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MARKET *view*

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CHINA: BAD NEWS, ATTRACTIVE VALUATION?

KEY HIGHLIGHTS

- China is suffering from three crises at the same time: (1) the Zero Covid policy under Xi Jinping, which is leading to supply chain problems worldwide, (2) a housing crisis and heavily over-indebted real estate developers, and (3) excessive regulation, which is hitting the technology sector in particular.
- The latest purchasing managers' data suggest that China's gross domestic product will slump much more sharply this year than the Chinese government expects.
- The flood of bad news is reflected in prices: Chinese equities are trading around one standard deviation below their long-term mean. A cautious addition of Chinese equities to a diversified global portfolio now seems sensible to us again due to the low price level.

The renewed Covid lockdown, a bubble in the real estate sector, what the markets perceive as misguided regulation and geopolitical tensions have caused stock prices in China to plummet. The MSCI China Index fell from a 129.78-point high on 17 February 2021 to just 59.28 points on 15 March 2022. That's a 54.4% drop in 13 months.

The Chinese government is determined to get a grip on the renewed spread of the coronavirus with strict lockdown measures, and as a result, the Chinese economy is slowing down. In April 2022, the Caixin Purchasing Managers' Index fell to 46.0 for the manufacturing sector and 36.2 for the service sector, the lowest values since the first wave of the pandemic in 2020. Last year, the Chinese economy recovered strongly and grew by 8.1% in real terms. But the government's 5.5% growth target for this year looks increasingly unattainable. Covestro, a leading German producer of polymers, strengthened its presence in China by investing billions in recent years. CEO Markus Steilemann has now surprised the markets with a strong profit warning. He expects the logistical problems in China to continue for a few more weeks. And Covestro is not the only company affected by the rigid zero Covid policy in China. There is an increasing shortage of primary products worldwide, as ships are not being loaded and unloaded in China, along with a shortage of truck drivers due to people not being allowed to leave their homes for weeks. The resulting supply chain disruptions will also hit the European and American economies. While corporate results are still fairly stable in the first quarter of 2022, global supply chain problems and mounting cost pressures are likely to be increasingly reflected in corporate earnings in the coming quarters.

What's more, the property crisis could lead to a profound crisis of confidence in China. The real estate industry is significant in the People's Republic, contributing 29% to its gross domestic product according to a study by Rogoff / Yang (2021). But some real estate developers are heavily indebted. Evergrande alone, the second largest real estate developer, has debts of over 300 billion USD. That's more than the national debt of South Africa!

If foreign currency bonds are not serviced, the People's Republic's confidence among international investors will suffer. Worse still, the bulk of Chinese investors' wealth is in real estate. Defaults would not only damage the confidence of international investors, but also that of private households in China. Rogoff / Yang (2021) therefore warn that a house price crisis could quickly lead to a decline in economic value added of 5-10% over several years.

And that's not all: for decades, Western observers have overlooked the fact that economic reforms in China were not meant to lead to a Western-style liberalisation, but to a strengthening of the Communist Party. Deng Xiaoping's idea of "socialism with Chinese characteristics" from 1979 onwards was aimed at increasing prosperity under the supremacy of the Communist Party. And the subsequent theories of the Chinese Communist Party and its presidents, the "Three Represents" thesis under Jiang Zemin, the "Scientific Development" view under Hu Jintao and later the "Xi Jinping Thought on Socialism with Chinese Characteristics in the New Era", were also aimed at increasing prosperity rather than conceding Western freedoms. The well-known "Document No.9" attributed to President Xi Jinping warns against democracy according to Western values, human rights, the rule of law and other Western principles. Citizens are to get richer but stay quiet. When entrepreneur Jack Ma, one of the founders of internet giant Alibaba, criticised Chinese regulators, the communist government tightened regulation and imposed penalties. Alibaba shares fell from HKD307.40 on 28 Oct 2020 to HKD71.25 on 15 Mar 2022, a whopping 77% loss. Tencent slumped from HKD743.96 on 25 January 2021 to HKD298.00 on 15 March 2022. Other companies, such as New Oriental Education, whose business model was fundamentally questioned by regulators, lost over 90% in value. The list could go on and on: excessive regulation in China has led to heavy losses for investors, especially in the once flourishing IT sector.

At the same time, interest rates in the USA are rising substantially. Capital is flowing out of emerging markets. The Chinese renminbi has weakened significantly lately: on 28 February 2022, it was still trading at 6.31 to the USD, down from 6.62 at the beginning of May. Geopolitical tensions with the US are mounting with China's public support for Putin. All this is not promising news.

As markets plunge, countercyclical investors ask when to start buying stocks again. First: the news flow coming out from China is so bad that an improvement can reasonably be expected at some point. A recovery from this Covid wave will lead to strengthened growth. State media report that the Communist Party Politburo has agreed to bolster domestic consumption via aid packages. And the State Council Finance Committee has hinted to somewhat more market-compliant regulation. Moreover, it should be reminded that the Chinese central bank has recently lowered the minimum reserve requirements, thus making more liquidity available to the market. In the past, the Chinese government could be relied on to prop up the economy when demand falls. This is because citizens are supposed to remain calm, following the principle: rising prosperity against continued sacrifice of liberties.

For all the bad news, two factors argue in favour of slow exposure to China from a countercyclical investor's perspective: I) Sentiment is poor as reflected by the high level of short positions in Hong Kong. 2) The valuation of the MSCI China Index has already fallen sharply as measured by the price-to-book ratio (P/B) and the future 12-month price-to-earnings ratio (P/E), shown in the graphs. Currently, the MSCI China Index is trading around one standard deviation below its long-term mean, according to the aforementioned two-valuation metrics. A cautious addition of Chinese equities also leads to better diversification, given the low correlation with equities from developed countries. Admittedly, it does take some courage to buy Chinese stocks, considering the bad news pouring out from the Middle Kingdom.

CHART 1: MSCI CHINA PB RATIO WITH +/- 1 STANDARD DEVIATION

Source: Bloomberg, Period: 04.05.2012-04.05.2022

CHART 2: MSCI CHINA 12 M FORWARD PE RATIO WITH +/- 1 STANDARD DEVIATION

Source: Bloomberg, Period: 04.05.2012-04.05.2022

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