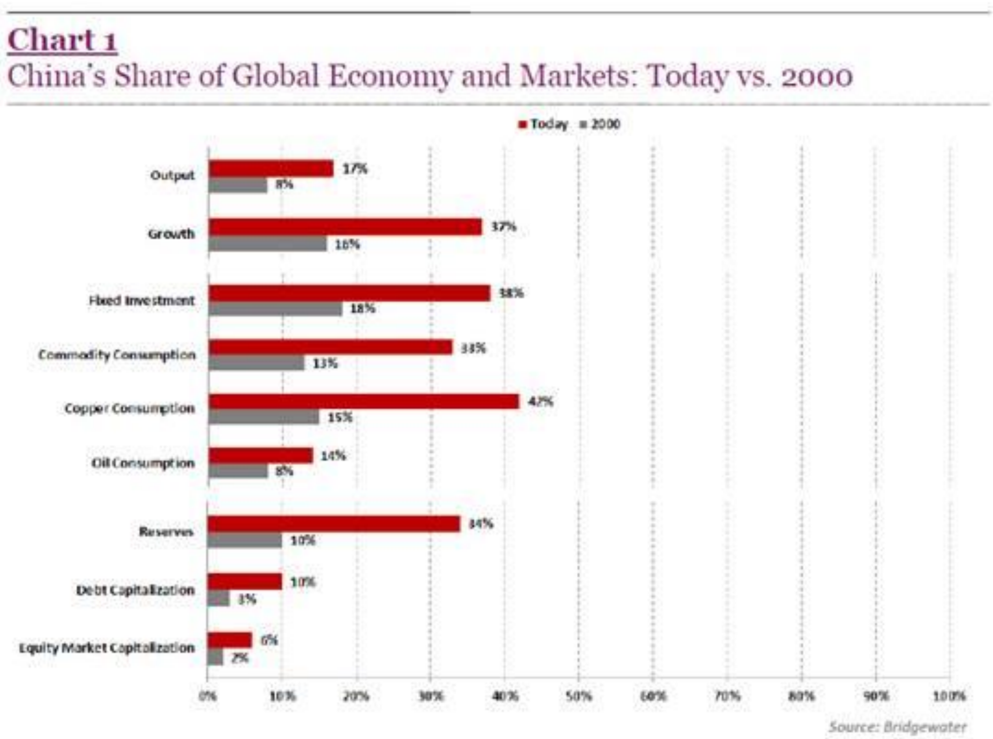
Thursday July 18th, 2013

Good morning,

Since the year 2000, China has become an increasingly important part of the global economy. The impact that it has had is astounding. As illustrated in the chart below, China's position has more than doubled in the areas of output, growth and consumption. Consider that China's share of global copper consumption has gone from 15% to over 40% over the last 13 years, and that its share of oil consumption has reached 14%, up from 8% (while not a double, a significant increase nonetheless).



As investors in the Canadian stock market, which has a large exposure to energy and materials, we cannot ignore what is happening in China, especially in terms of demand for commodities. For a week this past May, we participated in an investor tour of China that gave us an opportunity to meet both Chinese and Canadian companies that have operations in China. We were also fortunate to meet with a number of local experts who shared their insights and perspectives with us.

We viewed this trip as a chance to either challenge or confirm our preconceived notions about China and its rate of growth. We were interested to witness first-hand the continued massive construction and infrastructure projects underway, the increasing use of cheap labour to secure China's role as factory to the world, and the increasing levels of pollution resulting from the its focus on industrialization.

On all three counts we were both right and wrong.

Construction and Infrastructure Projects

With respect to our first concern, we were surprised by the lack of construction sites – or forests of cranes – in Shanghai and Beijing. Our initial reaction was that a significant slowdown in real estate and infrastructure projects must be underway, and that the resulting reduction in their demand for resources would be negative development for Canadian companies. What we discovered, however, was that development was still occurring, but not in the developed and cosmopolitan cities of Beijing and Shanghai. Both Beijing and Shanghai have already experienced enormous growth over the last 20 years; this growth led to millions of people from central and western China moving to the eastern coast. This migration has put enormous pressure on the infrastructure of cities like Beijing. The Chinese government's focus is now on the development of secondary and tertiary cities in the interior, and to encourage people to stay in the region in which they were born. We found it fascinating that these secondary and tertiary cities, many of which were unfamiliar to us, each have populations of between 5 and 10 million people. Those forests of cranes do still exist in China, but they are moving west to the interior of the country.

Low Cost Labour Advantages

We also expected to hear of China's continued dominance as the manufacturing centre of the world, fuelled by its low-cost labour. While manufacturing remains inexpensive in China, that situation is changing rapidly. Wage inflation is becoming a big issue, especially for Canadian companies that are sourcing goods from China. Minimum wage is increasing at about 20% per year and Chinese factories are beginning to lose business to lower-cost countries like India, Bangladesh, Cambodia and Vietnam. Because China still offers better infrastructure and higher productivity than many of these competitive nations, its higher labour costs are being offset for now. However, we expect that both the productivity and infrastructure issues in these other countries will be resolved in time, making them even more competitive.

The Chinese government is mandating wage increases with a target to double wages by 2020. The policy's objective is to develop the Chinese consumer and reduce the country's reliance on western demand for its goods. In order for domestic consumption to increase, the Chinese need higher salaries. The mecca for North American consumer goods companies has long been the potential one billion customers that China has to offer; the Chinese government is now recognizing this vast market itself, and will focus on developing its domestic consumer over the next decade. Longer term, this means that China, with higher labour costs, may become more like Japan or South Korea, producing more high-value added goods (like cars) for export, rather than more commoditized goods for which the country has historically been known.

The Impact of Pollution

Finally, on the issue of pollution, our perceptions were confirmed. The high level of pollution, and poor air quality was very noticeable. Although it was 'sunny' every day we were there, we only actually saw the sun on one of those days. Our discussion with the former head of Research in Motion's Chinese division brought us a new perspective on the topic. He shared that the environment and environmental protection are becoming more important issues for Chinese citizens. Ordinary people are organizing to protect the environment. Although direct government protests and criticism are not well tolerated in China, the government seems to be open to listening to environmental concerns. It was interesting to parallel China today with Eastern Europe in the 1980s. At that time, protests against the Soviets in the former Warsaw pact countries primarily started out simply as green movements focused on environmental protection. Only later did these protests become overtly political. While China is not Eastern Europe in the 1980s, there are some interesting parallels that suggest change is afoot in the country.

Looking Ahead

We believe the implication of these developments in China will both benefit and be detrimental to Canadian companies. On the resource front, we believe that demand for commodities from China will likely remain strong, especially because the Chinese government is financially well-positioned to continue to support development. However, we believe that the government has shifted its policy focus from infrastructure to the development of the Chinese consumer. The result may be slower demand growth for commodities at the margin, relative to what we've experienced over the last decade. We are therefore cautious about certain commodities where supply has grown significantly ahead of demand.

Rising wages in China will undoubtedly be detrimental to those Canadian retailers that rely on inexpensive Chinese goods. On the other hand, a wealthier Chinese consumer may be of benefit to companies like Manulife that have an established presence in China. Historically, there has not been much demand for life or health insurance in China because the average person had low levels of disposable income. As the average Chinese consumer becomes wealthier, insurance will become a higher priority purchase. In addition, we believe higher levels of income will result in greater energy consumption by the Chinese – oil consumption in particular should increase as more Chinese consumers can afford to purchase automobiles.

The biggest benefit from our trip to China was gaining a more nuanced perspective on the Chinese government and the long-term implications of its policy shifts. China over the next ten years will be very different from the China of the last ten years. The last decade was about establishing China as the manufacturing centre for the world and about all the infrastructure required to make that happen. The next decade is about developing the Chinese consumer and increasing domestic consumption. As Canadian investors, we still expect to see significant absolute demand for commodities, but at a slower rate of growth relative to the past. We therefore need to remain vigilant in the more vulnerable areas of resources where there has been significant supply growth.

As our clients know, we are bottom-up investors at Sionna, focusing on the fundamentals of the underlying businesses in which we invest. While we do not shift our portfolios based on macro-economic themes, we believe it is important to understand how economic factors might impact our investee companies. To ignore the economy's influence would be irresponsible of us. Understanding the evolution of a major global market like China informs the way we view and value individual company investments. That's why important learnings and observations, such as those discussed above, are vital to our investment process. They contribute to our portfolio construction process and result in portfolios we believe are well-positioned to compound client capital over the long term.

The Sionna Team

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