

Optimism about China equities explained

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Bin Shi
Head of Chinese Equities

Chinese stocks had a dramatic downturn last year, yet our Head of China Equities Bin Shi is optimistic about the Year of the Tiger. Bin Shi talked with Charles Li, Head of Global Wealth Management Client Coverage APAC, and explained his reasoning in a webinar: this is an excerpt of that conversation.

Charles: The China stock market had a highly volatile year in 2021 driven by government policy, regulatory changes, and not to forget, COVID-19. Do you see the market turning around and strengthening in the Year of the Tiger? What have you learned from last year?

Bin Shi: One of the lessons was we need to react faster, and we cannot blame everything on government policies. 2021 was one of the toughest years — if not THE toughest year — for China equities since my professional career started in 1994. While we expected some slowdown in the economy, we underestimated the severity of government regulatory actions toward high-flying sectors such as Internet giants and education companies. There were three contributors to last year's underperformance: 1) the market did not favor blue chips, 2) we did not respond quickly enough to market signals, and 3) we did not own the stocks that did well.

We believe the market cycle began to turn again in the fourth quarter of last year, and we believe blue chips will come back in favor as investment style preferences shift. We plan to move faster and move wider. Identifying changes in fundamental drivers and acting on them quickly will improve our decision-making. Our team also needs to continue to expand our stock coverage beyond our traditional holdings, so we don't miss opportunities that can end up costing us.

Charles: Regarding government policies: Will the regulatory clampdown ease and will economic growth be able to reaccelerate?

Bin Shi: I think we are past a turning point in terms of policy risk, and we are becoming a lot more positive on Chinese equities in 2022. Policy was key to last year's market sell-offs — and could be key again for possible gains this year. Beijing introduced many regulatory reform measures when there was a lot of confidence in the economy at the beginning of the year. For the effected industries it's painful in the short term, but in the long run it's probably better for more healthy growth. But the economy has slowed down significantly since, and the government is responding and changing its course. Case in point: supportive measures are now being discussed especially for the highly regulated property and Internet sectors.

To be sure, we are not talking about a complete reversal of reform mandates. We just expect to see them in less frequently and in smaller in magnitude. Market expectations for some of these hard hit industries are at such rock bottom that any little bit of good news or a slightly more friendly policy environment could potentially touch off a stock rally. The current negative China market sentiment highlights the gap between perception and reality, which confirms our positive outlook on China equities for the year. Our cash level now is probably the lowest in our history.

Charles: That's exciting to hear. Last year you were rather cautious on valuations of policy-supported sectors including green energy, electric vehicles and the like. Have your views changed?

Bin Shi: Valuations of such companies have come down in the fourth quarter and especially in December, but I think there's further to fall. Because investors piled into these sectors — you hear stories of health care funds buying into electric vehicle and battery manufacturers — they remain overconcentrated and too expensive. We looked hard for opportunities during the fourth quarter sell-offs but were not able to identify many that could deliver above a very low or even negative return, based on our valuation model. Ultimately, we do see strong growth for renewable energy companies for the long term, but we will wait until their stocks become more reasonably priced before taking part and diversifying our holdings.

Charles: How about Internet giants? Will government regulations ease for this sector?

Bin Shi: It really depends on how you look at it. Policies that aim to prevent these companies from gaining too much of an unfair advantage and to create a more open and level playing field for other tech companies will likely continue. Spinoffs from Internet giants, be it a media arm or financial subsidiary, will go on as long as they are deemed to facilitate an unequitable marketplace. For example, Tencent and Alibaba can continue to focus on their core business, but it's important that their systems and platforms are open to smaller companies that are not affiliated with them. However, we believe that the worst is behind us.

Charles: What are some of the portfolio adjustments you are making? Any high conviction investments that you want to call out?

Bin Shi: Sector-wise, there are those like education, which is unlikely to recover anytime soon (where we have greatly reduced our exposure), while other sectors like health care and property developers were oversold last year and now present attractive investment opportunities. Highly leveraged property developers, for example, will continue to have a tough time and probably not survive the government's effort to deflate the country's real estate bubble. On the other hand, industry leaders with healthy balance sheets and sound fundamentals could do well once the exaggerated end-of-the-world assumption is dispelled. We have made some changes but they may not appear to be substantial for the top 10 positions because we still have strong conviction in our top holdings and believe the companies are competitive and well positioned.

Charles: Let us switch gear now and turn to macro. With monetary policy, China is easing interest rates while the world's other major economies are in tightening mode. Will this divergence provide some support to China equities?

Bin Shi: Yes, I think it will. China is definitely going in the

opposite direction from the US with monetary policy, after 15 years of moving in step. If you look back to last year, the Federal Reserve (Fed) had a pretty loose monetary policy, but it did not prevent the Chinese economy from slowing down or prop up China equities. I think this year it's going to be the opposite. The People's Bank of China (PBOC) cut its benchmark lending rates to support the real economy in January, and the move is likely to be the start of an easing cycle, which is in contrast to the Fed getting ready to raise rates to curb inflation this year. Historically, emerging market equities in a way have been at the mercy of the rise and fall of US interest rates — they tend to get hammered when US rates go up. I think this time the story could be different.

Charles: What about economic growth? Now that China's gross domestic product (GDP) growth is losing steam, will China stocks still perform as well as in previous years?

Bin Shi: Historically speaking, there hasn't been much correlation between economic growth and equity market performance for China. Many market participants would go so far to say China A shares performance has nothing to do with the Chinese economy, given that China has been growing at a nice clip for decades now and markedly faster than many countries. After all, equity market performance is dependent on many factors, and in the case of certain China A equities last year, valuations started out extremely high, which trumps economic growth as a factor. Looking at price-to-earnings ratios (P/E), a lot of Chinese companies were trading at more than 50 times earnings before the recent downturn. Even though the average P/E of the A shares market has since come down, it's clear that economic growth is not a significant market mover.

Charles: We have discussed a lot of opportunities in China equities. On the flip side, where do you see risks?

Bin Shi: I am not overly concerned with some of existing risks such as the China-U.S. tensions. The two countries need each other, and it's impossible to break up, so to speak. For me, the biggest uncertainty for investing in China is almost existential and always the same: will it continue on the road of economic reform and be open? The risk of a retreat on that path is very unlikely in our opinion, as the majority of the Chinese population enjoys the benefits of the country's opening up and reforming its economy and it's hard to go back. It certainly does not impact our case for investing in China for the long haul.

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