CLEARPOINT

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DANIEL MEGES, SENIOR ANALYST, RESEARCH

CHINA'S CHANGING PLACE IN THE WORLD

BY DANIEL MEGES, SENIOR ANALYST, RESEARCH

China's economy is playing a different role in the global economy, spurring a rethink of how to invest in the world's second largest economy.

The world has changed and China is increasingly at the center. China is now driving global growth, significant in determining the global business cycle, and increasingly defining the technological frontier from semi-conductors and gene therapy to green-energy and artificial intelligence. In light of these dynamics, Clearstead is taking a hard look at our exposure to Chinese equities and how to gain optimal access to this thriving market.

In 1980, the Chinese economy was smaller than each of the economies of Italy, Brazil, Spain, and Canada.[1] By 1990, it was nudged out of the top-ten largest economies in the world completely by Russia.[2] At this time, nearly half of the Chinese population lived in significant poverty, there was essentially no middle class, and China had less than 300 publicly listed companies—all Hong-Kong based—and none of these firms were global leaders of any sort.[3][4] A global investor in the early 1990s rightly had little interest in China. However, in the nearly 30 years since then, the world commerce has dramatically shifted and China has become a central driver of the global economy.

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Institutional and Private Client teams with Joe Adams and Adam Felten, respectively.

Joe Adams has joined Clearstead as an Associate Consultant. Prior to joining Clearstead, Joe was a student at John Carroll University where he completed a BS in Business Administration (Finance and Economics).

Adam Felten has joined Clearstead as an Associate Portfolio Manager. Adam is a recent college graduate from Xavier University and has interned at Fifth Third Bank, Eisert Wealth Management and One America in various financial planning roles.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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Today, China boasts global leaders in numerous sectors including IT, healthcare, and industrials. There are over 5,000 publicly listed companies traded on local exchanges.[5] China is the second largest economy in the world and boasts a middle class of approximately 400 million people[6] (nearly 75 million more people than the entire US population) with average incomes, once adjusted for purchasing power, akin to the average income in some of the less affluent US southern states.[7]

China's Global Rise

	Per Capita Income	Middle Class	Publicly Listed Firms
1990	$986	<10 Million	284
CAGR	+11%	+15%	+12%
2017	$16,842	400 Million	5,472

Source: Clearstead, World Bank, Brookings Institute.

NEAR-TERM DYNAMIC: US-CHINA TRADE WAR & CHINA'S SLOWING ECONOMY

Now you may be thinking at this point—sure China is a key global economy, but is now the right time to invest in China? Isn't China a risky market? It is certainly true that China's economy has been decelerating for most of the last decade. In part, this is due to its demographics and the slower growth in its working-age population, and in part it is due to its transformation from a fixed-asset investment/export oriented economy to a more developed/consumer-oriented economy. As China has navigated what economists call the "Middle Income Trap,"[8] its economy has slowed from the low-to-mid teens a decade ago to approximately 6%-7% more recently.[9]

This gradual slowdown has been compounded by uncertainty related to the ongoing US-China trade war. As of early June, the trade talks remain fluid and there is a real possibility that no deal is reached and the US imposes additional tariffs—covering all Chinese exports to the US. However, even with a positive conclusion to the trade talks, most global firms and market watchers have concluded the US has permanently transitioned from a strategy of accommodation vis-à-vis China to one of competition and confrontation.

According to McKinsey, this has spurred most multinational firms operating in China to reconsider their China-based supply chains and explore other countries and supplier options.[10] In fact, a McKinsey survey from Q4-2018 found that 31% of US respondents were already delaying or canceling investment decisions targeted for China, another 18% were considering relocating some or all of their manufacturing outside China, and 3% were even thinking about exiting the China market altogether.

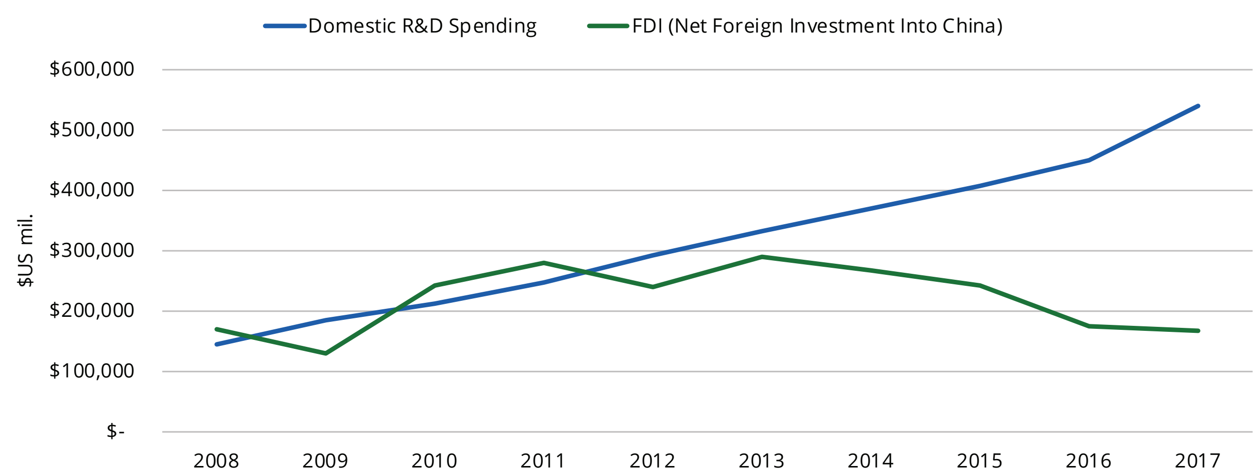
It is unavoidable that the trade war as well as the change in US rhetoric regarding China[11] will provide a near-term headwind to China's financial markets and economic animal spirits. However, equally unavoidable are the long-run factors that will allow China to weather these economic obstacles and continue to grow robustly, and these current economic challenges may create an advantageous entry point for the long-term investor.

LONG-TERM DYNAMIC: SECULAR GROWTH & PRODUCTIVITY GAINS

To understand the transformation of China's economy, we would first highlight the diminishing role of foreign investment in the Chinese economy. From 2000-2010, China accumulated more than 30% of all foreign investment targeted to the developing world, and heavily relied on it to build its export-oriented industries and drive productivity improvements across numerous sectors.[12] In short, 20 years ago, China needed the foreign capital and the "know how" to modernize its economy and to catch up with the West.

However, since the global financial crisis, China's domestically generated R&D spending has caught up to America's level of spending and its dependence on foreign-led investment has greatly diminished.[13] This has led to Chinese global champions on the cutting edge of technology in a myriad of sectors—from biotechnology and artificial intelligence to e-commerce and 5-G infrastructure. China, in short, has developed industrial and technological capabilities in many areas on par with the US, Japan, and Western Europe and is positioned for a significant and sustained rise in productivity across its economy.

Changing Nature of Chinese Investment



Chinese Domestic R&D Year Over Year Growth	**--**	**26.8%**	**15.2%**	**16.1%**	**17.9%**	**14.3%**	**10.9%**	**9.9%**	**10.7%**	**20.0%**
Chinese Domestic R&D Share of Total US R&D Spending	**36%**	**46%**	**52%**	**58%**	**67%**	**73%**	**78%**	**82%**	**88%**	**96%**

Sources: Clearstead, OECD, World Bank.

While many economists point out that China's working-age population may peak in the next few years, begin a gradual decline, and work to blunt economic growth in the coming decade,[14] they tend to ignore or minimize the impact of the nearly 20% of the Chinese population—nearly 280 million people—that still live outside of any urban center and continue to work in very low-productivity agriculture.[15]

Essentially, China has a reserve workforce that is nearly 80% the size of the entire US population that has yet to fully integrate into the modern Chinese economy. Similarly, human capital formation and advanced education has exploded in China. In 1986, about 2% of 18-year olds attended college, while, for the past few years, approximately 40% of 18-year olds have enrolled, and the total number of college graduates has ballooned to 120 million last year, up from about 15 million in 2000.[16] To take a pessimistic view of China's growth over the next five to seven years, one has to assume the unlikely case that longstanding trends in improving Chinese education, productivity, and urbanization completely stall.

There are longer term risks to China's economy, but none are likely to become acute over the next five years. A system of one-party rule, such as China's political system, could become destabilized if there were a widespread, grass-roots movement towards democracy. But there is little-to-no evidence of this at present. Other risks relate to China's rapid increase in corporate debt over the past decade—which stands at nearly 160% of GDP—or its currency, which some market watchers view as undervalued.[17] However, most of the corporate debt resides in a relatively small number of state-owned enterprises, while China's central government and its households hold very little debt overall.[18] Because of this, any potential bad debts are corporate, not household, and because this leverage was largely driven by state-controlled banks lending to state-owned enterprises to stabilize demand after the global financial crisis, it provides the state with the ability to manage the timing and pace of recognition of any nonperforming loans. Furthermore, the leverage that has built up in the Chinese economy is largely denominated in local currency, and the Chinese government has signaled that keeping its currency (Renminbi) stable against the dollar is a key priority.[19] [20]

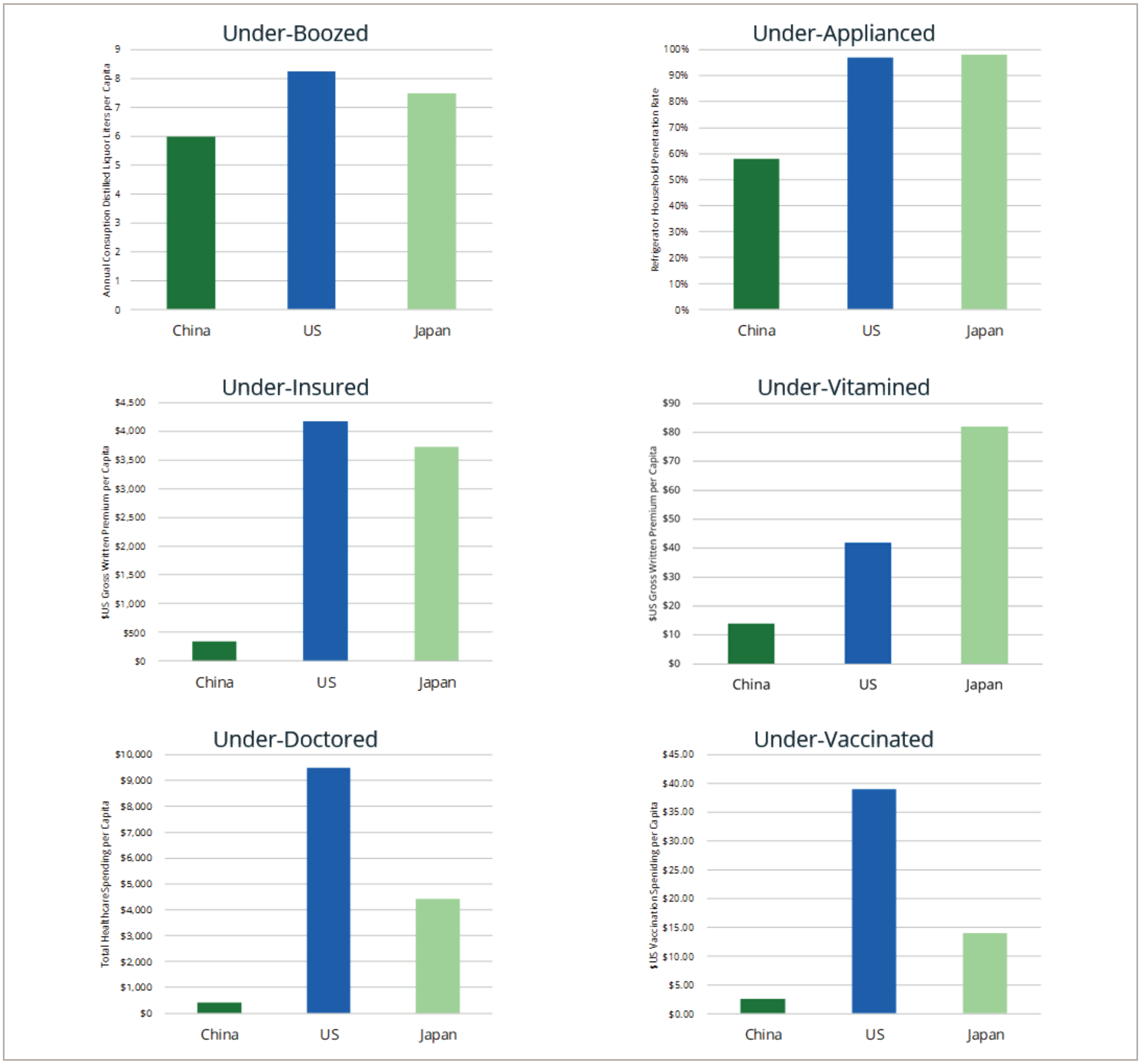
CHINESE CONSUMER – 1950S AMERICA ALL OVER AGAIN

The economic slowdown last year in China masks some strengths of China's domestic, non-export-oriented economy, which has shown resilience in the face of a slowing export sector and is positioned for long-run sustained growth. The growth of the Chinese middle class has been staggering and, over the next decade, companies oriented to servicing the needs of China's middle class will be poised to reap exceptional profits and growth.[21]

China's middle class is under-banked and under-insured, lacking many appliances found in Western homes, consuming private education in record numbers, and travelling at home and abroad at record levels. However, these new consumers are increasingly oriented to local brands and companies rather than seeking global brands and products, according to several consultancies and research firms.[22] [23] Local brands are winning in numerous categories because they better address consumer needs in three areas: value for money, quality, and aftersales service.[24] Investors seeking to exploit the mass-market Chinese consumer growth trend will need to invest in firms traded on China's on-shore markets that are oriented towards the Chinese consumer first and foremost.

For instance, Midea Group is a leading Chinese maker of air conditioners and other appliances and it is front and center in the healthier living trend sweeping China. The company invests $1.4 billion dollars annually—some the highest R&D spending in the global industry—to develop high-end (and margin) health-promoting products such as water-purifiers and integrated air-conditioner/air-purifiers. The company is making substantial profits, and in addition to its air conditioning/refrigerator business, has the top brands in China for induction cookers, pressure cookers, rice cookers, and instant kettles.[25] Its primary consumer market is China, and its revenues grew by 23% annually between 2015 and 2018.[26]

The Chinese Consumer will Power Sustained Growth



Sources: Clearstead, OECD, World Bank, NIH, William Blair, Electrolux.

YOUR PORTFOLIO LIKELY NEEDS MORE CHINA

Despite China's incredible rise in the global economy, it represents a very small portion of most investors' equity allocation. A recent survey by Cambridge Associates suggests that institutional investors allocated less than 7% of their portfolio to

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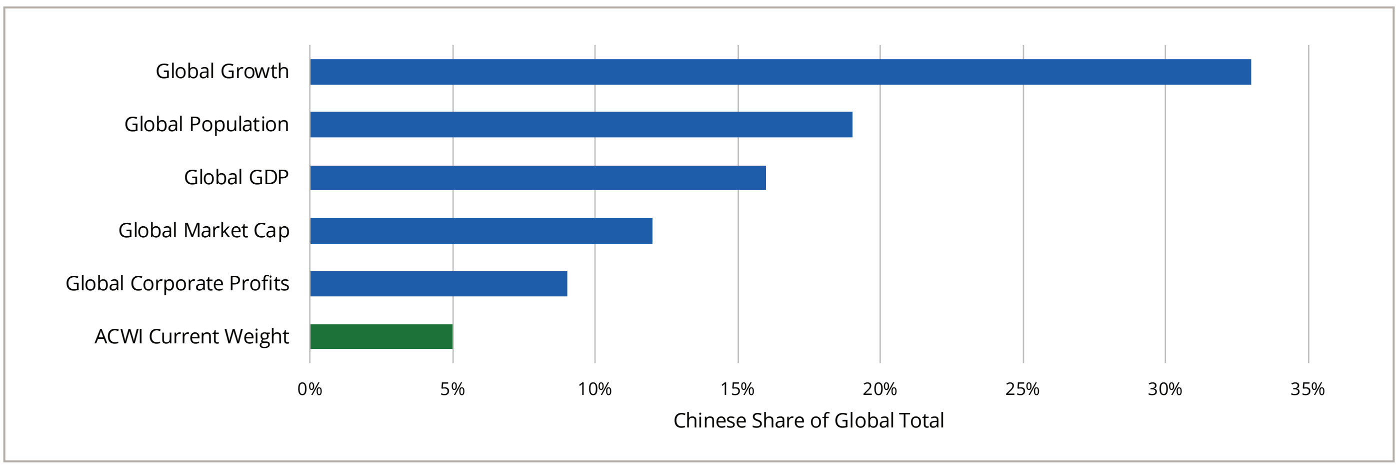
China—though more than 25% of respondents indicated they are considering increasing their exposure.[27] In terms of US retail investors, the share of equity exposure to China is very small—less than 1% on average, according to analysis of Morningstar data.[28]

MSCI has taken notice of China's rising role in the global economy and they are in the process of increasing China's inclusion in their key global indices including the MSCI ACWI, MSCI ACWI ex US, and the MSCI Emerging Markets. MSCI announced their plans to increase China's equity representation in these indices in 2017 and have slowly begun to increase the inclusion of China's domestically, on-shore traded (A-share) stocks into its indices.[29]

China's on-shore (A-Share) market represents more than 3,000 companies with a total market capitalization of $9 trillion dollars.[30] Currently, about 5% of the MSCI ACWI index is represented by Chinese equities—Hong Kong listed, Chinese foreign listed, and Chinese on-shore shares combined—but even at the end of MSCI's Chinese equity expansion initiative (not expected to conclude for another few years), Chinese equity will only account for about 7% of the total MSCI ACWI Index.[31]

How much exposure to Chinese equities is appropriate given the size and role of China in the global economy? China represents about 16% of global GDP at nominal prices according to the IMF,[32] about 12% of all global consumption, and Chinese firms account for 9% of total ACWI corporate profits according to FactSet.[33] With nearly 1.4 billion people, China alone is about 19% of the world's total population.[34] Looking at global equity markets as a whole, Chinese equities—combining onshore and offshore equities and including shares that are not free floating—are about 12% of the global market cap. In all, Clearstead believes that most institutional and retail investors will be seeking to increase their total equity allocation to Chinese equities in the coming years. Currently, Clearstead's model portfolio for the long-term investor has about a 5% equity allocation to China which is in line with the index.

China's Under-Appreciated Role in the Global Economy



Sources: Clearstead, OECD, World Bank, MSIC, IMF, Cambridge Assoc.

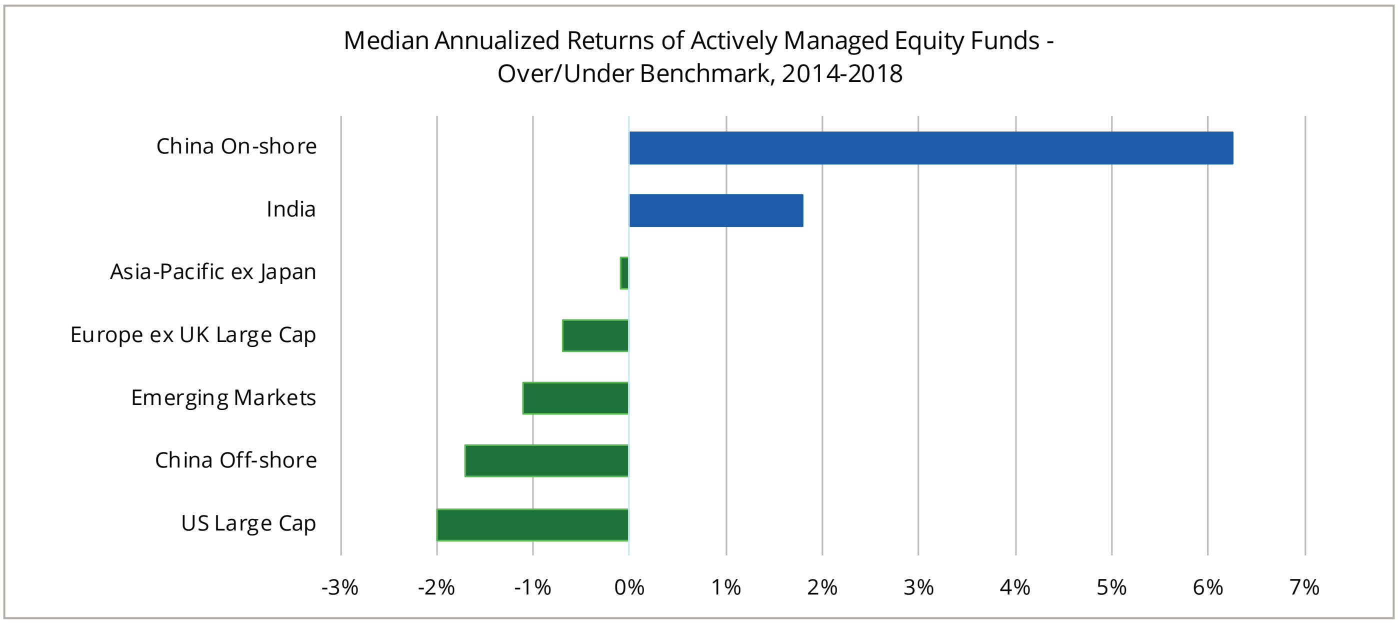
CHINA'S ON-SHORE MARKET – AN ACTIVE MANAGER'S PARADISE

The Chinese on-shore equity market is volatile, inefficient, and sentiment driven, but it is also very liquid and non-Chinese investors are nearly absent. The Chinese on-shore equity market has less than 3% ownership by non-Chinese investors and it is dominated by retail Chinese investors—more than 85%, compared to about 50% in the US and 35% of Hong Kong—with very short investment horizons.[35]

Furthermore, while Chinese listed firms are numerous and the markets are liquid, many firms barely cover their cost of capital because of a business culture that is used to easy financing from state-owned banks, and little history of returning value to shareholders.[36] These "zombie" companies are poor investment options and passive investing vehicles that buy the full index are likely to be a high-risk and inefficient way to access this market. However, a sizable minority—approximately 30% according to some reports or nearly 1,000 companies—of China's on-shore listed firms are growing incredibly fast, compounding earnings, and delivering handsome returns for shareholders.[37]

China is a big country with distinct market segments, cultures, geographies, and people/places in different stages of development. These circumstances and the reality of rapid change in China can be daunting for investors who are not on the ground in China, nor familiar with its local markets, business culture, and government institutions. In light of these complexities, it is not surprising that active managers have, overall, demonstrated their ability to consistently outperform and generate alpha for their clients in the local Chinese markets. Because of the persistent volatility, smart strategies protect significantly to the downside when markets fall and provide investors meaningful upside when they move sharply higher. In addition, the Chinese on-shore market is very diversifying and its five-year correlation to the S&P 500 is below 0.50.[38]

Active Managers Consistently Outperform in Chinese On-shore Equity Markets



Sources: Source: WSJ April-2019, based on Schroders & Morningstar data.

Past performance is not an indicator of future results. Data represents median annualized performance of the Morningstar categories listed compared to the Morningstar category benchmark, as of December 31, 2018.

Additionally, China's on-shore markets are more sector diversified than the Chinese companies listed in Hong Kong or other foreign exchanges. The on-shore Chinese markets have much higher weighting for healthcare, consumer staples, materials, and industrials than what is currently available in the Hong Kong or other international listings, which are dominated by the IT and Financial sectors. The Chinese on-shore market is the most efficient way to get direct access to the companies that are set to persistently grow and compound profits over the next five to seven years.

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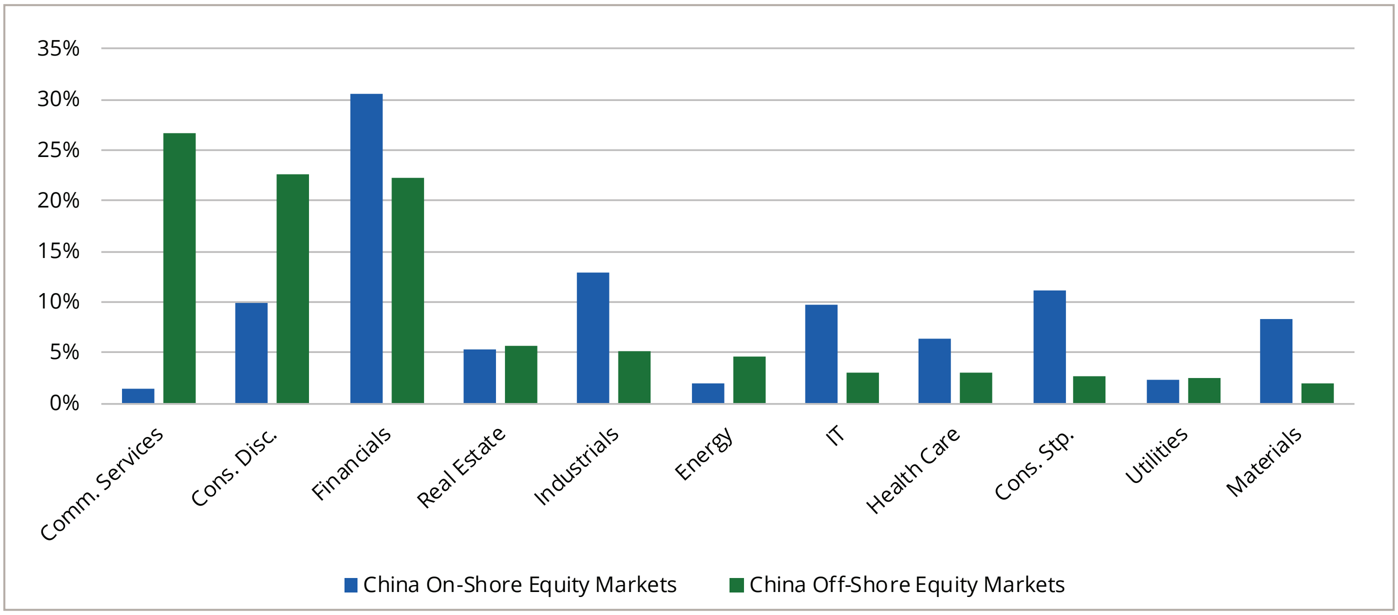
China's On-shore Equity Markets Are More Sector Diversified



Source: MSCI, sector weights as of 4/30/2018.

CLEARSTEAD HAS A PLAN FOR CHINA EQUITY

Investment in China has substantial risks and may not be a suitable choice for every investor. China faces several economic and geopolitical challenges at the moment that may diminish future returns. These risks include high levels of domestic debt, a potential currency devaluation and political risk associated with the evolution of one-party, communist rule. These risks are real, but in our view manageable over the coming years, especially in light of the opportunity presented. The sheer size of the market and its alpha-generation potential make it too important an opportunity to leave the size of an investor's equity allocation tied to an index provider.

Here at Clearstead, we have been actively looking for China-specific strategies to help our clients leverage the opportunity of the China market and studying if (and how) a small dedicated China position could be used to augment a client's exposure to emerging market equity. We have put a premium on identifying managers with deep teams that feature robust language and accounting skills, as well as extensive knowledge of the nuances of the Chinese market. Lastly, we at Clearstead stand ever ready to partner with our clients and provide the best, objective guidance we are able regarding this large and quickly evolving market opportunity.

Sources:

(1) World Bank national accounts data, and OECD National Accounts data files.

(2) World Bank, national accounts data, and OECD National Accounts data files.

(3) World Bank, urban population (% of total), poverty gap at $3.20 a day (2011 PPP) (%).

(4) World Bank, listed domestic companies, total.

(5) World Bank, listed domestic companies, total.

(6) Brookings Institution "The Unprecedented Expansion of the Global Middle Class" Feb-2017.

(7) Foreign Policy Journal "China's Middle Class is Pulling UP the Ladder Behind Itself", Feb-2018.

(8) The "middle income trap" is a theoretical stage of development, in which countries having attained between $1,000 to $12,000 per capita income (World Bank working definition), begin to stagnate in terms of economic growth and income levels.

(9) World Bank, national accounts data, and OECD National Accounts data files.

(10) McKinsey "China and the world: Inside a changing economic relationship" Dec-2018.

(11) The Hudson Institute, "Remarks by Vice President Pence on the Administration's Policy Toward China", Oct-2018.

(12) J. L. Ford*, S. Sen* and Hongxu Wei* "FDI and Economic Development in China 1970-2006: A Cointegration Study" July-2010.

(13) OECD "Gross Domestic Expenditure on R&D", 2008-2017.

(14) Capital Economics "Will Emerging Markets Outperform in the Long-Run?" March-2019.

(15) Clearstead Research Calculations; World Bank, Employment in agriculture (% of total employment) (modeled ILO estimate).

(16) Neuberger Berman - White Paper "China: The Anatomy of an Equity Market" January-2018.

(17) US Congressional Research Service "China's Currency Policy" Feb-2019.

(18) Matthews Asia Sinology "China's Debt Problem" March-2019.

(19) Matthews Asia Sinology "China's Debt Problem" March-2019.

(20) U.S.-China Economic and Security Review Commission "2018 Report to Congress" Nov-2018.

(21) McKinsey Quarterly "Mapping China's Middle Class" June-2013.

(22) Credit Suisse "China's New Retails" September-2018.

(23) McKinsey "The Real Reason Why Chinese Consumers Prefer Local Brands" Dec-2017.

(24) McKinsey "The Real Reason Why Chinese Consumers Prefer Local Brands" Dec-2017.

(25) Midea Group "Investor Relations Presentation" Sep-2017.

(26) Bloomberg Data - Midea Group co Ltd.

(27) Cambridge Associates "The Case For Dedicated China Exposure" March-2019.

(28) Clearstead Research Calculations; CNBC Report "A Stubborn Investing Rule Share Shared by Jack Bogle and Warren Buffet" April-2017.

(29) MSCI Press Release "Results of MSCI 2017 Market Classification Review" Jun-2017; MSCI Press Release "MSCI Equity Indexes May 2019 Index Review" May-2019.

(30) Lazard Investment Research "Bringing Their "A" Game: The China A-Share Equity Market and Foreign Investors" Feb-2019.

(31) Cambridge Associates "The Case For Dedicated China Exposure" March-2019.

(32) IMF DataMapper, GDP, current prices, World Economic Outlook, April-2019.

(33) Cambridge Associates "The Case For Dedicated China Exposure" March-2019.

(34) World Bank, population, total, 2017.

(35) Lazard Investment Research "Bringing Their "A" Game: The China A-Share Equity Market and Foreign Investors" Feb-2019.

(36) Callan Research "China A-Shares: Key Issues for Investors to Consider" June-2018.

(37) Matthews Asia "Value Creators By Percentage & Number of Companies" Slide 25, Sep-2017.

(38) Callan Research "China A-Shares: Key Issues for Investors to Consider" Correlation for 5 Years ended March 31, 2018.

MARKET BENCHMARK RETURNS

May 31, 2019		1M	3M	12M	YTD
US Large Cap	S&P 500	-6.4%	-0.7%	3.8%	10.7%
US Small Cap	Russell 2000	-7.8%	-6.6%	-9.0%	9.3%
Developed Intl	MSCI EAFE	-4.8%	-1.5%	-5.7%	7.6%
Emerging Intl	MSCI Em Mkt	-7.3%	-4.5%	-8.7%	4.1%
Real Estate	NAREIT	0.2%	4.4%	15.0%	16.9%
Core Fixed	BarCap Agg	1.8%	3.8%	6.4%	4.8%
Short Fixed	BarCap 1-3Yr	0.7%	1.6%	3.7%	2.1%
Long Fixed	BarCap LT G/C	4.1%	8.6%	10.1%	10.4%
Corp Debt	BarCap Corp	1.5%	4.5%	7.4%	6.9%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.