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MARKET VIEW

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China: stop or again?

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After an excellent start to the year, buoyed by expectations of a normalisation of global growth, Chinese equities (Shanghai Shenzhen CSI 300) have underperformed since March. Let's try to understand the reasons for this and assess whether it is now the right time to buy them back.

What are the origins of this relative underperformance?

1. The tightening of credit conditions is de facto putting a brake on growth

China has certainly benefited fully from the strong rebound of the global economy, even surpassing the pre-crisis growth trend (6.5% vs. 6%) by the end of 2020. Nevertheless, in order to limit overheating, policymakers have given priority to controlling financial risks and moral hazard. Government support to issuers was therefore reduced and banks were ordered to limit lending. These efforts brought credit growth back to pre-covid levels but acted as a brake on economic activity.

2. Currency appreciation

The outperformance of the Chinese currency (RMB or Renminbi) is remarkable given that it coincides with the economic slowdown mentioned above.

The strength of the RMB can be attributed to three main factors. First, although credit growth is decelerating in China, the data does not suggest that the economy is collapsing. PMI indices are in expansionary territory. Moreover, the global recovery is boosting demand for Chinese goods, and China's large current account surplus is a supporting factor for the RMB. Third, although Sino-U.S. real bond spreads are narrowing for short-term maturities, Chinese real rates remain relatively high, especially for long-term maturities. This dynamic is attracting foreign capital flows into Chinese bond markets. Given that these forces are likely to continue in the future, the Chinese authorities are taking control and adjusting the RMB/USD exchange rate by buying US Treasuries in USD. The appreciation of the RMB should therefore be contained in the coming months and limit the negative impact on exports.

3. Growth and technology bias hit by US-China technology war

The tightening of regulations in the internet sector is having a significant impact given its heavy weight in offshore indices (over 40% of MSCI China). Since last October, the regulatory tightening has taken on several dimensions. Examples include the systematic auditing of fintech companies (stricter capital requirements) as well as a debate on the issue of competition, which is resulting in investigations and fines for companies with a dominant position (US$2.8 billion for Alibaba for example).

As a result, the HS Tech and CSI Internet indices have fallen by 27% and 34%, respectively, since their mid-February highs, underperforming not only the broader Chinese markets but also the US technology sector. At the same time, 2-year EPS estimates have remained stable at +30% on average, allowing the sector's valuation to improve, with forward P/Es down 10 points to 32x in y+1 and 25x in y+2 , reasonable levels for growth stocks in the technology sector.

There are several recent signs pointing to a willingness to ease tensions. US Trade Representative Katherine Tai has indicated that she plans to meet with her Chinese counterpart "in the near future". The upcoming appointment of the head of the Bureau of Industry and Security at the Department of Commerce, the agency responsible for enforcing the Foreign Trade Act, is also a sign of China's willingness to engage in dialogue.

Conclusion: should you buy or stay away?

Undoubtedly, tighter internet regulation, deleveraging and the credit crunch have weighed on the recent performance of Chinese equities. While the slowdown in lending may not have reached its end yet, the different nature of the current deleveraging cycle has had only a limited material impact on equities. And regulatory risk has become more balanced and better understood.

After the correction seen in the first quarter, the risk/return ratio is therefore tilted in favour of a repositioning over the next six months, particularly in growth sectors, including the Internet. The recent change in the Fed's stance is also flattening the yield curve and, thus, favouring growth stocks. At 15 times earnings (12 months forward) for the SS CSI 300, this is a far cry from the 21 times reached last March. We believe this is an opportunity to reposition.

However, we believe that this appreciation phase will not be a straight line.

The phase of the Chinese growth miracle is over. Potential GDP growth is slowing down structurally (demographics and the impact of the one-child policy) and it will be more difficult for Beijing to maintain financial and socio-political stability.

China is not in a position to radically alter the course of national politics before the twentieth National Communist Party Congress in 2022. The Xi administration is focused on normalising monetary and fiscal policy and avoiding socio-political disruption ahead of this critical event, when General Secretary Xi Jinping may be given the position of 'supreme chairman' once held by Mao Zedong. This means that Beijing is unlikely to make a major change of course before the 2022 reshuffle - and even then, a change in direction is unlikely. For example, the Communist Party fears the impact of a slowdown in potential growth on employment. Maintaining the 'social pact' will necessarily require domestic support measures, including domestic favouritism.

As a result, tensions with the US and China's Asian neighbours will persist. The rise of political uncertainty is a secular trend that will resume sooner or later, at the expense of a stable and predictable investment environment.

Relative value, therefore, but at the cost of high volatility.

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