SPOTLIGHT | APRIL 2021

CHINA: TRANSITIONING TO A BRAVE NEW WORLD

Key points

- Volatility is back in Chinese equity markets: after rallying 90% from its trough in March 2020 to a peak in February 2021, MSCI China has fallen by 16% over the past month.
- This volatility has been driven by a combination of cyclical concerns as Chinese policy has slowly begun to normalise, increased regulatory/anti-trust pressure by domestic Chinese authorities, as well as visible geopolitical tensions.
- Cyclical concerns are likely overstated as China has no need to tighten policy dramatically as it did in 2011 or 2015 given the more modest pandemic-related stimulus in 2020.
- Increased regulatory pressure, on the other hand, could turn out to be more concerning. If it were to stifle the ability of China's 'Big Tech' companies to generate and redeploy capital into new, high growth industries, premium valuations could suffer despite attractive near-term earnings prospects.
- Moreover, while the anti-China rhetoric of the US is not a surprise in the early days of the Biden administration, an early capitulation by the European Union may signal that a US-led containment effort is taking place more rapidly than anticipated.
- For investors, we continue to see cyclical and strategic opportunity in the next leg of China's transformation. A domestic focus on soft consumption and early-stage innovation may provide shelter from potential regulatory and external pressure ahead.

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The return of volatility to China markets

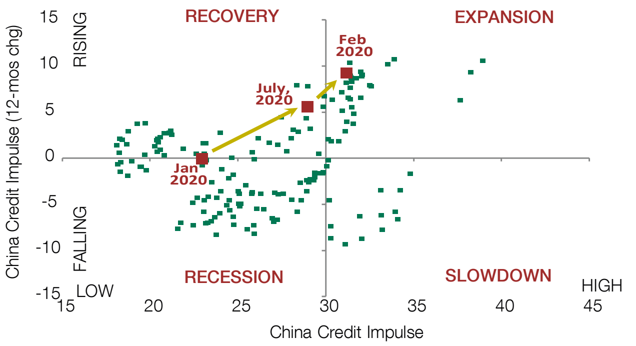
China's equity markets have been roiled by a combination of concerns in recent weeks, culminating in the fallout from the Archegos family office liquidations in late March.

However, this volatility has retraced only a portion of the 90% rise in MSCI China since the lows touched in March 2020, and is inconsistent with the transition to outright economic expansion China's economy has witnessed recently.

For investors, this transition from recovery to economic expansion is significant. Historically, such a pivot has led to average and median returns of 8-9% in the following six months, with positive returns having occurred almost 90% of the time.

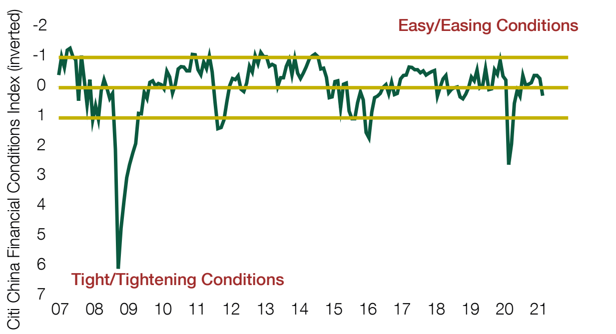
Admittedly, recent moves by Chinese authorities to tighten lending growth raise concerns that China's economy may have reached its post-pandemic peak, potentially giving rise to a credit tightening cycle followed by a substantial equity market correction, as happened in the aftermath of the Global Financial Crisis.

China has transitioned from recovery to outright economic expansion in recent months



Sources: Bloomberg Finance L.P. and UBP

China financial conditions never saw the easy conditions that have triggered previous tightening cycles



Sources: Citi, Bloomberg Finance L.P. and UBP

However, we believe that China's situation today is quite different from that in 2010-11. Back in 2008-09 China, the 3rd biggest economy in the world at the time, injected over USD 1 trillion in stimulus, exceeding the USD 787 billion in stimulus deployed by the largest global economy, the United States. This rekindled a credit bubble built upon an already fragile banking system that prompted China to reign in credit growth rapidly in 2010-11.

Turning to today, China's policy response has been much more muted. Indeed, even at the worst of the pandemic in China during its shutdowns in January and February 2020, the Chinese recession was quite modest by historical standards (Chart 1).

Indeed, the recent reflationary policies have merely brought financial conditions back to their historical averages, contrary to the stimulus after the Global Financial Crisis of 2008-09 that re-started asset bubbles within the economy.

As a result, we expect the policy response to be meaningfully different from that seen in previous cycles, focused primarily on moderating policy to avoid the re-emergence of asset bubbles especially in the leveraged property sector.

Thus, even though investors' caution about China's recent change in policy is understandable, in view of China's broader economic context such cyclical concerns appear to overstate the domestic risks that have appeared to threaten the post-pandemic expansion in recent months.

Anti-trust regulations introduce a new headwind to 'Big Tech' in China

Rather than cyclical concerns, what is more concerning is the increasingly confrontational attitude of China's regulators towards domestic 'Big Tech' leaders such as Alibaba and Tencent.

Regulatory action began in late-2020 with the cancelled listing of Alibaba's fintech arm, Ant Group. Widely considered a clash of personality cult between China's President Xi Jinping and Jack Ma, Alibaba's founder and now former Chairman, it gave rise to new anti-trust measures and stricter enforcement by Chinese regulators against the country's leading platform and payments companies.

While such moves may seem to contradict the focus on innovation of the Chinese Communist Party's latest Five Year Plan, China has been wary of excessive concentration of power among corporates since the 1990s, as Mr. Shan Weijian highlighted in our recent webinar on China.

Indeed, the introduction of competition into the airline and telecom sectors in the 1990s and 2000s is a reminder of how expansion coupled with unexpected regulatory changes represents a risk for equity investors in Hong Kong and China. These efforts have continued in the online marketplaces with the tightening of online games and videos approvals since 2008-2009, a clamp down of online microlending platforms since 2019-20, and new regulations on K-12 after school tutoring and online education since 2020.

Given that China's biggest technology firms represent well in excess of 30% of MSCI China's market cap, regulatory headwinds which weigh on long-term growth prospects or their ability to reinvest in new and emerging sectors may challenge their premium PE ratings vs. the broader market.

While such regulatory pressure could cause near-term volatility, America's mature 'Big Tech' firms may show the way forward.

Tighter regulation could prompt China's tech leaders to redeploy their free cash flow towards share buybacks and dividends instead of reinvesting it, much like some of their American counterparts have begun to do providing support to shareholder returns looking forward.

Geopolitical pressures re-emerge across multiple axes

With the end of the Trump era in the United States, we surmised that the tension between the two largest economies in the world would stabilise, though probably not recede from the confrontational stance seen at the end of the US-China Trade War in 2019.

The recently concluded US-China summit in Anchorage, Alaska gave the US and China an opportunity to reset their relationship under the newly installed Biden administration. Instead, the acrimonious summit cast aside any hopes of a return to a pre-Trump détente between the world's two great powers.

What was perhaps more surprising was that the U.S. revived the Indo-Pacific alliance referred to as 'The Quad', comprising the United States, Japan, Australia and India. Having been informally in place since 2004 and reinvigorated in 2017 under the previous administration, the new alliance held its first formal, though a virtual summit.

While the staying power of this alliance is unclear, given its history, the prominence of India especially in light of its on-going border clashes with China may bring the 2nd most populous nation closer to the American sphere of influence.

Moreover, and perhaps most importantly, was the lead taken by the European Union in leveling sanctions against its largest trading partner in response to 'human rights violations and abuses'.

Though joined by the United States, Canada and the United Kingdom, the significance of the sanctions lies in them being the first EU sanctions on China for human rights abuses since the 1989 Tiananmen Square crackdown.

Moreover, this comes only months after China and the EU agreed to a Comprehensive Agreement on Investment (CAI) that would have eased barriers on the mainland to EU investment flows. Yet unratified by the European Parliament, retaliatory sanctions against members of the European Parliament put the agreement at risk.

Though China has a few cards up its sleeve in this on-going strategic competition, the ability of the US to bring both India and the European Union into its camp at this early stage raises the risk of a continued containment effort on the part of the new US administration. It remains to be seen, however, whether the alignment of India and the EU with the US is opportunistic and could shift depending on the issue at stake, or whether progress has been made to render it more strategic in nature.

As we have outlined previously, the US retains the ability to exploit China's reliance on global capital and access to advanced technology, in case hostilities escalate.

Unsurprisingly, China has anticipated this: it is no coincidence that its latest Five-Year Plan focuses on domestic self-sufficiency, which it will need if the US, the EU, India and China were to turn more confrontational.

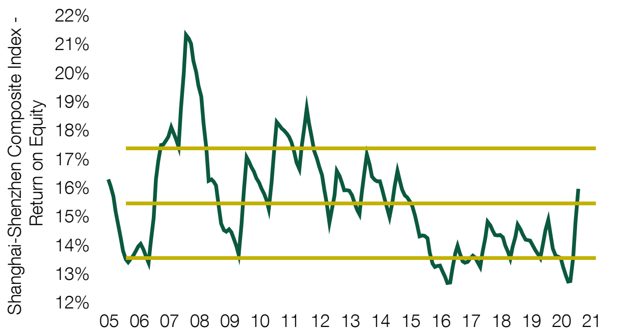
Positioning in China as it Transitions into a Brave New World

On balance, while clouds have indeed appeared on the horizon, they potentially serve as a catalyst to accelerate the self-sufficiency drive imbedded in China's most recent Five-Year Plan. Thus, with cyclical concerns about the economic expansion likely overstated, this provides investors with an opportunity to once again align with the overall China policy focus on domestic transformation amidst cyclical economic recovery.

Such a domestic focus plays into China's A-share markets both for raising capital and in terms of domestic consumption. Looking at mainland listed A-shares, cyclical earnings prospects look set to benefit from not only the cyclical economic expansion underway but also the domestically focused transformation set to be spurred by China's Five-Year Plan.

Indeed, even just assuming a cyclical earnings recovery, China A-shares now trade below mid-cycle PE multiples, suggesting earnings AND PE-driven performance catalysts lie ahead for investors.

Cyclical earnings recovery lies ahead of China A-share listed equities



Sources: Bloomberg Finance L.P. and UBP

Admittedly, the prospect of valuation headwinds driven by regulatory pressure for China's 'Big Tech' names leaves index-oriented MSCI China investors exposed to the potential for falling PEs as an obstacle to overall returns. As a result, we favour stock selection and/or actively managed exposure to benefit from domestically focused, reliable earnings growth.

Although recurring spikes in tension between the US and China can't be ruled out, we doubt that tensions escalate to the levels seen during the heights of the US-China Trade War of 2018-19, limiting the threat to the USD/CNY exchange rate in the medium-term. Indeed, a renewed strengthening in the Chinese yuan against the US dollar may be a concession which China is willing to make, especially as it pivots towards a domestic consumption focus and away from export reliance that historically benefitted from a weak currency regime.

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