ABS GLOBAL INVESTMENTS
EMERGING MARKETS EQUITY

China's Re-Opening

Local Views

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INTRODUCTION

After maintaining the world's strictest Covid controls and self-imposed isolation for nearly 3 years, China began dismantling its infamous zero-Covid policy at the end of 2022. The move was sudden and sharp. Investors generally welcomed this policy pivot and almost immediately began to contemplate a potential recovery in consumption and economic activity as China joins the rest of the world in their return to "normal".

We spoke to our local specialist, Mr. Yik Luen Hoong, to learn more about the implication of Covid normalization and what investors can expect going forward. Mr. Hoong has been investing in China for over 30 years and is the co-founder and portfolio manager of New Silk Road Investments. ABS first met Mr. Hoong in 2012 and has been partnered with his firm since 2019.

– Donald Leung, Partner, ABS Global Investments (HK Office)

LOCAL VIEWS: AN INTERVIEW WITH YIK LUEN HOONG

In recent weeks we have seen an unexpectedly fast pivot in Chinese policy regarding Covid. The dismantling of Covid controls happened nearly overnight. How did this sharp change in policy happen and what were its key drivers?

Amidst all the pessimism, the Chinese equity market took a dramatic upturn the moment October passed. Investors began to sense a stealth reopening effort under way in China. Local authorities became more lenient in enforcing the strict lock down, boarding trains and planes in some cities no longer required recent PCR testing certificates, some Chinese cities led by Shanghai began to place large orders for a locally engineered oral inhaled Covid booster, ex-health officials began to spread the news that there could be changes in China Covid policy in conferences, and most importantly, government controlled media, including People's Daily, began to publish articles highlighting the much-reduced virulence of new Covid strands, in addition to assuaging people's fear of Long Covid syndrome.

However, when the video of a fire ripping through an apartment block in Urumqi, Xinjiang's capital on November 24th and killing 10 people circulated widely on the web, a wave of protests swept through multiple Chinese cities as people vented their anger at the government's uncompromising zero-Covid policy that appeared to have hampered both of rescue efforts entering the building and those of residents trying to flee. The genuine expression of public dissatisfaction jolted the China Communist Party (CCP) from its assumption that the Chinese people would continue to tolerate limited personal freedom of movement to keep Covid at bay. At the same time, it seemed the younger generation was no longer able to stomach the economic cost of Covid control and the CCP's effort to protect the vulnerable through severe lockdowns was no longer tenable.

Consequently, the dismantling of Covid control measures accelerated as most key cities began to announce reduced segregation criteria, and booster vaccination of the older and vulnerable resumed with urgency.

In fact, restrictions have been loosened much faster than what we anticipated, and China has basically abandoned its Zero Covid Policies (ZCP) removing all forms of segregation and allowing free people movement across the country within a period of 14 days. Even international travel restrictions were lifted on January 8th.

The dismantling of China's Covid policy was accompanied by skyrocketing infection rates. What is the impact of this outbreak? Has the healthcare system been able to handle the extra stress?

As the highly transmissive but less virulent Omicron strands swept through the country, tens of millions of people fall prey to viral infection every day. Inevitably, many older people flooded the clinics and hospitals, and have died along the way, mostly due to medical complications arising from pre-existing illnesses. While the Chinese government has not been transparent in updating Covid *death rates, circumstantial evidence and our personal social media feedback are reasonably reassuring. Many infected friends quickly recovered within a week or so, with varying degrees of severity in symptoms. Although. there are reports of overwhelmed mortuaries, we did not see pictures of bodies on the street. In fact, the peak infection crested in Metropolitan Beijing recently, while Shanghai and Guangzhou passed their peaks as of the end of December, and fortunately their healthcare systems were not overwhelmed. Medical supplies have caught up and the healthcare facilities in other parts of China seem to have been boosted in time.*

While the reopening process was less than ideal, China seems to be able to muddle through this round of onslaught with maybe 200,000 Covid-related death by the arrival of spring, with the bulk of the population acquiring some form of natural immunity. The absolute number of deaths is high, but we should put it in perspective given the size of the population and the inevitable death of those already medically compromised. The situation is similar to other parts of the world where elder and medically vulnerable suffered disproportionately. CCP had bought 3 years' time for this unfortunate segment of the population, but society has now got to move on.

What are the implications of this Covid U-turn for the Chinese economy? Can we expect stimulus and supportive government policies in 2023?

China's NBS December PMI delivered the lowest reading since the initial Covid outbreak in the first quarter of 2020, highlighting the short-term pains of this difficult transition away from the pandemic. Based on the experience of other economies which generally experienced strong economic activity rebound from the relaxation of stringent Covid control measures, we remain constructive on a subsequent strong recovery in the second quarter of 2023 onwards post the near-term growth dip in the first quarter.

Housing Sector

Other than the major policy shift on zero Covid policy, the market also cheered the policy U-turn on the harsh housing sector crackdown which has been another major drag on Chinese economy over the past two years. PBoC and the China Banking and Insurance Regulatory Commission (CBIRC) issued a joint statement of "Financing Support to the Property Market for Stable and Healthy Development" on 11th November. This is by far the most forceful policy adjustment since the introduction of the "Three Red Lines" as it goes beyond stimulating housing demand and supporting home completion, and explicitly urges commercial banks and shadow banking channels to provide financing support to the entire property market value chain from homebuyers, developers to construction companies. To facilitate the stimulus execution, a 25 basis points cut in Reserve Requirement Ratio (RRR), the second RRR cut in the year, was announced by PBoC on November 25th. These positive moves show policy makers' strong determination to manage the downside risks and stabilize the property market although we do not think they are meant to bail out highly indebted developers. Meanwhile, we expect Beijing to roll out more demand-side measures, including mortgage rate cuts, to boost the confidence of homebuyers.

Regulatory Pressures

The Central Economic Work Conference (CEWC) was concluded on the December 16th, echoing the Politburo meeting's tone of going all out to restore business confidence and revive growth for 2023. The conference stressed policy makers' unwavering support for private sector as well as promoting the development of the digital economy and platform companies, which essentially reverses the government's tough stance on sectors that have been under regulatory scrutiny over the past two years. In addition, CEWC also elevated domestic demand, principally consumption, to a priority position given the mounting challenges to the export sectors in 2023. All these have sent out a clear signal that policy makers are ready to loosen their tight-fisted grip on the private sector which has been always a primary engine of consumption, employment, innovation, and investment.

Savings

In the first 11 months of 2022, despite suffering from Covid-zero policy, Chinese households accumulated excess savings of RMB5 trillion, approximately 4.5% of China's GDP, through cutting discretionary spending and mortgage payments. When infections peak and confidence returns, the household saving pattern is expected to normalize gradually, which should release pent-up demand and drive strong consumption recovery in the next one to two years.

Stimulus

We do not expect a massive stimulus like that of China post 2008 or of the US and EU during the pandemic, as China is wary of creating large deficits and introducing structural inflation. However, all signs so far lead to supportive policies on all fronts, *including real estate, domestic consumption, and the end of tightening regulation on the internet platform companies (announcement of new game approvals for Tencent, Alibaba's Ant consumer unit receiving approval for capital raise, etc.) We expect these supportive and incremental policies to continue in 2023 until there is a full recovery.*

Foreign Policy

On the foreign policy front, President Xi's meetings with President Joe Biden and other G20 leaders in Bali suggested an improvement of China's foreign diplomacy with the West, particularly the United States. Despite the continuing strategic competition between China and the U.S., the two largest economies and trading nations, President Xi and President Biden's meeting has laid out a foundation of opening bilateral channels of communication, which gives the world a hope that the Sino-America bilateral relationship would stabilize and avoid needless confrontation.

GDP Growth

We are hopeful for a rapid bounce back of the Chinese economy, and alongside corporate profits and investor confidence, especially when compared to their respective low bases in Spring of 2022. With Covid restrictions fully lifted, the Chinese economy could grow between 5-6% in 2023 and this could position China as a stand-out versus the rest of the developed economies, which will have to face recession risks in 2023 after the significant interest rates hikes.

At this rate, we now expect the Chinese economy to begin bouncing back as soon as the second half of January, where millions of Chinese will be crisscrossing the country for the Chinese New Year family reunions, unrestrained from the first time since the pandemic started in 2020. Restaurants and malls in Beijing and Shanghai are getting crowded again (picture to the right was taken by an analyst of New Silk Road in a Shanghai train station in mid-January) while cinemas are reporting much better attendance numbers. Package tours and travel tickets are getting sold out. All these portend a strong consumption rebound in 2023.

Shanghai Hongqiao Train Station: January 19, 2023

Again, with the rest of the world having to deal with the negative impacts of the rise in the interest rates, China will likely be counter trend to post easy mid-single digit economic growth in the new year.

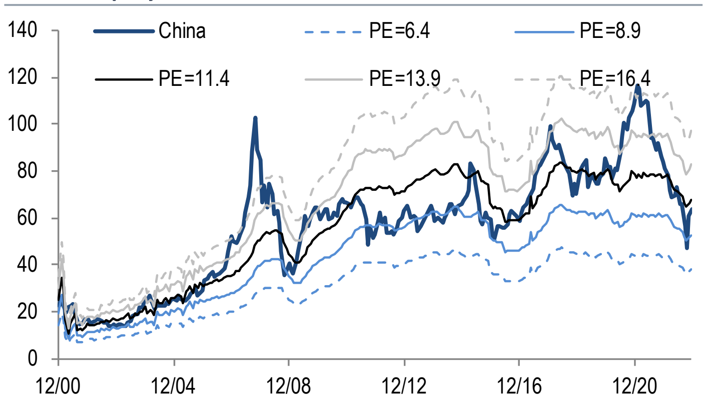
The stock market has been rallying since the reopening news. Is it running ahead of fundamentals? Can investors expect more upside?

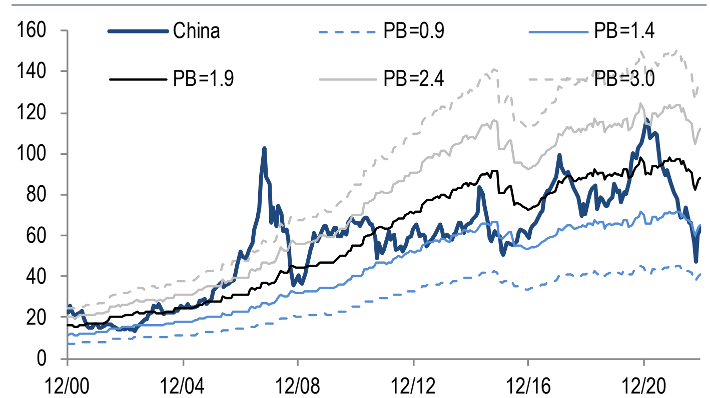
The charts below from Citi Research show that MSCI China touched very depressed forward P/E and P/B levels in October shortly after the 20th Party Congress, reaching levels last seen in the 2008 global financial crisis. Although the market has had a strong rally since it was deemed "un-investable", valuation levels are still very low, and we are at the early stages of an earnings recovery.

Some overly pessimistic global investors are still hesitating to reverse their underweight positions in China materially. Speaking to several brokers, much of the initial buying has been short covering and macro trades. Longer term investors have yet to buy with conviction.

Although there may be a period of consolidation after this rebound, we think that robust company earnings post Zero-Covid, light positioning by investors, supportive policies, and valuations should allow the Chinese equity markets to move further upwards.

Chinese Equity Valuations





Source: CitiResarch. Past returns are not a guarantee of future results. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

How should investors position themselves given this policy U-turn? What areas of the market will be winners and losers of the re-opening?

2023 is a year of returning to normal. The overall situation has started normalizing with the exit of Covid-zero, falling Producer Price Index (PPI), property policy easing, weaker dollar, and stabilization of the Sino-US relationship. This is the first time that economic cycle, regulatory and Covid policies are aligned in three years. We expect domestic consumption to rebound strongly driven first by reopening and then followed by improvements, including but not limited to more effective business communications, more efficient supply chain coordination, reduced uncertainty in investment from private sector, and better execution of government-led infrastructure investment plans.

When everything starts moving as per usual, we should see a virtuous circle in economy recovery that should benefit most sectors. We see significant opportunities in domestic consumption (consumer goods, retail, entertainment, domestic travel and healthcare services), which shall be underpinned by the release of excess household savings, and later by recovery in job market and income expectations.

We also continue to focus on companies that benefit from China's long-term policies and benefit from the technological bifurcation with the west such as renewable energy, electric vehicle supply chain, pharmaceutical, cybersecurity, hardware technology and artificial intelligence.

CONCLUSION

After delivering its worst year of economic growth in decades, China has sent a clear message to the market. Zero-Covid policies will no longer be impeding economic activity and weighing on China's growth outlook. In contrast to 2022's GDP growth of 3.0%, local governments have set targets that are equivalent to a 5.0-6.0% growth for the whole country in 2023[1]. The combination of re-opening efforts moving forward at full force, low base effects and potentially positive policy support suggest that this goal could be achievable.

The reversal in equity markets is expected to be equally robust. After two consecutive years of declines in MSCI China in excess of 20%, valuations are at an extremely low level. We believe there will be room for rerating driven by broad-based economic recovery and earnings normalization. While there will be winners and losers as in any phase of economic cycles, we continue to believe investors with deep local knowledge will be able to take advantage of the upcoming opportunities.

BIOGRAPHY: YIK LUEN HOONG

Mr. Hoong is a Founding Partner and Portfolio Manager of New Silk Road Investments which was set up in 2009. He is responsible for managing their China strategy. He began his career with the Government of Singapore Investment Corp. (GIC) in 1990-1993. He then spent 15 years working in a variety of roles spanning direct investment and public equity research. He was the Head of China Equity Products at Deutsche Bank before founding New Silk Road. He holds a CFA and graduated with Honours in Electrical Engineering from the National University of Singapore.

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[1] Source: Reuters. https://www.reuters.com/world/china/most-chinese-provinces-set-growth-targets-above-5-2023-2023-01-18/

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