FUNDAMENTALS

China's rising middle class: sector implications

Today's China no longer matches the view of the country that most people have. Could this gap between perception and reality offer a wealth of investment opportunities?

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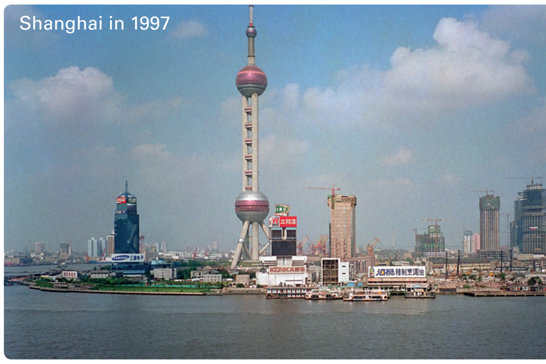

Shanghai in 1997

Shanghai in 2017

With a middle class the size of America's, the scale of China is often underappreciated. Despite slowing GDP growth, a dramatic shift in the underlying mix of goods and services of unprecedented proportions is underway. Having exposure to the right sectors and companies is therefore crucial as China makes its transition to the next era.

The Pudong skyline in Shanghai isn't the only clear sign of how much has changed in China over the past twenty years. The country's distribution of wealth has also changed dramatically. As recently as 2000, for example, over 1.1 billion of China's 1.3 billion population had a GDP per capita of less than \$2,500. By 2017, this number had fallen to just 137 million, with the rest of the population becoming several times richer on average.

Investors also need to take note of how this rise in affluence has been distributed. The country's wealthiest citizens are likely to be found on China's east coast. Indeed, according to figures released recently from China's National Bureau of Statistics, China's richest coastal regions were five times as wealthy as its poorest inland province in 2017.

By way of comparison in European terms, this means that while some of China's western and central provinces have a GDP per capita similar to or lower than that of Georgia and Belarus, four of the eastern provinces are as roughly as wealthy as Portugal or the Czech Republic.

Figure 1 overleaf shows the changing wealth distribution of China in more detail, with one clear overall message: the majority of the Chinese population have become more affluent in the last two decades, and in many cases, significantly so. The wealth currently concentrated along the east coast is expected to spread through the rest of China as other provinces also increase their GDP per capita to above \$10,000. Meanwhile, it is also expected that China's already wealthy eastern provinces will continue to grow wealthier over time.

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Figure 1: Rising affluence: mapping the change in Chinese wealth distribution

2000	2018	2030

Chinese population with annual income >$10k p.a.

2000	2018	2030
<1M	~500M	~850M

Percentage of Chinese population with annual income >$10k p.a.

2000	2018	2030
<0.1%	~35%	~60%

Source: World Bank, LGIM estimates

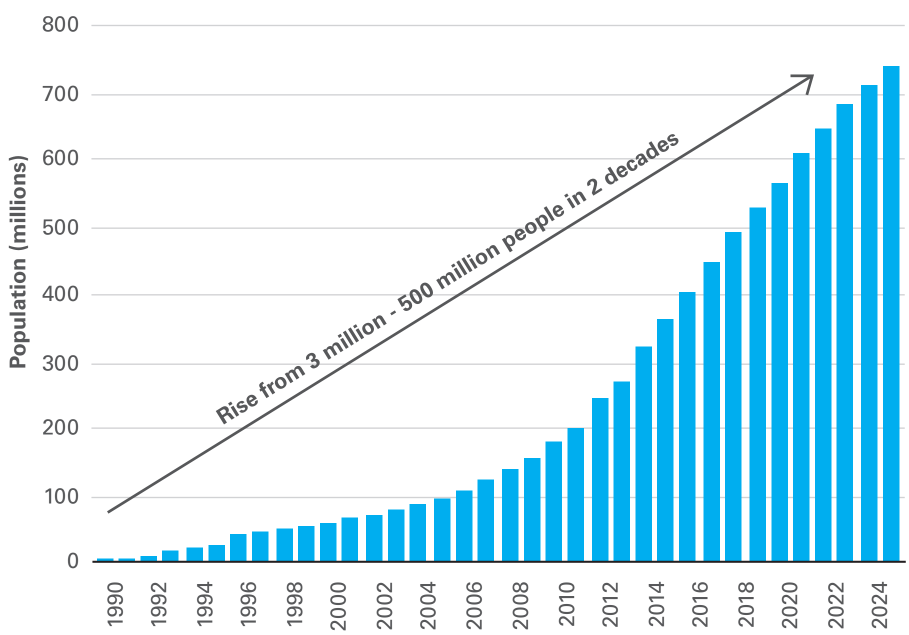
Using the World Bank's classification[1] of annual income levels, we will now explore what the changes in wealth levels could mean for China, its economy and investments.

China's higher income segment is similar in size to that of the US and the EU, and several times that the size of UK (Figure 4, overleaf). As a result of this sheer size, sectors in China that are expected to grow will become meaningful from a global context. Meanwhile, Chinese companies in these sectors could match their global peers despite the latter having aggregate country GDP per capita levels that are higher than China.

THE UNPRECEDENTED SCALE OF CHANGE

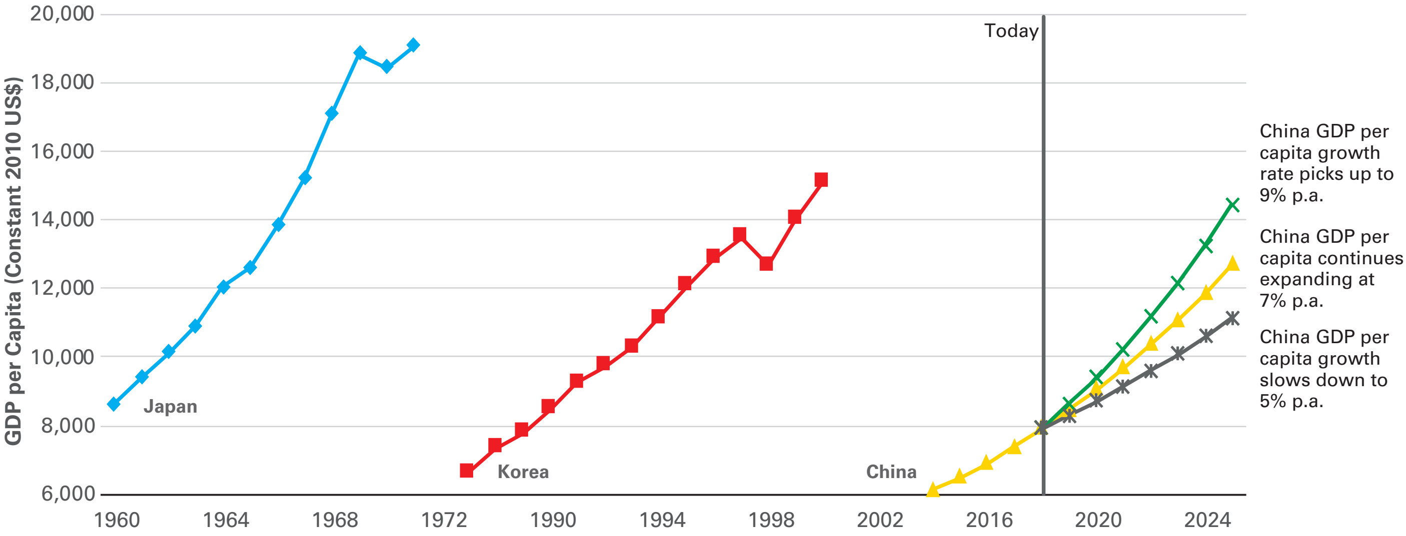
The scale of change happening in China is unprecedented. In less than two decades the size of China's middle class has risen from less than 0.3 million to over 500 million (Figure 2). Other growing countries have gone through a similar level change in terms of overall GDP per capita rising over a short period of time, notably Japan between 1960 and 1980 and South Korea between 1976 and 1996 (Figure 3, overleaf). However, neither can match the sheer size of the middle class being created in China, due to China's large population of over 1.3 billion people.

Figure 2: China's middle class (1990 – 2025E)



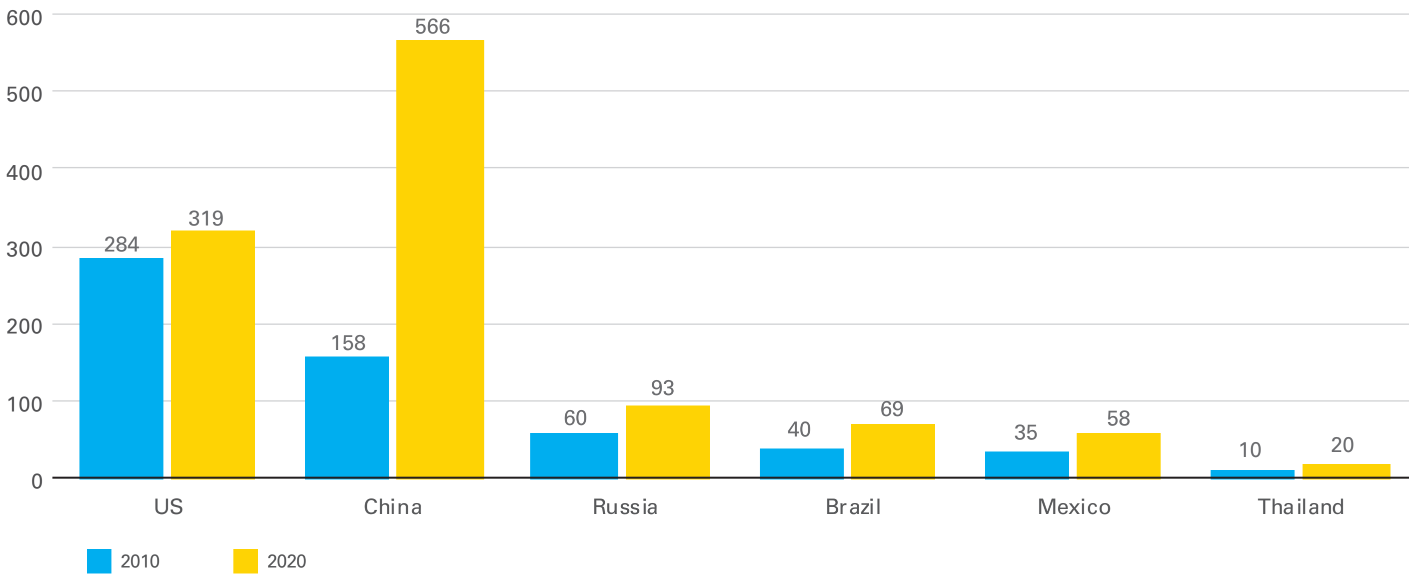
1. World Bank: For the current 2018 fiscal year, low income economies are defined as those with a GNI per capita, calculated using the World Bank Atlas method, of $1,005 or less in 2016; lower middle income economies are those with a GNI per capita between $1,006 and $3,955; upper middle income economies are those with a GNI per capita between $3,956 and $12,235; high income economies are those with a GNI per capita of $12,236 or more.

Figure 3: GDP per capita expansion examples – Japan and South Korea (identifying inflection points)



Source: World Bank, LGIM Estimates

Figure 4: Higher income segment (millions of people): 2010 vs 2020



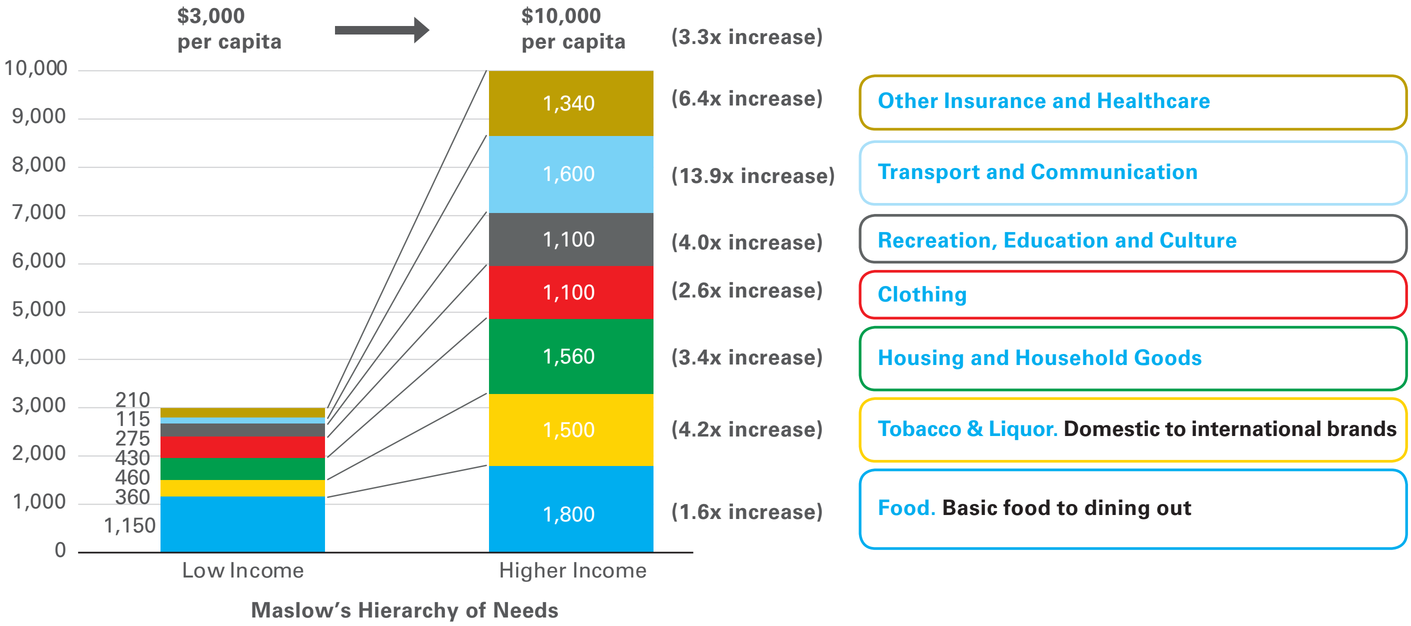
Source: World Bank, LGIM Estimates

THE IMPACT OF THE CHANGE IN WEALTH DEMOGRAPHICS

Abraham Harold Maslow was an American psychologist best known for creating his eponymous hierarchy of needs, where physiological (air, food, drink, shelter, warmth, and sleep) and safety (security, order, law, stability) needs first have to be met before moving on to belonging (insurance, education, wealth generation etc.) esteem (education) and self-actualisation needs (travel, technology). Maslow's hierarchy of needs can be expanded towards a framework looking at emerging or growing nations as they become wealthier, resulting in their priority of needs changing over time.

Growing nations that have seen their GDP per capita grow rapidly over time from $5,000 to over $10,000 experience a similar change in population spending, which shifts from basic needs such as food, clothing and housing, towards insurance, education, healthcare, travel, banking and other services. Figure 5 illustrates the change we would expect in China's population as it moves from low to higher income levels. Again, the majority of similar trends have been witnessed in Japan and South Korea as they transitioned to higher income per capita levels.

Figure 5: Chinese consumption baskets by income group



Source: Reserve Bank of Australia, World Bank, LGIM Estimates

A NATION UNDERGOING CHANGE

As a larger proportion of China's population becomes middle class, and that middle class becomes more affluent, a large cultural impact, sectorial shift and macro-economic transition is likely to ensue.

On the cultural side, there is a tough transition underway with a rise in nuclear families alongside service sector growth giving rise to a rural to urban migration. The impact of this transition is unlikely to be smooth with increasing levels of income inequality which can result in social unrest throughout China.

From a sector perspective, the impact of the above will likely result in an increasing shift towards the service economy with a rise in growth of 'new economy' sectors. It could also lead to a normalisation in the growth rates of 'old economy' sectors such as basic consumer products, low value consumer goods, or real estate – sectors that have historically (2000 to 2018) experienced very strong growth.

Beneficiaries of the rising Chinese middle class

- **Insurance:** Rise from the current insurance penetration of 4.2% to 8.5% by 2025, resulting in new annual business growth of 15-20%
- **Travel and recreation:** Chinese outbound travellers are predicted to reach 203 million by 2020 (four times the UK), with growth of 14% in 2018
- **Tech:** China has its own equivalent of Google, Facebook and Amazon and these are Baidu, Tencent and Alibaba. Each of these companies has a similar level of market cap, in excess of $500 billion (compared to the combined market cap of all FTSE 100 companies at $2 trillion)
- **Private wealth:** Asia-Pacific including Japan will exceed North America and Europe as the largest private wealth markets globally at over $75 trillion by 2021

At risk from the rising Chinese middle Class

- **Basic food (agriculture):** Slow-down in growth as the population growth stagnates and food consumption shifts away from agriculture to more meats and processed foods
- **Household goods:** Absolute budget spend on household goods stays constant while there is a rise in spending on tertiary categories
- **Real estate:** Shift in assets from physical to financial as the market becomes more mature

Finally, as the economy transitions from a majority of GDP coming from manufacturing towards services, the overall annual GDP growth in China may go through periods of lower growth, i.e. adjustment, as the decline in one is not adequately offset by the rising growth of the other.

We will now take a closer look at three of the sectors that we believe are likely to see strong growth: Insurance, travel and private wealth. We will also explore a fourth sector (technology) in a future article.

INSURANCE

CHINA'S COVERAGE GAP

With a lack of social safety nets and rising wealth, education and disposable income, the Chinese are becoming much more aware of the need to save for medical protection. China currently is one of the least covered regions globally by insurance (Figure 6) and President Xi Jinping has emphasised the need for private medical and life insurance and retirement planning.

With awareness rising and the government having an incentive to reduce the burden on the state, Chinese insurance companies (e.g. AIA, Ping An, China Life and PICC) are insuring an increasing percentage of the population.

We saw a similar boom in Japan and South Korea as GDP per capita exceeded $10,000. At this point, people tend to plan more long-term and think about preserving capital. Rising medical cost inflation in China of over 8-10% is also highly supportive of this trend.

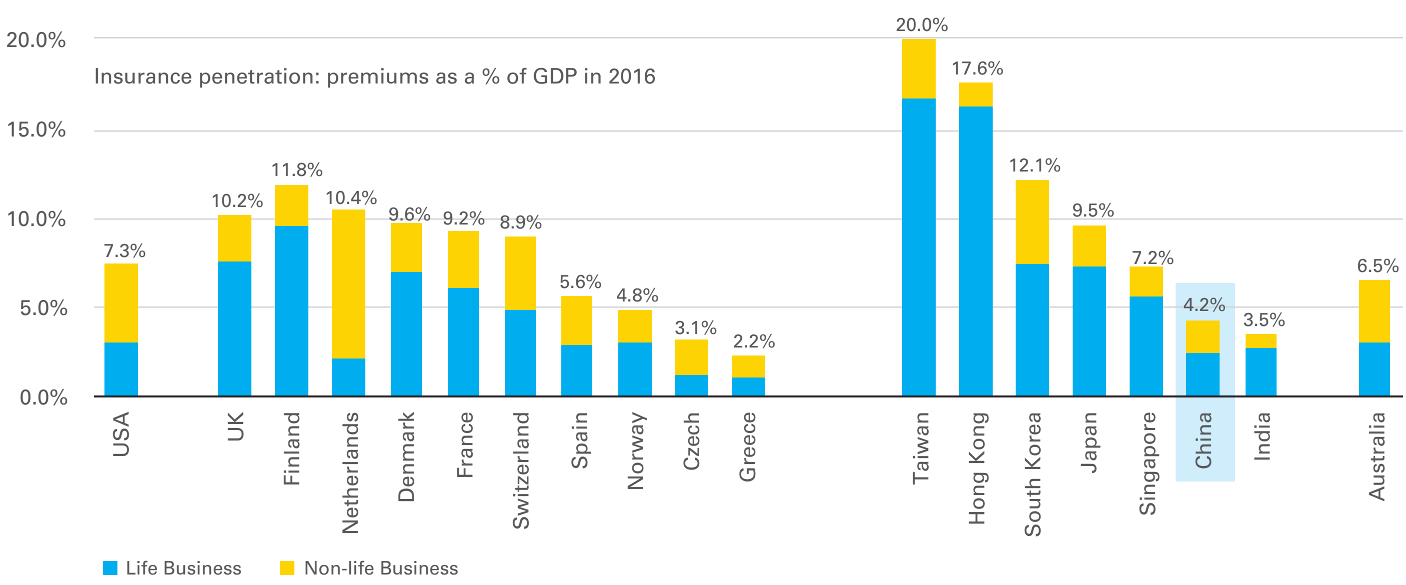
Over the last year, the value of new insurance business growth in China has been 20% vs. 12% over the previous five. By means of comparison, insurance penetration rose doubled in Japan between 1960 and 1966 and rose from 4.0% to 8.1% in South Korea between 1984 and 1990. If China were to catch up (adjusting for GDP per capita), new business would grow by a 15-20% compound annual growth rate from 2018 to 2025.

Other factors that make the insurance market quite attractive include:

1) **High local interest rates** – China's 10-year yield is at 3.7% (cf. the UK's yield is 1.4% and US's of 3.0%, Japan's 0.05% and South Korea's 2.8% (all as at 9 May 2018), leading to attractive investment yields for insurance products

2) **Technology adoption** – China's insurers are very active in adopting new technology to achieve higher growth in premiums, better underwriting profitability and greater efficiency

Figure 6: Insurance penetration: premiums as a % of GDP in 2016



Source: Swiss Re

TRAVEL

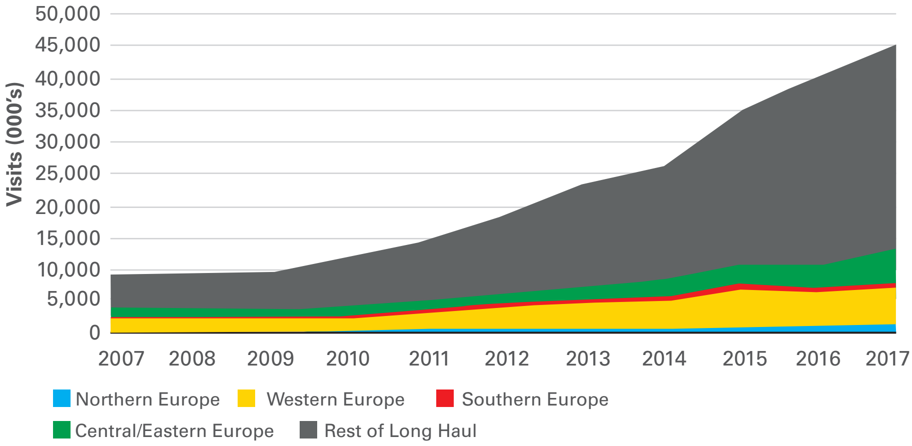
CHINA – NOW WITH MONEY TO SEE THE WORLD

You may have been wondering why you keep running into Chinese tourists on Bond Street or up the Eiffel Tower. According to national statistics, Chinese outbound travellers are predicted to reach 203 million by 2020 (four times the UK), with growth of 14% in 2018. This is driven by three key destinations: South Korea, Japan and Thailand, and increasingly also Europe (Figure 7).

In 2017, the 130 million outbound Chinese travellers were estimated to have spent over £150 billion on overseas travel, including airlines, airports, hotels, luxury brands and duty free. This has been fuelled primarily by a rise in GDP per capita on a PPP-adjusted basis. At $16,624 (*2017 IMF data*) the disposable income level of more than 30% of China's population is in-line with that of the UK (currently 350 million people and 865 million by 2025).

The loosening of visa restrictions and increasing number of passport holders are also key factors. Only 10% of Chinese hold passports, compared to 75% for Brits. Due to China's enormous scale, even this low number results in one in 10 international tourists being Chinese. As more Chinese become wealthy enough to travel abroad, businesses that serve them are likely to experience significant increases in demand. And what's more, Chinese tourists spend more on average than other nationalities (Figure 8).

Figure 7: China's long haul* outbound travel



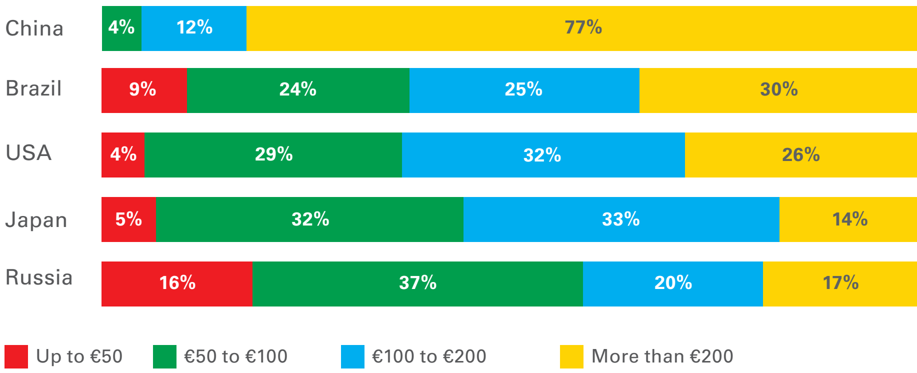
*Long haul defined as tourist arrivals to destinations outside Northeast Asia

Source: Tourism Economics

Figure 8: China's high propensity to spend overseas

Chinese travellers are likely to spend significantly more in Europe than overseas travellers - helpful to airport retail growth at major hubs

Expenditure per person per day (includes accommodation, food and other activities - excluding flight tickets to Europe)



Source: Destination Europe - European Travel Barometer November 2017

Technology has reinforced this trend. With the rise of service apps, Chinese travellers no longer need to rely on tour groups or local interaction to travel widely.

There are a few ways to invest this growing theme. These include direct travel-related names such as Qantas and Samsonite, which benefit directly from the purchase of more outbound travel tickets and luggage. Furthermore, Alibaba and Tencent enable travel via apps providing bookings and instant payments, while European-listed luxury companies such as Moncler or Burberry receive 30% of total sales from Chinese customers (outside of China).

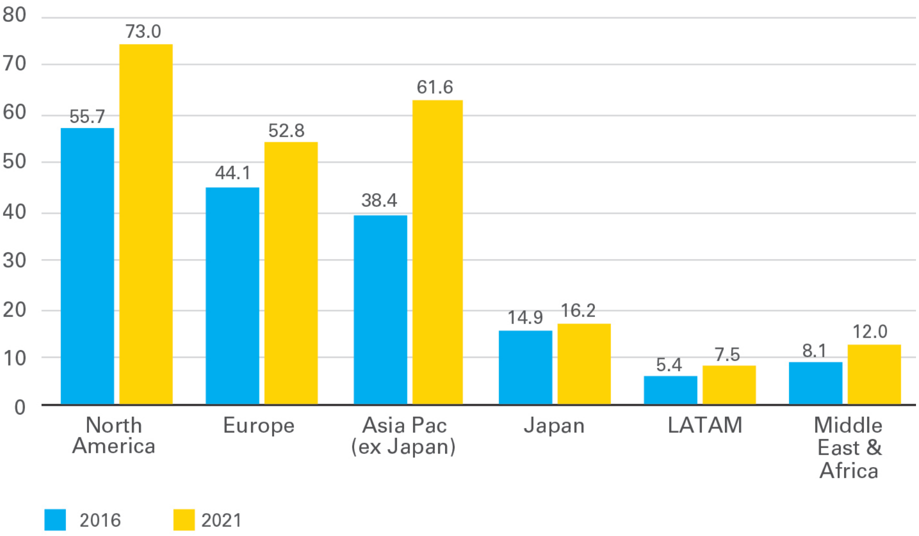
WEALTH

ASIA TO BECOME THE BIGGEST WEALTH MARKET

Asia-Pacific is not currently a well-recognised private wealth market globally. By 2021, however, the region (including Japan) looks set to overtake North America and Europe as the world's largest private wealth market at over $75 trillion. As incomes in China continue to rise, there is a disproportionate increase in the population's disposable income – driving higher savings and wealth creation. This, in turn, should result in Asia and particularly China becoming a break-through region that leads the growth in global private financial wealth creation over the next five years.

Much of this wealth is currently uninvested; Asia stands out as a market with the highest levels of cash and deposits compared with other regions globally, as much of this allocation stems from a cultural aversion towards risk. The wealth market in Asia is ripe to be institutionalised in our view.

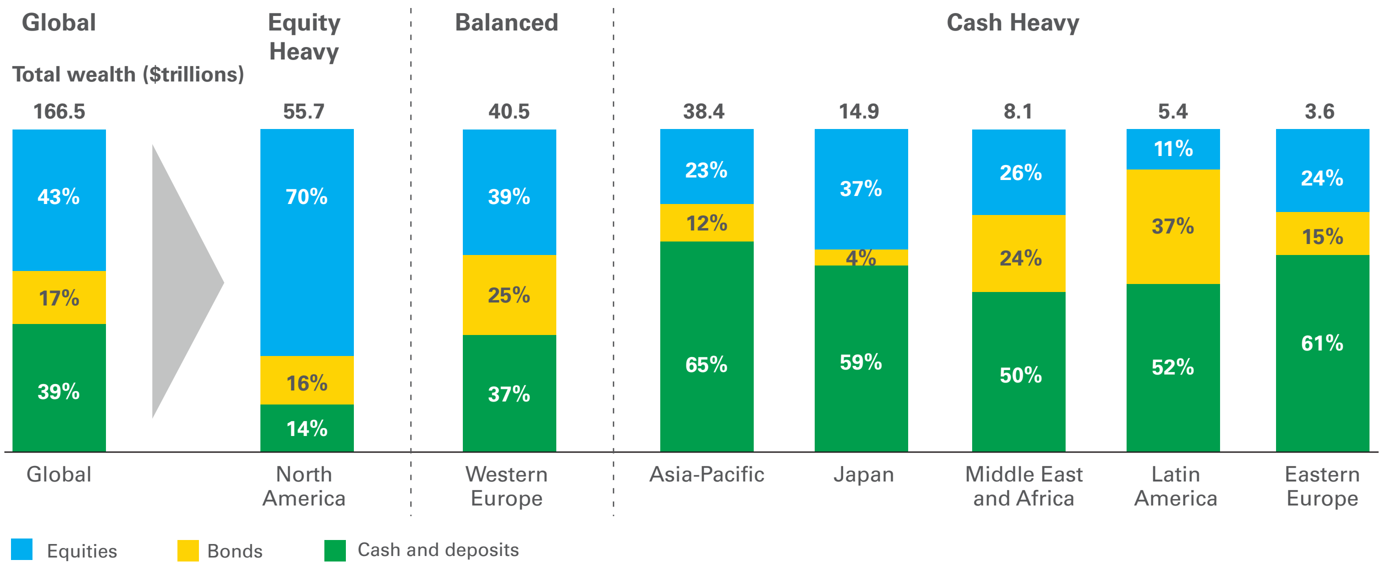
Figure 9: Private financial wealth



As it matures with more asset management and insurance players entering the market with a focus on pension and retirement planning, it is expected that much of that wealth will make its way to potentially higher returning asset classes such as global equities and bonds.

Historically, wealth in Asia has not made its way into equities and bonds as the domestic markets have gone through extreme periods of volatility (such as the boom and bust of China's A-share market between 2014 and 2016). As more global institutions make their global products available to local investors with a strong demonstration of better risk-adjusted returns with lower volatility, this should encourage a shift away from a sub-optimally invested growing private wealth market.

Figure 10: Global asset class preferences, share of wealth by asset class



Source: BCG Global Wealth Market-Sizing Database, 2017.
Note: Private financial wealth, including life insurance and pensions, is measured across all households. Because of rounding, not all percentages add up to 100.

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