Perspective from
Templeton Emerging Markets Equity

Consumption: China's next growth driver

November 2024

Consumption is widely viewed as the next driving force of economic growth in China following the slowdown from a credit-fueled investment-led growth model. Geopolitical tensions resulting in increased protectionism and the diversification of supply chains away from China limits the likelihood of a return to the prior growth model.

Creating the right environment for a structural increase in consumption is not a straightforward task for policymakers. This is especially the case in China, where in comparison to its global peers, the population has grown accustomed to spending less and saving more.

Reasons for the high level of household savings and cautious consumer behavior include:

- Inadequate social safety nets, including pensions, health and education
- Weak consumer confidence
- Negative wealth effect
- Job insecurity

Structural issues in the economy including high inequality and an aging population further complicate the situation. Taken together, these factors have hampered consumption in China.

Policymakers had been undertaking gradual measures to tackle the economic slowdown, however, they had been reluctant to implement a large scale "irrigation" style stimulus. There are signs this may be changing. In recent months, policymakers intensified efforts to address weaknesses in the economy and boost consumer confidence.

We believe that the government needs to undertake comprehensive fiscal and social reforms to sustainably boost long-term consumption, including:

- Enhancing social welfare programs
- Improving healthcare and education systems
- Increasing job security
- Hukou reform

By addressing these fundamental issues, there is the potential for a sustained improvement in consumer confidence, which is essential for a structural increase in consumption and in turn economic growth.

To conclude, we focus on three sectors and companies that we believe are well positioned to leverage future consumption trends in China.

Under-consumption in China

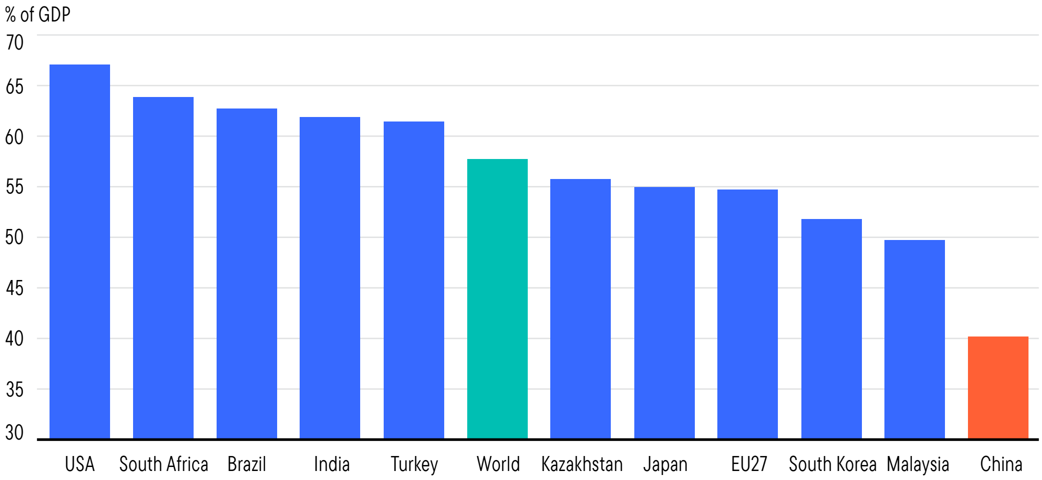
China's reliance on government spending, infrastructure and property investment to drive economic growth as opposed to private consumption, which could be viewed as a more sustainable growth driver, has resulted in a fundamental imbalance in its economy. In contrast, its global peers rely on consumption to fuel economic development.

China's private consumption rate has consistently remained below its global peers.[1] In the last 30 years, China's average consumption rate was 40%, compared to 58% for the world.[2]

Exhibit 1: China's Consumption Below Global Peers

Average Annual Private Consumption, % of GDP

1994–2023



Source: The Economist Intelligence Unit.

Its consumption rate is also low when compared to countries with similar levels of gross domestic product (GDP) per capita. In 2023, China's GDP per capita was US$12,614, in line with Türkiye (US$12,986), Kazakhstan (US$13,137) and Malaysia (US$11,649).[3] However, China's consumption rate remained far below levels recorded in these countries.

Similarly, if we compare China's consumption rate to its advanced Asian counterparts, its current state of economic development is similar to that of Singapore in 1979 and South Korea in 1994 (in terms of GDP per capita in constant dollar terms).[4] The consumption rates in those economies (at 54% and 52%, respectively) at that time were still higher than that of China now.[5]

What's holding China's consumption back?

Stimulating private consumption in China faces several significant hurdles. The country's high rate of precautionary savings signals a tendency to save rather than spend. This is partly due to inadequate social benefits, which make households more inclined to save for future uncertainties. Additionally, demographic factors, such as an aging population, further complicate the situation. Weak consumer confidence is another major factor, which is further compounded by the negative wealth effect. Job insecurity also plays a crucial role. This insecurity leads to lower consumption and exacerbates income inequality.

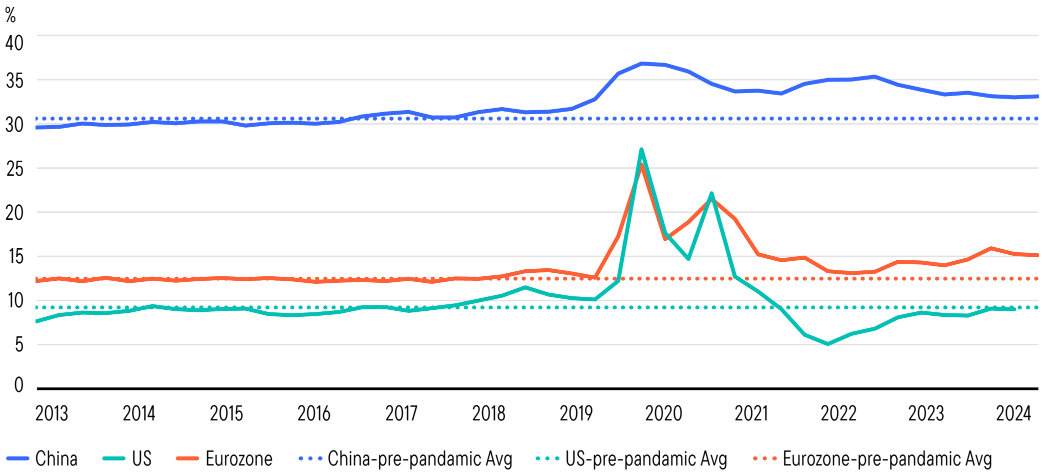
High precautionary savings rate

China has consistently ranked among the highest savings nations globally. This trend has largely paralleled the country's robust GDP growth and government's initiatives to encourage savings at the turn of this century.

Exhibit 2: China Ranks High in Household Savings

Household Savings Rates Globally

December 2013–September 2024



Sources: National Bureau of Statistics of China, US Bureau of Economic Analysis, Oxford Economics, FactSet. As of September 2024.

Financial repression, often seen as a key driver of China's historically rapid economic growth, has also significantly contributed to its high household savings rate. By artificially keeping interest rates low and enforcing strict capital controls, along with subdued private bond and equity markets, households were left with limited avenues for wealth accumulation. This scenario encouraged higher savings, which in turn enabled banks to offer an abundance of cheap loans to state-owned enterprises (SOEs), corporations and the government. Additionally, the real estate market benefited as buyers had increased access to affordable mortgages, spurring property purchases and speculation in the market.

The real estate sector emerged as a pivotal driver of China's economic growth in the years following its boom. In the short term, the real-estate boom created a wealth effect, spurring consumer spending and contributing to a robust economic performance. The heavy reliance on the real estate sector, however, led to economic imbalances, as other sectors lagged behind. Additionally, the soaring property prices exacerbated social inequality, making home ownership increasingly unattainable for many citizens. Over the longer term, the unsustainable nature of this boom became evident. The rapid escalation in property prices eventually reached a tipping point, leading to a market correction. This collapse in prices triggered a wave of debt defaults among developers, who had over-leveraged themselves in the pursuit of growth.

Demographic changes have also played a major role. The introduction of the one-child policy in 1979 generally resulted in reduced household expenditure, as fewer children meant lower overall costs, including those for education. However, over time, the focus on a single child has intensified the pressure to succeed. This has led parents to invest more heavily in their child's education, channeling additional funds into advanced educational support such as after-school tutoring and extracurricular activities. These investments aim to enhance the child's skills, ensuring they excel academically and increasing their chances of success in adulthood.

Additionally, with fewer children to support the elderly, there has been an increase in precautionary savings for retirement, as individuals need to plan more thoroughly for their future. This is further reinforced by the lack of a comprehensive social welfare system, prompting individuals to save more for emergencies and future needs.

Unequal retirement benefits

In China, there is a stark contrast in the distribution of retirement benefits among different groups. Accounting for only 7% of the retired population in 2022, government retirees are at the top of the spectrum, receiving pensions that are approximately double those of corporate retirees.[6] This gap becomes even more striking when compared to the state-funded plan for urban and rural residents which includes individuals not covered by formal employment, including rural workers and urban residents without formal jobs. This group received a modest RMB205 (US$30) per month in 2022.[7]

Putting this into perspective, government- and corporate-employed retirees received about 30 and 15 times more than their urban and rural resident counterparts, respectively, in 2022.[8] Despite representing 55% of the retired population, urban and rural resident retirees received the lowest pension benefits.[9] This uneven distribution means that most retirees must allocate a larger portion of their income towards future financial security.

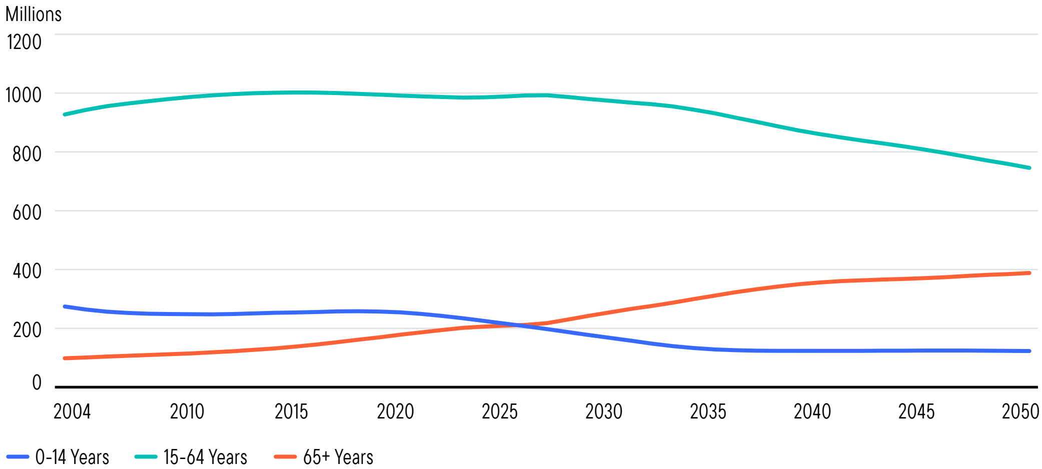
Demographics

China's population declined for the first time in six decades in 2022 amid falling birth and increasing death rates. This trend is expected to continue for the foreseeable future, with China's population projected to fall by more than 10% by 2050.[10] A shrinking population will impact consumption expenditure as the number of consumers continues to decline.

Exhibit 3: China's Population on the Decline

Population Trends in China

2004–2050 (forecast)



Source: United Nations, Department of Economic and Social Affairs, Population Division (2024). World Population Prospects 2024, Online Edition. As of 2024. There is no assurance any estimate, forecast or projection will be realized.

In addition to a declining population, increasing life expectancy and a relatively low retirement age compared to its global peers has also resulted in an aging non-working population, which further weighs on consumption as concerns about social security and health care lead this segment of the population to reduce spending.

The life expectancy for individuals in China has risen to 78 in 2023 from 52 in 1963, while the statutory retirement age remained unchanged during this time.[11] The average retirement age in China is 54, making it one of the lowest in the world.[12] In comparison, the average retirement age for Organization for Economic Co-operation and Development (OECD) member countries was 64 in 2022.[13]

Furthermore, this growing dependency is pressuring the working population. By 2050, China's elderly population (aged 65 and over) is expected to more than double to 31% of the total.[14] The elderly dependency ratio, which measures the ratio of the retired to working-age population, defined as 15-64 years, has doubled in the last two decades, and is expected to increase to 52% by 2050.[15] In a traditional society that values supporting and taking care of parents, this growing dependency further impacts savings and consumption patterns in the country.

Raising the retirement age

In an effort to address this discrepancy, the government approved a policy to raise the statutory retirement age over a 15-year period from 2025 onwards, from 60 to 63 for men, 55 to 58 for women in white-collar jobs, and 50 to 55 for women in blue-collar jobs.[16]

This should also help stabilize productivity in the longer term and alleviate pressure on China's social security system. According to the Chinese Academy of Sciences, China's basic pension insurance fund would run out of money by 2035, if no action was taken.[17]

Weak consumer confidence

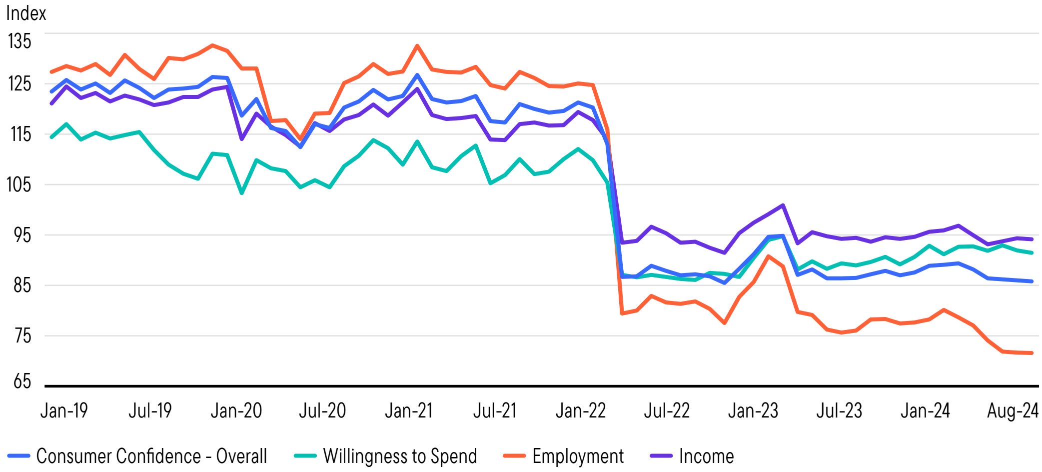
Consumer confidence, a crucial determinant of consumer behavior, has experienced significant fluctuations in China over the past five years. The widespread uncertainty and economic disruption caused by the COVID-19 pandemic led to a sharp drop in consumer confidence, weighing on consumption. However, as the situation gradually stabilized, consumer sentiment rebounded to pre-pandemic levels.

The recovery was short-lived. In 2022, strict lockdowns in major cities such as Shanghai and mobility restrictions across the country led to a dramatic collapse in consumer confidence. Despite the eventual lifting of all restrictions, consumer confidence has remained fragile. The anticipated rebound in sentiment has been sluggish, with few signs of improvement. This persistent weakness is evident in the labor market, where concerns about employment prospects have intensified, exacerbating the overall lack of confidence.

Exhibit 4: Consumer Confidence in China Remains Fragile

China Consumer Confidence Index and Sub-Indexes on Willingness to Spend, Employment and Income

January 2019–August 2024



Source: National Bureau of Statistics of China, Daiwa Capital Markets Hong Kong Limited. As of August 2024.

Negative wealth effect

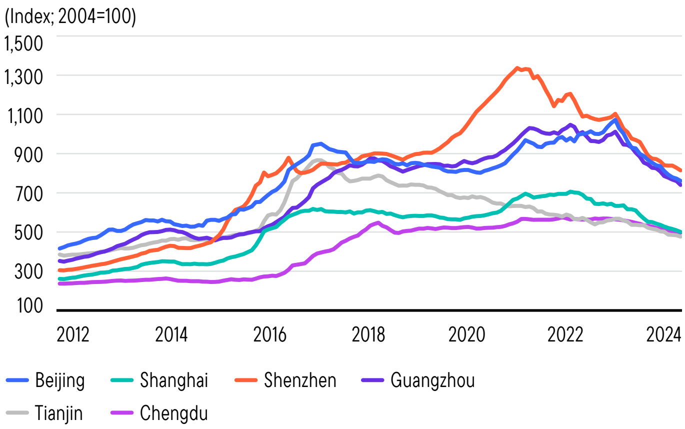
With property accounting for about two-thirds of household wealth and over 80% of households owning an apartment, the property crisis has disproportionately weighed on consumer confidence and spending.[18] China's property market entered a period of unprecedented correction in 2021. The government's "Three Red Lines" policies to manage borrowing in the real estate sector triggered a liquidity crunch, resulting in extensive debt defaults by property developers, including some of the largest in the country.[19] This rattled consumer confidence and investor sentiment in real estate. Unprecedented lockdowns amid the COVID-19 pandemic further weighed on the sector.

The property crisis filtered through to the wider economy, impacting employment in key sectors such as construction and cement. It also dampened sentiment toward equity markets, another key household asset. The government subsequently relaxed lending restrictions and undertook efforts to support the ailing property market. Nevertheless, the impact of these measures on consumer confidence has been limited as real estate prices remain under downward pressure.

Exhibit 5: Decline in Property and Equity Prices Impacting Wealth

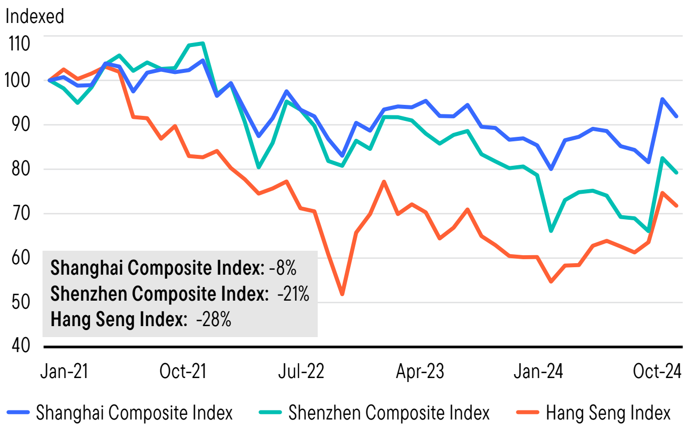
China Centaline Secondary Property Price Index

January 2012–September 2024



Chinese Equity Market Returns

January 2021–October 15, 2024



Sources: China Real Estate Index System (CREIS), Centaline, CEIC, Morgan Stanley Research, Bloomberg. Centaline data as of September 2024. Equity market data as of October 2024. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

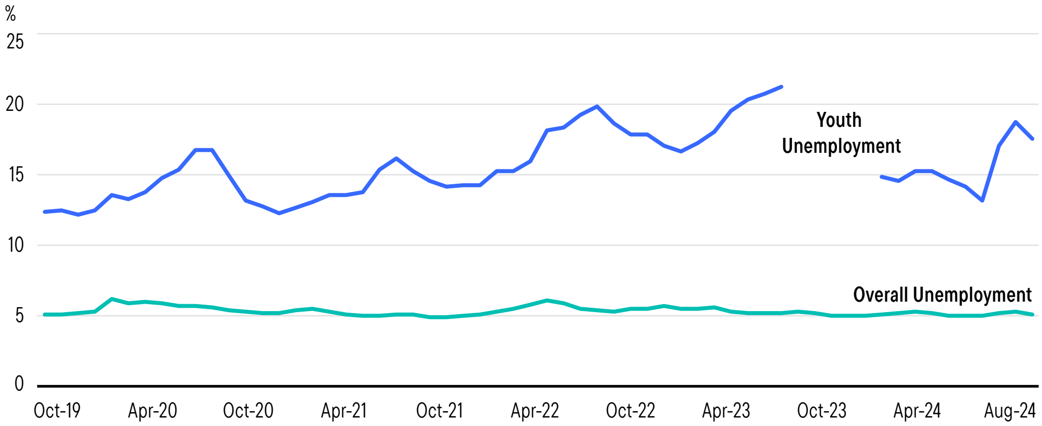
Job insecurity

Although the overall unemployment rate in China peaked at over 6% amid the COVID-19 pandemic, it has since stabilized, returning to pre-pandemic levels.[20] However, youth unemployment has been on an upward trajectory over the past five years. In June 2023, youth unemployment reached an unprecedented high of 21.3%, prompting the government to temporarily suspend the publication of this data to reassess the methodology.[21] When the data series resumed in December 2023, it excluded current students and reported a rate of 14.9%.[22] Despite this adjustment, the influx of a record 11.79 million college graduates into the job market in 2024 caused youth unemployment to spike again, reaching 17.6% in September 2024.[23]

Exhibit 6: Youth Unemployment Rising

Unemployment Rates in China

October 2019–September 2024



Source: National Bureau of Statistics of China. As of September 2024.

The COVID-19 pandemic and subsequent lockdowns severely disrupted job creation across the country, with sectors that typically employ a large number of young people, such as the services sector and small and medium-sized enterprises (SMEs), being particularly hard hit. Additionally, regulatory crackdowns in key industries like information technology, education, and finance have exacerbated the imbalance in the job market. These crackdowns have led to significant job losses and reduced hiring, further contributing to the challenges faced by young job seekers.

The combination of these factors has created a challenging environment for young people entering the workforce. Many are struggling to find stable employment, leading to increased job insecurity and financial uncertainty. This situation underscores the need for targeted policies and initiatives to support youth employment and address the structural issues within the job market.

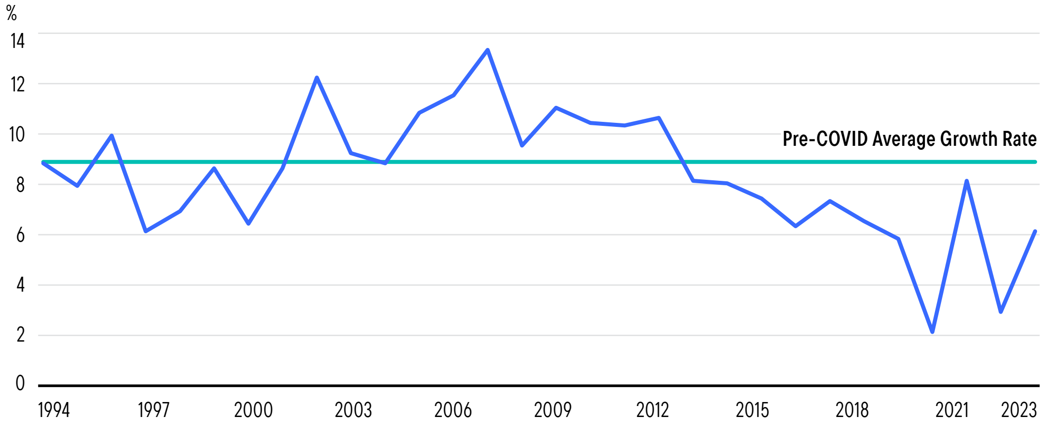
Lower-income growth and inequality

In addition to rising unemployment concerns, those who are employed are facing the challenge of declining income growth rates, which further dampens consumer spending. A significant contributing factor to this issue is China's historical reliance on an investment- and export-driven economic model. This approach resulted in low wage growth and interest rates to support investments and keep labor costs low in the manufacturing sector. As a result, income levels have remained low compared to the size of China's economy.

Exhibit 7: Income Growth Remains Low

Per-Capita Disposable Income Growth Rate in China

1994–2023



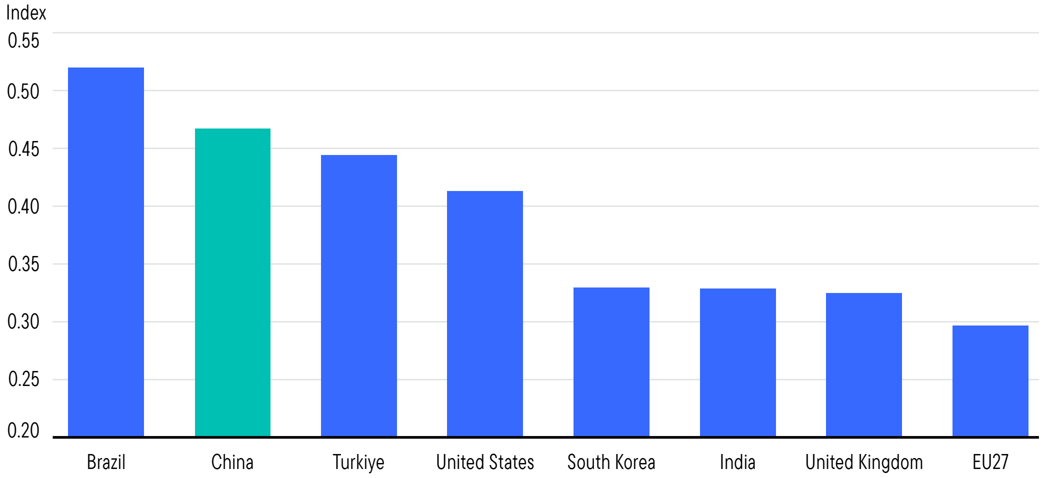
Source: National Bureau of Statistics of China. 1994-2023.

For individuals, income and wealth are key factors that determine consumption. For the economy as a whole, however, the distribution of income and wealth also plays a role. This is because low-income households tend to have a higher propensity to consume than high-income households.

China's fast but uneven economic development has resulted in severe inequality across the country. Its Gini coefficient, a measure of the dispersion of income in a population, was 0.47 in 2022.[24] In comparison, the Gini coefficient in more developed countries such as South Korea, the EU and the United Kingdom is less than 0.35. Income equality, however, is more uneven in the United States, which has a coefficient of 0.4, but is still below that of China.[25]

Exhibit 8: Economic Inequality

Gini Coefficients across the world



Source: National Bureau of Statistics of China. 2004-2022.

China's hukou system could be one reason behind the higher inequality in the country. Established in the 1950s, China's hukou system is a household registration policy that classifies citizens as either rural or urban residents based on their place of origin. This classification restricts access to various social services, including education and health care, to one's registered area, which could effectively limit rural residents' access to better employment opportunities and higher-quality services that are generally available in urban areas. Despite efforts to ease these restrictions, significant disparities persist.

What have the authorities done to stimulate consumption?

Increasing focus on addressing slowing and uneven growth in household consumption in recent years led the government to implement a large-scale equipment upgrade and trade-in program for consumer goods—the first in more than 10 years. It was hoped that the program, which encouraged the replacement of old consumer goods with new ones through subsidies and discounts, would trigger the replacement of big-ticket goods including household appliances and vehicles.

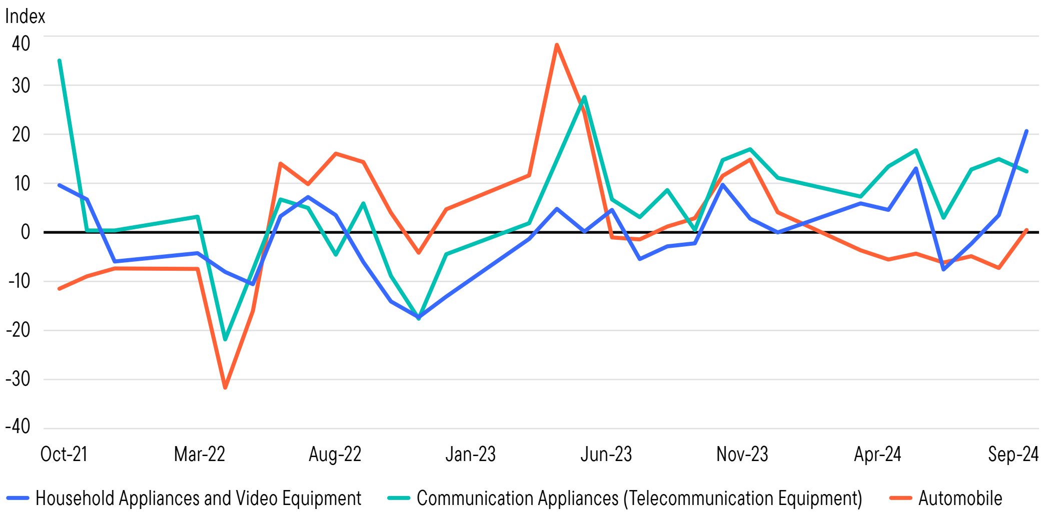
To further support this initiative, the National Development and Reform Commission subsequently announced the allocation of about US$42 billion in funds from the ultra-long special treasury bonds.[26] We also saw several domestic companies adding to the government's initiative by providing additional subsidies and discounts to purchasers to boost sales. The program has resulted in a rebound in demand for household appliances as well as video and telecommunication equipment. Retail sales in the automobile sector also started to show signs of a recovery, ending months of decline.

Moreover, the People's Bank of China has been gradually reducing its lending rates in hopes of lowering the mortgage-servicing burden on consumers, boosting credit demand to stimulate consumption and help revive the real estate market, a key pillar of the Chinese economy.

Exhibit 9: Retail Sales Showing Signs of Recovery

Consumer Goods Retail Sales Growth in China

October 2021–September 2024



Source: National Bureau of Statistics of China, As of September 2024.

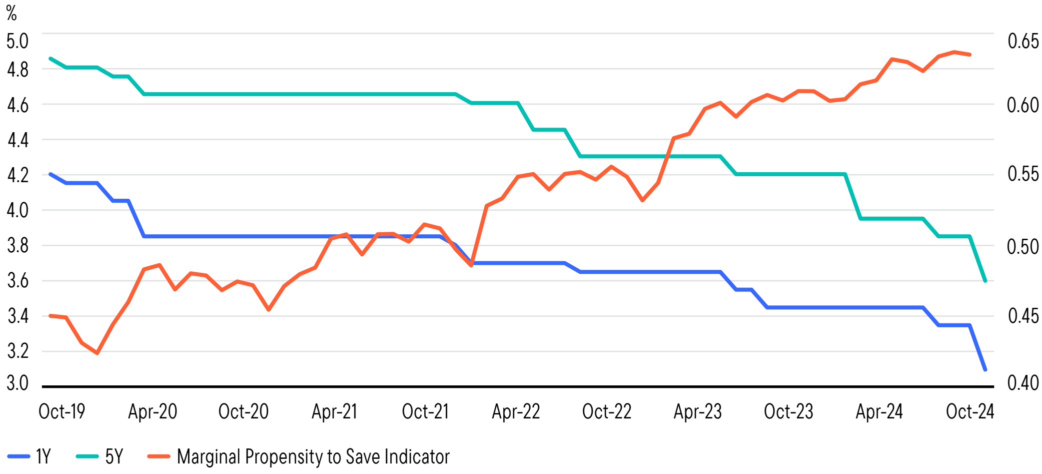
Rising marginal propensity to save

Despite interest-rate cuts, household savings have continued to rise with limited impact seen on consumption, reflecting a broader sense of economic uncertainty in China. Moreover, lower interest rates, which typically reduce the income generated from savings, have meant that higher savings are now needed to generate the same amount of interest income. Additionally, the long-lasting impact of the COVID-19 pandemic reinforced the importance of financial security, prompting many to build up their savings.

Exhibit 10: Households Continue to Save Amid Financial Insecurity

Loan Prime Interest Rates and Marginal Propensity to Save Indicator in China

October 2019–October 2024 (for interest rates); October 2019–September 2024 (for savings indicator)



Sources: China Foreign Exchange Trade System & National Interbank Funding Center, National Bureau of Statistics of China, FactSet, The People's Bank of China, Bloomberg. As of October 2024.

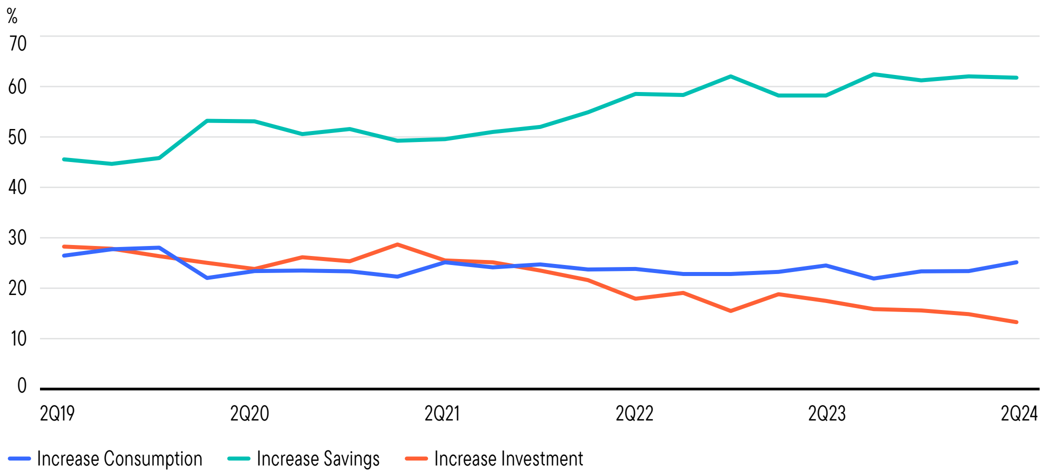
In addition, lower interest rates and the lack of attractive investment opportunities have led to higher demand for time deposits (that tend to have a higher savings interest rate than demand deposits) and has motivated property owners to pay down existing mortgages. Consequently, consumers are opting to lock in their savings for extended periods or reduce debt rather than increase spending. Comparing the slower growth in on-call deposits to the faster growth in fixed-term deposits highlights this increasing propensity to save in recent years.

Weaker confidence in income and employment has also made consumers more inclined to save than spend or invest. In response to how residents plan to allocate their income in the subsequent three months, 61.5% of respondents in the People's Bank of China survey said that they were inclined to increase savings, while 25.1% were in favor of increasing consumption.[27]

Exhibit 11: Weaker Consumer Confidence Weakens Desire to Spend or Invest

Residents' Willingness to Consume, Save and Invest

Second quarter 2019–Second quarter 2024



Source: People's Bank of China Statistics and Analysis Department. As of June 2024.

More aggressive policy support

The continuation of weak economic indicators and increasing realization that China's GDP growth will likely fall short of the government's target have led policymakers to become more proactive. Moreover, although concerns of a weaker renminbi prevented larger rate cuts, the start of a loosening monetary policy in the United States, provides the central bank with more room for flexibility.

Pointing toward a clear shift in the mindset of China's top leadership and growing determination to actively tackle the slowdown in economic growth, significant stimulus measures were announced in September 2024. At the Politburo meeting that followed, President Xi Jinping affirmed his commitment to actively use fiscal and monetary policies to address the challenges in the domestic economy and stabilize and lift the real estate and equity markets.

Policies to support growth

- 50 basis points cut in the reserve requirement rate by end-2024.
- 20 basis points reduction in the policy interest rate.
- Cut existing mortgage interest rates by 50 basis points.
- Central bank to provide 100% financing to local governments to buy unsold housing inventory and convert them into affordable homes.
- Minimum downpayment for second or more homes reduced to 15% from 25%.
- RMB800 billion in funds for mutual fund companies, insurers and brokers to purchase stocks and undertake share buybacks.

This coordinated effort from policymakers has raised expectations for fiscal stimulus measures to follow in the near term, possibly in future Politburo meetings. This shift in policy was well-received by equity markets, boosting investor confidence and resulting in a big rally in onshore and offshore Chinese stocks. In the week following the announcement, the Shanghai and Shenzhen Stock Exchange (SSE) Composite Indices jumped 21% and 29%, respectively.[28] Similarly, Hong Kong's Hang Seng Index rose 16% over the week.[29] Volumes also increased multi-fold on all three exchanges.

Valuations

Despite the recent surge in equity prices, taking a long-term view, valuations of Chinese equities remain attractive. Over the past few years, Chinese stocks have faced significant pressure and have been largely overlooked by investors. However, the pivot in policy support appears to have sparked a notable shift in investor sentiment, which is evident among both domestic and foreign investors.

In addition to boosting market confidence, investors also re-evaluating the growth potential of Chinese companies. Valuations, which had been suppressed, are now being reassessed, with many investors recognizing the underlying value and growth prospects.

What needs to come next?

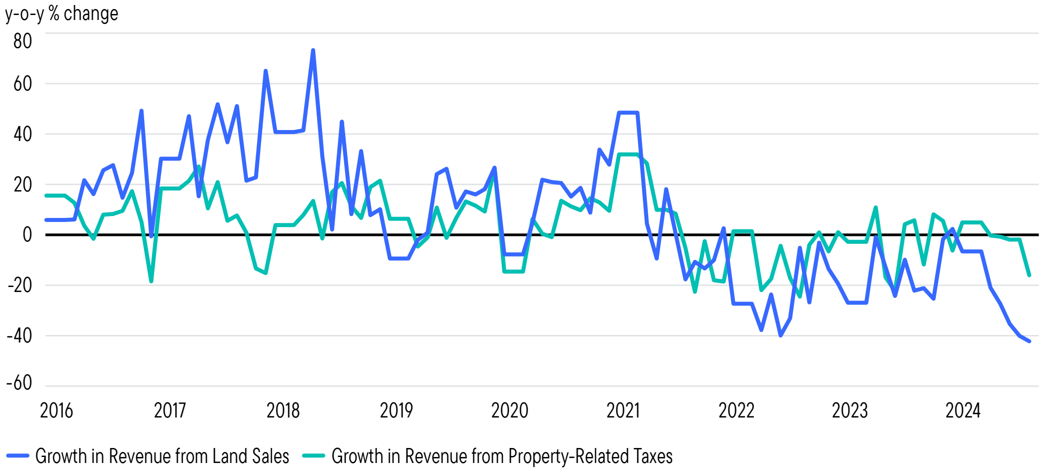
Although the authorities are taking positive steps, it is still too early to determine the success of these measures. The effectiveness will to a certain extent depend on how quickly local governments can align with the central government's directives.

Many local governments are currently struggling with reduced revenues from land sales and property-related taxes, which underscores the need for increased fiscal support from the central government. Prior to the downturn in the property market, land sales revenues constituted 31% of total revenues in 2020.[30] However, this figure dropped to 20% in 2023 and is projected to decrease further this year due to weak land sales.[31]

Exhibit 12: Reduced Land Sales and Taxes Pressure Local Governments

Growth in Government Revenues from Land Sales and Property-Related Taxes

January 2016–August 2024



Sources: Ministry of Finance of the People's Republic of China, National Bureau of Statistics of China, Nomura Global Economics. As of August 2024.

We believe that expansionary fiscal measures are essential to complement the announced monetary policies to effectively stimulate private consumption, reduce the high savings rate and foster a substantial recovery in the domestic economy. This is particularly important because monetary policy alone may have a limited impact in an environment where structural issues persist, reducing consumer willingness to spend despite lower borrowing costs.

Scale of fiscal support

The scale of fiscal support from China's policymakers will also be crucial in determining its overall impact on the economy. Current expectations for the stimulus package vary widely, with estimates ranging from RMB2 trillion (approximately US$283 billion) to RMB4 trillion (US$566 billion) or 1.6% to 3.2% of GDP. For context, China's largest stimulus to date was implemented in response to the 2008 financial crisis, amounting to RMB4 trillion (US$586 billion), which represented 12.5% of GDP at that time.[32]

A significantly larger fiscal package, such as one reaching RMB10 trillion (US$1.4 trillion) or close to 8% of GDP, would likely have a more sustainable effect. Such a package could greatly enhance market confidence and provide robust support for the long-term structural development of the domestic economy. This level of fiscal intervention could stimulate consumer spending, drive investment in key sectors, and accelerate infrastructure projects, thereby fostering sustainable economic growth. Additionally, it could help mitigate the impacts of external economic pressures and ensure a more resilient economic framework for the future.

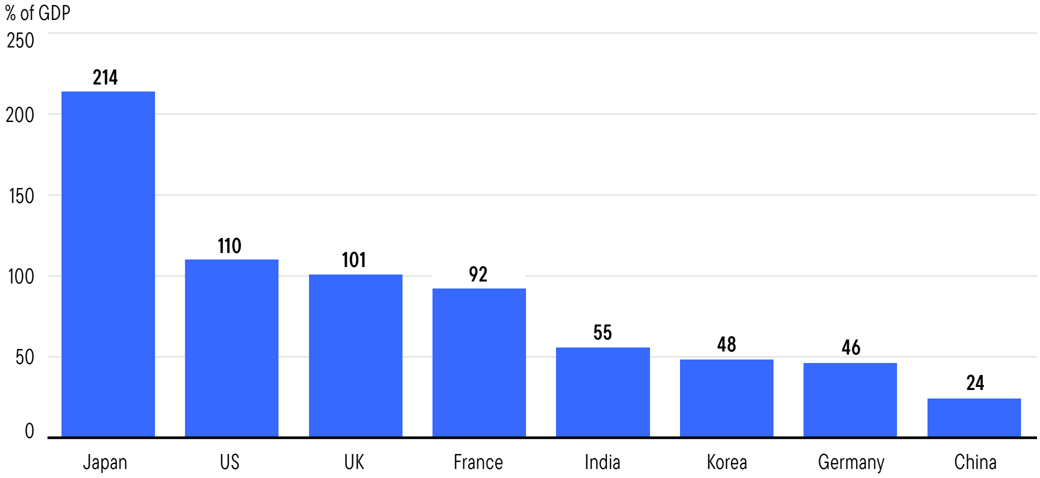
Room for more government debt

In our view, China's conservative fiscal policies in recent years have positioned it favorably compared to many other major economies. This prudent approach has resulted in a central government budget and a balance sheet for the People's Bank of China that both have substantial capacity for expansion. China's central government debt stood at approximately 24% of its GDP. This is significantly lower than the debt levels of its global counterparts.[33] Thus, the Chinese government can afford to increase spending or introduce stimulus packages to boost the economy without the immediate risk of unsustainable debt levels.

Exhibit 13: China Can Afford Stimulus

Central Government Debt, % of GDP

China data is for 2023; data for other countries is for 2022.



Sources: Ministry of Finance of the People's Republic of China, National Bureau of Statistics of China, International Monetary Fund, Macquarie Macro Strategy. China data is for 2023; data for other countries is for 2022.

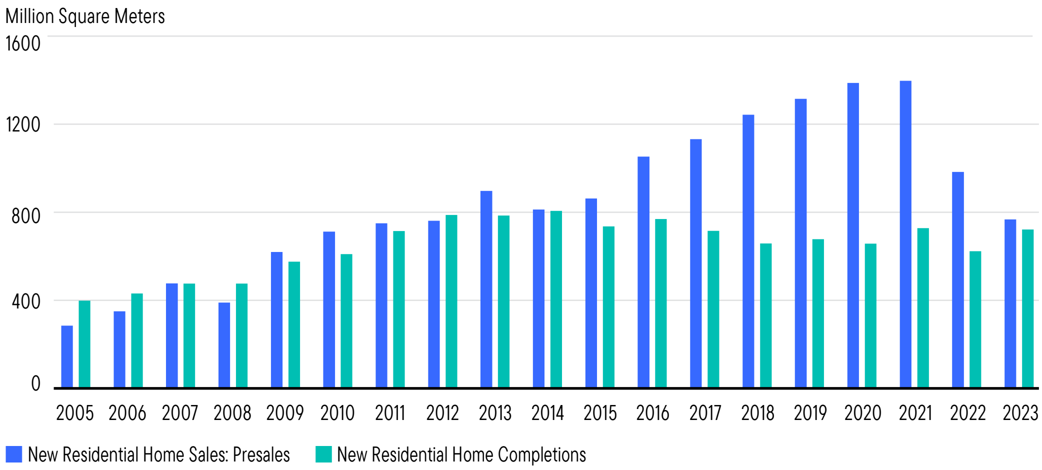
The residential property market

With more than 80% of households owning an apartment in China, stabilizing the property market is crucial for enhancing consumer confidence.[34] Similarly, a stable property market reassures homeowners about the value of their assets, which can lead to increased spending. This boost in consumer confidence is essential for supporting higher levels of consumption. Thus, we believe that it is imperative for the government to focus on reviving the sector. With at least 48 million unfinished homes that have been presold to owners in China, the central government could also encourage banks to provide loans to developers to help fund the completion and delivery of these homes to their buyers.[35]

Exhibit 14: Property Market is Key to Consumer Confidence

New Home Pre-Sales and Completions in China

2005–2023



Sources: National Bureau of Statistics of China, Nomura Global Economics. 2005-2023.

In addition to targeted fiscal support for the lower-income, migrant and rural cohorts, strengthening the population's social safety net through comprehensive pension and health care reforms is crucial, in our view. Increased spending on pension benefits, basic health insurance and childbirth subsidies could help boost income levels and also help address structural issues. Additionally, providing employment support to companies, particularly to address the rising youth unemployment, could have a significant long-term impact.

Hukou reform

Further, reforming the hukou system could be crucial for transitioning the Chinese economy toward a consumption-led growth model by enhancing labor mobility and economic integration, and reducing social inequalities. Allowing rural migrants to obtain urban hukou would grant them access to better job opportunities, higher wages and improved social benefits. This, in turn, could increase their disposable income, reduce the need for precautionary savings and boost consumption. Additionally, such reforms could increase urbanization, stimulate housing demand and revitalize the property sector.

Although the State Council has announced a five-year plan to reform the hukou system, challenges remain. Local governments often rely on the hukou system for city planning and resource allocation, which may lead to resistance. Concerns about increased employment competition and a strain on existing resources could also result in pushback from existing urban residents. Aligning local government goals with those of the central government and providing fiscal transfers could incentivize local governments to support these reforms, equipping them with the resources to manage potential strains on existing infrastructure.

Conclusion

These initiatives would not only enhance consumer confidence but also encourage spending by alleviating the financial insecurities that lead to high savings. By ensuring that citizens feel more secure about their future, they are more likely to spend rather than save excessively. This, in turn, would create a more robust and resilient economy by fostering a healthier balance between savings and spending, ultimately leading to a more sustainable economic recovery.

China Consumer Case Studies

Consumer discretionary

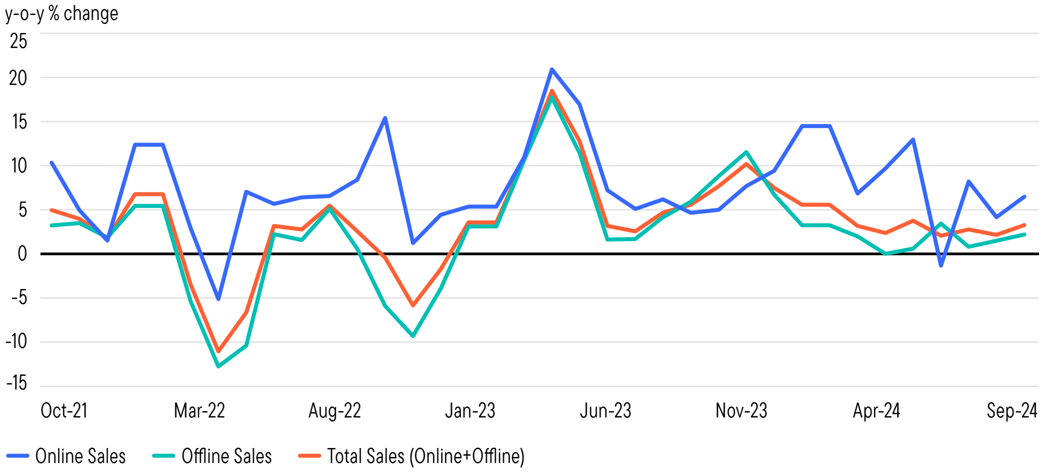
China is the largest e-commerce market in the world. Online retail sales of goods and services totaled RMB15.4 trillion (US$2.2 trillion), double the US$1.1 trillion in the United States.[36] In China, over RMB13.0 trillion (US$1.8 trillion) worth of physical goods were sold online, accounting for 28% of total sales in the country in 2023.[37] Looking ahead, the e-commerce market in China is expected to record a CAGR (compound annual growth rate) of 5.6% between 2024 and 2028.[38]

We expect online sales growth to continue and outpace the overall growth in retail sales as well as offline or brick-and-mortar retail in the coming years. A key reason for this is the increased efficiency in the aggregation of diversified supply and demand avenues across the country onto one online shopping platform. This provides a "one-stop" shop for consumers to purchase a wide range of products from sellers based anywhere in the country due to its comprehensive logistics and transportation network. Hence, despite near-term muted growth outlook for overall retail sales, online retail should also be able to continue gaining wallet share from the offline retail segment.

Exhibit 15: Online Sales Set for Continued Growth

Retail Sales of Physical Goods in China

October 2021–September 2024



Sources: National Bureau of Statistics of China, Morgan Stanley. As of September 2024.

A leading company in China's online retail space is Company X. It operates one of the largest e-commerce marketplaces in China, providing brands and merchants with the infrastructure to acquire and retain customers online. By leveraging its relationship with customers and merchants, the company has been expanding its business to capture a larger wallet share of consumers and merchants domestically as well as expanding its presence overseas. Sales on its domestically-focused platforms rose 26% between FY2020 and FY2024.[39]

Although the company's domestic marketplace faces intensifying competition and a challenging sales growth outlook in the medium term, the profitability of its core business has remained relatively stable. This is partly due to the advertising and commission revenue generated from merchants that use the platform's marketing tools to access its user base.

We remain positive on the strength of the company's e-commerce ecosystem and ability to generate strong cash flows. The company is also developing other businesses including international e-commerce and cloud computing.

The company's long-anticipated entry into the Hong Kong Stock Connect program earlier this year, which enables mainland Chinese investors to buy Hong Kong-traded stocks, has broadened its investor base. A larger and more diverse pool of investors can enhance market confidence and stability, further supporting share prices. Additionally, the company's attractive valuations and robust shareholder return policy, featuring share buybacks and dividends, could further bolster share-price growth in the longer-term.

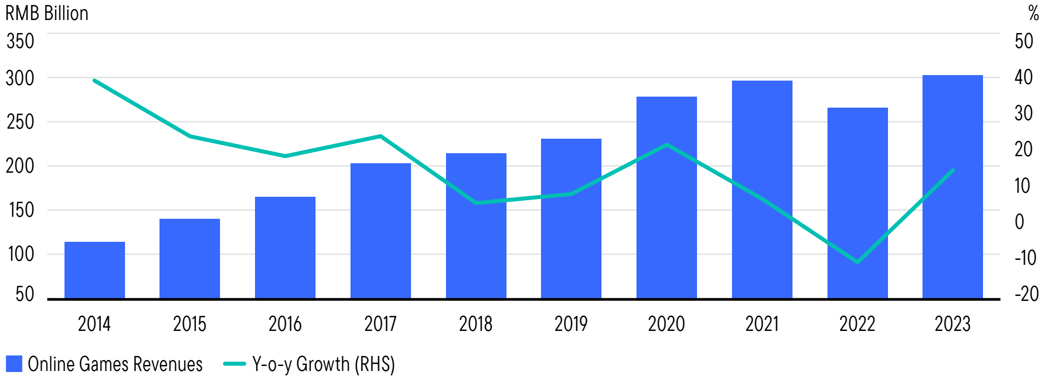
Communication services (online gaming)

China's online games market generated US$44.6 billion in revenues in 2023, making it the second-largest in the world, behind the United States, which had US$49.9 billion.[40] In term of number of players, China is the global leader with a record 668 million players.[41] Looking ahead, the online gaming market in China is expected to record a CAGR of 7.6% between 2024 and 2029.[42]

Exhibit 16: Global Gaming Leader

Online Gaming Revenue in China

2014–2023



Sources: CNG, China Renaissance. 2014-2023.

In China, the three most popular game genres are role-play game (RPG), Multiplayer Online Battle Arena (MOBA) and First-person shooting (FPS).[43] E-sports games, where players can engage in online competitions with other players, and the embedding of mini-games within mobile applications have also been growing in popularity. Many of these games have social features which allow players to interact with each other, creating a sense of community, which helps sustain player engagement.

Online gaming can be viewed as a relatively more inexpensive form of entertainment and can continue to grow in an environment where consumers are not willing to spend on more costly alternatives. Although many games are free to play, in-game purchases allow players to personalize their gaming experience by buying virtual products such as skins to change their avatar's appearance. These purchases provide gaming companies with a significant revenue stream. Some games also have in-game advertisements, operate on a subscription model, or have pay-to-win models, which incentivize spending by offering players competitive advantages to win.

China's largest online games platform in terms of revenue, Company Y, controls the "top of the funnel" of Chinese internet users. It is engaged in the provision of value-added services (including online games), advertising and business services. The group has a solid track record in expanding the addressable market and wallet share by leveraging its strength in user connection and traffic.

The company's core game titles have had resilient performance over the years, and it plans to launch additional titles for its global audience to expand its international market share.

In China, an improving regulatory environment is supportive of the growth in that market with the video gaming regulator continuing to approve new gaming titles. In 2023, China's National Press and Publication Administration (NPPA) approved 1,075 game licenses, more than double the number in 2022.[44]

In addition to its gaming business, the company operates the country's most popular messenger application in China, which has brought multiple revenue streams thanks to the development of new features based on user engagement. Improving monetization from its messaging application, for example, led advertising revenue to increase by close to 50% from 2019 to 2023.[45] In the area of FinTech, payment digitalization and the growing migration of financial services to online methods also provide growth potential. Revenues from the company's business services segment more than doubled between 2019 and 2023.[46]
We view the company as a well-diversified and resilient company with longer-term growth drivers across multiple areas.

Consumer staples (beverages)

China is the world's leading beer market, in terms of both consumption and production. In 2023, China consumed 42 billion liters of beer, accounting for 22% of the global total.[47] In comparison, the United States was a distant second with a consumption of 21 billion liters.[48] In per capita terms, however, the United States is far ahead with 65 liters, more than double the 30 liters in China, an indication of the long-term growth potential of beer consumption in China.[49] Although beer consumption growth has stagnated in recent years, we have seen the emergence of a shift from a quantity-driven to quality-driven market in China.

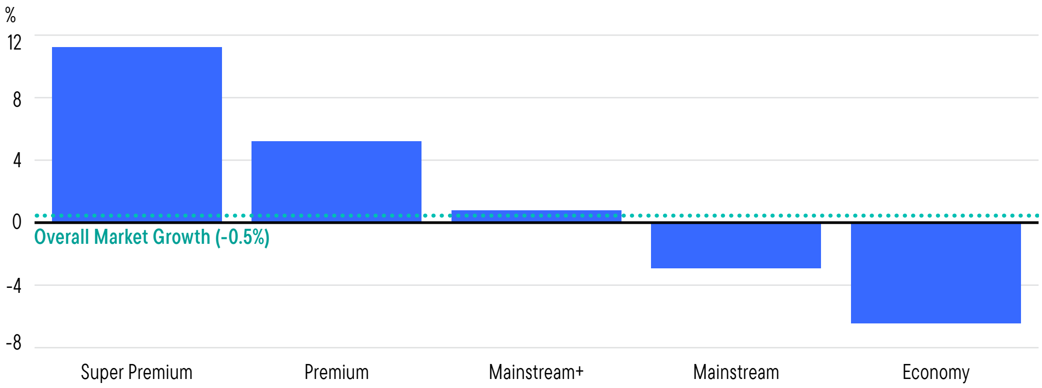
In China, beer is highly accessible to consumers, with 95% of the population able to afford the beverage.[50] Narrowing down to premium and super premium brands, affordability falls to 40% and 13% of the population, respectively.[51] By 2032, however, affordability for premium and super premium brands is expected to rise significantly to about 70% and 40%, respectively, supported by higher disposable income in affluent consumers and increasing product availability.[52] This creates an attractive opportunity for companies in this space.

Changing consumer preferences and lifestyles, growing health and wellness consciousness, and the higher perceived quality and status of premium brands have made them more attractive to the domestic market. While the weak macroeconomic environment has slowed down the premiumization trend recently, we believe that the situation should normalize with consumers reverting to higher quality beers in the longer-term. As a result, the growth in the premium and super premium segments should capture market share from mass-market beer brands, even if overall beer consumption growth remains subdued.

Exhibit 17: The World's Leading Beer Market

China Beer Volume Compound Annual Growth Rate (CAGR) by Segment

2023–2028 (estimate)



Source: Bernstein Societe Generale Group. As of September 2024. There is no assurance that any estimate, forecast or projection will be realized.

Company Z, the largest beer company in Asia, and part of a leading global beverage company, has a significant presence in China. With leading positions in the premium and super premium beer segments, it is well positioned to benefit from the premiumization trend in the country. The company has a large and strong brand portfolio of more than 50 beer brands, including over 25 brands licensed from its parent company. South Korea, and to a lesser extent, India and Vietnam, are also key markets for the group.

While the company's sales in China have been impacted by a slowdown in the premiumization trend amid the soft macroeconomic environment and weak consumer sentiment, we believe this to be temporary, especially as the government focuses on increasing fiscal and monetary measures to boost consumer confidence.

The company's strong market position in the premium and super premium beer segments, focus on in-home sales channels and geographic expansion bodes well for its longer-term outlook. For example, the company recently partnered with Swire Coca-Cola to increase the domestic penetration rate of high-quality brands and boost demand for the company's products in the Anhui and Huibei provinces. We believe continued collaborations such as this could help the company expand its sales in underpenetrated cities and retail channels.

In addition to China, the company's earnings benefit from a dominant market position and steady growth in selling prices in South Korea. The Indian market, although currently a small market for the company, it boasts significant earnings potential with the local beer industry recording double-digit growth and the company outperforming its peers.

Endnotes

1. Private consumption rate is measured by private consumption expenditure as a percentage of gross domestic product (GDP).
2. Source: The Economist Intelligence Unit. 1994-2023.
3. Source: The World Bank Group, World Development Indicators.
4. Ibid.
5. Ibid.
6. Source: "China: Aging population, extremely uneven pension benefits, and low consumption." Nomura Global Markets Research. August 13, 2024.
7. Ibid.
8. Ibid.
9. Ibid.
10. Source: United Nations, Department of Economic and Social Affairs, Population Division (2024). World Population Prospects 2024, Online Edition. There is no assurance that any estimate, forecast or projection will be realized.
11. Source: United Nations, Department of Economic and Social Affairs, Population Division (2024). World Population Prospects 2024, Online Edition.
12. Source: "At 54, China's average retirement age is too low." The Economist. June 24, 2021.
13. Source: OECD, Pensions at a Glance 2023: OECD and G20 Indicators
14. Source: United Nations, Department of Economic and Social Affairs, Population Division (2024). Data Portal, custom data acquired via website. United Nations: New York. Available from https://population.un.org/DataPortal/ (accessed September 16, 2024). There is no assurance that any estimate, forecast or projection will be realized.
15. Source: National Bureau of Statistics of China, United Nations, Department of Economic and Social Affairs, Population Division (2024). World Population Prospects 2024, Online Edition. There is no assurance that any estimate, forecast or projection will be realized.
16. Source: "China approves plan to raise retirement age from January 2025." Reuters. September 13, 2024.
17. Source: The Pension Fund Actuarial Report 2019-2050. Center for International Social Security Studies, Chinese Academy of Social Sciences. April 2019.
18. Source: "Why Are China's Households in the Doldrums?" Liberty Street Economics. September 27, 2023.
19. China's "Three Red Lines" policy set three key financial thresholds that developers needed to adhere to: (1) Liability-to-asset ratio (excluding advance receipts) of less than 70%; (2) Net gearing ratio of less than 100%; (3) Cash-to-short-term debt ratio of more than 1x. If developers failed to meet these criteria, their ability to take on new debt was restricted.
20. Source: National Bureau of Statistics.
21. Ibid.
22. Ibid.
23. Source: "Colleges call on students to stay on in education." China Daily. October 7, 2024. National Bureau of Statistics.
24. The Gini coefficient ranges from 0 to 1, with 0 representing perfect equality and 1 indicating absolute inequality. A coefficient of above 0.4 indicates a high level of income inequality in a population.
25. Source: National Bureau of Statistics of China, World Bank Poverty and Inequality Platform, Eurostat. As of 2022; except for the United Kingdom, South Korea and India, which is from 2021. November 28, 2023.
26. Source: "China announces new measures to boost trade-in program." The State Council, The People's Republic of China. July 25, 2024.
27. Ibid.
28. Source: Factset. Price change between close of market on September 23, 2024 and September 30, 2024. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator of future results.
29. Ibid.
30. Source: China Fiscal Chartbook, Local governments under heavy pressure. Macquarie Group Limited. September 30, 2024.
31. Ibid.
32. Sources: National Bureau of Statistics. "China Announces 4 Trillion Yuan Economic Stimulus." Bloomberg. November 9, 2008.
33. Source: "Local governments under heavy pressure." China Fiscal Chartbook. Macquarie Group Limited. September 30. 2024. China data is for 2023; other countries data is for 2022.
34. Source: "Why Are China's Households in the Doldrums?" Liberty Street Economics. September 27, 2023.
35. Source: "China's 48 million Unbuilt Homes Threaten to Prolong Crisis." Bloomberg. August 14, 2024. (Based on pre-sales data from 2015 to 1H24.)
36. Source: "Total Retail Sales of Consumer Goods in December 2023." National Bureau of Statistics of China. January 18, 2024. "US ecommerce sales reached $1.119 trillion in 2023" Digital Commerce 360. February 26, 2024.
37. Source: "Total Retail Sales of Consumer Goods in December 2023." National Bureau of Statistics of China. January 18, 2024.
38. Source: Research and Markets. China Ecommerce Market Opportunities Databook - 100+ KPIs on Ecommerce Verticals (Shopping, Travel, Food Service, Media & Entertainment, Technology), Market Share by Key Players, Sales Channel Analysis, Payment Instrument, Consumer Demographics - Q1 2024 Update. February 2024. There is no assurance that any estimate, forecast or projection will be realized.
39. Company Annual Reports.
40. Source: "Last looks: The global games market in 2023." Newzoo International B.V. May 16, 2024.
41. Source: "China's Gaming Industry: Trends and Regulatory Outlook 2024." Chine Briefing from Dezan Shira & Associates. February 22, 2024.
42. Source: Modor Intelligence. Gaming Industry - China Size and Share Analysis - Growth Trends and Forecasts (2024 – 2029).
43. Source: CNG. Derived by genre; Top 100 mobiles games grossing share. 2023.
44. Source: "China's Gaming Industry: Trends and Regulatory Outlook 2024." Chine Briefing from Dezan Shira & Associates. February 22, 2024.
45. Source: Company Annual Reports
46. Ibid.
47. Source: GlobalData, Bernstein analysis.
48. Source: Ibid.
49. Source: GlobalData, Bloomberg, Bernstein analysis, US Census Bureau.
50. Source: China Consumer: The Newest Normal. Bernstein. January 2024.
51. Ibid.
52. Ibid.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

The government's participation in the economy is still high and, therefore, **investments in** China will be subject to larger regulatory risk levels compared to many other countries.

There are special risks associated with investments in **China, Hong Kong and Taiwan**, including less liquidity, expropriation, confiscatory taxation, international trade tensions, nationalization, and exchange control regulations and rapid inflation, all of which can negatively impact the fund. Investments in **Hong Kong and Taiwan** could be adversely affected by its political and economic relationship with China.

Any companies and/or case studies referenced herein are used solely for illustrative purposes; any investment may or may not be currently held by any portfolio advised by Franklin Templeton. The information provided is not a recommendation or individual investment advice for any particular security, strategy, or investment product and is not an indication of the trading intent of any Franklin Templeton managed portfolio.

IMPORTANT LEGAL INFORMATION

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. This material may not be reproduced, distributed or published without prior written permission from Franklin Templeton.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as of the publication date and may change without notice. The underlying assumptions and these views are subject to change based on market and other conditions and may differ from other portfolio managers or of the firm as a whole. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market. There is no assurance that any prediction, projection or forecast on the economy, stock market, bond market or the economic trends of the markets will be realized. The value of investments and the income from them can go down as well as up and you may not get back the full amount that you invested. **Past performance is not necessarily indicative nor a guarantee of future performance. All investments involve risks, including possible loss of principal.**

Any research and analysis contained in this material has been procured by Franklin Templeton for its own purposes and may be acted upon in that connection and, as such, is provided to you incidentally. Data from third-party sources may have been used in the preparation of this material and Franklin Templeton ("FT") has not independently verified, validated or audited such data. Although information has been obtained from sources that Franklin Templeton believes to be reliable, no guarantee can be given as to its accuracy and such information may be incomplete or condensed and may be subject to change at any time without notice. The mention of any individual securities should neither constitute nor be construed as a recommendation to purchase, hold or sell any securities, and the information provided regarding such individual securities (if any) is not a sufficient basis upon which to make an investment decision. FT accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FT affiliates and/or their distributors as local laws and regulation permits. Please consult your own financial professional or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction.

Brazil: Issued by Franklin Templeton Investimentos (Brasil) Ltda., authorized to render investment management services by CVM per Declaratory Act n. 6.534, issued on October 1, 2001. **Canada:** Issued by Franklin Templeton Investments Corp., 200 King Street West, Suite 1500 Toronto, ON, M5H3T4, Fax: (416) 364-1163, (800) 387-0830, www.franklintempleton.ca. **Offshore Americas:** In the US, this publication is made available by Franklin Templeton, One Franklin Parkway, San Mateo, California 94403-1906. Tel: (800) 239-3894 (USA Toll-Free), (877) 389-0076 (Canada Toll-Free), and Fax: (727) 299-8736. **US:** Franklin Templeton, One Franklin Parkway, San Mateo, California 94403-1906, (800) DIAL BEN/342-5236, franklintempleton.com. Investments are not FDIC insured; may lose value; and are not bank guaranteed.

Issued in Europe by: Franklin Templeton International Services S.à r.l. – Supervised by the *Commission de Surveillance du Secteur Financier* – 8A, rue Albert Borschette, L-1246 Luxembourg – Tel: +352-46 66 67-1, Fax: +352-46 66 76. **Poland:** Issued by Templeton Asset Management (Poland) TFI S.A.; Rondo ONZ 1; 00-124 Warsaw. **Saudi Arabia:** Franklin Templeton Financial Company, Unit 209, Rubeen Plaza, Northern Ring Rd, Hittin District 13512, Riyadh, Saudi Arabia. Regulated by CMA. License no. 23265-22. Tel: +966-112542570. All investments entail risks including loss of principal investment amount. **South Africa:** Issued by Franklin Templeton Investments SA (PTY) Ltd, which is an authorized Financial Services Provider. Tel: +27 (21) 831 7400, Fax: +27 (21) 831 7422. **Switzerland:** Issued by Franklin Templeton Switzerland Ltd, Stockerstrasse 38, CH-8002 Zurich. **United Arab Emirates:** Issued by Franklin Templeton Investments (ME) Limited, authorized and regulated by the Dubai Financial Services Authority. **Dubai office:** Franklin Templeton, The Gate, East Wing, Level 2, Dubai International Financial Centre, P.O. Box 506613, Dubai, U.A.E. Tel: +9714-4284100, Fax: +9714-4284140. **UK:** Issued by Franklin Templeton Investment Management Limited (FTIML), registered office: Cannon Place, 78 Cannon Street, London EC4N 6HL. Tel: +44 (0)20 7073 8500. Authorized and regulated in the United Kingdom by the Financial Conduct Authority.

Australia: Issued by Franklin Templeton Australia Limited (ABN 76 004 835 849) (Australian Financial Services License Holder No. 240827), Level 47, 120 Collins Street, Melbourne, Victoria 3000. **Hong Kong:** Issued by Franklin Templeton Investments (Asia) Limited, 62/F, Two IFC, 8 Finance Street, Central, Hong Kong. **Japan:** Issued by Franklin Templeton Investments Japan Limited. **Korea:** Issued by Franklin Templeton Investment Trust Management Co., Ltd., 3rd fl., CCMM Building, 12 Youido-Dong, Youngdungpo-Gu, Seoul, Korea 150-968. **Malaysia:** Issued by Franklin Templeton Asset Management (Malaysia) Sdn. Bhd. & Franklin Templeton GSC Asset Management Sdn. Bhd. This document has not been reviewed by Securities Commission Malaysia. **Singapore:** Issued by Templeton Asset Management Ltd. Registration No. (UEN) 199205211E, 7 Temasek Boulevard, #38-03 Suntec Tower One, 038987, Singapore.

Please visit www.franklinresources.com to be directed to your local Franklin Templeton website.

The views and opinions expressed are not necessarily those of the broker/dealer; or any affiliates. Nothing discussed or suggested should be construed as permission to supersede or circumvent any broker/dealer policies, procedures, rules, and guidelines.

FRANKLIN
TEMPLETON

US-GTM-3668469-3568469
EMECC-U1124