From China's New Growth Drivers to Europe's Opportunities Beneath the Headlines

Talking with Lei Wang, CFA, Portfolio Manager of Thornburg International Value Fund

Lei joined Thornburg Investment Management in 2004 as associate portfolio manager and was promoted to portfolio manager in 2006. Lei holds a BA and an MA from East China Normal University and an MBA from New York University. He is a CFA charterholder. Prior to joining Thornburg, he served as an associate for Deutsche Bank as well as for Enso Capital Management. He has also worked as a bank supervision manager at China's central bank.

Q: China recently concluded its 19th National Congress, with President Xi Jingping declaring that the country will be "moderately prosperous" by 2020. But it's already the world's second-largest economy, and by 2020 its total output will be double what it was in 2010. What should we expect out of China in the years ahead?

Lei Wang: China is evolving very rapidly. Twenty years ago, its GDP (gross domestic product) amounted to a little less than $1 trillion. Today, it's worth more than $11 trillion. More interesting, though, is how its growth drivers are changing.

Its large population, nearly 1.4 billion people, had provided a big, low-cost labor pool of relatively well-educated people to drive the industrialization process, which basically involved manufacturing for export. China's admission to the World Trade Organization in 2001 ramped up its industrialization by providing better access to global export markets, especially the U.S.

Over the next 20 years, the Communist Party is focused on shifting China's economic drivers from fixed-asset investment, heavy industry, manufacturing, and exports to sectors involving rising domestic consumption, which also helps cut the adverse environmental effects from heavy industry-led growth and investment. As a one-party state with a "command capitalism" system, the Party puts technocrats in charge of driving the economic "re-balancing." They oversee the reform of generally capital heavy, inefficient state-owned companies while making sure the dynamic parts of China's "new economy," especially the private-sector internet and tech companies, continue to thrive.

They have to go in this direction because China's labor pool is no longer that cheap, the government's focus on protecting the environment is for real, and the demographic challenges are significant—hence the change in the one-child policy, which will take a couple decades to play out. Party leaders really think about the long

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Thornburg International Value Fund Top 10 Holdings as of 9/30/17

UniCredit S.p.A.	5.5%
Électricité de France SA	3.4%
Commerzbank AG	3.3%
Shin-Etsu Chemical Co., Ltd.	3.2%
Credit Suisse Group AG	3.1%
Canadian Pacific Railway Ltd.	3.1%
China Petroleum & Chemical Corp.	3.1%
SAP SE	3.0%
Infineon Technologies AG	2.9%
Ctrip.com International, Ltd. ADR	2.9%

game, not just the next election cycle as often happens in the U.S. or the West generally.

Q: How far along is the shift toward the new economic drivers, the rebalancing?

LW: It's surprising how fast it's happening. Beijing and China's other tier-one cities are already virtually cashless: digital payments and electronic wallets are pervasive. Ride sharing, including bicycle sharing, uses electronic payments. Even street food vendors accept electronic payments. The last time I was in Beijing, and invited some friends out to dinner, the restaurant wouldn't take my cash; the waiter explained he just needed to scan a payment app on my smart phone, which I hadn't downloaded. So my friends ended up paying for me. The running joke is that people no longer need leather wallets, just smart phones, which are putting pick-pockets out of business.

Technology-based business models are booming in China, not to mention Japan, South Korea, and other parts of Asia, where Silicon Valley replicas are sprouting up fast. But China has a few advantages.

Q: Such as?

LW: The government supports new technologies in various ways, not just financially but also by limiting regulatory or bureaucratic hurdles. Lobbying efforts for commercialization of new technologies aren't nearly as involved and expensive in China as they are in the U.S. and Europe, where entrenched interests can lobby to slow or stop the growth of new, technologically innovative companies that threaten their interests. A Chinese company that wants to change the way retail sales and distribution takes place, like Alibaba, will usually find top-down, government support for its bottom-up entrepreneurial efforts.

So Chinese companies can quite quickly leverage the technology prototypes developed in Silicon Valley or domestically and do so with skilled local labor and roll them out to a massive population base. And then they have lots of data that they can leverage. Chinese consumers are upgrading their consumption, creating huge amounts of data in the process. And the companies can use the data to tailor their offerings. It's a huge opportunity.

That's what is really driving the growth opportunities over the next 20 years. Think about the enormous amount of data generated by the apps, products, and services related to the IoT (internet of things). There will be tons and tons of data readings. And in the coming world of 5G (fifth generation of broadband cellular network technology), it won't just be consumer-related data, it will also be machine-generated data revolving around artificial intelligence, advanced manufacturing, robotics, data transmission, cloud-storage, and analytics. Think about the productivity advances related to all that.

And remember, that's leveraging the largest base of consumer data and the largest manufacturing base in the world.

Q: Which companies are the best positioned to capitalize on the data revolution there?

LW: In China, Baidu, Alibaba, Tencent, and JD.com have all built massive networks to capitalize on their growing data pools (Baidu and JD.com are not currently held in the Thornburg International Value Fund). We, of course, invest selectively and opportunistically in this space, and expect that, depending on valuations, our exposures will vary in the years ahead. But we're not just focused on the big and mega-cap stocks in China. We spend a lot of time on the ground there looking for young, innovative companies with strong business models and bright prospects. There are all kinds of fascinating investment opportunities sprouting up in China. It's why the portfolio's exposure to China has stayed on the high side of its historical range.

Q: Where else are you finding interesting investment opportunities?

LW: Well, we're bottom-up investors, but from a geographic perspective it is fair to note that Europe is seeing a robust

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macroeconomic recovery, with the region's PMI (purchasing managers' index) data leading the pack among major developed economies globally. The European Central Bank (ECB) clearly remains in accommodation mode, having just lowered its monthly asset purchases but extending the buying program to September 2018. ECB chief Mario Draghi also made clear in late October that the ECB will ramp the purchases back up "if the outlook becomes less favorable," as he put it. And while per-share earnings have risen nicely over the last year, they're still well off their pre-global financial crisis peak.

Q: Aren't you worried about political risk? Brexit and separatists in Catalonia have generated quite a few headlines.

LW: Headline noise can create opportunities, as investors look at the headlines rather than at company fundamentals. As nervous investors rush for the exits and broad markets come under pressure, share prices decline more than a firm's fundamentals might imply. And often the events can influence things elsewhere, but almost like an inoculation. Take Brexit, which, once the surprise result was known, caused U.K. markets to sell off. But since Brexit to the end of October this year, U.K. benchmark equity indices gained nearly 30%.

And following Brexit and the associated political travails the U.K. government is having in negotiating its future relationship with the E.U., you could even argue that there's been a reduction in political risk in Europe. Look at the election of Emmanuel Macron in France and his party's majority in the French parliament. He appears to be making progress on challenging labor and tax reforms that should make France more competitive. French executives I speak with say if he accomplishes even a third or a quarter of what he's attempting, it represents meaningful progress.

As for Catalonia, it's noteworthy that turnout in the referendum for independence was less than half of eligible voters. National leaders in Europe have backed Madrid rather than accept separatists' appeals to mediate, and some 1,700 businesses in Catalonia have reportedly said they're moving elsewhere in Spain. It's also worth noting that Spain's IBEX 35 stock index was up a point or so in the month following the October 1 vote. So it appears markets aren't overly worried about Catalan separatists.

Q: Are there types of stocks, or sectors, that you think are currently attractive?

LW: European banks have been doing great this year. And as a group they're still trading at cheaper levels than their U.S. counterparts—at less than 1x price-to-book (P/B), which is a fair amount less than the roughly 1.4x P/B among big U.S. banks. We also like other cyclical sectors, and not just in Europe. Industrials and information technology stocks that we deem to offer attractive discounts relative to their earnings prospects.

But I would note that we also always seek to have a balanced portfolio that can perform over market cycles. So we also have what we consider to be undervalued stocks with resilient earnings, particularly in the telecommunications and utilities sectors.

Q: Can you give a few examples?

LW: We hold Deutsche Telekom and China Mobile, which had nearly 900 million mobile subscribers at the end of September, and more than 600 million of whom are 4G customers. Its forward price-to-earnings is 12x, which isn't demanding, and it has a 3.6% dividend yield.

Among utilities, we have Électricité de France, Iberdrola in Spain, and National Grid in the U.K. We also hold Kepco (Korea Electric Power Corp), which we think is too cheap with a forward P/E of 5.7x and dividend yield of just more than 5%. If power tariff increases come as expected next year and coal costs ease, which we also expect, Kepco should prove a good investment that pays us nicely while we wait. ■

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Gross Domestic Product (GDP) – A country's income minus foreign investments: the total value of all goods and services produced within a country in a year, minus net income from investments in other countries.

P/E – Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share. Forecasted P/E is not intended to be a forecast of the fund's future performance.

PMI (Purchasing Managers' Index) – An indicator of the economic health of the manufacturing sector and for the economy as a whole. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. A PMI of 50 or higher generally indicates that the industry is expanding.

The IBEX 35 is the benchmark stock market index of the Bolsa de Madrid, Spain's principal stock exchange. It is a market capitalization weighted index comprising the 35 most liquid Spanish stocks traded in the Madrid Stock Exchange General Index and is reviewed twice annually.

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