Investment Institute

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Investing for a
world of change

Investing in the West in a China-led world

Applying a 'China-lens' to investment analysis

Part 2, chapter 3 of Re-Orientation

Power's perspectives

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Applying a ‘China lens’ to investment analysis

China's rise is one of the mega-trends of our times. Few investors can afford to ignore it.

Applying a 'China-lens' to investment analysis

Every investor's needs are different, but some broad principles apply when considering how China's continued rise could affect the prospects for Western companies and markets. We explore below the key questions investors should ask of Western companies, examine some common China-related themes and influences that are likely to be relevant for many international portfolios, and suggest examples of businesses that may stand a better chance of prospering in a China-led world.

Key questions for investors

Given the changing nature of global trade and the challenge to Western nations that China's rise represents, the key question for investors is 'what should I invest in?', and its all-important antithesis, 'what should I avoid?'. Within this overarching enquiry, there are subsidiary questions:

- What sectors should I invest in, and which avoid?
- Which countries should I invest in, and which avoid?
- Which asset classes should I invest in, and which avoid?
- Will global investing conditions curtail my freedom to choose where to deploy my capital?

A given investor will likely have a unique answer to each of the above, depending on their circumstances, tolerance for risk, ESG (environmental, social and governance) priorities, and willingness to diversify globally.

But with that caveat, here are some general observations with near universal applicability:

Intangible assets are key to value-creation

Much value-creation will migrate from the physical to the metaphysical, from machine capital to intellectual capital. In the West especially, this will mean companies come to be valued more on their intangible assets than their tangible ones; so, broadly services much more than goods. But Asia will not be far behind in this trend. It already has a good number of companies that match this 'metaphysical' characterisation such as Ali Baba, Tencent and SEA*.

Commoditisation will challenge profitability

The production of a wide range of goods will commoditise, meaning that they cannot cover their cost-of-capital charge with their profits. Even services will face intense competition, including from artificial intelligence; so they may start to commoditise too. Don't forget that low and even negative real interest rates are making many Western companies appear profitable: if financial repression were not lowering debt-service payments, these so-called zombie companies would be loss-making.

Conditions will be tough for Western manufacturers

Investing in manufacturing sectors located in the West will become progressively more difficult, unless companies rely on locally-located automated and semi-automated factories.

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* No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided. This is not a buy, sell or hold recommendation for any particular security. For further information on specific portfolio names, please see the Important information section.

The cheap-labour advantage may be unreliable

Investing on the basis of a ‘cheap-labour’ advantage will become more difficult as factories face automation on the one hand and country-hopping driven by labour-cost arbitrage on the other.

Strength at home will give strength abroad

Large domestic markets will confer global competitive advantages. That is, a quasi-protected home-base will, via economies of scale and clustering effects, help reduce base costs. This means products can then be sold abroad at competitive prices (a practice often dubbed ‘dumping’ by the final market). This will be a huge advantage for China.

Brands are at risk

Incumbent brands will be important but perhaps not as bullet-proof as before, especially as Asia’s middle class grows and favours brands more familiar in its part of the world and beyond; Chinese cellphones dominate not only their home market but the African market already.

Be mindful of FX effects

Currencies will be key for investors to consider, especially if the US dollar’s reserve-currency crown starts to tarnish.

Benchmarks will change

Investment indices will see significant weighting changes, particularly with regards to geography, in the coming decade. Broadly, they will shift towards the East at the expense of the West.

> Companies will come to be valued more on their intangible assets than their tangible ones.

Western companies with defensible businesses in the face of a rising China

While China's rise and consequent influence on global trade are likely to present headwinds for many Western businesses, some companies appear better placed to ride the tailwind of Chinese growth. The following are examples of the types of company whose business models may stand them in better stead than their peers.

Philip Morris International: this is a Swiss-based tobacco products company which owns the iconic brand Marlboro outside of the United States. It is the owner of the intellectual property behind the healthier IQOS system which heats rather than burns tobacco. PMI's presence in Asia is strong: 34% of company revenues. However, Chinese sales are minimal: tobacco products there are made and distributed by a state monopoly. The IQOS system may yet bypass – legitimately – this Chinese monopoly.

S&P Group & Moody's: with Western capital flows into China's – and Asia's – capital markets set to accelerate, the independent opinion of a well-established debt ratings' agency from the West will be particularly valued.

ASML: even though China is determined to catch up in all areas related to microchip design and manufacture, the lead established by this Dutch multinational in the field of lithography – especially extreme ultraviolet lithography machines – will be hard for any follower to close in the coming decade.

Booking.com: with its knowledge of Western tourist facilities second to none, this online Dutch booking agency – with its 28m listings – is well positioned to benefit from the boom in overseas tourism emanating from China and East Asia at large.

Estée Lauder: this American cosmetics company – with a clutch of well-known brands – has expanded aggressively online and into Asia. In 2019, Estee Lauder bought cult Korean brand Dr Jart+, inventor of BB Cream.

Agilent: this American healthcare equipment and services company – the world leader in spectrometry – already earns 40% of its revenue from China. Strong in the sphere of hardware in providing analytical instruments, it reinforces its market position with software, services and consumables for the entire laboratory workflow.

Heineken: the Dutch Brewer – leading with the Heineken brand itself – has a significant share of Asia's high-end beer market; Amstel is also one of its 'global' brands. Via Heineken Asia Pacific, it controls 45 breweries in 19 countries in the region, selling over 50 beer brands.

Schwab: With outside investment into Asia's equity markets set to soar in the coming decade, this US brokerage has moved early and aggressively to secure its footprint in the region.

Diageo: this UK multinational is the world's second largest distiller after China's Kweichow Moutai, and the world's largest whisky producer. It owns a number of iconic brands: Johnny Walker whisky; Gordon's gin; Smirnoff Vodka; Captain Morgan Rum; Guinness Beer.

Nestlé: this Swiss company is the world's largest food business. It has a strong presence in the baby food, medical food, bottled water, breakfast cereals, coffee and tea, confectionery, dairy products, ice cream, frozen food, pet food and snack segments. Its biggest brands are Nespresso, Nescafé, Kit Kat, Smarties, Nesquik, Stouffer's, Vittel, and Maggi. It owns 23.3% of L'Oreal of France, the world's largest cosmetics company.

LVMH: Louis Vuitton Moët Hennessy is a French luxury goods company embracing not just the high profile brands in its name: from Cloudy Bay wines to Christian Dior fashion and leather goods; from Givenchy Perfumes to Tiffany watches and Jewellery; from Hong Kong's Duty Free Shoppers retail outlets to Belmond hotels. Its products are pervasive in the cities of Asia.

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Conclusion

As we observed in our 'Re-Orientation' paper, the shift in the gravitational centre of global trade from West to East poses challenges for every trading nation, but above all those in the West that have long dominated international commerce. This does not, of course, make the West uninvestable – far from it. But it will require investors to think carefully about the implications of China's rise, since each nation and industry will be affected differently. With this in mind, we draw four conclusions for investors:

1 Asia will be the factory for the world

Asia is going to increase its domination of 'making things', and of being the factory for the world – though robots will increasingly blur the advantages of its lower-cost labour (perhaps it is not surprising that China is already the largest buyer of industrial robots). Some Western production will remain. But almost by definition, if not small scale and artisanal, it will have to be heavily automated.

2 Services will be key for the West

The West is going to have to increasingly rely on services sold globally to fund imports from all sources, but particularly from Asia as the latter will dominate the production of 'things'. Commodities will naturally be sourced worldwide.

3 Keep an eye on capital accounts

Services aside, the importance of the capital account to finance net deficits on Western current accounts will increase. Typically, this will mean investment capital flowing into Western stock markets. Debt capital will become progressively more difficult to attract if Western bond rates remain artificially low, suppressed by the political necessity of financial repression.

4 Watch for currency effects

For the West, imbalances – if they remain structural to the point of being chronic and cannot be offset by capital inflows – may start being reflected in the exchange rates of overspending countries weakening against those of the surplus countries, particularly those of Asia. The Anglo Saxons (the US, UK, Canada, Australia and New Zealand) could face such pressures before the Western current account surplus-runners (the eurozone, Japan and Switzerland). But if China in particular disrupts the eurozone's current production profile – in aircraft, automobiles, wind turbines, industrial robots and many other industrial spheres – then today's Western current-account surplus-runners might yet join the Anglo-Saxons as chronic current-account deficit-runners and, by so doing, feel downward pressure on their exchange rates.

For more on China's rise, and its implications for investment markets, please visit www.ninetyone.com.

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