



ALLIANCEBERNSTEIN®

CHINA'S GREAT WALL OF WORRY

MYTHS VS. REALITIES

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IN THIS PAPER: China's rise as a preeminent economic power makes it impossible for globally minded investors to ignore. With the integration of China's domestic-listed equities and bonds into major global indices, the potential of investing in the broad economy is increasingly opening to the world. It's time, then, for investors to familiarize themselves with misconceptions that can distort the view of China's economy and corporate landscape. In this paper, we survey seven myths about the Chinese market—from a looming debt bubble to export dependence to an inability to innovate—and explain what investors need to pay attention to in order to make informed decisions as they tap China's opportunities.

MYTHICAL CHINA

China's relentless growth and emergence as a preeminent economic power have made it impossible for globally focused investors to ignore. With the integration of China's domestic-listed equities and bonds into major global indices, the potential of investing in the broad economy is increasingly opening to the world.

But despite projections that this giant will eventually surpass the US and claim the mantle of the world's largest economy, China remains a developing country with its own unique brand of economic peculiarities.

While China's central government has ably shepherded the country to unprecedented expansion, it still exerts a dominant and sometimes heavy-handed influence on the economy and markets. Many investors are understandably unnerved by China's perceived mountain of debt, its giant shadow-banking sector, and a potential real estate bubble. Still others worry that the country is overly dependent on low-cost exports and infrastructure projects, rather than domestic consumption and innovation. And environmentally responsible investors are uncertain about the steps China is taking on its environmental front.

Such an investment climate may appear overly exotic and too risky. However, before deciding to pass over China, investors need to familiarize themselves with several misconceptions that can distort perspectives about China's economy and corporate landscape.

In this paper, we survey seven myths about the Chinese market and explain what investors need to pay attention to in order to make informed decisions about how they tap China's opportunities.

CAPITAL MARKETS

Myth: China's capital markets are liberalizing.

Reality: Lingering restrictions and government intervention mean markets won't resemble those of the US or Europe anytime soon.

It was another sign of the wave of foreign investment destined for China's capital markets. In February, MSCI announced plans to quadruple the weighting of Chinese equities in its benchmark indices this year.

But days later, MSCI decided to drop Han's Laser from its indices because of regulatory intervention: ownership of the stock was about to touch a long-standing government-imposed ceiling on foreign investment.¹ Buy orders halted. The turn of events illustrates both the opportunity and the complications from the opening of China's equity and bond markets to foreign investors.

ADDING ONSHORE SECURITIES

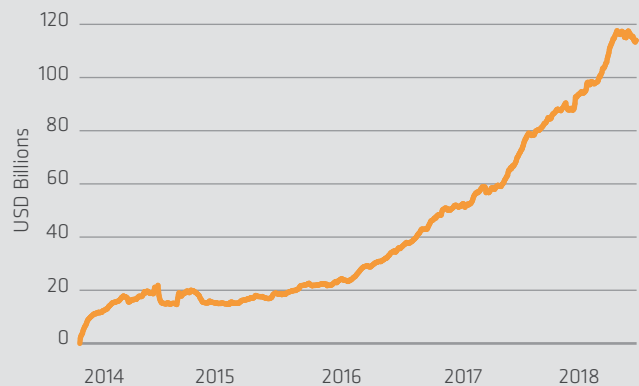
Seeking a more accurate reflection in trading indices of China's giant but underrepresented capital market, prominent global bond and equity benchmarks are increasingly adding China's onshore securities.² As a result, foreign inflows into its stock market are projected to double in 2019 to US\$89 billion, according to Citigroup. Cumulative net flows have already reached US\$114 billion through April 30, 2019 (*Display 1*).

Today, China's A-shares market, which is composed of stocks that trade on the mainland exchanges, looks a lot like the US stock market circa 1965. It's still unevenly regulated, marked by patchy governance of its listed companies, and dominated by retail investors, whose tendency to buy high and sell low can exacerbate volatility.

But thanks in large part to the inclusion of Chinese stocks in the MSCI Emerging Markets Index in 2018, the liberalization of access to China's A-shares market and its regulatory framework—such as the

DISPLAY 1: FOREIGN FLOWS INTO CHINA'S STOCK MARKET HAVE SURGED

Cumulative "Northbound" Net Flows into China's Markets*



Through April 30, 2019

* "Northbound" flows represent flows into onshore Chinese equities (A-shares) via the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect, known collectively as China Connect. It is used as a gauge of international money flowing into China A-shares.

Source: Bloomberg

strengthening of trading-suspension rules—has progressed much more rapidly than expected. Regulators were compelled to make sweeping (and beneficial) changes to enable China A-shares to be included in that index.

Foreign and institutional participation has already increased as funds that track the index buy Chinese shares to match its holdings. Institutional investors, driven less by emotion than by fundamentals, tend to lend stability to retail-dominated markets.

¹ At 30% of total market cap, China's limit on foreign ownership of investments is low relative to those of its regional and emerging-market peers, offering scope for China to conform to international practices.

² Chinese securities have historically been accessed via multiple markets, depending on the type of investor. "Offshore" bonds for foreign investment trade in CNH, a currency over which China cannot exert control; "onshore" bonds for domestic investment trade in CNY, China's domestic currency, which has historically traded in a narrow band. The CNH was created in 2007 when China extended its currency into the international marketplace without fully opening its capital account. Similarly, there exist A-shares (onshore), B-shares, H-shares and even N-shares for equity investment in Chinese companies, with markets defined by both buyer and currency of issue. Recent liberalizations are permitting foreign investors direct access (onshore) to domestic markets.

WHAT DO CHINA'S MYTHS AND REALITIES HAVE IN COMMON?

In recent years, two principal stories have emerged about China. The first is that China wants to shift away from its traditional bank- and government-driven financing model and toward a capital-market financing paradigm. The second story is that China is transitioning from a “black” smokestack economy to a more sustainable, innovative and “green” economy. Both these stories about China are true.

The myths and realities we explore in this paper fall into one or the other of these narratives. The myths largely reflect China's old economic and financing models, while the realities grapple with both China's rapid evolution and the central government's aspirations—along with the policy priorities that back them. Investor concerns reflect the real aches and pains that come with major transitions.

Four myths and realities that we tackle in this paper delve into the first story—that China is moving to a new financing model.

- + The opening of China's capital markets to foreign investors is complicated by the reformation of the country's old-school regulations and restrictions.
- + China is struggling to work down its mountain of debt through the redistribution of credit throughout the economy.

- + The central government is reining in shadow credit—which stems from inefficient allocation of capital combined with lax regulations—by encouraging a shift in the mix of debt toward transparent bank loans and corporate bonds.
- + The urbanization of China supports a continued real estate binge.

Our final three myths and realities concern the second narrative—what are perceived to be the new drivers of China's growth. This is the “middle-income transition”—a phase in which a major shift toward more sustainable growth brings both progress and destruction.

- + China is no longer dependent on exports; today, domestic consumers account for the lion's share of Chinese GDP growth.
- + China's companies are far more concerned today with productivity and innovation than with imitation.
- + The central government has shuttered the worst polluters while driving a rapid expansion in environment-friendly initiatives.

As China evolves along a positive secular trajectory, investors will have to navigate a complex landscape of opportunity, cyclical risk and regulatory friction.

A similar trend is expected to play out in China's fixed-income market, as an influx of more than US\$100 billion is projected in the onshore bond market in 2019, according to Goldman Sachs and Standard Chartered.

While enormous, China's bond market—the third largest in the world—is not as well researched or as active as China's equity market. Foreign ownership of the government bond market is 7.9%, according to Standard Chartered—a significant presence but still well below the levels of foreign ownership among other large government bond markets. Thirty percent of outstanding US debt, for example, is foreign-owned.

So, ready or not, index funds are being forced to add more Chinese bonds and shares, and global investors will gain exposure to China's capital markets. For bond investors, China government and policy bank bonds can serve as an additional source of diversification, income and stability. This is a positive development that opens a range of opportunities for active investors.

RESTRICTIONS STILL APPLY

However, global investors entering the Chinese market should acknowledge some limitations while doing so. Not all parts of China's capital markets have the same trajectory. Its currency and bond markets aren't going to be truly open anytime soon, with currency values and bond yields not fully determined by a free two-way flow of capital and economic forces. China, at least in the next few years, is unlikely to resemble US or European capital markets.

While some restrictions are being lifted, many will remain, giving the Chinese government ample leverage for heavy-handed intervention in the markets. For example, Chinese citizens and corporations are still barred from transferring more than US\$50,000 per year abroad—a buffer to control the flow of capital and prevent potential disruptive currency devaluation. Another sign of intervention: the volatility of the renminbi remains remarkably low despite China's changing economy.

THE KEY TEST: A BOUT OF VOLATILITY

Though China's giant capital markets seem open and embracing to foreigners, investors need to remember that these are new and developing markets with plenty of risk and uncertainty. Limits on foreign ownership of equities like Han's Laser are just one example.

A key test of the government's commitment to this process will likely come at a time of market volatility in China, and foreign portfolio inflows may reverse—conditions all open markets periodically experience.

In 2015, when equity markets grew turbulent, around half of Chinese companies suspended trading to avoid major hits to their share prices. Regulators instructed state-connected investment firms to shore up markets by buying stocks. Some suspensions dragged on for months, spooking investors.

But change is afoot. In 2016 and again in late 2018, Chinese regulators reduced the duration of suspensions. And the government's silence—rather than intervention—during an episode of volatility in 2018 spoke loud and clear.

How Chinese policymakers react to bouts of volatility in the future will be the true indication of China's commitment to being part of the global financial system. So, even though gaining exposure to China's onshore markets is important, investors should do so with eyes wide open and acknowledge that a once-in-a-lifetime change in financial markets will not always be smooth sailing.

A DEBT BUBBLE

Myth: A great mountain of debt threatens an economic meltdown.

Reality: Large foreign reserves provide a buffer against shock.

It started as a way to buffer the economy from the global impact of the great recession. To keep the country's growth engine running, China's permissive monetary policy fueled construction of roads, bridges and other infrastructure projects. Government-run companies and municipalities received easy credit to carry out the works and create jobs.

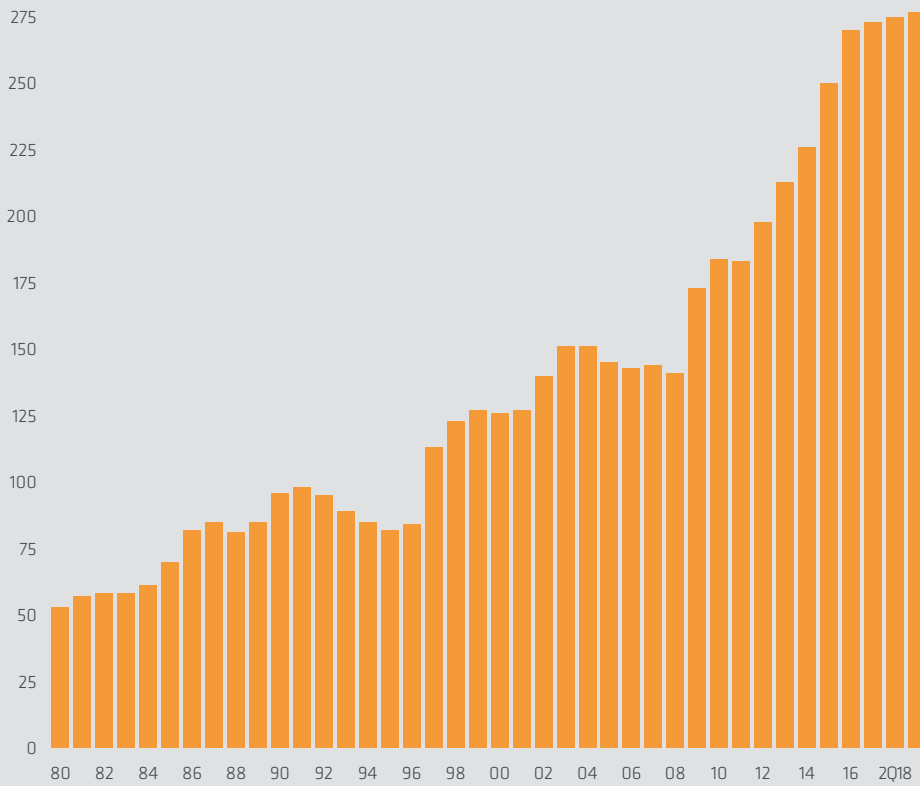
The result? Alongside China's continued economic expansion, its mountain of debt has expanded dangerously over the past decade, soaring to US\$37 trillion, or 277% of GDP (*Display 2*).

That's twice the average debt level of other emerging markets. China's corporate debt level of 140% of GDP—a figure that does not include shadow banking—far exceeds the average levels of both emerging and developed markets. State-owned enterprises (SOEs) carry the most debt, with a rate of 85% of GDP; households and municipalities carry rates of 59% and 56%, respectively.

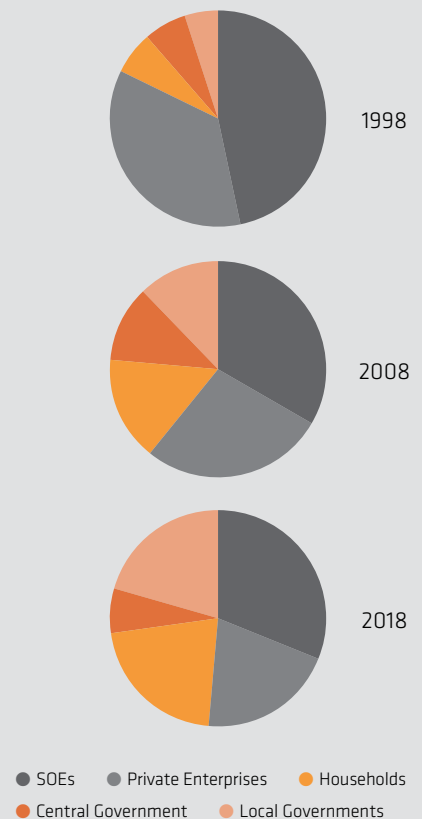
China's credit-to-GDP gap, a metric that measures the potential of a banking strain, is nearly three times the high-risk threshold. Many worry that China could follow in the footsteps of Japan, whose debt bubble popped in the early 1990s and which is still paying the price. But we believe that the government can avert a blowup and wean the economy off its debt habit if it redirects the credit to private businesses and away from SOEs.

DISPLAY 2: CHINA'S DEBT BURDEN HAS GROWN DANGEROUSLY LARGE

Debt-to-GDP Ratio: China (Percent)



Share of Leverage



Through September 30, 2018
Source: CEIC Data

China's shadow-banking sector has contracted.

THE FOREIGN RESERVE BUFFER

How has the credit binge gone on so long without an explosion?

For one thing, China's creditors are domestic rather than foreign, and the country's savings rate is high. And with US\$3 trillion in foreign reserves—in addition to capital controls that the country implements against outflows—China has been well buffered against external economic shocks.

China's high debt levels are supported by an economy that continues to grow at a robust pace in the high single digits. The property sector is healthy (see The Real Estate Bubble), with no near-term risks of crisis—thanks in part to stabilized household leverage. And the banking sector is improving; the government has already embarked on a campaign to clean up China's messy shadow-banking system (see Shadow Banking).

Indeed, a meltdown is not inevitable. If the government redistributes credit throughout the economy, it can manage the debt load while

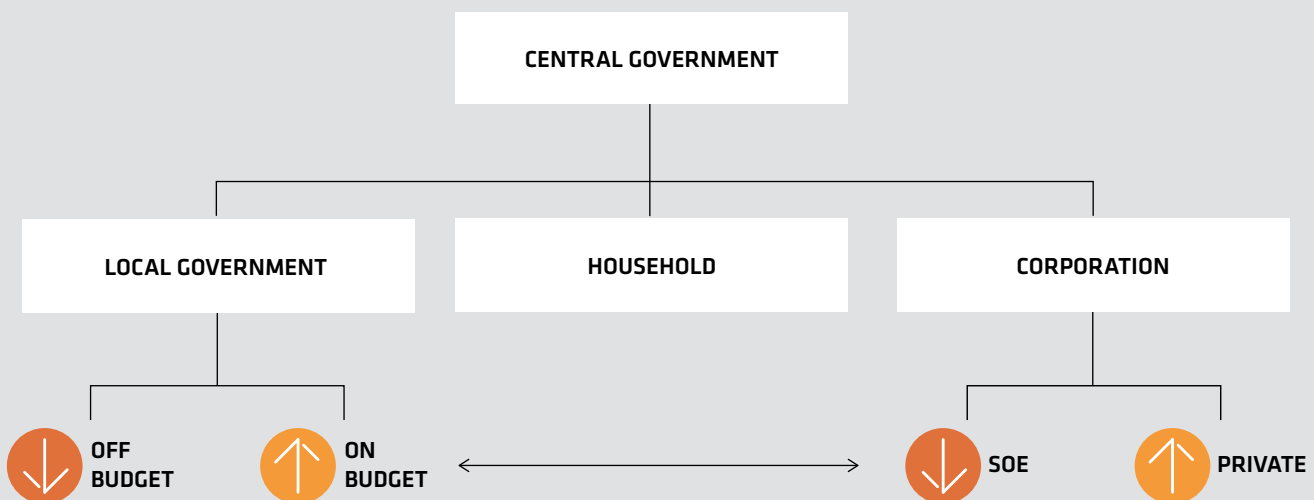
reducing the risks of a systemic crisis. In our view, the top priorities should be pursuing further deleveraging of SOEs through tools such as M&A consolidation and debt-equity swaps. Policymakers also need to pursue deleveraging for municipal governments' off-budget debt (see Shadow Banking).

TARGETED DEBT REDISTRIBUTION

In order to keep China's growth engine humming through deleveraging, the central government itself can take on more debt, and it's in the process of doing just that. It can also encourage additional credit for private businesses, which account for 45% of exports and 70% of innovation but don't have enough access to credit. Lastly, municipal governments can leverage up their on-budget debt to fund infrastructure projects that support growth (*Display 3*).

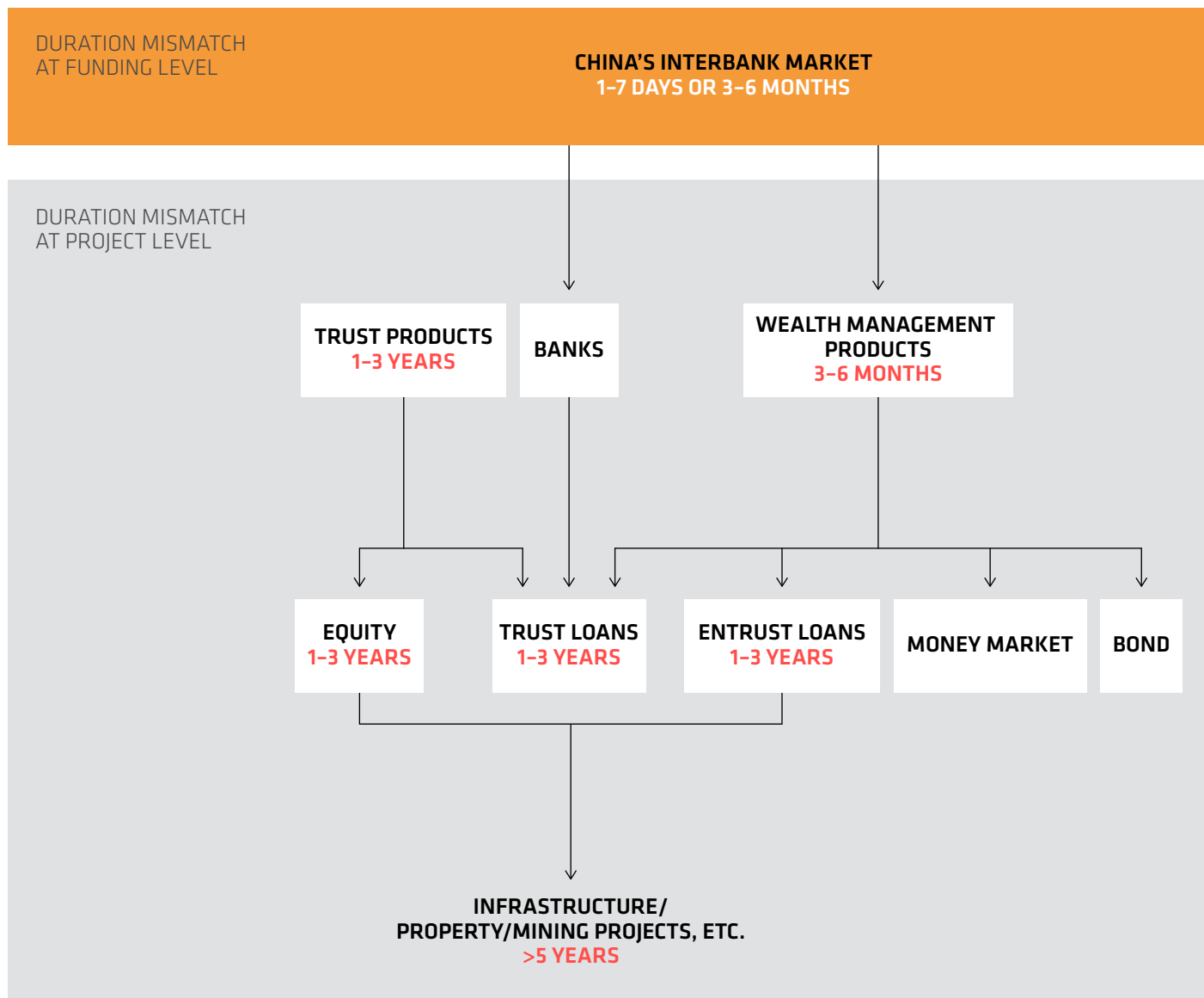
The bottom line is that China can manage its debt problem in a selective, targeted and dynamic way through more reform. This would stabilize the current debt level and significantly reduce systemic risk for the Chinese economy in the medium and long term.

DISPLAY 3: FINDING ROOM FOR ADDITIONAL LEVERAGE



Source: AB

DISPLAY 4: SWAPPING OF LOAN CREDITS CREATES COMPLEX WEB



Source: AB

SHADOW BANKING

Myth: China's shadow-banking system risks an imminent financial crisis.

Reality: Government reform is shrinking shadow-banking credit.

Protestors crowd in front of distribution banks and government offices. Their banners read “Liars” and “Pay me back.” They are China’s mom-and-pop investors who bought wealth-management products that invest in shadow-banking credit that subsequently defaulted. For these middle-class men and women, not getting their money back on shadow-banking investments means the loss of their lifetime savings.

Shadow banking is a phenomenon in the global financial system in which financial intermediaries provide services that are similar to those offered by commercial banks, but that are conducted outside of institutionalized banking regulations.

In China, shadow banking has surged over the past decade from a negligible phenomenon to a pile of credit nearly equal to the size of the country’s annual economic output—clouding the health of the wider financial system. But even though this opaque lending activity represents a risk, we don’t see a near-term catalyst that is likely to trigger a wider meltdown.

Fed by China’s easy-money monetary policy and a lax regulatory environment, China’s shadow-banking lenders expanded to serve private corporate borrowers considered too risky by traditional banks. In our estimation, shadow loans represent some 22% of total debt in China today. It’s a sector that is laden with risk and vulnerable to a liquidity crunch or an asset deterioration.

A CREDIT TANGLE IN THE SHADOWS

What has evolved is a tangled financial system whose tentacles extend into the traditional banking sector. Shadow loan products tend to have opaque and convoluted structures.

Meanwhile, loan credits are swapped between banks and nonbank financial institutions (*Display 4, page 6*), making it difficult for regulators to see through the structure or assess the risk. Shadow lenders also play fast and loose with their books by backing longer-term loans with short-term funding vehicles—a duration mismatch that is vulnerable to a liquidity shock.

Rather than disappoint investors and undermine their reputation, banks involved in shadow loans backstop bad credit to circumvent default. The result of doing so, however, is that investors stop caring what they invest in, providing they reap these essentially guaranteed returns.

Once investors do not—or cannot—distinguish between good credits and bad ones, prices cease to reflect the underlying risk. In turn, this leads to an inefficient allocation of capital in the economy, with money flowing equally after good and bad investments.

To keep the wheel turning, shadow lenders must attract more capital to fund their backstops to bad credit, in a game of “dance until the music stops.” Indeed, much of the shadow-banking system essentially functions as a bait-and-switch scheme in which capital is shifted around to conceal bad loans.

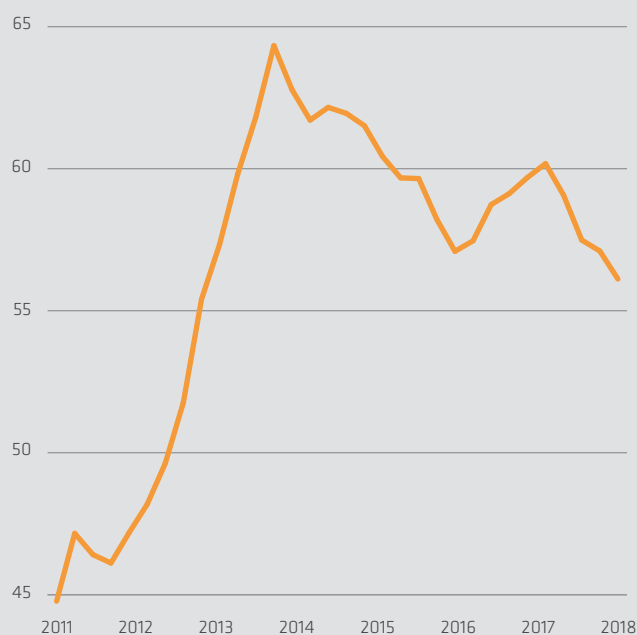
Most concerning, the broader economy is exposed to the shadow sector. Credit activity is deeply interconnected with the traditional banking system: lenders and intermediaries include banks, brokerage firms, insurance companies and mutual funds. That means that a crisis in the shadow loan sector could become contagious and risks spilling over into the broader financial system, infecting the entire economy.

GOVERNMENT CRACKDOWN

So why has there been no implosion? For one, China’s central government is aware of the problem and is taking action to rein in shadow credit.

DISPLAY 5: SHADOW BANKING HAS SLOWED

China's Shadow Banking Credit as a Percent of Nominal GDP (YoY%)



Through December 31, 2018
Source: AB

New regulations require lenders to explicitly explain to investors that there's no guarantee they'll reap the projected return. Shadow lenders are also being required to forgo riskier lending. Banks are moving some of the loans back onto their balance sheets, to provide more transparency. More reserves are being set aside for bad loans. And the government has tried to fix the mismatch in the credit duration of the shadow loans.

There's evidence to suggest that the efforts are bearing fruit. China's shadow banking sector contracted from 60% of GDP in

2017 to 56%—the equivalent of US\$7.5 trillion—by the end of 2018 (*Display 5*).

LOOSE MONETARY SUPPLY HELPS STAVE OFF TROUBLE

The government's loose monetary-supply policy has also helped ensure that there's no broad-based liquidity squeeze thus far. As the central bank prints money, it's finding its way to SOEs; from there, the money flows indirectly to private companies along the supply chain. This limits systemic credit risk—but only so long as the spigot remains open.

The change in the mix of debt from complex shadow-banking credit to bank loans and corporate bonds is also a welcome trend because it reduces overall financial system risk.

That said, shadow credit still bears close monitoring. The current accommodative policy gives government regulators time to further boost transparency. However, in the long term, a new buildup of shadow credit could reemerge if stimulus—from either China's formal banking system or the capital markets or both—proves inadequate.

THE REAL ESTATE BUBBLE

Myth: China's property market is in danger of imminent meltdown.
Reality: Strong demand for new housing and government land ownership are fundamental bulwarks against a near-term crisis.

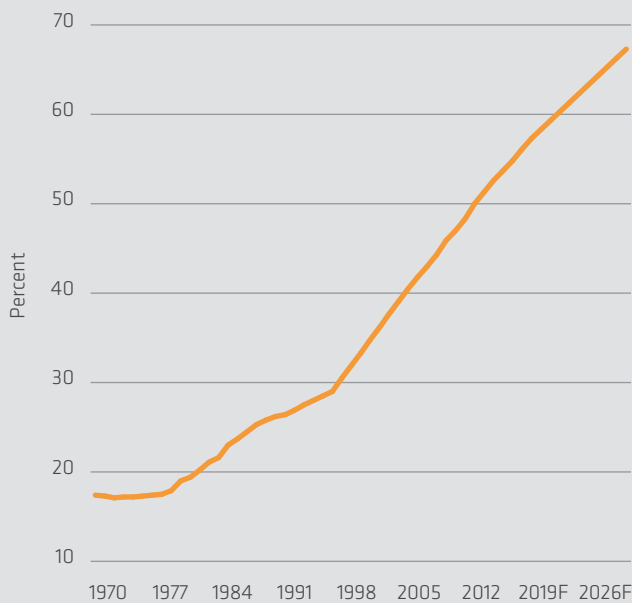
High-rise residential towers stand empty in Kangbashi, a satellite district of Ordos City in the Chinese province of Inner Mongolia. Traffic lights flash over roads with no automobiles. Shopping malls lack stores. A sleek modern museum edifice attracts few visitors.

Dozens of similar ghost cities in China that may never reach full capacity offer surreal evidence of the country's real estate bubble. One in five residential units in China is uninhabited. The overbuild is driven in part by municipalities, and in part by investors who see only a steady appreciation of property values. Some consider this phenomenon the elephant in the room for China's economy. A property crisis would weigh down the entire economy. By some estimates, the real estate industry and related sectors account for 20% to 30% of GDP.

China's real estate binge isn't likely to turn into a hangover anytime soon.

DISPLAY 6: CHINA'S POPULATION IS INCREASINGLY URBAN

Urban Population of China as a Share of Whole



As of April 30, 2019
Actual data through December 31, 2016; estimated data through April 30, 2018; AB projections through December 31, 2026
Source: Bloomberg and AB

ANOTHER JAPAN?

The growth of China's real estate market over the past 15 years has been relentless, almost defying economic logic. Sales, barely existent before 2005, totaled 15 billion square meters in the ensuing period through 2018. Over the last decade, prices have skyrocketed from four to 10 times over.

Many of the buyers are small households on their second or third properties; they are parking savings in an asset that seems a safer bet than China's volatile equity market. In addition, developers and builders are highly leveraged.

It all seems headed toward a replay of the 1990s real estate implosion in Japan that hobbled the economy for decades afterward. The recent slowdown in Chinese economic growth only compounds the worry.

BUILT-IN DEMAND FOR HOUSING UPGRADES

But despite short-term price swings, there's no implosion lurking around the corner, in our view.

There are good fundamental explanations for this conclusion. For one, housing demand in the country's top-tier cities will remain robust, because China's population continues to move out of rural areas: an urbanization pace of 1 percentage point a year means that China's cities will add another 200 million over the next decade (*Display 6*).

What's more, there's built-in upgrade demand: some 60% of China's homes were built during the more austere Communist period before 1999 and aren't considered suited to modern tastes and larger family sizes.

In addition to enjoying strong demand, China's property market is not as leveraged as it appears. At the end of the third quarter of 2018, total household debt amounted to 59% of GDP. Although household leverage has grown significantly over the past five years, that rate is still a lot lower than in developed nations like the US and Singapore—both of which have household debt rates of over 80%—and Australia, which has a rate of more than 100%.

Moreover, the total value of loans carried by the construction sector is roughly equivalent to the value of annual property sales. We believe that type of leverage doesn't pose a systemic risk of a meltdown.

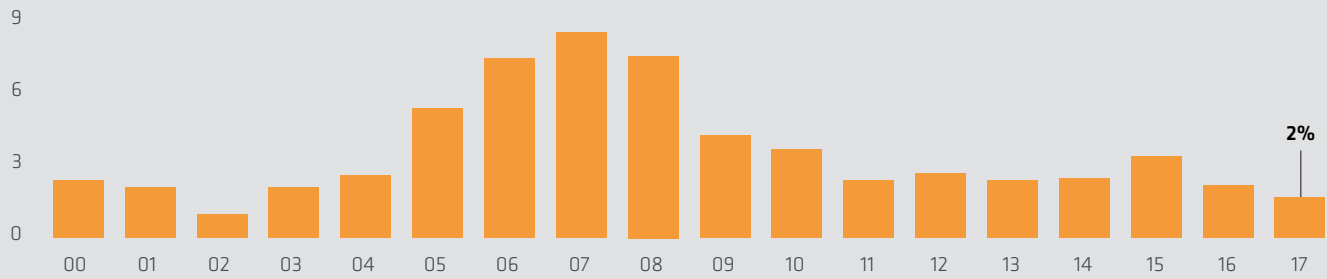
GOVERNMENT AS MONOPOLY OWNER OF LAND

On the supply side of the equation, the structure of the property market serves as another counterweight against an implosion. As the monopoly owner of land in the country,³ the government keeps underlying land values from dropping, making it hard for the price of property values to reverse into a nose dive.

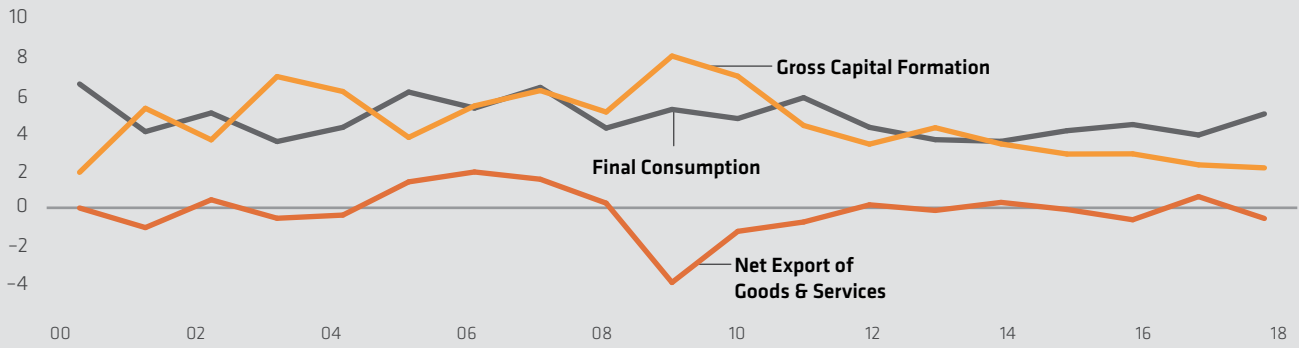
³ The Chinese government owns all land in China but sells property rights to developers.

DISPLAY 7: CHINA IS A PRIMARILY DOMESTIC-DRIVEN ECONOMY

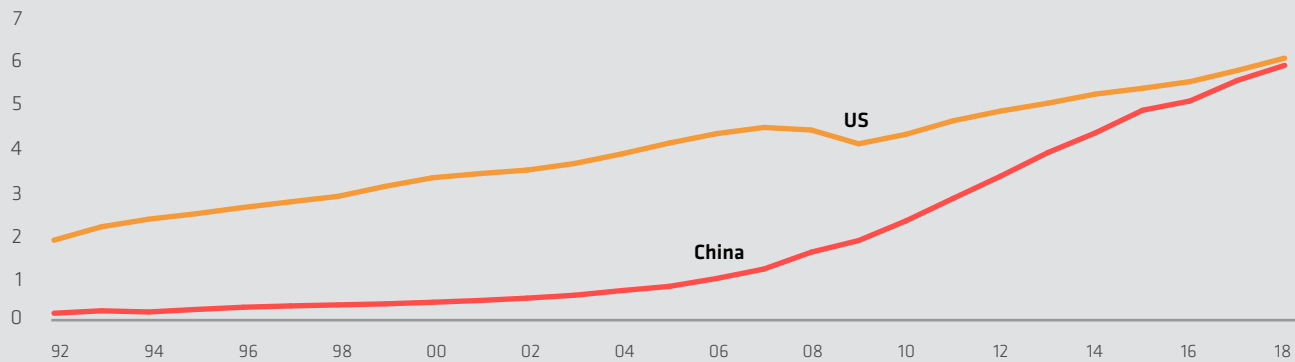
Net Exports as a % of Nominal GDP



Contribution to GDP Growth (Percent)



Cumulative Retail Sales (USD Trillions)



Top display through December 31, 2017; center display through December 31, 2018; bottom display through March 31, 2019
 Source: Bloomberg, CEIC Data, National Bureau of Statistics of China (NBS) and AB

Given that the value of China's property market is several times larger than the value of its equity market, the government is committed to policies that will cushion short-term price shocks. It's also pursuing gradualist reforms, such as weaning local governments off their dependence on real estate sales taxes. The government will also seek to smooth out structural imbalances in a market that's divided between the white-hot primary cities, and the less hot second- and third-tier cities.

All this may make Chinese real estate seem drastically overheated and the preponderance of ghost cities like Kangbashi seem like a warning of an eventual meltdown. But investors need to be aware that there are fundamental factors that are likely to help avoid a crisis in the near term. Over the longer term, however, investors should carefully monitor economic and policy developments to ensure that the country's real estate binge doesn't turn into a hangover.

CONSUMPTION

Myth: Economic growth relies on low-cost exports and infrastructure.
Reality: Consumer spending in China's massive market is the biggest component of growth.

Black Friday is widely celebrated as America's biggest shopping holiday—the November kickoff to Christmas season. But November is also the time when China marks an annual consumer extravaganza of its own—and one that is even bigger: Singles' Day.

Observed on November 11, Singles' Day began more than three decades ago as a celebration for bachelors. In the past decade, however, it has become a day of record-breaking online shopping. According to *Business Insider*, during a 24-hour time span, Alibaba.com alone raked in US\$30.8 billion—double the US sales on Black Friday and Cyber Monday combined. The Singles' Day shopping spree tells a bigger story about how China's economy is shifting.

HOMEGROWN CONSUMERS: A NEW DRIVER

While infrastructure, real estate and exports propelled Chinese growth over the last two decades, domestic consumption has become the primary economic driver today. Of the 6.5% real GDP growth in 2018, more than 5 percentage points were driven by consumer consumption; 2.1 percentage points came from investment, while net exports were negative because of the US-China trade conflicts (*Display 7, page 10*).

While China is far from saturated with infrastructure, and manufacturing remains an important source of employment, a consumer base with more disposable income has become the dominant force for the Chinese economy. This has implications well beyond China, as tourists flock to New York and Tokyo, and foreign brands, as well as Hollywood, seek to cater to Chinese tastes.

But it would be a mistake to view Chinese consumers as a homogenous unit. The reality is more nuanced. The 300 million middle-class households and the 400 million working-class households have very different characteristics. For example, Chinese middle-class households earn an average of RMB20,000 monthly income, while their working-class peers bring home roughly half of that.

TWO CLASSES OF CONSUMERS

As a result, the two sets of consumers have vastly different spending priorities. Those in the middle class typically live in large cities and have become sophisticated consumers of products ranging from smartphones to household staples to sportswear. These middle-class consumers are behind the rise of a new class of domestic Chinese consumer brands.

The working-class consumers have solid income growth and high levels of property ownership, but historically have had limited access to foreign brands. Now that they have more money, they are prepared to spend to upgrade their living standards and lifestyles. Foreign brands are expected to benefit from the rise of the working class.

There is also a large generational difference among China's consumers. Those in the older generation, having lived through China's past turmoils, are prodigious savers. The younger Chinese, typically only children, thanks to government policy, consume and take on debt like peers in developed economies. The aging demographic will figure as another driver of consumption patterns over the next decade, as older Chinese are expected to need more healthcare services.

These overlapping changes among the Chinese mean that the consumer market will remain dynamic and complex. For example, Luckin Coffee, a Chinese brand, is beating Starbucks in large cities. But Starbucks is still opening stores profitably in smaller, underpenetrated cities. Luxury brands are continuing to gain traction from middle-class consumers, which benefits companies as diverse as Prada, the Italian fashion house, and Kweichow Moutai, the Chinese liquor manufacturer.

At the same time, consumers are demanding lower prices from e-commerce platforms such as Alibaba Group's Taobao or Pinduoduo. For investors who are aware of the nuances in spending patterns and evolving tastes, the consumer market will provide a rich source of opportunities for decades.

INNOVATION

Myth: China's companies lack innovation.

Reality: Chinese companies are boosting productivity and are the source of original technology.

Athletes globally lace up Yue Yuen Industrial sneakers without ever knowing it. The Hong Kong-based footwear company supplies shoes to Nike and adidas, making it the largest athletic footwear company in the world.

But the vast majority of Yue Yuen's 300-million-shoe output no longer carries the "Made in China" label. Instead, Yue Yuen has aggressively moved production from China to Vietnam and Indonesia over the last few years to reduce production costs. Along with the manufacturing shift, Yue Yuen has invested in technology and automation. The changes have translated into a 30% increase in productivity.

NO LONGER A LOW-COST MANUFACTURER

The evolution of Yue Yuen is a microcosm of an important trend playing out in China. Over the last two decades, a big part of China's growth story has been the development of a low-cost manufacturing industry that became the dominant global supplier of everything from televisions to toys, phones to furniture. Westerners frowned upon China's technology copycats.

That's changing today. China is no longer the best source of cheap labor: two decades of average annual wage growth above 10% have meant that many other emerging economies offer much cheaper labor alternatives. And the combined impact of the one-child policy and an aging population means that China's total workforce is barely growing today, so China no longer has a need to create millions of low-end light manufacturing jobs.

Can China grow by boosting productivity and innovating rather than solely by manufacturing based on cheap labor? Along with Yue Yuen, there are several data points that suggest China can successfully navigate this transition.

BIG SHIFT IN JOB CREATION

One of the most obvious is the shift in the structure of the economy and the creation of jobs. Over the last five years, China has created about 40 million jobs in the service sector and lost about 30 million jobs in the manufacturing and agricultural sectors, according to Wind and China Reality Research. But manufacturing output is still growing, so productivity is clearly rising while the workforce is upskilling.

In construction, China used to rely heavily on imports of excavators and other heavy equipment from companies like Caterpillar and Komatsu. But local manufacturers—led by companies such as SANY Heavy Industry—have steadily improved their technology and boosted market share at the expense of foreign brands. In early 2019, SANY Heavy issued a profit upgrade while Caterpillar warned of disappointing sales because of weak demand from China.

VIRTUAL DOCTORS

Lastly, there is genuine technological innovation under way.










Take China's homegrown giants like Alibaba Group, Tencent and Ping An Insurance. These companies not only dominate the domestic market in areas such as e-commerce, social media and mobile gaming, but they have also leveraged their heft to create new business models in sectors like fintech and healthcare. Ping An Good Doctor allows users to consult a virtual doctor in telephone booth-sized clinics. Mobile payment apps such as Alipay and WeChat Pay have largely replaced the need for cash—even in corner grocery stores and in outdoor markets.

These are all relatively recent developments among China's enterprises. Investors need to pay close attention to tech innovation and to rising productivity among manufacturers like Yue Yuen. Ignoring these trends means missing out on the opportunities created by the new era of China's economy (*Display 8, page 13*).

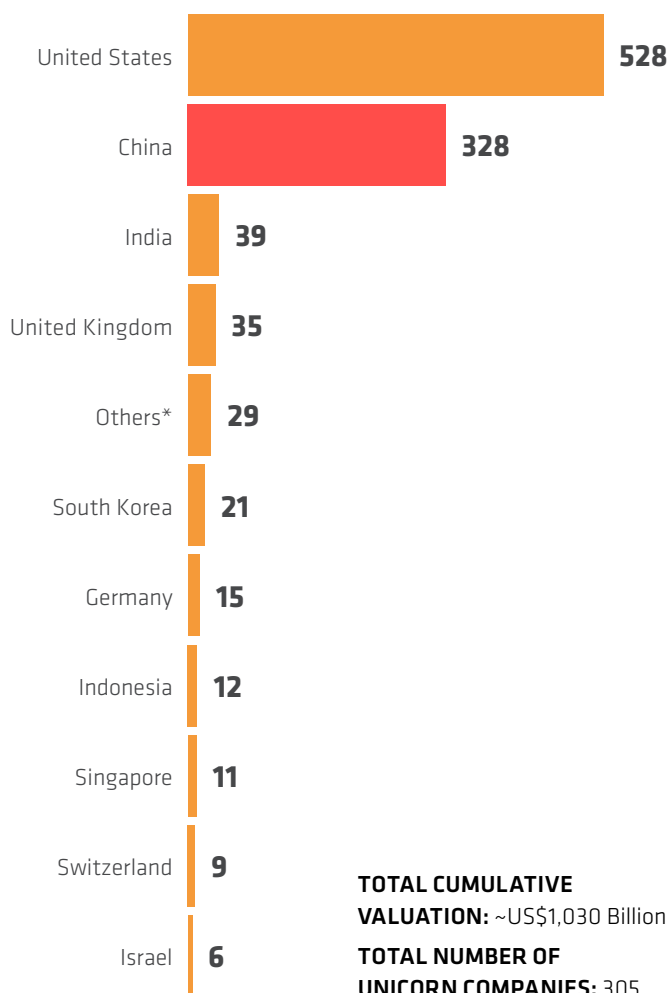
DISPLAY 8:

CHINA IS A BREEDING GROUND FOR UNICORNS

TOP 10 UNICORNS IN THE WORLD

Company	Valuation (USD Bil.)	Date Joined	Country	Industry
ByteDance	75.0	4/7/2017		Digital Media/ AI
Uber	72.0	8/23/2013		On-Demand
DiDi	56.0	12/31/2014		On-Demand
Airbnb	29.3	7/26/2011		e-Commerce/ Marketplace
SpaceX	21.5	12/1/2012		Other Transportation
WeWork	20.0	2/3/2014		Facilities
Stripe	20.0	1/23/2014		Fintech
Palantir	20.0	5/5/2011		Big Data
LU.com	18.5	12/26/2014		Fintech
JUUL	15.0	12/20/2017		Consumer Electronics

COUNTRY BREAKDOWN BY UNICORN VALUATION (USD BILLIONS)



References to specific securities are presented to illustrate the application of our investment philosophy only and are not to be considered recommendations by AllianceBernstein.

As of December 31, 2018

Unicorns are privately held firms worth at least US\$1 billion.

* Others include Brazil, France, South Africa, Sweden, Malta, Colombia, Japan, Spain, United Arab Emirates, Luxembourg, Nigeria, Portugal, Estonia, Hong Kong, Canada, Australia and Philippines.

Source: CB Insights and AB

THE ENVIRONMENT

Myth: China's heavy industry is a serial polluter.

Reality: The government has shuttered the worst culprits and is focusing on cleaning up the environment.

The thick smog that covers the city of Wuhu, 350 kilometers west of Shanghai, offers a potent reminder of one of China's most vexing problems: air pollution from coal plants and dirty industry. In Wuhu, the massive plant billowing smoke into the sky belongs to Anhui Conch Cement, China's largest cement maker.

But that image doesn't tell the whole story. In 2014, Chinese Premier Xi Jinping declared war on pollution, and companies like Conch have responded. The company has reduced energy consumption and emissions, while adding advanced systems to recycle heat, manage waste and control dust. According to one Conch manager, government inspectors are so serious, they even check trees near the plant to see if leaves are covered in dust, to ensure that companies don't get a pass because they cleaned up before inspection.

IN PURSUIT OF CLEANER GROWTH

Conch's efforts highlight how China is evolving from its old smoke-stack economy of 10 years ago. Citizens are demanding more of local officials. With social media, citizens can both highlight environmental problems and form effective protests. In short, the environment has become the number-one social issue. Government antipollution measures are a serious policy priority and are here to stay.

Undoing the damage will take time, but China is taking steps in the right direction (*Display 9, page 15*). The cleanup attempt is also opening up investment opportunities.

CHINA'S GREEN COMPANIES

For example, as the government has shuttered the inefficient and the worst-polluting plants in heavy industries like paper, steel and chemicals, it has boosted profitability of the better-quality players. In the energy sector, China is moving away from coal-fired electricity

and domestic heating, while driving a rapid expansion of urban gas supply networks.

In addition to helping improve air quality in China's cities, this shift is also creating opportunities for companies all along the gas supply chain. The government has also set targets for electric and hybrid vehicles, spurring growth of electric vehicle manufacturers.

The net effect of all these actions is that we are starting to see the tide turn. Beijing air quality—once a source of national embarrassment—is getting noticeably better. Chinese officials are now seeing environmental targets built explicitly into their performance criteria, and in major Communist Party speeches, the environment is as prominent as, or in some cases even more prominent than, economic growth. It's a slow process to correct after decades of neglect, but the trend is definitely pointed in the right direction.

Chinese companies involved in the turnaround—from energy infrastructure to car makers to green factories—stand to gain.

CONCLUSION: CLARIFYING THE PICTURE

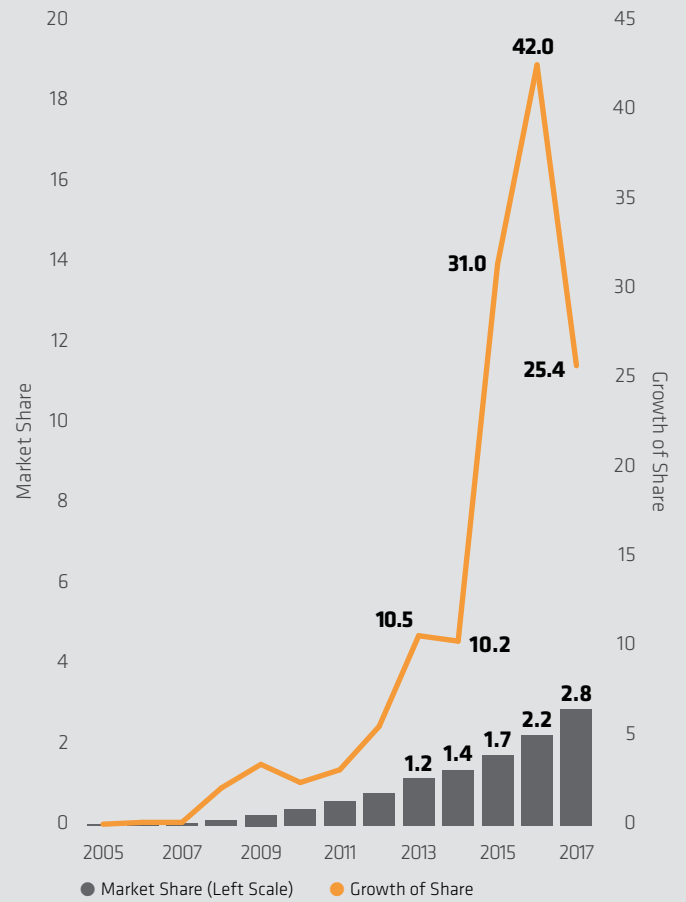
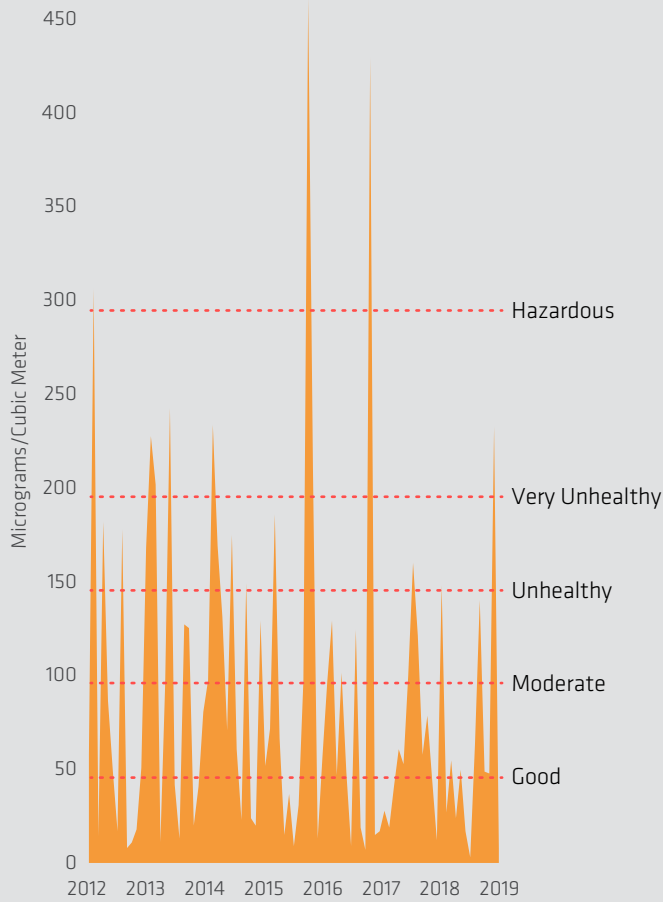
As China's onshore capital markets gain more exposure to the rest of the world, globally minded investors have a rare opportunity to participate. But China's growth story is a complex and rapidly evolving one. There are several genuine cautionary flags, like the debt-laden economy, the property bubble and the environment, that understandably might put off investors.

Still, observers should be careful to avoid a rush to judgment. Rapid growth and liberalization of China's markets make these stories worth revisiting frequently. And for those who can distinguish between myth and reality, the opportunities in this giant market are considerable. With a discerning knowledge of China's financial markets, its policy priorities and the trends under way in the economy, investors can navigate their way to identifying the Chinese securities that will enhance their overall investment portfolio.

DISPLAY 9: TO REIN IN POLLUTION, CHINA COMMITS TO RENEWABLE ENERGY

China Air Quality Index: PM 2.5 Concentration

Share of China Energy Market: Solar and Wind (Percent)



Left display through March 31, 2019; right display through December 31, 2017 (latest available)
 Source: Bloomberg, Haver Analytics, NBS and AB

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