JOHCM Funds

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Emerging Markets Spotlight

Beijing is changing its policy on Covid and property. Is this a bottom for China stocks?

We believe China's policy choices have broken its economy and equity market. This may be the start of changes needed.

KEY POINTS

- China's economy has potential to recover but was constrained by extremely negative policies in key areas. Chinese stocks have steadily sold off in recent months as investors became more pessimistic.
- In November Beijing made major policy moves on Covid re-opening and real estate industry debt. Investors should broadly see this as a buying opportunity for the best-positioned Chinese companies.
- Some parts of China's equity market remain unattractive, including state-owned banks, private-sector real estate developers and tech giants with very poor corporate governance.
- We significantly reduced our Chinese underweight since the end of October and before the policy changes were announced. Now, Chinese assets have moved sharply higher.

One of the main characteristics of emerging markets investing is volatility. Things can turn very quickly — positively or negatively. Our investment process is designed to accommodate this.

We are constantly alert to market drivers, change and trend, positive and negative surprises and changing forecasts and surveys.

The past two weeks have seen significant shifts in Chinese policy, which put some market drivers into a new context. Our process emphasizes a disciplined and repeatable country-based analytical process.

As always, we follow our core five-point framework in reviewing the outlook for Chinese equities (in USD terms) over the next two years. These are growth, liquidity and credit environment, currency, and management and politics, and valuation.

Here is our latest thinking on these market drivers in relation to China.

VALUATION

For any market, ongoing economic growth and corporate earnings disappointments undermine the fundamentals to which valuation multiples are applied. Worsening liquidity conditions justify lower valuation multiples. A poor currency outlook will reduce expected US dollar returns.

Most significantly, the downside to valuation multiples when politics goes bad is always much, much more than you think.

The MSCI China forward price/earnings ratio (based on consensus 12-month forward estimates) has declined from a peak of 18.5x in February 2021 to 8.3x at the end of October.

This compares to a recent average of 11.3x. Other valuation metrics have similar patterns. Cheap, but cheap alone is not enough.

Valuation is the only one of these five factors that are unambiguously supportive. But valuation alone is not a buy case.

GROWTH

Growth in China is weak by historic standards, with strong exports offset by very weak domestic investment and consumption.

- Third-quarter GDP was up 3% year-on-year. Industrial production lifted 6.3% and exports grew 10.7%.But retail sales were up only 2.5%
- Property sales (for the 31 main listed players) lost 29%.

The crippling effect of the "three red lines" restriction on lending to property developers continues to have a devastating effect on the sector. Meanwhile ongoing Covid lockdowns hurt confidence-hit consumers.

The outlook does not seem to be improving either. PMI surveys for October weakened to 48.7 for non-manufacturing and 49.2 for manufacturing. Can fiscal policy drive growth?

Next month's Central Economic Work Conference can shift the emphasis of fiscal policy while keeping to agreed policy parameters. **Probably the most effective change would be to directly support households, given the current downturn in domestic consumption.**

Targeted fiscal measures have been successfully used to support consumption in previous downturns. Examples include subsidies for rural purchasers of home appliance in 2008 and support for car buyers in 2014-15.

But given the weight of real estate and adjacent sectors in the economy, this is unlikely to do more than help specific industries.

LIQUIDITY AND CREDIT ENVIRONMENT

The liquidity and credit environment will need to do some of the lifting. However, monetary stimulus is constrained by weak private credit demand and concerns about the exchange rate.

The capacity certainly exists. Despite global inflationary pressures the Chinese economy is heading into deflation.

PPI inflation dropped into negative territory in October after a September print of just +0.9%. Household and corporate excess deposits continue to collect in the commercial banking system.

The liquidity and credit metrics we track look very promising. Total outstanding credit grew 10.5% in the year to October, while M2 money supply growth in October was 11.8%.

These represent a continuing pick-up in credit and money growth and a return to the more stimulative measures of early 2020 and in 2016-2017.

However deeper changes are needed for this to work:

1. Private sector credit demand is extremely weak. Simply making it cheaper and more available is unlikely to change that. This is a classic crisis of confidence in which the central bank can end up "pushing on a string". **Either policies change to create confidence or fiscal policy must do the work.**
2. While the three red lines restrictions on private sector property developers are still in place, **the key sector that isn't borrowing will remain unable to do so.**

CURRENCY

The currency was at its all-time real effective exchange rate in the first quarter of 2022. Though it is notionally supported by net exports — and protected by capital controls — it is likely to weaken relative to the US dollar.

This is partly because of interest rate differentials and partly because **policymakers in east-Asian exporters must keep their currencies reasonably in-line with the depreciating Japanese yen.**

MANAGEMENT AND POLITICS

The previous drivers are important, but management and politics are the key.

In November, President Xi Jinping was appointed for an unprecedented third term. In an overhaul of the Politburo Standing Committee, market-friendly reformers (including Premier Li Keqiang) were removed and replaced with Xi loyalists. State media have begun referring to Xi Jinping as "Core" leader and establishing his political views ("Xi Jinping Thought") as doctrine.

This marks a move away from the "Collective Leadership" system of Chinese politics which has been in place since the 11th Party Congress in 1978. The economic focus on technology and quality of life adopted at the 2017 Congress remains in place. The main changes at this congress were around governance and national security, with emphases on international relations, geopolitics, and reunification with Taiwan.

What does this mean for the economy, and for a market looking for some political and policy relief?

The policies that have dramatically undermined growth — real estate restrictions and zero Covid — remain key. As do the political developments that have hugely increased investor perception of risk in China — clampdown on tech companies, support for Russia, cold conflict with the West.

We essentially believe China's policy choices over the past two years have broken its economy and equity market. We may now be seeing the beginning of changes that are needed to fix this.

On November 11, the People's Bank of China and the banking regulator extended the end-of-2022 deadline for banks to limit their property and mortgage loans. This major step is likely to substantially ease a credit crisis in the Chinese real estate sector.

Leading banks must reduce the share of total loans made to property companies to 40% and the share made to mortgages to 32.5%. But the deadline has been indefinitely extended. This is likely to restore confidence in the property sector — particularly for homebuyers — though the most leveraged developers still face a difficult future.

On the same day we saw changes in China's Covid policies — though officials stressed these were a refinement, not a relaxation.

The 20 new Covid policies include shorter compulsory quarantines, reduced testing, and less latitude for local officials to impose their own restrictions. Rising cases suggest this is not likely to lead to a rapid full re-opening of the economy.

But Beijing's health commission said the government would keep advancing "in small steps". **Markets have taken these steps as a sign that the Chinese economy — and Chinese companies — are on a path to the same post-lockdown, mini-booms we saw in other economies.**

Then on November 14 President Xi met President Biden in Indonesia. Officials from both sides said substantial differences remained between the two, but the face-to-face meeting appeared cordial. The discussions are a sign that China is not Russia.

REMAINING ALERT TO OPPORTUNITIES

Our investment process has a monthly review of the key top-down drivers of USD equity return for all countries. We take no strategic views. No market is an automatic overweight and no market is automatically excluded.

We do not think Chinese equities — whether A-shares, H-shares, or overseas listings — are "uninvestable". We remain alert to opportunities.

Some parts of the Chinese equity market do look very difficult to invest in.

- Public sector banks remain mere policy tools and investor mistrust here is very high.
- The more leveraged private sector developers are still unlikely to survive their debts coming due.
- Corporate governance at some big technology companies — most notably Alibaba — is very poor and hard to look past.
- Some Chinese state-owned companies remain sanctioned by the US Treasury and are literally uninvestable for most foreign investors.

But China is a huge market. It is the biggest emerging market by market capitalization and by number of listed securities.

Since the end of October we have significantly reduced our Chinese underweight.

The great bulk of this move happened before the policy changes were announced. Since those announcements, Chinese assets have moved sharply higher.

We will continue to follow our process and react to both the level of these market drivers — as well as change, trend, surprise, forecasts, and surveys. A mix of positive and negative drivers continue to influence China. But the outlook is much better than a month ago.

And it is always a mistake in emerging market investing to assume that any trend — up or down — will continue forever.

Source for all data JOHCM/Bloomberg (unless otherwise stated)