Asia Now

2019

INSIDE

ILLUSTRATION BY JON REINFURT

THE CHINA EDITION

China's investment landscape has undergone a dramatic metamorphosis over the past two decades. Within China today, financial markets are increasingly diverse, domestic consumption is rising and innovation plays a leading role in growth. AsiaNow looks at trends on the ground in the world's second-largest economy.

Matthews Asia

China boasts a vibrant, entrepreneurial economy, creating opportunities for investors with a long-term view. Long gone are the days when all you had to invest in were copper, coal and communism. Now, for every internet giant in the U.S., there is a comparable giant in China. Everyday businesses that we recognize instantly at home—insurance companies, sportswear brands, recruitment firms, liquor companies, fast-food chains, car manufacturers, coffee shops and increasingly even pharmaceutical companies—have peers among listed Chinese equities. Other types

Continued from Page 1

of businesses that can be found in China's equity markets include online dating apps, recruitment platforms, peer-to-peer lending platforms and private express parcel delivery services.

Yet despite this evolution, China has never really been taken seriously as a part of global investor portfolios—certainly not as much as it should, given the size of the opportunity. This is due in part to fear of the unfamiliar and also for good, but largely outdated, reasons.

I remember when I embarked on my investment career in China, based out of Hong Kong, and visited my first Chinese companies in the 1990s. There was the textile factory tour, where the machines were not even plugged in let alone switched on, and the company accounts (on one side of letter paper) were six months late. Another textile company CEO bemoaned, "We'll be bankrupt next year." (So much for lack of transparency.) There was an engineering company that was a cluster of dormitories, hospitals, schools and, oh, yes, a production line. The washing machine company whose products were used to wash vegetables and not clothes. And the hotel operator who answered my question about future business strategy with a curt, "That's for us to know, not you." I had a coverage list of 25 companies and had 24 sells and one hold. "What is the point?" asked the salespeople. "We can't get people to sell what they don't own!"

Yet, how much China has progressed over the past two decades. Anyone visiting Shanghai or Beijing now would be hard-pressed not to admit that they are modern cities and that people enjoy middle-class lifestyles. Transport around the country is a lot more comfortable, faster and safer than it was when I was squeezed onto a hard wooden seat for a 58-hour train journey. People enjoy the arts, media, leisure, entertainment and technology. When I was living and working in Shanghai, I used to take a taxi across the city with a bagful of renminbi to deposit my rent in my landlord's bank account. Now, bank transfers and mobile payments are commonplace.

So, too, have the quality and variety of companies improved—technology companies providing solutions for consumer entertainment, business efficiency and the distribution of financial products and health care solutions; innovation in biotechnology and transport; the emergence of domestic brands and the demands for intellectual property protection.

Incomes in China are rising, consumers are upgrading their spending habits and innovation is playing a larger role in China's growth.

China has always been the victim of irrational fear from the West. It is the image of the old, communist, poor, unsophisticated China that remains in many people's heads. The distrust of everything the government says as an obvious lie. (Who really trusts any government to tell it straight anymore?) Index provider MSCI's inclusion of China's domestic A-shares in its benchmarks was greeted with howls of protest that seemed to suggest that all Chinese companies are incompetent, corrupt, old-fashioned or government-owned.

More recently, trade conflicts between China and the U.S. have been an overhang for global equity markets. The average opinion of the market seems to be focused only on the short run and assumes that U.S. policy alone drives Asia's economies, including China. At Matthews Asia, we take a longer-term view, recognizing China's ability to chart its own destiny. Incomes in China are rising, consumers are upgrading their spending habits and innovation is playing a larger role in China's growth. We expect both the U.S. and China to remain important contributors to global prosperity and wealth.

We invite you to look beyond the rhetoric and the averages, to see behind the caricature and to view modern China through the eyes of my colleagues on the Matthews Asia investment team. We have always embraced China as an investment destination, and our years of experience have taught us not only to watch out for potential pitfalls, but also to seize opportunities. If I can get over the years of following poor-quality and defunct businesses and still appreciate the opportunity and growth that China offers long-term investors, then so might you.

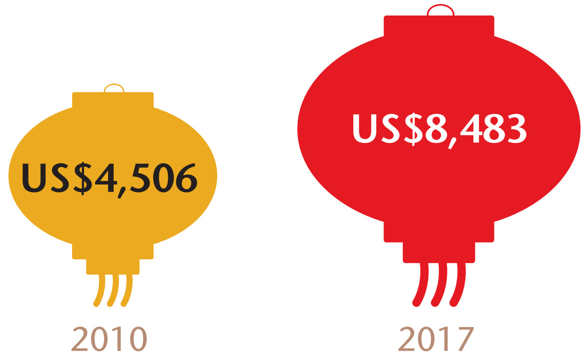
By Robert Horrocks, Ph.D., Chief Investment Officer

Across China, personal income nearly doubled over a recent seven-year period.

At a global level the middle class is defined as people making more than US$11 per day or roughly US$4,000 per year, according to the Brookings Institution. This also happens to be close to the minimum you would need to afford the monthly payments on a new car in China.

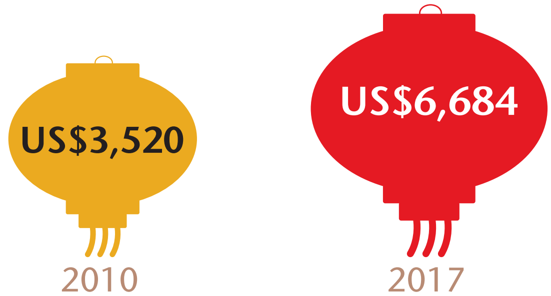
Growth of Average Annual Income In Urban Centers

Largest, richest cities



Largest, highest-income cities include Beijing, Shanghai and Shenzhen.

Larger, high-income cities

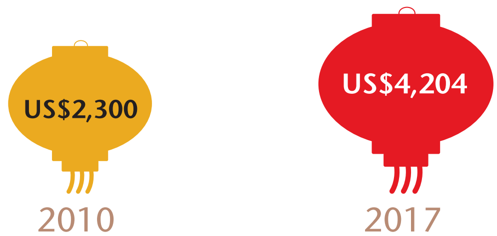


Larger, higher-income cities include Tianjin, Hangzhou and Chengdu.

Larger, middle-income cities

Larger, middle-income cities include Jinhua, Yantai and Xining.

Less developed cities



Smaller cities growing quickly include Anyang, Lianyungang, Quanzhou and Xianyang.

Source: National Bureau of Statistics of China.

The Consumer

Consumer spending provides economic stability

News reports of trade conflicts miss the larger story. China's growth is being driven by domestic consumer spending, not by exports. The rise of China's middle class means that the country charts its own economic destiny. In this section, we look at what 400 million Chinese millennials are shopping for. We also explore where Chinese travelers went on 4 billion domestic trips in a single year and what 5 million residents in the middle-class city of Anyang are coveting as their incomes rise.

In this Section

Millennials Spend, Businesses Follow

Chinese millennials—those born roughly between the early 1980s and the mid-1990s—are trendsetters. Businesses take note of millennial spending patterns and segment their product lines accordingly, looking for the right marketing strategies and price points to appeal to this important group of consumers. Income among millennials is rising. In a survey conducted by KPMG and Mei.com, 31% of China's millennials expect a significant increase in their income over the next five years compared to just 18% of non-millennials.[1] Key areas of consumption that businesses are watching include food, housing, clothing and transportation.

In addition to having rising incomes, millennials use smartphones to organize every aspect of daily life. They are accustomed to having everything delivered on request, from video-on-demand to entertainment and coffee. Capturing the millennial wallet requires delivering goods and services quickly. Businesses need a nimble, flexible approach to win over these influential consumers.

More Than 400 Million Young Consumers in China

Chinese millennials, along with the even younger Generation Z, are strikingly similar to their U.S. and European counterparts in the use of mobile technology and their purchasing patterns. A key difference is the size of the cohort in China, with roughly 404 million consumers ages 15-39 in China, versus 107 million in the United States.[2] Today, this group of young consumers makes up more than a third of China's overall population. Their purchasing power and habits are reshaping China's economic landscape. As a group, millennials represent nearly three quarters of all e-commerce users.

Millennials are changing consumption patterns across many industries, but they aren't the target market for all products. Purchases of mutual funds or life insurance, for example, are more likely to be made by older consumers. And while millennials' incomes are rising, those incomes are not yet dramatically higher than the overall population. Finally, tastes and tastemakers among millennials can change quickly, leaving businesses exposed if they invest too heavily in millennial trends.

Millennials spend more than other groups, but they also spend with purpose and intent. They want meaningful experiences that reflect their aspirations and personalities. For companies serving millennials, an emphasis on experiences, personalization and keeping up with fast-changing tastes is essential.

Among Chinese millennials:

88% Shop online more than once a week

80% Plan an increase in purchases in the next year

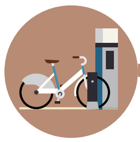
67% Post comments to an online store

Source: Mei.com and KPMG. "China's Connected Consumers: The rise of the Millennials." 2017

THE MILLENNIAL IMPACT

Farm-to-table dining is gaining popularity. The premium placed on food quality and attentive service also has given rise to successful hot-pot chains in China, where a pot of steaming broth is used for cooking food directly at the table.

Dressing down is the new dressing up. Athletic leisurewear is the default mode for everyday life. Shirts featuring logos of popular beverage brands are worn by many younger consumers. The ability to customize apparel also appeals to millennial consumers, as it allows for more self-expression and individualization.



In urban settings, millennials often skip car ownership altogether, opting instead for the ease of ride-sharing via apps. Bike-sharing apps also are a popular form of transit, and when distance is an issue millennials can take advantage of China's vast new network of high-speed rails.

1. KPMG and Mei.com, China's Connected Consumers, *The Rise of Millennials*, 2017
2. Sources: National Bureau of Statistics of China and U.S. Census Bureau

Have Itinerary, Will Travel

Perhaps no change better symbolizes the opening of China over the past half century than the expansion of domestic and international travel. During China's "bamboo curtain" era under Mao's regime, few were allowed to leave the country and travel even within China was severely restricted. Jump to 2018, when Chinese travelers took more than 5.5 billion domestic trips and 140 million journeys abroad, according to the Chinese Tourism Academy.[1] The country formerly hidden behind the curtain is now the world's largest outbound travel market.[2]

Domestically, both leisure and business travel are surging and driving the transformation of China's hospitality industry. As recently as the early 1990s, the hotel business in China was dominated by state-owned enterprises (SOEs) and a few high-end foreign hotels. Domestic travelers had few lodging options, especially in small and midsize cities. They either stayed with family and friends or in rudimentary guest houses with no amenities to speak of other than a bed. That's all changed since 2000, as the rise of discretionary incomes and private businesses has created demand for more and better travel accommodations.

Several Chinese entrepreneurs have adopted the U.S. motel franchise model and developed chains of midrange and budget hotels extending to small and midsize cities. The chief driver of this trend is business travel generated by small and medium-sized enterprises. Business travelers want reasonably priced, clean and comfortable accommodations, but don't demand a lot of floor space or extras. Leisure travelers have become a bit more demanding—with higher incomes come higher expectations for amenities, stimulating competition to deliver a satisfactory experience at a fair price. As with much of China's service economy, key differentiators for hotels are often technology-powered, including the ability to check in from a smartphone and reduce wait time at the counter.

On the international front, some 120 million Chinese citizens have passports, with 30 million more expected to be issued in 2019.[3] It is no longer unusual to see groups of Chinese tourists in Paris or London, New York or San Francisco, or even on African safaris. Increasingly, though, China's middle class is discovering destinations closer to home, such as Thailand's temples and beaches. Direct flights from midsize Chinese cities to Southeast Asian countries make regional travel convenient and affordable for more people.

Personal freedom, rising incomes, entrepreneurship, an open economy—all the forces that have reshaped China over the past three decades—have awoken the urge to travel. Hospitality providers, tour operators and companies building the infrastructure to support tourism stand to benefit from this growing demand.

1. Xinhuanet.com, "China Focus: Golden week beckons as billions of Chinese hit the road," January 2019
2. McKinsey & Co. "Huanying to the new Chinese traveler," November 2018
3. McKinsey & Co. "What can we expect in China in 2019?" December 2018

China's Emerging Consumers

Restaurants are full in Anyang, a bustling city of 5 million residents nestled within China's Henan province. At a local branch of a domestic hot-pot chain, there is a wait to get in, even though meals cost more than in other restaurants serving similar fare. Diners are willing to pay more for better service, higher-quality food and an improved dining experience. As incomes rise, residents are upgrading their consumption patterns accordingly.

Average income in Anyang is 30,421 renminbi (RMB) a year,[1] or about US$4,403, enough for many residents to own a car and dine out on occasion. Among the highest income earners in Anyang, disposable income reaches up to RMB 53,165 (US$7,695) per year,[1] similar to Shanghai. Cities such as Anyang, with large populations and rising incomes, have been called "China's emerging markets" by an e-commerce executive. The description is apt as China's middle-income cities have populations in aggregate larger than Turkey, Russia or Brazil. Growth in these cities is being driven by a surge in private sector employment, the rise of the services economy and the connectivity of digital platforms that allow locals to take part in the larger domestic economy.

The largest employer in Anyang is still the local steel mill, but steelwork makes up less than 2% of the city's overall employment. Roughly 30% of Anyang's residents work in the services sector.[1] Restaurants such as the hot-pot chain provide job opportunities that didn't exist a generation ago. Entrepreneurship is also growing, belying the city's reputation as a sleepy steel town. Among a group of recent high school graduates, one in six started his or her own business.

Top-income cities tend to impose fairly strict limits on inbound domestic migration, with Shanghai capping its population at 25 million by 2030 and Beijing at 23 million by 2020. However, middle-income cities such as Anyang tend to have more flexible residency frameworks, allowing talent and labor to move with relative ease among job centers. Anyang's skyline is dotted with cranes, reflecting a robust pace of housing construction. Many residential buildings house people from rural townships that Anyang has absorbed within its city limits. Some residential developments include shopping malls, theaters and restaurants. Consumers can now find global brands at their local malls, including IMAX and Burger King. Residents are hoping that others such as Starbucks, McDonald's and Uniqlo follow suit. Residents currently drive two hours to Zhengzhou or one hour to Handan to buy items not yet available locally, including some luxury goods. Zhengzhou can also be reached by high-speed rail in one hour via the high-speed rail station that opened in Anyang in 2012.

In many ways, Anyang reflects China's future: employment centers become even more urbanized, connectivity among cities improves, incomes grow and consumption continues at a healthy pace. China's middle class—including its heartland—is expected to help boost China's economy to the No. 1 spot globally within a generation. Far from becoming a rust belt, middle-income cities in China's heartland are becoming engines of consumption and growth.

1. Henan Province Statistical Yearbook 2018

As of June 30, 2019, Matthews Asia held no positions in IMAX, Restaurant Brands International (parent company of Burger King), Starbucks, McDonald's or Fast Retailing (parent company of Uniqlo).

China's Boomtowns: The Emerging Middle-Class Cities You've Never Heard Of

Standards for middle class reflect how far an income will stretch in the context of a person's local economy. In 2018, 90% of Chinese households owned their homes, an informal benchmark of middle-class status globally.

City	Province	Region	Population	Average Annual Disposable Income Per Capita (USD)
Quanzhou	Fujian	East China	8.6 million	$6,198
Xianyang	Shaanxi	West China	4 million	$4,980
Anyang	Henan	Central China	5 million	$4,424
Lianyungang	Jiangsu	East China	4.5 million	$4,405

Source: CEIC, data as of 2017

Innovation

Innovative companies blaze a path for growth

Having already outpaced the U.S. and Europe in terms of mobile payment adoption and volume, China's next wave of innovation stems from entrepreneurial business models. In this section, we look at China's nascent market for business software, the rise of streaming media and profiles of companies listed in China's domestic stock market, known as A-shares. We also take a look at the next wave of fintech innovation, including wealth management and insurance products purchased via smartphone.

In this Section

There were 24 million small and medium-sized enterprises in China as of the 2016 census, a group that is expected to grow to 43 million by 2020.

Business Software Surges

In China, software designed for consumers and featured on popular e-commerce platforms is extremely sophisticated and well-developed. Software designed specifically for businesses, however, is a relatively new category. This has spurred a race to become the next Microsoft, Salesforce or QuickBooks for China's domestic market of small and medium-sized enterprises (SMEs).

An Underserved Market Primed for Growth

There were 24 million SMEs in China as of 2016, a group that is expected to grow to 43 million by 2020.[1] By comparison, the U.S. had fewer than 6 million SMEs in 2016.[2] Research by the McKinsey Global Institute indicates these smaller businesses, whose revenues are primarily from local sources, tend to be the least-optimized in terms of using digital tools, including enterprise software.[3] Areas of opportunity for software developers could include sectors such as agriculture, hospitality and construction.

When it comes to enterprise software, one size doesn't fit all. Business software benefits from being customized to the needs of the user. Software providers often tailor code for larger clients and must provide robust client-relationship management to train and educate clients on how to use the software. A lack of legacy systems in China fosters a mobile-first approach, with cloud-based apps for smartphones. Architectural decisions for software design can be based on the cloud and mobile apps, rather than an internal mainframe or desktop PCs. Cloud-based systems allow scalability and help software providers accurately track and charge based on the number of users. Software buyers can no longer deploy a single CD ROM of software across an entire organization. Users and licenses are tracked in real time.

Beijing Attracts Coders

Demand, talent and venture capital for building enterprise software come together in Beijing. While Shenzhen is sometimes called China's "Silicon Delta," the hub of artificial intelligence (AI) and software programming is shifting to China's capital city. Software coders laid off from consumer-software providers are being rehired by makers of enterprise software. To retain talent and keep employees from moving to competitors, employers often provide coders with a range of assignments and opportunities to launch new products internally. Chinese product lines are often multifaceted, allowing employees a degree of flexibility and creativity once they find a software firm they enjoy working for.

The U.S. is currently home to the largest number of software coders, but China has the fastest growth rate in software engineers entering the field worldwide. The growth rate of developers in China is forecast to increase between 6% and 8% each year leading up to 2023, according to a study by Evans Data Corp.[4] While China is not yet set to surpass the U.S. in the total number of coders, it is quickly catching up and may have an edge in key areas, boasting more than twice as many coders specializing in cloud software. Software development is experiencing a similar growth surge as China's biotech sector did five years ago, when clusters of talent, demand and capital began to foster rapid growth in clinical drug trials.

Optimizing Human Talent

As China continues its evolution toward a services-based economy, optimizing human talent is essential. Notably, the size of China's workforce is no longer growing due to low birth rates and an aging population, so new sources of GDP growth will need to come from increased productivity among existing workers. Demand for enterprise software is forecast to rise as companies work to streamline functions such as human resources, accounting and payroll. Cloud-based platforms allowing mobile access will play a big role in the evolution of China's enterprise software industry. Local insights into the needs of local customers will help China's domestic software providers support growth in the world's second-largest economy. SMEs especially can benefit from the growth in cloud-based enterprise software solutions. For investors, tapping the enterprise software boom early can help capture the growth of companies with a first-mover advantage.

As of June 30, 2019, Matthews Asia held no positions in Microsoft, Salesforce or Intuit (owner of QuickBooks).

1. National Bureau of Statistics of China. Census conducted in 2016. Data for the year 2020 is estimated by Statistica.com.
2. U.S. Census Bureau, "Annual Survey of Entrepreneurs," 2016
3. McKinsey Global Institute, Digital China: Powering the Economy to Global Competitiveness, 2017
4. Evans Data Corporation, Developer Population Growth Shifts Toward China, India and Emerging Countries, 2018

Streaming Media Makes a Splash

Piracy of popular music, movies and other recorded media in China has long been an obstacle for helping artists and other content creators get paid. But artists increasingly are sharing in the profits of the content they create. One reason is the explosive growth of streaming media. Music, movies, TV shows and live content are readily accessible and relatively affordable over the internet—to the point that consumers are more inclined to pay for what they want than go through the hassle of pirating.

Rising middle-class incomes and easy mobile-payment platforms make subscriptions both affordable and easily accessible. Not only that, but with the proliferation of streaming services, entertainment options have multiplied exponentially. Smartphone-equipped millennials enjoy interactive streaming services that allow them to chat with performers, as well as sharing sites where amateurs can post videos and reach a vast audience. Even e-commerce has tapped into the market's thirst for streaming, with shopping sites delivering video content (think infomercials) to spark sales.

Having so many media outlets creates the need for a fairly constant stream of fresh content, of course. The rapid growth of streaming has been a boon to China's creative industries and spurred investment in co-productions with Hollywood studios. And, like the dominant providers in the U.S., competition for subscribers is driving China's top streaming players to invest in high-quality original content. In fact, video-on-demand producers are now reportedly outspending traditional broadcasters on production.

The rising cost of original content could dampen profitability in the near term and lead to industry consolidation. Nonetheless, Chinese consumers have decided on the future of at-home and on-the-go entertainment. Now it is up to the purveyors to turn streaming media into sources of sustainable revenue.

"The rapid growth of streaming has been a boon to China's creative industries and spurred investment in co-productions with Hollywood studios."

ILLUSTRATION BY JON REINFURT

FINTECH'S *Next Frontier*

In 2018

1 billion smartphone connections in China

98.6% of internet users accessed the web via a mobile device

Sources: GSMA Intelligence, "The Mobile Economy China 2019," March 2019; China Internet Watch, "China Internet Users Snapshot 2019," April 2019

Rising middle-class affluence in China created a need for financial products and services that barely existed two decades ago. With China's sluggish banking system slow to respond, private companies stepped in to fill the void, abetted by popular mobile technologies. The smartphone now enables Chinese consumers to access virtual supermarkets of investment, insurance and credit products.

- **INVESTMENTS:** Online, consumers have access to a variety of money market, mutual and exchange-traded funds (ETFs). They can review performance, compare products, join conversations with other investors and ultimately buy funds directly via their phones.

- **CREDIT AND LENDING:** Consumers can often access credit lines to facilitate shopping or tap services within e-commerce and gaming platforms. Some platforms also offer short-term, unsecured loans comparable to payday loans in the U.S. Algorithms and big data are used for approvals. Rather than relying on third-party credit scores, a financial platform can often assess a borrower's credit worthiness from its own proprietary data culled from the borrower's history on the platform. Using proprietary data can greatly speed the loan approval process.

- **INSURANCE:** Consumers can shop multiple providers for all types of insurance products—life, health, property, auto, accident and several flavors of travel insurance. The boom in Chinese travel has spawned a sub-industry of insurers providing specialized products covering flight delays, overseas travel, travel accidents and domestic road travel, among others.

The real driver of growth in mobile fintech is the consumer. Mobile technology offers access to financial products to people who otherwise would have few ways to participate in China's economic growth, reaching areas with no financial infrastructure. As incomes in China rise, middle-class consumers are turning to products that can build and protect wealth. And the smartphone is helping to promote the new products at scale, making mobile fintech a rising area of innovation for China's economy.

Rising consumption means that innovative companies in China's domestic A-share market have an opportunity to carve out unique opportunities for growth.

Stars Align for A-Shares

Home to more than 3,500 publicly traded stocks, the Shanghai and Shenzhen stock exchanges are gaining increasing attention from global investors looking to capture China's growth potential. The quality of China's domestic stocks, known as A-shares, can vary widely, ranging from highly innovative companies with deep competitive moats to lower-quality companies with less differentiation from competitors. Notably, many companies with a domestic focus—Chinese businesses selling to Chinese customers—are available only in the A-share market.

At a laser-cutting facility in Shenzhen's Nanshan District, for example, advanced hardware is being crafted using lasers rather than metal saws and blades. Workers can mark, cut, weld and clean metals and other materials with extreme precision. Demand is rising for these sophisticated production techniques, which can be employed in everything from smartphones and laptops to auto frames. Laser production reduces the potential for human error when welding by hand and improves the refinement of the end product.

The laser industry has high barriers to entry as companies developing the technology need strong engineering and design expertise, as well as deep pockets for research and development expenses. There are currently only a handful of countries in the world with advanced laser industries, including Germany, Japan, the United States and China. The growth market for China's laser manufacturers is both domestic and global. On the domestic front, China's laser industry has an advantage in customizing products for the needs of Chinese customers through local relationships, local language skills and an understanding of local supply chains. On the global front, China's laser producers are competing in foreign markets on quality and speed to market, illustrating the opportunity set within the A-share universe.

Innovating to Meet Local Demand

Chinese consumers often have different purchasing patterns than those in other markets. Savvy companies in the A-share market are leaning into this opportunity. With liquor, for example, consumers tend to favor local products. Baijiu is a clear, grain-based liquor with alcohol content higher than 50% that is popularly served at banquets and celebrations such as weddings. In China, the baijiu category is similar to the wine category in the West, with lots of different varieties and flavors. It is a unique product with a long national heritage and an aspirational positioning in Chinese lifestyles.

Chinese liquor can contain many different aromas, depending on where it is made, the type of grain and the yeast used in the fermentation process. Certain regions produce certain aromas, creating a protective moat that is difficult to replicate. Liquor makers advertise what makes their brands unique using social media platforms, in an effort to grow their domestic customer base and attract a wider range of consumers. Some are beginning to segment for different age groups, recognizing that some consumers who are new to drinking baijiu may prefer a lower alcohol content. Shares of companies manufacturing baijiu can be purchased in the A-share market, another example of how the domestic stock exchanges offer growth opportunities driven by the Chinese consumer.

Accessing A-Shares

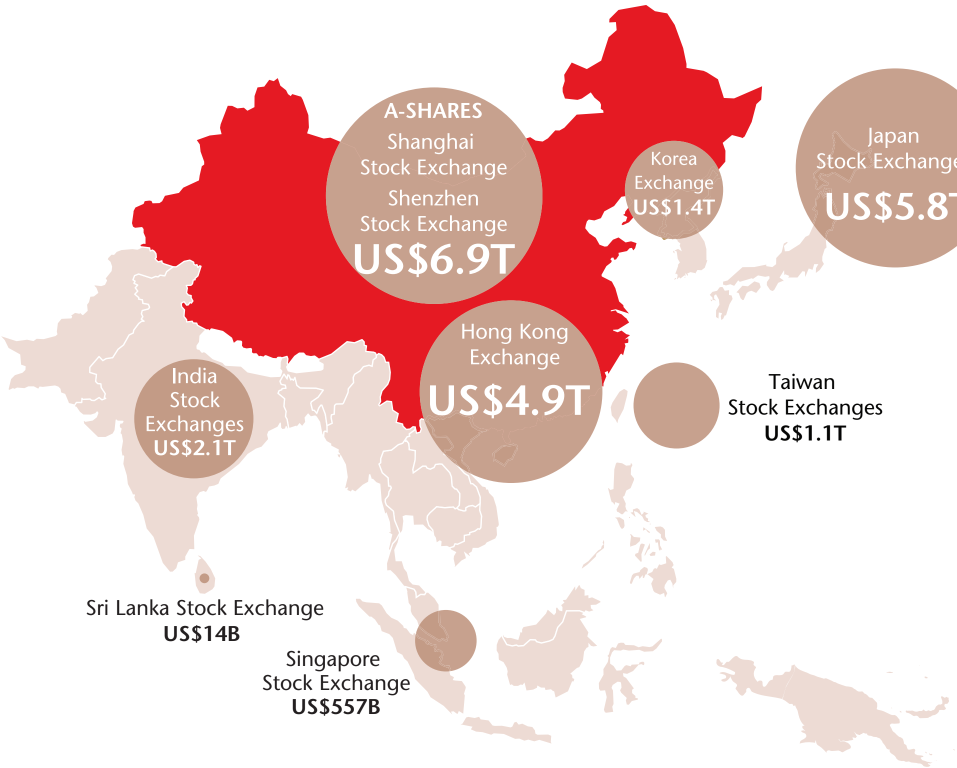
Global investors interested in capturing China's growth can benefit from understanding the makeup of China's equity markets. A-shares and H-shares represent the largest portion of Chinese equity markets. A-shares represent China's onshore, domestic markets, where stocks trade through stock exchanges in Shanghai and Shenzhen. At present, individual foreign investors can typically gain exposure to the A-share market only through a mutual fund or exchange-traded fund (ETF). H-shares represent stocks of companies incorporated in China that trade on the Hong Kong Stock Exchange. Individual foreign investors can typically buy individual securities in the H-share market, as well as invest in the market through a mutual fund or ETF.

Rising consumption means that innovative companies in China's domestic A-share market have an opportunity to carve out unique opportunities for growth. Investment strategies that take an "all-shares" approach can help investors capture China's growth from many different angles. Because quality can vary widely in both A-shares and H-shares, an active approach to security selection can add value and help manage downside risks in all markets where Chinese equities trade. From laser cutting to liquor, meeting the needs of local businesses and consumers in China will continue to be a catalyst for higher-quality companies in the A-share market. The key to capturing this growth is understanding the ever-changing needs and tastes of the Chinese consumer.

China A-Shares Represent One of the World's Largest Stock Markets

US$6.9 trillion market cap in A-shares—primarily from mainland Chinese markets

TOTAL MARKET CAPITALIZATION



Domestic Hong Kong Exchange market cap includes only the market cap portion of the Hong Kong exchange listed entities

Sources: Bloomberg; Wind Info. Data as of December 31, 2018

Sustainability

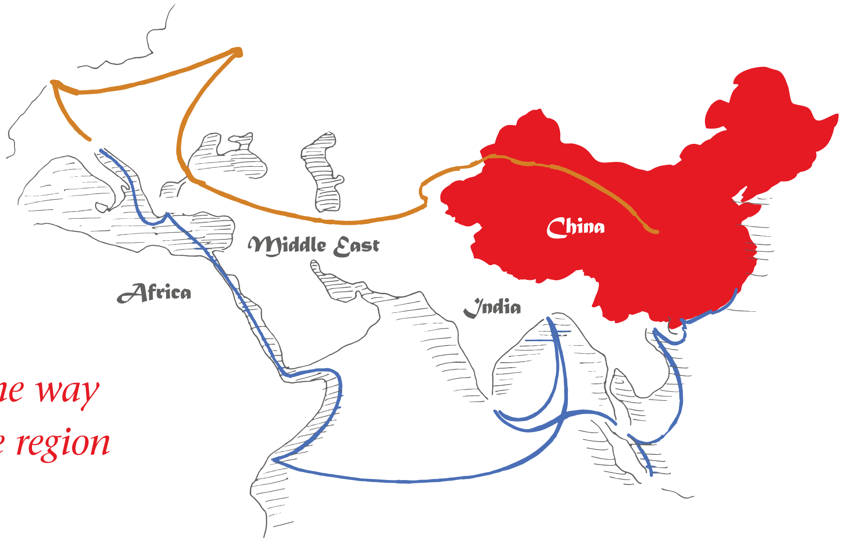
China focuses on quality of economic growth

China's growth creates both risks and opportunities. In this section, we examine trading partnerships throughout the region that will help China maintain access to natural resources and lower-cost labor pools in developing economies such as Sri Lanka. We look at the transition toward a cleaner energy mix and transit options fueled by renewable energy. We consider the importance of property rights in sustaining China's market-based reforms. And we mark some of the milestones of China's journey toward its present-day entrepreneurial economy.

In this Section

- New Silk Roads
- Environmental Progress
- What Is the Biggest Risk?
- China's Journey

New Silk Roads



China's Belt and Road project paves the way for closer economic ties throughout the region

THE ANCIENT TRADE ROUTE that once connected China and the West, the one that made Marco Polo famous and first brought Asian silk to Europe, is being resurrected. Announced in 2013, the Belt and Road Initiative (BRI) combines a land route ("Belt") and maritime route ("Road") that links China's major cities to Europe and the Middle East. It will involve infrastructure development worth over US$1 trillion in over 60 countries, from Sri Lanka and Pakistan all the way to Greece and, most recently, Italy.

The BRI seeks to enhance trade while spurring economic development and addressing significant infrastructure needs in Asia. Trade is at the core of the BRI's aspirations, as it allows China to employ its key strategic advantage of manufacturing economies of scale to produce goods at the right (low) price to meet demand in emerging economies. Trading with emerging markets helps China to more efficiently utilize spare capacity, from tradable goods to infrastructure. Building infrastructure to support and secure trade flows also underpins the rationale for the BRI. China further stands to gain access to natural resources to fuel its economy, the world's second-largest, while building strategic influence as a global power. Partner countries, in return, gain access to the lucrative Chinese domestic market. Moreover, as many developing countries scramble to build infrastructure, the Belt and Road project has emerged as a source of scarce concessional funding, filling the vacuum left by multilateral agencies.

Sri Lanka is a prime example. Strategically located in the middle of the maritime "road," the country has emerged from decades of civil war and started rebuilding with significant support from Japan and China. While the country suffered a tragic terrorist attack in April of 2019, the country remains on a path for economic development. Chinese investment includes a deep-water port and airport in Hambantota, near the island's southern tip, and an ambitious US$15 billion project to expand Colombo's central business district. The Colombo Port City is a 665-acre project built on reclaimed oceanfront land that aims to become a new financial center for South Asia. China's investment comes at a crucial time—three credit rating agencies downgraded Sri Lanka's sovereign rating amid the political crisis of late 2018. The project's multiyear foreign direct investment inflow will help stabilize the country's macroeconomic profile.

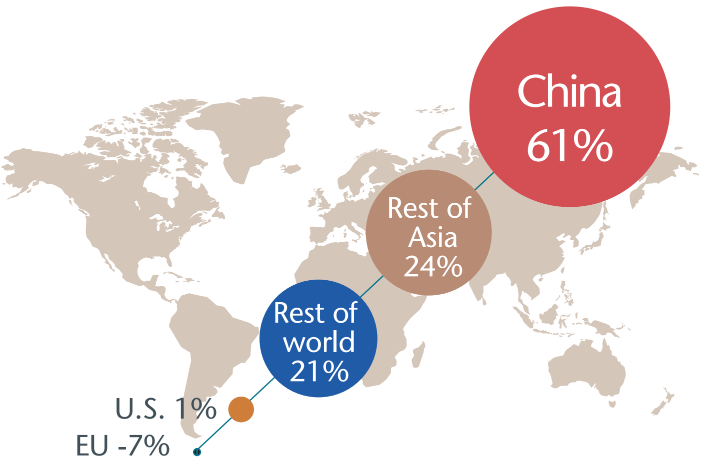
It hasn't all been smooth sailing, however. After Sri Lanka granted a 99-year lease on the strategically located Hambantota Port to a Chinese state-owned enterprise in exchange for debt relief, critics characterized the country as an unwitting pawn in China's broader geopolitical aims, portraying the investments as white elephants and a land grab. In reality, the Hambantota region has been historically underdeveloped, with a young working population lacking employment opportunities. The investments have also largely been hamstrung by local politics. As one local told Matthews Asia, the effect of Chinese investment is "early days but we are beginning to see changes." Located astride major East-West shipping lanes, the port is envisioned as a major regional trans-shipment hub, attracting manufacturing and logistics investment and creating business opportunities. Similarly, development of the airport is expected to boost the local economy.

It is important to view large-scale infrastructure projects from a long-term perspective, supported by on-the-ground due diligence, to understand their likely economic impact. As long-term growth investors, we believe developments along the new Silk Road are improving economic opportunities throughout the region, supporting our optimistic outlook on Asia's long-term growth.

Environmental PROGRESS

Growth in World Carbon Emissions (1990 – 2015)

China is the dominant contributor to growth in carbon emissions.



Source: Trends in Global Co2 emissions 2016 report by PBL Netherlands Environmental Assessment Agency and EU Joint Research Center

CHINA IS THE WORLD'S LARGEST producer of industrial goods such as crude steel, coal and cement. Not coincidentally, it also is the world's largest producer of carbon pollution. Its massive industrial and power production facilities have created notorious air quality issues, and regulators see the imperative to bring these industries under control. For Chinese policymakers, environmental protection is less a matter of external pressure and more about acting in their own best economic and political interests. In the context of world politics, increasing renewable energy sources can help China reduce its dependence on imported oil and mute the impact of swings in oil prices on the economy. And in the context of domestic politics, creating a cleaner environment is essential to maintaining social harmony and political stability.

China's environmental measures are part of a larger shift in economic priorities from "quantity to quality," advancing further toward an economy in which household consumption supersedes industrial production as a driver of growth. This is reflected in stricter enforcement of existing environmental policies. In 2014, the government imposed clean air rules that included a nationwide cap on coal use, and that called for smog-plagued Beijing to lower concentrations of fine particulate matter in the air by 25%.[1] Since then, China has raised more barriers to entry in polluting industries and closed down small, less-efficient producers. It has made it more difficult to invest in new projects in coal mining, aluminum, steel and cement. In early 2018, in a bid to better protect the local environment and air quality, China also began banning all foreign plastic waste, and many other recyclables, which it had long imported to reuse as raw materials for processing and manufacturing. While the average Chinese person produces about half the solid waste of the average American, China's vast population still means that it needs to contend with roughly 60 million takeout food containers daily, according to a report by The Washington Post.

In addition, companies increasingly are being held responsible and paying for wastewater treatment, and a permit process limits the number of companies allowed to discharge wastewater. A result of these measures has been increased consolidation and merger activity in such sectors as steel, cement, coal and thermal power plants, creating fewer but larger players with less focus on volume and more on profitability. Notably, China's crackdown on pollution is serious. Prosecutions for a range of environmental offenses, such as illegal deforestation or unlawful mining, rose 21% from 2017 to 2018, and authorities arrested more than 15,000 suspects in 2018—a 51% rise[2] in arrests from the year before.

The government also is targeting households, meanwhile, although its methods are less "stick" and more "carrot." Subsidies for gas service and appliances have encouraged rural consumers to switch from coal to gas for heating and cooking. The subsidies are not permanent, but a ban on coal will likely drive further conversion, particularly when consumers realize that gas is more efficient and cleaner. This has created opportunities for gas distribution companies that are eager to receive concessions to supply gas and sell appliances in rural areas.

1. The New York Times, "The Upshot: Four Years After Declaring War on Pollution, China Is Winning," March 12, 2018
2. Reuters, "China Environmental Crime Arrests Up More Than 50 percent in 2018: Ministry," February 14, 2019

Investing in Cleaner Transit

Another approach to cutting emissions is incentivizing the switch to electric vehicles (EVs). In 2011, China began imposing annual quotas on the number of license plates issued in Beijing, a practice that has since expanded to more regions and cities. EVs, however, are not subject to the same quotas as internal combustion engine cars. Generous subsidies and tax breaks have further helped turn China into the world's largest EV market.

China is also encouraging people to drive less by investing in public transportation systems. Over the past 10 years, the number of cities with subway systems has grown to 35.[1] Meanwhile, the expansion of high-speed rail lines has reduced the need to drive between cities. China's high-speed rail system is expected to transport 3.5 billion[2] passengers in 2019. The government's goal is for the system to cover 80% of cities by 2020.

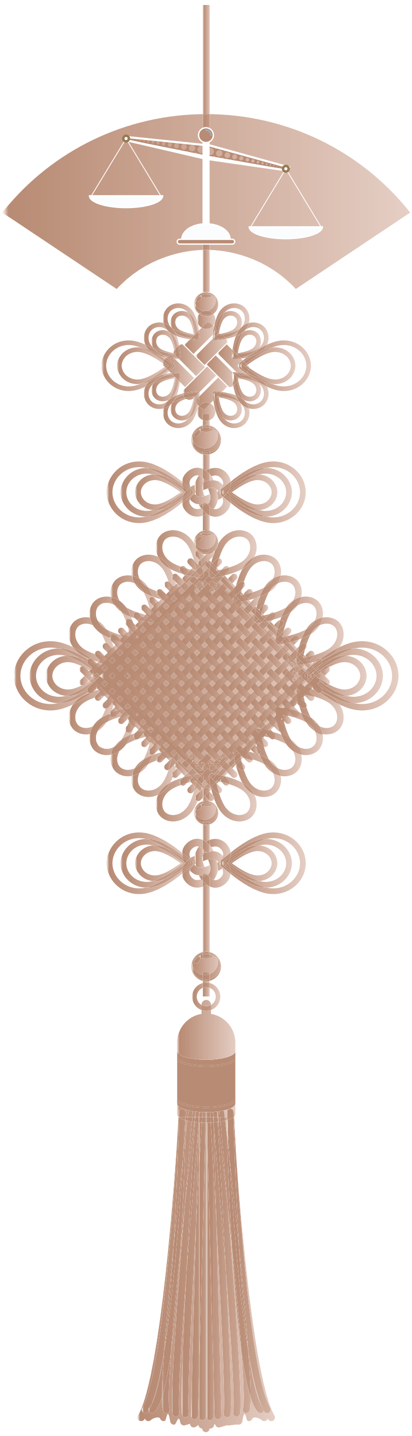
By moving personal and public transportation from fossil fuels to electrical power, experts predict that China's oil demand will peak in 2025 before gradually declining,[3] in which case China would no longer be the leading driver of global crude demand.

1. Shine Consultant, The 12th Annual City-Rail Summit, January 2019
2. GB Times, "China's high-speed rail network to surpass 30,000 km in 2019," January 3, 2019
3. Morgan Stanley Research, 'EVs + HSR': A Disruptive Force for China Oil Demand, March 2019

Beijing Subway Map

Endnote by Andy Rothman, Investment Strategist, Matthews Asia

What Is the Biggest Risk?



I AM OPTIMISTIC ABOUT CHINA'S medium-term economic prospects, within the context of expecting gradually slower year-over-year growth rates. This optimism is based largely on the continuing evolution of government policy designed to embrace private enterprise and markets. My biggest concern is that there has been little parallel evolution in China's governance and institutions.

China's economy and society increasingly are based on property rights, yet the country lacks the rule of law, which is needed to effectively protect these property rights and ensure a fair, rules-based commercial environment.

This is already the source of many problems. Corruption, weakness in industries dependent on intellectual property rights and the widespread theft of land from farmers—the main cause of protests across the country—are all consequences of the lack of rule of law.

In the near term, China can thrive, as people find ways to navigate corruption and the opaque system, and as the Chinese Communist Party works to reduce interference in the legal system by local officials. But as the pace of economic growth inevitably slows over the coming decades, China's unique form of authoritarian capitalism is unlikely to provide the necessary institutional support for a modern, market-based society.

There are, at this moment, no signs that the Party is preparing to establish the rule of law. The Party appears to want to continue to use the legal system to exercise its political control over the population, rather than to move toward a system that is designed primarily to protect the rights of individuals by limiting the government's power.

We do need to acknowledge, however, that back in the mid-1980s, when I first worked in China, it was not apparent that the Party was prepared to significantly relax its control over people's daily lives. But, a decade later, the Party stopped telling its citizens where to live and what to farm. In the mid-1990s, we did not expect the Party to dramatically shrink the state sector and pave the way for private firms to become the engine of growth. Private home ownership was not on the horizon. Today, most urban Chinese work for private companies and own their homes.

During the past two decades, the Party has evolved in many ways. It has taken a path that is unique among authoritarian regimes: relaxing day-to-day control over people's lives and commercial activities while strengthening the Party's control over the political and legal systems. This is a key reason the Chinese Communist Party has outlived other authoritarian regimes. Constant, pragmatic reform of economic policy is also why GDP growth averaged 10% for more than three decades before cooling to an average of 7% over the past seven years.[1]

Establishing the rule of law would require the Party to take another major step: to cede to its citizens some of its control over the political and legal systems. Failure to take this step is not a short-term risk for investors, but I believe it will be key to China's economic prospects over the next 10 to 20 years.

1. CEIC

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China's Journey

From a closed society mired in poverty to a vibrant, entrepreneurial market economy supporting a thriving middle class

HOME OWNERSHIP[1]

1980
Zero
Private property ownership was forbidden

2018
90%
of Chinese households owned their homes

MIDDLE-CLASS GROWTH[2]

2000
4%
of urban population

2018
30%
of urban population

INFANT MORTALITY[3]

Per 1,000 live births

2000
30.1

2017
8.0

RETAIL SALES[6]

2000
US$472 billion

2018
US$5.7 trillion

LUXURY GOODS SALES[5]

(% of Global Luxury Goods Sales)

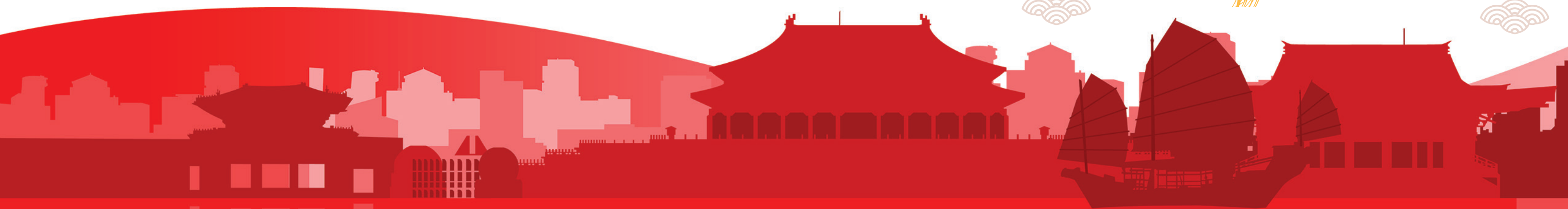
2000
1%

2018
33%

CARS ON THE ROAD[4]

2000
16 million

2018
232 million



From 1949 into the 1980s, the Chinese government controlled most aspects of individual life. Today, those shackles are all but gone from an economic perspective. People are free to choose where to live and work, launch their own businesses, grow their personal wealth and spend it on whatever they please. This massive expansion of individual economic freedom has unleashed powerful market forces, elevating 800 million people out of poverty and powering the growth of a thoroughly modern society—with all the opportunities and challenges that implies.

1. South China Morning Post "China property: how the world's biggest housing market emerged" Nov. 26, 2018
2. China Briefing "China's Middle Class in 5 Simple Questions" Feb. 13, 2019
3. World Bank
4. CEIC. Cars on the road include trucks and passenger vehicles.
5. Bain & Company "What's Powering China's Market for Luxury Goods?" March 18, 2019. China's consumption of global luxury goods in 2018 was more than the U.S. or Europe.
6. CEIC