WORLDWIDE
ASSET MANAGEMENT

MARKET PERSPECTIVE – MAY 2016

Middle Class Growth in Asia

By Portfolio Manager Mogens Akselsen

China is at a turning point. Whereas the country was previously a major supplier of cheap labour, the price of Chinese production output has now risen to a point where many companies at the lower end of the value chain are moving their production facilities to cheaper countries.

This is a trend leading to new growth and an expanding middle class on new continents. Especially countries like Indonesia, Vietnam, Bangladesh and the Philippines are now developing consumption patterns similar to those we saw in China some 15 years ago. Consumption patterns are changing from a basic minimum of necessities to a more service-driven pattern in which population groups with middle class status are starting to demand durable consumer goods, insurance, new technology, real estate, etc.

We recognise this pattern thanks to our more than 25 years of experience from investing in Asian companies.

> **Consumption patterns are changing from a basic minimum of necessities to a more service-driven pattern.**

Drop in Chinese production creates growth

Fifteen years ago, China was still competitive when it came to cheap labour. The country manufactured everything from toys and shoes to plastic cans by applying a relatively simple manufacturing model. Today, Chinese labour is not quite as cheap, due in part to higher wage costs and in part to a decline in the size of the Chinese labour force. In 2015 alone, the Chinese labour force contracted by 3.7 million people. Not least Chinese factory rent levels and the price of power and water have risen considerably in recent years.

> **Today, Chinese labour is not quite as cheap, due in part to higher wage costs and in part to a decline in the size of the Chinese labour force.**

In addition, China is projected to have an estimated 440 million people over the age of 60 by 2050. That puts about one in four of China's population in the 'elderly' category. We are seeing the same trend in Japan, where the shortage of labour has caused major problems. A few years ago, the Chinese government abolished its one-child policy to counter this trend, but it is not expected to have much of an effect, as most Chinese still prefer to have just one child. However, even if Chinese families chose to have more than one child, it would obviously take quite a few years before it would have an effect on the size of China's labour force.

Rising Chinese output costs are causing many companies to move to other countries where it is cheaper to set up a business. As a result, countries like Indonesia, Vietnam, Bangladesh, India and the Philippines are now welcoming foreign companies. This will mean a strong boost in middle class numbers in these countries and thus also an increase in consumer demand for more sophisticated products such as new technology, life insurance, better housing and brand name products.

This is the background for the Asia strategy's exposure to the automotive industry through its investment in Philippine company GT Capital, whose investments also include the financial sector. GT Capital's current portfolio of businesses is well positioned to capitalise on broad-based economic growth in the Philippines, particularly in domestic consumption.

> **Countries like Indonesia, Vietnam, Bangladesh, India and the Philippines are now welcoming foreign companies.**

Another example is the fund's exposure to Bank Rakyat in Indonesia, the country's second largest bank, which specialises in microfinancing for the growing Indonesian middle class. Bank Rakyat has some 30 million customers and a distribution network of more than 4000 branches.

Striking similarities in consumption patterns

Expanding incomes change consumption patterns, and it is often underestimated how much of an exponential effect changes in the higher income groups typically have. Rising household incomes cause the number of wealthy households to explode, which is a relevant indicator to look for when you are searching for areas offering above-average opportunities. The phenomenon has a so-called 'ketchup effect': demand surges once the 'pent-up' demand is released.

This pattern in sectors such as insurance and real estate sales – as previously seen in China – is now being repeated in other countries. A good example is car sales in India today compared to car sales in China some fifteen years ago. When income levels rise, so do car sales, and generally at the same rate as we previously saw in China.

We are especially seeing similarities in the challenges the two countries are facing as a result of decades of industrialisation and rising energy consumption. In particular, pollution represents a special challenge, with India and China at the top of the list of the worst affected countries. Both countries have long faced extensive problems with environmental contamination that could, in the long term, hinder their continued industrialisation if they fail to get it under control in time. We believe that similar trends will unfold on other continents that have a rapidly growing middle class.

Expensive labour creating cheap technology

With China recognising that its competitive strength has been impaired, the 'Middle Kingdom' is on the verge of a technology driven automation of its production processes. Robotics will take over where human labour is too expensive and where Chinese technological know-how can be developed, distributed and sold.

As demand grows, the supply price will fall. In 2008, an industrial robot with a ten-year life cycle would be paid for after an average of 11.8 years. By 2015, the investment repayment period had fallen to as little as 1.7 years. We believe that trend will continue. We see investing in Chinese industrial robotics as a strong trend over the next few years, with infrastructure as another obvious candidate area for investment. In the longer term, we also expect to see early signs of growth in both of these sectors in Asia's other emerging markets.

> **Robotics will take over where human labour is too expensive and where Chinese technological know-how can be developed, distributed and sold.**

Pollution and a lack of education may hinder growth

While China's population is generally well educated, this is far from the case in many of the countries currently seeing a rising middle class expansion. To some extent, China's economic growth is based on companies taking advantage of a well-educated population that can quickly copy new products and technology solutions and develop them further. Cases would be mobile technology and the wind turbine industry. For example, China was quicker to solve challenges in the wind turbine industry than the countries that originally developed the technology.

While China's population is generally well educated, this is far from the case in many of the countries currently seeing a rising middle class expansion.

Given the relatively low education levels of their populations, the question is whether these countries, each of which has its own individual cultural background, will be able to evolve the same way China has. We believe they will, although they will do it at their own pace. We are confident that the Chinese consumption pattern will appear in new versions on new continents, and that all of these versions will be based on a rapidly growing middle class.

Another possible impeding factor is indicated in recent research showing that pollution on the Asian continent is having a huge environmental impact in other parts of the world. If these findings are confirmed and further substantiated, the governments of the polluting countries could come under pressure to resolve their environmental issues or, in the alternative, cut back significantly on their production.

Our extensive experience as investors in parts of the Asian continent gives us a sizeable advantage in recognising emerging market development patterns. As a result, we expect a great deal from our investments in companies that are expected to gain from this trend, e.g. the AIA Group, a company offering insurance and financial services in several Asian markets. Further to our environmental theme in Asia, we see immense potential in Beijing Water, a company offering water purification systems, and wind energy company Huaneng Renewables.