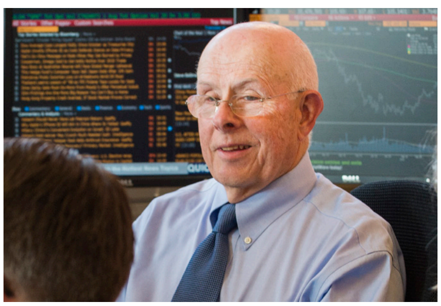
From "Newness" to Elusive Ghost Cities, China's Rebalancing: a Work in Progress

Thornburg Senior Advisor Bill Fries, CFA, recently visited China at what is turning out to be a rather turbulent time, not just amid uncertainty about U.S.–China trade relations, but also a spike in tensions revolving around North Korea. Fries, who launched Thornburg's International Value Fund in 1998, spent nearly two decades investing in China, which has grown into the world's second-largest economy. Today, questions surrounding its economic "rebalancing," growth outlook, and turbulent markets have also grown pressing.



A Conversation with Senior Advisor Bill Fries, CFA

Bill Fries is senior advisor of Thornburg Investment Management. He joined the firm in 1995 as the founding portfolio manager for Thornburg's first equity strategy, and until 2016, he co-managed Thornburg's international equity strategy. Bill maintains his role as investment analyst, providing his knowledge, insight, and experience as he mentors and collaborates with the investment talent at Thornburg. Bill began his career as a securities analyst and bank investment officer. His more than 40 years of investment management experience includes an extended tenure as vice president of equities at USAA Investment Management Company. He is a CFA charterholder.

Q: Where did you go, and how long did you stay in each place?

Bill Fries: Garrett Thornburg, Di Zhou, and I spent three days in Beijing; one in Hangzhou, where the G-20 summit took place last September; three days in Shanghai; and then Di and I traveled for a couple days in Hefei, and two in Kunming.

Q: What surprised you most during your visit?

BF: Well, first, the air in Beijing. It was crystal clear after it had snowed the night before we arrived. You expect that it's going to be smoggy. But that morning, snow was on the ground, the air was clear, and you could even see the mountains to the west and north. It was beautiful weather. Beijing is modern and massive with a few traditional neighborhoods still in place. What struck me is the newness, not only of Beijing, but all the cities we visited.

Q: The newness?

BF: In the major cities the residential construction is vertical; high-rise apartments. In the second-tier cities especially, there was a great deal of construction, mostly residential but also some office and some commercial. In Beijing, the new housing is tied into the metro and the highway loop systems. There are still some traditional gray, single-family structures, ranch-type enclaves with courtyards in the middle and the front door on the street. Property prices in these *hutongs* (narrow streets or alleys) are high.

Q: How was the street traffic?

BF: The traffic was very heavy. What was different for me this time—I hadn't been there in a few years—was the newness of the automobiles and the skill of the drivers maneuvering in the congestion. The cars travel tightly together, not very fast but moving at a measured pace and without many honking horns.

Q: ***Is China now the largest car market in the world?***

BF: It is. Its new vehicle market was 27 million last year. The passenger vehicle new car sales count was around 24 million. The total number of passenger vehicles on the road is around 180 million. That's up from well less than 50 million just 10 years ago. The popularity of SUVs is also noticeable. Half of new car sales in the major cities are SUVs or crossovers.

Q: ***With whom did you meet?***

BF: We met with companies of potential investment interest primarily. Two companies, a lithium-ion battery manufacturer and another developing an electric vehicle (EV), reinforced a view that until the bigger auto companies scale up their EV effort, the targeted 5 million EV industry target will be a challenge.

We also saw a maker of traditional Chinese medicines, Yunnan Baiyao. The company makes a blood-clotting agent. Its facility was immaculate, and so was the company campus. It has taken advantage of its brand franchise to launch a toothpaste product that has been a success, and other consumer products are in the pipeline.

We also met with managements from a number of financial service companies, including a subsidiary of Alibaba. Discussions focused on the wealth management business in China. It currently caters to high-net-worth individuals, but the success of direct-to-consumer online products, like Ant Financial's Money Market Fund, underscores the potential of the mass market.

That said, the mass market potential is handicapped by regulation, which is too light to protect consumers and limiting by restrictions on capital flows. Many high-net-worth individuals already have assets overseas, and Western companies are helping them manage those assets, mainly real estate. Someday, Chinese citizens may be allowed to invest in overseas securities markets more broadly. You already have the Shanghai and Shenzhen Connect, where mainland Chinese can buy Hong Kong–listed stocks. The potential is huge.

Q: ***We hear quite a bit about the risks associated with China's wealth management products. Did you get any sense for how big those risks are?***

BF: I've always been a little skeptical about the form of lending in China called "trusts." They're typically sponsored by a financial institution, but off balance sheet. They allow lending that gets around bank loan/deposit ratio restrictions. Maturities are relatively short, typically just a few years or less. The product may be packaged like a securitization and include funds comprising loans to a number of different borrowers. The concern relates to maturities coming due before project completion on time and within budget. Theoretically, the banks have no obligation. Of course, there is always "extend and pretend," but that isn't healthy either, though it does get the investor off the hook short term. Some of that is going on in China today, especially with state-owned enterprises. Nonetheless, trust paper could end up as liabilities for the financial institutions, depending on what the local courts and government determine if defaults come about.

Q: What types of yields are investors looking for from wealth management products?

BF: Bank yields are essentially homogenous as rates are regulated. A trust product that has a higher return than standard bank deposit rates attracts attention in a high savings environment, like China's. The country's gross national savings to GDP runs around 50%. People there need to put their money somewhere, and products that offer a few more points in yield sell. Higher risk paper evidently sells well if the yield is well above bank saving rates.

But when you have banks creating securitizations that won't be on their balance sheets, you have to wonder about the due diligence and the credit analysis on these products. I'm sure Chinese regulators are aware of the issue.

Q: Are there bigger credit issues in China, beyond wealth management products?

BF: Total credit to the private, non-financial sector is around 210% of GDP, but it's mostly internal debt, not dollar- or foreign-currency denominated. So it's less onerous than for those emerging markets that finance themselves primarily with U.S. dollars.

Q: China has been trying to rebalance its economy from investment-led to more consumption-based growth. How's the progress?

BF: The broadening of the economy is most apparent in the shopping infrastructure and service offerings. Retail malls are similar to those in the U.S., with most of the global brands leasing space. Mall

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traffic at a couple of the high-end malls seemed a little light. Maybe they are experiencing the same impact from online shopping as we see here. On the service side, an example of a convenience offering is a pick-up and drop-off bicycle service. Unlock the bike’s built-in lock with your smart phone and it’s yours to use for a fee payable on your phone. You can leave it anywhere, and people do. Several fast-growing companies are in this business with their bikes identified by color. Yellow and salmon are dominant in Beijing.

Retail price points in Beijing weren’t much lower than here, as near I could tell. In lower-tier cities, prices were lower. Wage rates in China are rising, which is usually a positive for both consumers and retail merchants.

A stock we hold is Yum China, so naturally I had a meal or two in Kentucky Fried Chicken and Pizza Hut. Their locations are as ubiquitous in China as in the U.S. Menus have more variety, though. One we visited was really crowded. I was surprised to get asked for an autograph by some middle-school kids. Why? I have no idea.

So China is making progress on economic rebalancing, especially in the coastal cities and Beijing. There’s not as much construction in these hubs as there was the last time I visited. But there was much more building in second-tier cities. The scale of the second-tier cities, though, is a little bit surprising. These are sprawling cities of seven or so million people.

Q: What about the internal rates of return on the malls? Isn’t Chinese online retail sales growth almost triple the annual total retail sales number, suggesting that the rates of return on the malls might be threatened by online commerce? If they’re developing more malls, is that the sort of low-quality return that malls in the West are now experiencing?

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BF: In real estate, the old saying still holds: “There are three important things: location, location, location.” I’m not sure the malls being built in the second-tier cities are excessive. One mall I visited was a little light in traffic during the work week, but it did have activity.

Q: Did you see any ghost cities? We hear much about the growth of Chinese ghost cities.

BF: No, I didn’t see any ghost cities. I saw things that could be interpreted as a ghost city, until completed. On the periphery of Kunming in southwestern China, they’re building lots of high-rise residences. And when they do it, they do it in scale. It’s not one tower. It’s a complex that might have eight or 10 towers. It may look like a ghost city at the moment, but I hardly expect it to remain unoccupied when finished.

I think it’s the same phenomenon in China that you have in the U.S. Young people in particular want to be in the big cities. China still has millions of people from rural areas migrating to cities. They have to have some place to live. There is pressure on housing from this internal migration. The new folks take over older complexes and the established people move into the new ones. Chinese like real estate for both living and investment, so prices don’t seem to be a bubble.

I also took a train about 150 miles west from Shanghai to Hefei, going through smaller cities and rural areas. I didn’t see anything that looked like a “ghost town.”

Q: Did U.S.–China bilateral trade relations come up in any of your discussions?

BF: One person brought up the fear of U.S. trade barriers. China’s very much in favor of free trade. But it’s not completely free on their end. For instance, luxury automobiles have a 40% tariff if they’re imported. So naturally there’s concern U.S. trade retaliation can undermine Chinese exports, its standard of living, and wealth creation.

And the creation of wealth in China is palpable. When you go to a city of seven or eight million people and you see the new high-rise apartment complexes, glass towers, and luxury cars, like Teslas—and we saw many—you realize there’s been a great deal of wealth created. You can’t create that much value without having people making money, and some a lot of money.

The Chinese certainly have the desire to continue improving their standard of living. And their disposable income is higher than it had been on my prior trips. Lifestyle aspirations are not much different than ours. I think the Chinese are emulating the lifestyles they see in the West, especially the urban professionals have lifestyles much like their U.S. counterparts.

Q: President Xi Jinping’s anti-corruption campaign has been ongoing. It affected Macau, China’s gaming haven. But Macau seems to be bouncing back in terms of gross gaming revenues and other metrics. Is there a shift in the campaign, or was it also a tacit

way for Xi to consolidate power that is now wrapping up?

BF: The campaign certainly impacted Macau gaming, as well as Chinese leisure travel and demand for luxury goods. More Chinese are going to Japan, Thailand, and other Asian destinations rather than Europe. The luxury goods boom of the past decade was fueled in part by Chinese going overseas to access the lower luxury goods prices, especially in Europe. Much luxury goods spending is done while traveling.

But Macau has rebounded, though the client mix is a little different, with somewhat more focus on the mass market rather than on VIPs. I think Macau's VIP market may still be down and that VIPs may be going to other places to gamble. But the only place you can legally gamble in China is Macau. Maybe the VIP market will rebound, but it's unlikely to surpass past peak levels.

Q: What's your biggest worry about China? Anything that keeps you up at night?

BF: Personally, my biggest worry is one man consolidating power, and intimidating all others and other branches of government. In all countries, you want the opportunity for choices or options. If some bad decisions are made, you would like to see some way of unwinding them. Consolidation of power in a single person or group makes that harder to do.

Remember, our standards in the West include an independent judicial system and freedom of the press. The government's priorities in China are more concerned with social stability and economic growth than with individual and personal freedoms, which we tend to favor. At some point there's a price you pay in terms of government control for the individual freedoms that we have in the West. It is not apparent that the governing party in China will change materially any time soon. But our two economies are interdependent, so let's hope for the continued success of the Chinese economy.

Q: Turning to markets, any new investing ideas from the trip that compel further exploration?

BF: We now hold Yunnan Baiyao, the company I mentioned earlier. We reinforced our view on the turnaround at Yum China. And we continue to evaluate other companies we saw. Our visit to a couple of auto dealers was fun and touches several areas of interest for us: batteries, cars, technology. We'll see. For value investors like us, the opportunity is not always in the present.

Q: China's equity markets have been a roller coaster in recent years. This year, they're up. Although Thornburg is a bottom-up investor, what's your outlook for Chinese stock markets broadly?

BF: Barring a North Korean missile precipitating a conflict within the peninsula or a U.S. imposition of punitive trade measures on Chinese imports, I would assume global trade continues to develop effectively and the comparative advantages of China and the U.S. continue to be operative. Valuations are not stretched in China, in my opinion, and in some cases are cheaper than in the U.S and the West more broadly. ■

Important Information

Yunnan Baiyao Group is 1.8% of Thornburg International Value Fund and 1% of International Growth Fund; Alibaba is 1.9% of Thornburg International Growth Fund, 5.4% of Thornburg Developing World Fund, and 0.05% of Thornburg International Value Fund; and Yum China Holdings is 1.6% of Thornburg Developing World Fund, as of 12/31/2017.

Gross Domestic Product (GDP) – A country's income minus foreign investments: the total value of all goods and services produced within a country in a year, minus net income from investments in other countries.

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