On China: Are We There Yet?

Newsletter for November 2022

Are we there yet? This is a question on the minds of the shrinking group of international investors that still remain invested in HK/ China stocks at the end of October. We feel the answer is slowly emerging from the haze of all the real and perceived negatives around China. The answer is a resounding "certainly looks like it". We are increasingly convinced that we have seen the bottom of MSCI China in late October as each of the negatives seems to have found an inflection point. Our view is that, at the margin, the China story will become less negative, both on the qualitative front and in terms of numbers over the next few quarters. This will mean that in spite of the sharp rally in China in the first ten days of November, we are looking at good returns over the next twelve months.

There are primarily five negatives that have plagued the market over the past two years.

The Property Sector Squeeze

This started with the "3 red lines" mandate which came out in the end of 2020. The broad indication was that the government had come to the conclusion that the potential pain from a market bubble burst in the future would be much bigger than the short-term pain from letting steam out of a euphoric market. The "3 red lines" were primarily targets to reduce debt by developers over the following 24 months. With Xi Jinping's "property is for living not speculating" statement made in 2017, there was a confluence of negatives for the sector. As is often the case in China, this policy was implemented at the ground level in districts, cities and towns. This led to a competitive race between these administrative entities to implement the broad top-down policy in their own way. The net result was that by the end of 2021, the property sector seemed to have suddenly hit a wall. In 2022 it become worse. For the first ten months, property sales dropped by over 55%, new starts by over 70% and construction activity by over 25%. Basically, the sector went back by about five years in terms of size over a short 12-month period.

Obviously, the repercussions were widespread. The first and direct impact was on the developers themselves as it was akin to a cyclist going uphill who was suddenly prevented from pedalling. Most developers (big and small) were leveraged. With a sudden drop in sales and the accompanying cashflow, their balance sheets deteriorated quickly. Even the best of companies (some of them government owned too) suddenly looked vulnerable.

The other collateral damage was in the finances of local governments. About 40% of local government revenues were coming from land sales. With land sales dropping over 55% in H1 2022 (it is worse if we exclude sales to government entities), local government finances started looking disastrous. In addition, there was a hit on all related sectors like white goods, construction material, ancillary services companies, etc. Most importantly, this was a huge hit to the household balance sheet as about 37% of it is residential property.

Clearly, however, the government was not aiming for the end of this important sector. This led to a slow and piecemeal reversal of policy from early 2022. This slow reversal seemed to have no real impact so far (similar to the negative policies which accelerated and took about a year to show impact). The first big coordinated push to reverse this trend happened last week, post the party congress, with sixteen clear measures being put out by the government. We think this has created a genuine bottom at the ground level. The recovery will be slow initially and more damage will happen to the weaker players even while the market is slowly turning. That suits the government well. They want to create genuine risk in this business and permanently eradicate the wild speculation that has broadly played out over the past ten years. As the old Chinese adage goes, “kill the chicken to scare the monkeys”. In 2008 America, Lehman was the chicken; in 2022 China, there are multiple chickens, the most prominent being Evergrande.

In conclusion we feel this negative has turned a corner. The forward outlook will remain rocky but will not get worse for the sector as a whole. Also, systemic risk to the economy from this sector will slowly reduce.

The Tech Sector Reset

This was the big regulatory reset. China finally flipped on this sector post the infamous speech by Jack Ma in October 2020, just before the IPO of Ant Financials, where he lectured the government on how to run the financial sector. This was the last straw on the camel’s back. What the tech sector (represented by big names like Alibaba, Tencent, Baidu, JD, Meituan, Didi, Pingduoduo) had become was, from the perspective of the CCP, wrong on multiple fronts. There were factors which could be equally true for the global giants – centralised control of large volumes of data, blatantly monopolistic practices where the big became bigger not only in their own territory and but in an increasing number of sectors, reducing worker rights and protection, large wealth accruing to founders and senior staff thus increasing disparity, etc. These are all valid problems and potentially to be tackled by the West too. China went head on targeting them.

In addition, there were problems which were China-centric; more accurately, problems that were threatening to the CCP. The broad problem was that the CCP felt that it was losing control over the “Chinese narrative” - the story that is the bedrock of the compact between the population of 1.4 bln. people and the CCP which is only about 96 mln. in size. The tech giants were not only getting very powerful monetarily (which, from the party’s perspective, increases the risk of higher officials being bought out) but were showing signs of pushing a narrative that was different from what the party wanted to push. Hence, this was the second source of the strong regulatory push that started in end 2020 (coincidently at the same time as the property clean up).

Using our chicken and monkey analogy, this time the chicken was the online education sector which was broadly wiped out overnight. When that happened, the sector and investors realised that this time it was much bigger and more serious. This was manifested broadly in the drop in the earnings expectations of the listed tech sector by about 40-50% over an 18-month period. With tech being at near half of MSCI in early 2021, the market earnings for 2022 dropped by nearly 33% from early 2021 to now. This was brutal for equity markets.

Again, here our view is that the changes are broadly at an end. A lot of regulations have been put in and the sector has cleaned up its act. Various voices from the government have been saying the same over the past few months, but the impact (like in the property sector) will only be felt gradually over the next few quarters.

The Zero-Covid Policy

This is an unusually Chinese problem. The strength of China's overly centralised, top-down political system became its weakness. Such a system is very useful for quick and efficient implementation of directives from above as there is no questioning and double guessing by the lower-level implementors. This is great as long as the directives from the top are correct. But at times when the directives are ill-conceived, the corrective mechanism is weak, as the feedback from the bottom does not reach the top. The Zero-Covid policy was one such directive from the top. It worked well when there were no vaccines and no knowledge about the potency and virality of the various strains of the Covid virus. But as vaccines emerged and the viral strains were better understood, the Zero Covid policy became counterproductive. Given its control of the narrative, the government could afford to stubbornly stick to its wrong policy for longer than a more open system would have allowed. But the damage was increasingly felt in economic terms. As this cost started to pile up and the Chinese saw how the world had opened up, the pressure from the ground level started building up to reverse course. This is where we are now. We will potentially see a faster roll out of vaccinations (primarily boosters), more access to the mRNA vaccines, more nuanced closures in pockets of the urban area.

Also, with the party congress out of the way, Xi has more political room to take higher infection and death numbers. President Xi walking around maskless at the G20 summit in Bali last week is a very big signal. He is being seen "without protection" amongst leaders from all around the world. The message is that it is safe if you have taken your vaccines. We think there will be a multistep choreographed dance to the slow fading of the Zero-Covid strategy over the next 6-12 months.

This was one of the biggest loads on economic activity and consumer and corporate confidence in 2022. We feel, again, that we have seen the worst here too.

The Party Congress And Consolidation Of Xi's power

This was the big political uncertainty for the past year. Obviously, a party of nearly 100 mln. members would have factions and differences of opinions. This requires the usual political machinations that we see in a more democratic system. The current Congress has clearly made the Xi faction the most powerful. Given the intransparency in the system, this consolidation of power has multiple implications. Clearly, the gung-ho buccaneering capitalism of the 2001-2012 phase, where the holders of capital were the most powerful, is behind us. This policy is clearly going to have a more balanced view between capital, labour and society. Hence, the financial markets have reset their calculations based on that.

Our view again is that the uncertainties related to this process have peaked out. Also, some of the regulatory head winds in the tech, property and other sectors were related to this political reset and hence, the regulatory uncertainty will settle at a lower level.

Geopolitics – From Complementarity To Competition

This is probably the most secular of the negative resets. The underlying compact of the western nations with China, since the latter's entry into the WTO, is being permanently reset. China is no more simply a source of low-end cheap goods and services. The pool of Chinese working age population has been shrinking for nearly a decade. Also, Chinese capabilities across sectors have now reached levels where all except the top end work can be done in China. While the US was a facilitator of improving China's capabilities since 2002, it now feels threatened and does not see any logic in helping out. With the Chinese government itself focusing a lot more internally in terms of economic growth, the two economies are trying to slowly become less interdependent.

Combine the above with China's internal and external geopolitical ambitions, and the potential area of conflict widens. We feel this will be an ongoing area of attrition and the only solution is to manage it without letting it get out of hand. With the US mid-term elections out of the way and the recent meeting between Xi and Biden in Bali, the negative rhetoric could temporarily slow down.

Conclusion

In conclusion, the China market might have found a bottom, though the climb up will be rocky and slow. The existential questions of "Is China is investible?" or "Is China going to be the next Russia?" have slowly receded. The discussion is gradually moving to economic growth, corporate earnings, etc. We are already seeing earnings inflecting in the tech sector, with all the major tech companies showing flat to increasing expectations for the last six months. MSCI China is slowly showing signs of bottoming out. The recovery will be erratic, but the market works on rate-of-change. And *that* is improving.

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