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October 2022: China Newsletter

Party Congress leads to volatility for Chinese equity markets

China update

Equities were under pressure globally in September due to concerns over recession and earnings downgrades amid a rising interest rate environment.

The MSCI World and MSCI Emerging Markets indices fell 9.3% and 11.7%, respectively. Although facing different challenges from the developed markets, Chinese equities also experienced large drawdowns, with the MSCI China and MSCI China A Onshore indices down 14.5% and 9.6%, respectively. All sectors had negative returns except for Energy, with Consumer Discretionary, Materials and Industrials falling the most.

Recent Chinese economic indicators including service sector Purchasing Managers' Index (PMI), suggest a contraction from July/August, as more cities were impacted by strict pandemic controls leading up to the Party Congress and export growth started to slow down due to weakening global demand.

Despite that, China's GDP grew 3.9% in the third quarter, showing a rebound which was ahead of consensus forecasts. Money supply growth, as measured by M2, accelerated to 12% year on year in September, indicating an accommodative monetary policy. In the coming quarters, we expect the Chinese government to roll out more stimulus measures to stabilise the economy. Hong Kong's recent move to remove quarantine requirements for international travellers and Macau's reopening to tour groups from mainland China are positive signals of a gradual reopening of the country.

China's 20th Party Congress

The hugely anticipated 20th Party Congress finally concluded in October with Xi Jinping securing a third term as the party leader, resulting in a large reshuffle of the Politburo Standing Committee (PSC). Xi has cemented his control of the China Communist Party (CCP), with all committee members now being his allies.

3.9%

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Following the event, there was significant selling, especially by foreign investors who viewed the PSC appointments as negative and counter to a reformist agenda. The Hong Kong's Hang Seng Index fell by 6.4% on the Monday after the new Politburo Standing Committee was announced at the Chinese Communist Party Congress. The Golden Dragon Index of US-listed Chinese companies fell by 14.4% on the same day, driven by panic selling by foreign investors. Similar falls were noted in other China-heavy companies, like Naspers, the parent company of Tencent, which was hammered that day by falling as much as 17%. On the other hand, locally listed China A shares were much more resilient, only down 2% for the day.

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As a Financial Times journalist put it, “The basic picture of China’s political order and economy doesn’t look much different on Monday afternoon than it did on Friday afternoon.” So, what’s changed?

It feels like foreign investors were hoping for good news even though the CCP went to considerable lengths to keep expectations down. When there was no such news, and with the perceived negative slate of new PSC members, this led to a fire sale of foreign-listed Chinese shares, which then recovered over subsequent days only to fall again as US tech giants delivered disappointing earnings. This volatility is expected to continue.

Our managers’ views

There is no doubt that the Party Congress outcome paves the way for Xi to continue with the policies he strongly believes in, whether they be “common prosperity”, his view on national security or stabilising and managing the property sector over the medium term. However, most local managers would argue that was already the case before the Party Congress and portfolios were positioned to reflect this. Government policies always create both headwinds and tailwinds, and the latter can provide significant investment opportunities.

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12%

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Key points were:

- Managers were not anticipating any significant policy shifts from the Party Congress as it focuses on people appointments. This was China’s equivalent of a parliamentary election and not a podium for new policy announcements, which will follow later. Domestic asset managers therefore found foreign investors’ disappointment from the lack of policy announcements confusing and unnecessary.

- There will be two policy meetings in December (a Politburo Meeting and a Central Economic Work Conference) and the National People’s Congress will be in March 2023. That is where we should look for clues to new economic policies and growth targets. The politics are over, and we should now expect the government to refocus on the economy and look to further ease the strict Covid lockdown policy. Furthermore, weakness in macroeconomic data or markets may prompt the government to roll out more pro-growth policies.

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- Now that Xi has full control, we could see more effective implementation of policies in the longer term, even allowing for bolder reforms. As highlighted in Xi's report read out at the Party Congress, continuous reforms and high-quality economic development remain high priorities. The report noted that "By 2035, China's per capita GDP will increase significantly, reaching the level of mid-tier developed nations." Government models predict that around 4.8% annual growth is needed to achieve this goal, but there may be a demographic issue which needs to be better understood (China's ageing population may constrain what can be achieved). Nevertheless, it is a clear statement of intent regarding "common prosperity", where the focus is on the growth of GDP per citizen instead of total country GDP growth.

- Three of the committee members, including the expected Premier, Li Qiang, were previously provincial or central government ministerial level party secretaries in the most developed regions of China. With the president's full support, these loyalists may have far more discretion than their predecessors.

- Li hails from Shanghai, the financial hub of China, with China's largest stock market. His reign saw the construction of a Tesla factory and the launch of the hugely successful STAR Market, which now competes with the Nasdaq to host fast-growing Chinese companies. However, he was also blamed for the crippling Shanghai lockdowns earlier this year.

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- Managers expect the China A share market to continue to see lower volatility than offshore "Chinese" markets as it is principally comprised of domestic-facing companies, driven by domestic investor flows and more responsive to any change in near-term economic policies. Investors in these local markets are far more appreciative of domestic issues, politics and sentiment.

Fast-growing companies are cheap

While it is important to understand the macro environment and watch out for policy changes, our managers are seeking exposure to select high-quality businesses in China. Chinese equity markets offer a wealth of opportunities, although their composition will look quite different in the next 10 years. For instance, given China's long-term goal of building up national strength and independence in science and technology, sectors such as semiconductors and renewable energy will continue to benefit from policy support. High-quality consumer companies will also likely recover as Covid lockdowns ease.

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Many of these companies are now trading at historically low multiples. These companies are already delivering the earnings expectations but are beleaguered by negative sentiment on China. The consensus forecast earnings growth of the companies in the OOCF is 28.5% over the next 12 months, compared to 12.4% for the MSCI USA, while the forecast price/earnings multiple is 15.5X versus 18.6X for the MSCI USA.

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Geopolitics

We don't think the risk of confrontation with Taiwan has increased any more than it has been for some time. The Party Congress reiterated the same stance on Taiwan with no fundamental changes or mention of any specific timetable. Chinese asset managers believe that intervention in Taiwan might be a long-term risk, but it is unlikely to materialise in the short to medium term. However, political gesturing and diplomacy are likely to continue.

It is important to note, though, that if Taiwan is taken by force, and the consequence is war, this will affect practically every supply chain and company in the world. China is different from Russia. Companies could extract themselves from Russia without major pain, but it is difficult to do this with China.

30 yrs

It took 30 years to move manufacturing to China.

For example, a recent Bloomberg piece estimated that it would take Apple eight years to move just 10% of its production capacity out of China. Moving supply chains doesn't just happen overnight, or even in 12 months. Apple is not the only company that would be impacted in this way. Almost all products consumed by the West have Chinese manufactured inputs or components. It took 30 years to move manufacturing to China, and it will take a long time to reverse this fully, if at all possible.

The week after the Party Congress reminded us that emotions can result in considerable volatility for Chinese equity markets. However, on the ground, high-quality companies continue to grow and create investment opportunities and significant value for the long-term investor.

While this geopolitical risk is well priced into Chinese equities, it is far from fully reflected in global companies that either rely on sales to the world's largest population or on manufacturing and imports from China.

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