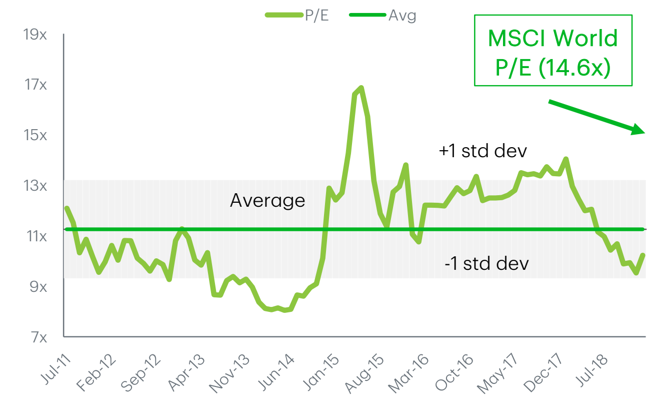
Figure 1: Equity Market Returns (2018, Year to Date Jan 31/2019)

China was the worst performing equity market in 2018 while 2019 YTD it is leading the pack



Source: Global Equity Market Price Returns (2018), YTD price returns (as of Jan 31, 2019). MSCI, FactSet. Net Returns in local currency.

Figure 2: Valuation – Chinese Equities are Trading at a Steep Historical Discount



Source: (JPM Haibin Zhu): MSCI, IBES, Datastream. Sector neutral PE = sector forward PE weighted by current sector weighting. Bloomberg Finance L.P.

Managing the slowdown in growth – fiscal and monetary stimulus

China's total debt began to increase rapidly following the financial crisis in 2008 as the country embarked on an unprecedented borrowing and spending spree, including massive infrastructure projects for brand new cities, and even building entire cities ahead of final demand. The past decade has seen the Chinese economy grow above 6.5% every year, according to the IMF. However, that pace of growth required substantial financing and, as a result, corporate and government debt levels increased over the past decade.

Since June 23, 2018, Chinese authorities have announced various policy-easing and pro-growth measures to manage the economic slowdown caused by the tightening of financial conditions that began in 2017. Announced measures (Figure 3) ranged from reductions in the required reserves banks hold at the central bank, a move that frees up lending for small firms, to personal and small business tax cuts, and infrastructure spending projects.

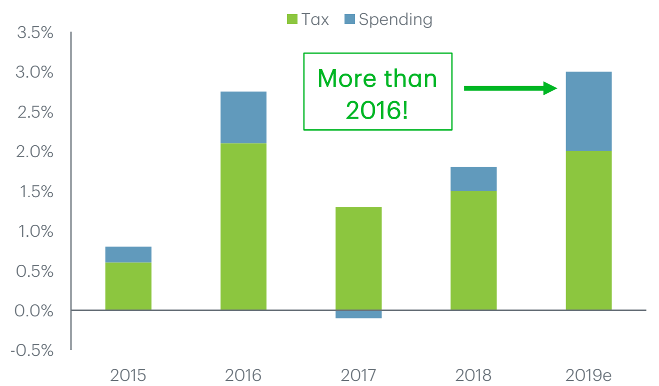
Figure 3: Recent China Easing Moves (June 23 - January 20/19)

1.	Weakened the yuan/dollar
2.	Lower SHIBOR
3.	More liquidity
4.	RRR cut for smal cos.
5.	Relending cut for small cos.
51.	China will cut import taxes on goods
52.	PBOC eased banking rules to make it easier to qualify for lower RRR
53.	RRR cut
54.	Beijing has extended foreign bond issuance for 33 mainland cos through June
55.	Beijing will promote the implementation of foreign investment projects, with the main focus on new energy industry
56.	China approves $125bn of rail projects in fiscal stimulus

Cornerstone Macro LLC, Financial Times.

As of January 31, 2019, the size of China's above-mentioned stimulus announcements, as a percentage of GDP, is larger than in 2016 (Figure 4) which was then more focused on fiscal spending versus personal and business tax cuts. Current stimulus announcements have been measured, with a focus on tax cuts to support employment growth, and consumer spending. We believe that the lagged effects of the stimulus will begin to show up in the near-term data and have a positive impact on the equity market.

Figure 4: China Stimulus % GDP

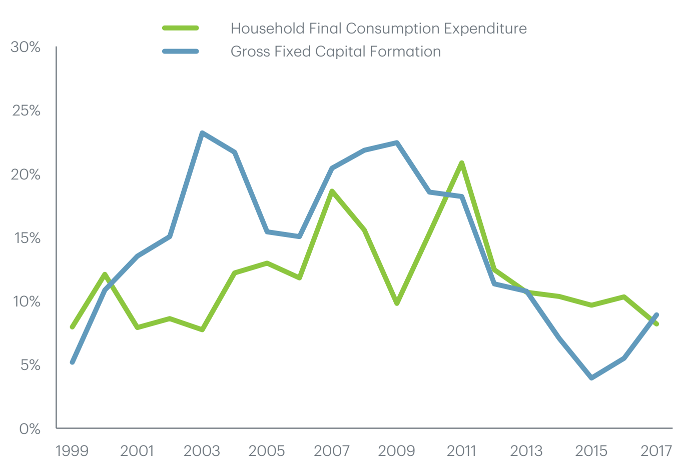


Source: Cornerstone Macro LLC.

Rising Consumerism – a long-term secular growth theme:

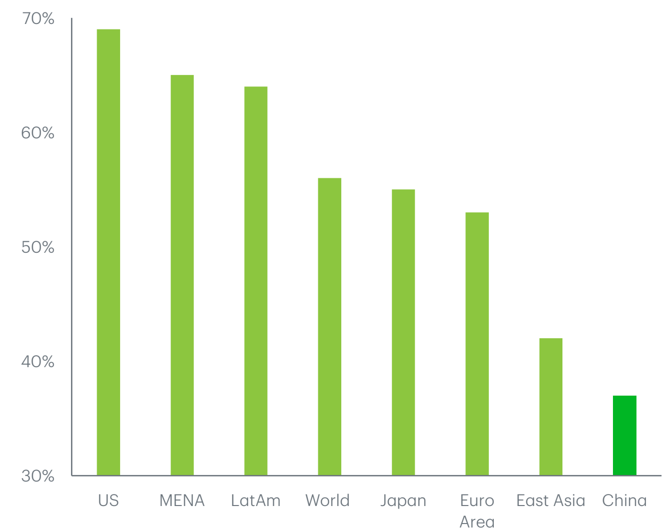
A long-term secular growth theme in China is a burgeoning middle-class that comes with rising prosperity and social mobility, leading to rising consumerism. In this section, we will lay out our thesis for investing in the rising Chinese consumer.

Figure 5: China Real GDP Components



Source: Wolfe Research Portfolio Strategy, China NBS, PBOC, FactSet, and Bloomberg Finance L.P.

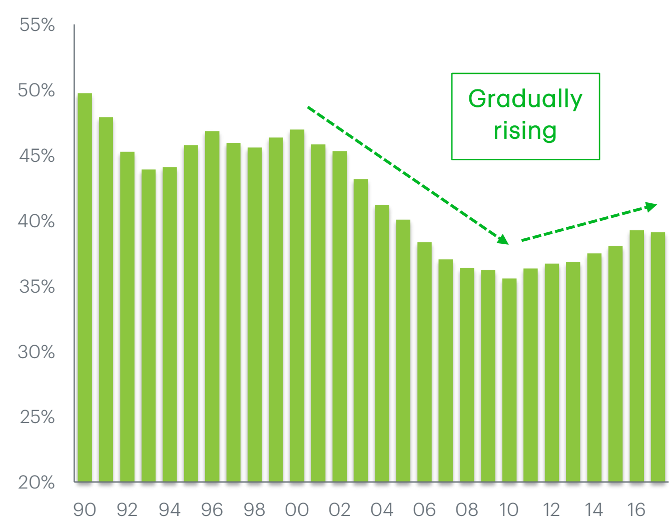
Figure 6: Private Consumption to GDP (2016)



Source: World Bank, JP Morgan.

We see the transformation of the Chinese growth story from investment-driven to consumption-driven (Figure 5) to be in the 3rd or 4th inning given the private consumption gap that exists relative to developed market countries (Figure 6). Following the impact from the financial crisis in 2008, household consumption as a percentage of GDP in China has been gradually rising (Figure 7).

Figure 7: Chinese Household Consumption as % of GDP



Source: Wolfe Research Portfolio Strategy, China NBS, PBOC, FactSet, and Bloomberg Finance L.P.

The “new middle-class” continues to expand:

McKinsey defines the “new middle class” in China to consist of people with annual household incomes of US$16,000–$34,000. This group has expanded rapidly from 100 million people in 2012 to 320 million in 2017, and is expected to increase to 480 million in 2022, according to the Hakuhodo Institute of Life and Living Shanghai based on a McKinsey article, ”Meet the Chinese consumer of 2020”. This new middle-class will drive consumption over the medium to long term, with some economists estimating the consumer economy in China will exceed the consumer markets of Germany or the U.K. The Chinese consumer remains in good shape despite the slowdown in the Chinese economy.

The growth in Chinese household debt over the last decade can be attributed to an increase in mortgage debt, driven by the rising cost of housing commensurate with strong nominal GDP growth. Debt-servicing metrics for consumers remain supportive as employment growth continues to be stable, and household equity remains in good shape as well.

Consumers are the driver of domestic growth, creating 78% of GDP growth in the first nine months of 2018, according to McKinsey. Disposable income growth and consumer confidence will be supported in the near-term by tax cuts and a relatively healthy urban job market. Stability in aggregate employment is a primary objective of the Chinese government. With the continued urbanization of the rural workforce we expect that the government will support private enterprise to ensure that employment growth will remain stable.

Conclusion

We believe China is appropriately managing a growth slowdown through various measures of monetary and fiscal stimuli, which should allow financial markets to focus on the positive long term growth opportunities in China.

In the next part of this two-part series, we will discuss how using an active approach to Chinese equities is preferable to a passive approach, and we detail the TD Greystone Asset Management Chinese A-share strategy.

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