Global Asset Management

4 economic trends reshaping China in the year of the Tiger

The RBC Asian Equity team

Celebrations of Chinese New Year – and the opening of the Winter Olympics – may be more subdued than usual as the country manages the latest challenges posed by Covid-19. Nevertheless, 2022 holds promise for the economy and its investors as China takes steps to tackle the structural challenges resultant from geopolitical shifts.

We see four main trends as critical in reshaping China's economic opportunities through 2022 and beyond.

Trend 1
Rising up the value chain

Chinese companies are increasingly emerging as strong global contenders with attractive growth profiles. Those businesses that have made the biggest investments in research and development are better positioned to maintain their competitiveness, by moving up the value chain.

Sectors such as IT and biotechnology, whose R&D spend is over 10% of their respective revenues, are among those to have benefited most.

Damage from the US sanctions against Huawei was deepened by China's limited capacity to produce semiconductor chips. Thanks to a government-backed production drive, however, China's global share of the semiconductor market leapt to 9% in 2020, up from just 3.8% five years ago[1].

Meanwhile, the country's biotech industry has also accelerated its innovation over the past decade and is attracting a growing amount of investor interest. The value of publicly listed biopharma innovators from China soared from $3 billion in 2016 to $380 billion in 2021, according to McKinsey.

[1] Source: Semiconductor Industry Association (SIA). As of 10 January 2022.

Trend 2
Moving capacity offshore

Following the Trump-era tariff hikes, Chinese exporters continue to battle with global supply chain and ports disruption. Those with a diversified production base have fared better – even within sectors hardest hit by the trade war, such as apparel and textiles.

Capacity 'offshoring' has become a key trend for Chinese manufacturers – over 50% of companies with direct exports to the US reported they had moved some capacity outside of China at the end of 2019, according to UBS survey data.

Businesses that relocated capacity offshore have reported offshoring benefits including reduced costs and greater closeness to customers. Fuyao Glass provides a good example. This Chinese auto glass manufacturer now has c.20% of its production base in the US. While the early move was not without its cultural clashes, something laid bare in the Netflix documentary 'American Factory', Fuyao enjoys the largest global market share (28%) in its product segment, and the relocation undoubtedly helped limit damage during the trade war[2].

Trend 3
Driving new growth from traditional industries

2021's regulatory crackdowns may have taken some wind out of the sails of the Chinese tech sector, but the digitalisation of services accelerated by the pandemic looks set to continue unabated in 2022. The government's enthusiasm for rolling out 5G, besides showcasing China's tech prowess, is also seen as a catalyst for boosting productivity.

New forms of offline services are growing too. Within China's thriving logistics market – the largest in the world – delivery services have grown apace alongside the ecommerce boom. Logistics consolidation is gradually taking place and should eventually enable sector leaders to enjoy higher growth with better margins.

[2] Source: Goldman Sachs Research, IHS Global Insight, Company data. As of 14 November, 2019.

Trend 4
A fresh phase of urbanisation

China's last wave of urbanisation has been a key source of productivity growth – equipping the country with a massive mobile workforce, increasing household income and lowering employment. The next phase is expected to see a shift of investment focus, aimed at distributing the benefits of growth more evenly.

Urbanisation 2.0 will target city clusters with higher interconnectivity and join mega-cities by streamlining governance structures into a single structure. China's top-five city clusters already have an average population of 109 million – this could reach 120 million by 2030[3], helping to drive productivity gains.

2021 brought some regulatory shocks for Chinese companies, especially in the tech sector, alongside the continuing global ripples set off by Covid-19. However, seeing the changes being made by Chinese companies and policymakers gives us cause for optimism that the country can overcome its challenges.

Economic growth in 2022 and beyond may be lower than in previous decades, but structural market changes could see equity returns increase in certain sectors. Inevitably, however, the benefits will be unevenly distributed, so investors will need to take a selective approach.

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[3] Source: Morgan Stanley Research: The Rise of China's Super cities: New Era of Urbanization. As of 7 November 2019.

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