

Future returns

Prospects for Chinese consumers: 2023 and beyond

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China's future prosperity hinges on the country evolving from a low-cost manufacturing centre to an economy driven by consumption. After three years of stringent Covid restrictions – and a myriad of economic challenges that have dented consumer confidence – is the transition still on track?

Need to know

- To ensure its future prosperity, China needs to move up the manufacturing chain to make higher value-added products, and more of its people need to afford to buy them
- Although there are clear challenges – such as a shrinking, ageing population – we expect China to remain an important market for our World Brands strategy
- We expect demand to be driven by an increasing number of Chinese consumers and growing affluence, and believe the market will be able to support a multitude of brands

End of Cheap China

Over the course of the 21st century, China grew into the world's second-largest economy by becoming a successful exporter of affordable goods. Those days now are numbered.

Lower-margin production has shifted to Vietnam and other parts of southeast Asia as wages and real estate costs climbed in China. Both Chinese and foreign manufacturers are offshoring factories. And with a shrinking and ageing population, China can no longer rely on an abundant supply of cheap labour to produce low-margin goods.

So where will China's future growth come from? In short, the country needs to move up the manufacturing chain to make higher value-added products, and more of its people need to afford to buy them.

Can China succeed? Can domestic consumption become at least as big a driver of GDP as exports to the West?



Juan Mendoza
Lead Portfolio Manager,
World Brands



Andrew Gowen
Co-Portfolio Manager,
World Brands



Henk Grootveld
Head of Trends Investing

Pent-up demand

In the short term, we see cause for optimism about Chinese consumer spending.

President Xi Jinping surprised the country and the world in December by lifting China's stringent zero-Covid policies and reopening its borders. The controls over movement were a drag on spending, and their removal has potential to unleash pent-up demand for consumer goods (notably [discretionary items](#)) and services (travel and experiences) this year.

Longer term, there are challenges – including a lack of affordable housing and high youth unemployment – that could lead consumers to be more cautious. However, many other economies in the West face those same hurdles and yet continue to grow.

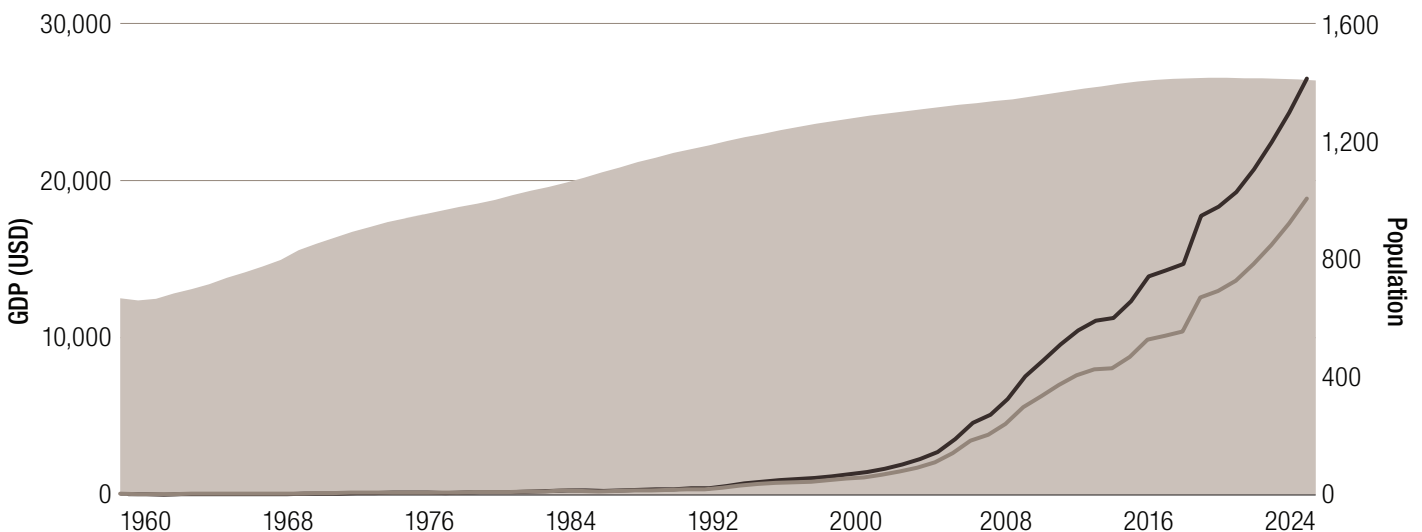
At LOIM, we expect China to remain an important market for our [World Brands](#) strategy, given the country's growing number of consumers and their increasing affluence. And critically for a strategy such as World Brands, Chinese consumers demonstrate the same appetite for established brands as their Western counterparts. This is perhaps most evident at the [higher echelons](#) of the consumer pyramid.

As Figure 1 below shows, China's GDP per capita is just breaching USD 13,000. This is roughly commensurate with levels reached by the US in the 1940s and the UK in the 1950s. South Korea reached these levels around 1990 (see Figure 2). History shows that when economies achieve per-capita levels above USD 10,000, consumers start to become a meaningful factor in the progress of that economy.

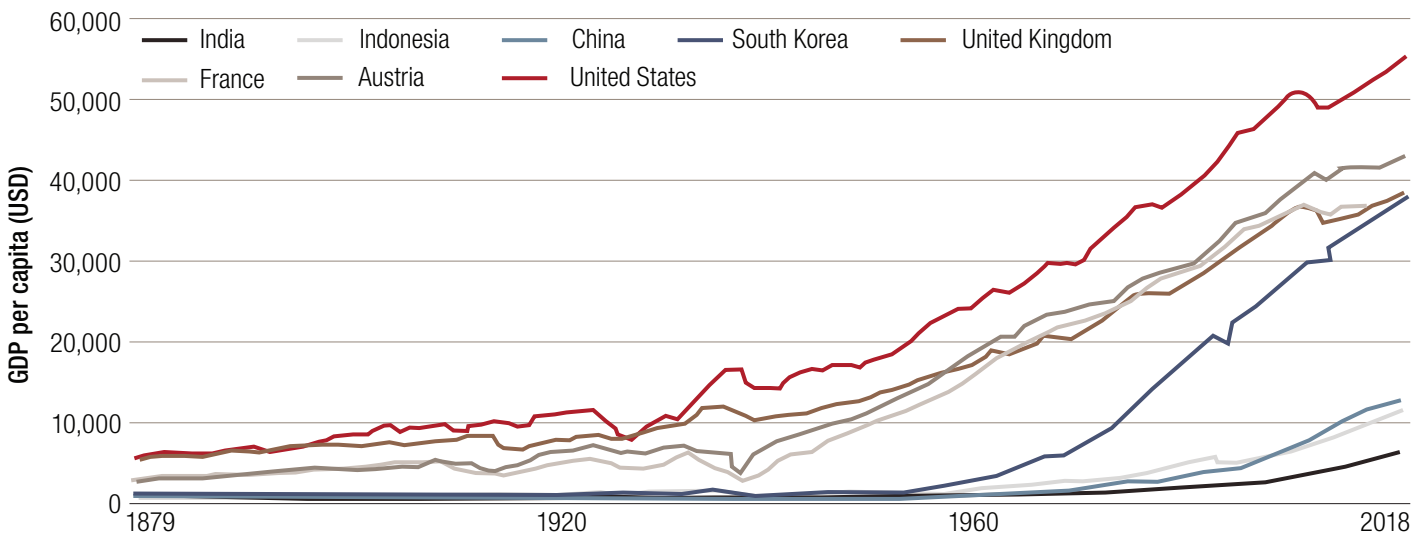
More importantly for World Brands, as those consumers achieve greater income security, they begin to search out products and brands that offer greater functionality and better quality, or that convey higher social status. The World Brands portfolio owns many of these brands – from food and drink to luxury goods and digital products – and we believe that the explosive growth of Chinese consumer spending over the next decades will be a significant tailwind for many of the holdings.

Although the Chinese consumer has been increasingly favouring local brands in recent years, we believe the market is vast enough to support both homegrown and foreign brands.

FIG 1. GROWTH IN CHINESE GDP PER CAPITA



Source: World Bank, International Monetary Fund.

FIG 2. COMPARISON OF GDP PER CAPITA BY COUNTRY

Source: Maddison project Database 2020 (Bolt and van Zanden, 2020). OurWorldInData.org/economic-growth CC BY.

Chasing luxury

The long-term health of the luxury industry depends largely on China, which is set to become the biggest luxury market by 2025, according to consultancy Bain.¹

Even amid economic uncertainty, global revenue from sales of luxury goods (including cars and services like hotels) is projected to have jumped 21% in 2022 to about EUR 1.4 trillion (at current exchange rates). That is according to the latest [Luxury Study](#) produced by Bain and Altagamma, the Italian luxury goods manufacturers' industry association.

Bernstein, another consultancy, also sees potential for strong luxury demand driven by China.

"We see [circa] 50% probability that a benign scenario materialises, whereby Chinese luxury demand rebounds between 25% and 35% in FY23, and Western demand continues to grow between 5% and 10%. The combined effect should be luxury demand growth in the mid-teens organically," said Luca Solca, Renny Shao and Clementine Flinois, analysts at Bernstein, in a note last month.¹

More affluent

The demand has been fueled by growing affluence in China as economic prosperity lifted millions into the middle class or above.

Last year, China's GDP grew only 3%, a reflection of renewed lockdowns and restrictions on speculative property development.

Even so, many categories of consumer goods grew substantially faster in China than in the rest of the world. The U.S., Japan and Germany expanded about 2% in 2022. Economists now forecast growth in China of 5.1% in 2023 and 5% next year.²

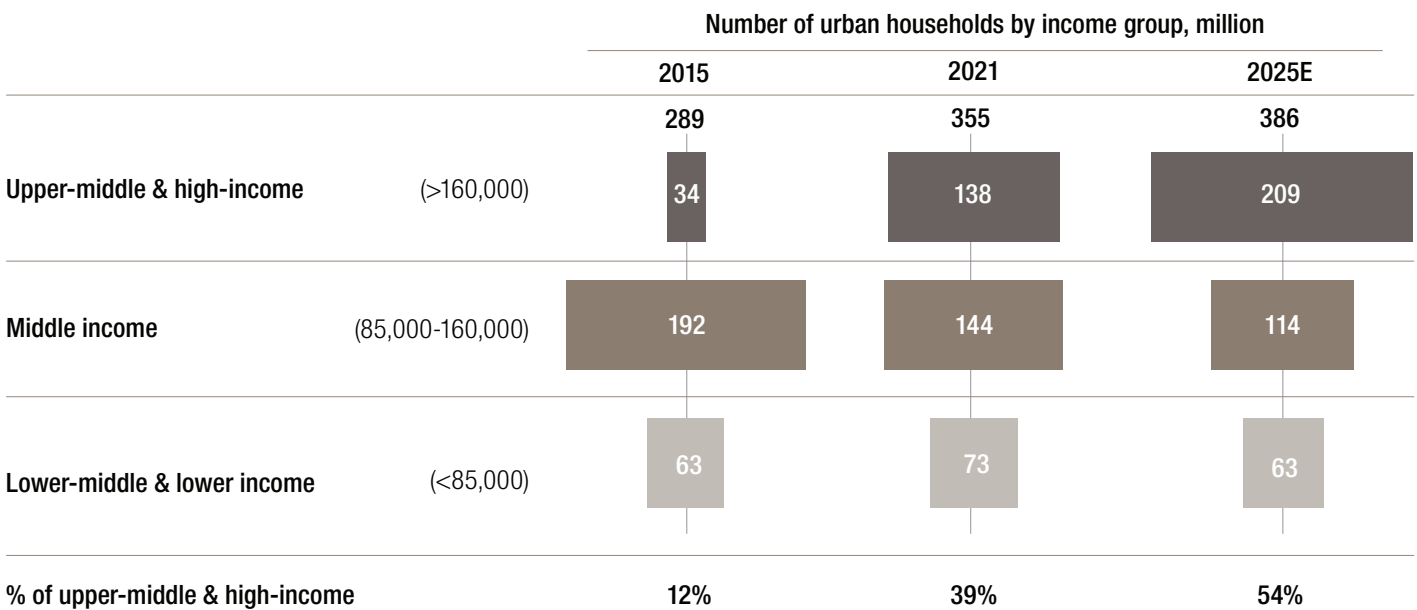
Beyond the next two years, there is potential for more people gain discretionary income – given that roughly half of the population still lives in poorer rural areas.

More people are entering the upper-middle and high-income brackets. McKinsey Global Institute (MGI) data show that the number of urban households earning incomes of more than RMB 160,000 (USD 21,800) expanded at a compound annual growth rate (CAGR) of 18% between 2019 and 2021, rising from 99 million to 138 million. By 2025, another 71 million households could enter this high-income bracket.

¹ [What China's reopening means for luxury | Vogue Business](#)

² [China's Economic Growth \(GDP\) Forecasts Raised to 5% After Covid Zero Reopening - Bloomberg](#)

FIG 3. ANNUAL HOUSEHOLD DISPOSABLE INCOME IN CHINA



Source: MGI insights China macro model.

Common prosperity

Expanding the middle class is a key part of the Chinese Communist Party's economic agenda, with a drive toward '[common prosperity](#)' being a core tenet of policymaking in recent years.

At a meeting this month, Xi [stressed](#) the importance of reviving consumption. China will establish a long-term mechanism to ensure that residents can spend "without worrying about the future," state media quoted him as saying in a study session of the politburo, a top decision-making body of the ruling party. China must implement a strategic plan to boost domestic demand, alongside efforts on supply-side reforms, Xi said.

China's government appears to be focused on creating the necessary infrastructure and environment to bring more people out of poverty. If it wants to move up the value chain, China will need more middle-class jobs. The key to this is technology and innovation.

The development of the so-called Greater Bay Area (GBA) is part of this effort. It comprises the two Special Administrative Regions of Hong Kong and Macao, and nine municipalities including Guangzhou and Shenzhen. China set out to link these areas into an integrated economic and business hub, creating an engine for innovation and growth.

The GBA is the richest economic region in South China, with a high concentration of global companies and most of China's most innovative technology companies. We expect it to be a very significant area, along with Beijing and Shanghai, for the companies that World Brand invests in.

We would hope to see similar linking of cities in other parts of the country. In recent years, both Western and Chinese brands focused their marketing efforts largely on the country's Tier 1 and Tier 2 cities, where consumption was higher. Attention is now shifting to the lower-tier cities that have greater potential for growth.

Morgan Stanley has estimated that lower-tier cities will have combined consumer spending power of about USD 6.9 trillion by 2030.³ That has potential to benefit brands at the high end (e.g., Louis Vuitton, Ferrari)⁴, as well as those in the middle (Sketchers, Estee Lauder).⁴

³ Bullish on China's Lower-Tier Cities, Morgan Stanley, May 2018.

⁴ Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

Will China grow old before it grows rich?

A main challenge for China is how to avoid the 'middle-income trap' as it loses the demographic tailwinds that helped shape its economy in recent decades. The country is an extreme example of the world's coming demographic crisis, given that China's population is expected [to be cut in half](#) and age rapidly.

The term middle-income trap [refers to](#) a previously fast-growing economy (e.g., South Africa, Argentina) that stagnates at middle-income levels, failing to graduate into the ranks of high-income countries.

China's Gross National Income (GNI) per capita reached USD 11.9k at the end of 2021⁵ – placing the country within reach of the World Bank's USD 12,376 threshold for high-income countries. China aspires to become 'a [moderately developed country](#)' by 2035, with GNI per capita doubling to ~USD 20k, as outlined in the country's 2035 long-term development target.

So, will China grow old before it grows rich? We have identified four major changes we believe the Chinese economy must undergo in order to cope with the demographics challenge and still make the jump to a high-income country. Some of them are already in progress.

1. Real estate

The economy needs to become less property dependent. Fuelled by rapid urbanisation, real estate development has been a major driver of economic growth in recent decades. Given the shrinking and ageing population, the focus should instead be on building more homes for the elderly and healthcare facilities.

2. Pensions

Increasing the tax-free investment opportunities for citizens in individually defined contribution schemes would help cool demand for privately owned real estate. Additionally, it would make sense given higher life expectancy to [increase the retirement age](#).

3. Healthcare

A further reduction of regulation and government-only ownership of the healthcare sector would increase the necessary investments in health services and facilities. After lessons learned from Covid, the government has started to deregulate parts of the sector, allowing online pharmacies and other online healthcare services from private Chinese companies.

4. Welfare system

China should consider an overhaul of the welfare system. One option is to introduce some basic unemployment insurance for all citizens. Additionally, eliminating the distinction between the urban hukou, official city citizens and rural people or Chinese migrant workers could yield benefits. Although more than half of the population now lives in cities, only 35% of city dwellers have an urban hukou, a system of official household registration needed to gain access to the welfare system. It is estimated that at least 250 million migrant workers lack access to social payments, whether for children's education or medical assistance.⁶

A new urbanisation plan with easier access to hukou has been an area of focus since Xi's first term, but implementation has been slow.

The combination of a new, well-funded pension system and more inclusive social security systems could potentially unleash the large personal savings in China that would stimulate the switch to a more consumer-oriented economy.

To read more, see [Will China grow old before it grows rich?](#)

⁵ Gross domestic product (GDP) and gross national income (GNI) are two measures of economic activity, but what they measure differs. GDP looks at the production level of an economy or the total annual value of what is produced in the nation; it measures an economy's size and growth rate. GNI is the total dollar value of everything produced by a country and the income its residents receive—whether it is earned at home or abroad.

⁶ The China-Britain Business Council (CBBC). [Does China Have A Welfare System?](#) January 2022.

Young consumers

In China, younger people have much of the spending power. This is largely a legacy of the government's former [one child policy](#), which yielded a generation of only children who became the focus of their family's financial resources.

Many members of Gen Z and Gen Y grew up with a greater sense of financial security than their parents and grandparents who lived through Mao Zedong's Cultural Revolution.

Social commerce is [well-established](#) in China, with brands using video channels such as TikTok⁴ and the messaging app WeChat⁴ to sell goods and services. This will continue to influence purchasing decisions. Influencer marketing, or KOL (key opinion leader) marketing, continues to resonate with younger consumers and [drive sales](#).

'Eco-friendly' or [green luxury](#) fashion brands have been particularly popular during China's annual Double 11 shopping festival in November. China also dominates in electric vehicle sales and production.

Resilience

In its 2023 [China Consumer Report](#), McKinsey noted that China's increasingly affluent shoppers are proving to be resilient. They are choosing more products for quality and functionality, which is a boon to high quality, artisanal products such as those produced by the European luxury goods industry. Equally, there has recently been a resurgence in the popularity of strong domestic brands. McKinsey concludes that companies that can respond quickly to these changing conditions will outperform competitors.

At World Brands, our strategy captures the opportunity by investing in global brands with significant exposure to the Chinese consumer. We do this via investments in international brands that have a domestic Chinese presence, as well as those that cater to the Chinese diaspora as they travel the world. Equally, World Brands invests in certain domestic Chinese brands.

Many of these companies are not only at the top of the pyramid (LVMH, Ferrari, Hermes),⁴ but also in the middle market (L'Oreal, Estee Lauder).⁴ This part of the portfolio will benefit from more people gaining incomes up to and above the level where they will have discretionary money to spend.

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