

For professional investors only, not retail investors. All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk.

Changing China

In little over 40 years, China has emerged onto the global scene as a key player in the world economy. It has regained a self-confidence last seen centuries ago. This rapid ascent has prompted change in global ideas about politics, economics and world order. Rather than rush headlong into capitalism, China has tried to modernise the planned economy, implementing incremental changes and downplaying any discussion of the ultimate goal. China has gone from a foundation of state-owned enterprises to having some of the most fascinating private companies in the world. As Deng Xiaoping noted, it doesn't matter if the cat is black or white, as long as it can catch mice. Over the 40 years of economic reform and trade liberalisation since 1979, China's GDP has grown more than 35 times. In 2014, it became the largest economy in the world (in purchasing power parity terms). The speed of China's ascendance and its strengthened global position have led to questions over where it might be headed.

China's ability to combine a gradual opening of its economy, a large state sector, and authoritarian rule has broken the historic link between economic development and political liberalism that is popular in the west. Instead, China has sought to embrace the economic benefits of globalisation without the external political ideology. China's thinkers want to create a world where national governments can be masters of their own destiny, especially given that China was not involved in writing those 'global' rules during the 20th century.

The ideal is a 'walled world', where nation states can trade with each other on global markets but maintain their own control over their economic future, their political system and their foreign policy. This is emerging as an ideological challenge both to the US philosophy of a 'flat world' and the European preference for liberal multilateralism. The idea of a walled world is steeped in Chinese history – the character for 'country' in Chinese has walls around it, Chinese cities are inside walls, and traditional Chinese houses are built around a square courtyard.

How do we make sense of a system like China? On the one hand it has undergone radical institutional transformation, yet on the other, it exhibits a pattern of persistent challenges to the western model of development. Planned resource allocation is a thing of the past, prices have been liberalised, competition encouraged, an industrial revolution has been unleashed, and integration with the global economy has been

achieved. Yet, China continues to see non-market institutions as a foundation to the economy and still wants to have national state-owned champions in key sectors. The link between public and private companies is often somewhat blurred.

China is big, pragmatic and so desperate to succeed that its political leadership is constantly experimenting with new ways of doing things. From this laboratory of social experiments, a new world-view is emerging, with China at the centre of big initiatives in financial sector reform, environmental improvement, technology innovation, industrial upgrading, urbanisation and consumer-led growth.

While the first patent filed in the US was in 1790 and signed by George Washington, China's first patent was in 1985. So, it may be a surprise to some that China accounted for 44 per cent of the world's patent filings in 2017, twice as many as America. What's more, it was a Chinese company that topped the international patent filings that year.

The Chinese government has embraced slower economic growth in recent years, referring to the situation as the 'new normal'. It is transitioning its economy to rely less on fixed investment and exports and more on private consumption, services and innovation to drive economic growth. High profile initiatives such as 'Made in China 2025', which focuses on the modernisation of 10 key sectors through extensive government support, and the 'Belt and Road Initiative' aimed at supporting huge infrastructure projects, are examples of China's growing economic and political influence. In some sectors, such as artificial intelligence, China's ongoing innovation and iteration is putting it in a position of global strength.

The speed of China's development and its focus on innovation across many sectors provide a fascinating opportunity for fundamental investors.

Although the Shanghai Stock Exchange traces its foundation back to the 1860s, it effectively closed because of the communist revolution and the formation of the People's Republic of China in 1949, re-opening only in 1990. Private companies were unable to list until the early 2000s. Even then, onerous listing requirements pushed many exciting new companies to seek capital outside of China.

Today, the scale of the China opportunity is immense. China's stock exchanges are the second largest in the world. The two mainland A-share markets alone have a combined market cap of roughly \$7.5 trillion. That's larger than the UK

and Japanese markets combined.

Almost 5,000 Chinese companies are listed on stock exchanges. This has doubled since 2010. The A-share market comprises over 70 per cent of these, providing access to a range of interesting companies, themes and sectors. The rest are listed outside of mainland China, predominantly on Hong Kong and US stock exchanges.

Acknowledging the role of private companies in China's economic miracle is important. Entrepreneurs have played a significant role in the economy. Companies such as Alibaba and Tencent have succeeded in one of the most competitive and dynamic economies, where change is rapid, consumers are fickle, markets are diverse, and competitive advantages are fluid. New entrepreneurs are often open to experimentation, unafraid of failure, and constantly adapting their business models to react quickly to the opportunities that present themselves. They do this not to establish a defensible position in their market, but to create the means to transform themselves again and again. Outsiders who fail to see beyond the one-party authoritarian rule can fail to appreciate how dynamic, innovative, and capable these entrepreneurs are and how disruptive they may be.

China's rise from a poor developing country to a major economic power in just a few decades has been spectacular. It has forced other countries to ask how China's rise may impact their economic interests and global influence over the next century. China's inclusion in MSCI bond and equity indices has also shone a light on the ongoing capital market reform process and the opening of its domestic markets to the world. The speed and scale at which innovation and development have taken place in China cannot be overlooked. China has already produced some of the biggest and most innovative companies in the world.

We at Baillie Gifford have been looking at this market for over a decade. A poorly researched market dominated by short-termism with large return dispersions is an exciting one for patient, curious stock pickers.

