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April 2020

China: out of lockdown – into recovery?

On-the-ground insights

China was the first to experience Covid-19, but it is the first to emerge from lockdown. What does the future hold for China's economy, is there a recovery, and what themes should investors watch out for? We covered all this and more at our exclusive webinar, read it all here.

Key webinar takeaways

- China's economy is recovering from Covid-19, but has yet to return to normal;
- Indicators like traffic congestion and coal consumption have shown a meaningful improvement, but we are not yet at the full recovery stage;
- Covid-19 has revealed a number of behavioural changes in China, such as the shift from offline to online, which present investment opportunities in sectors like after-school tutoring, financial services and healthcare;
- Leading companies will benefit from ongoing consolidation in many industries as small firms struggle;
- As world bond markets shifts to negative yields, China government bonds offer a unique value proposition to investors based on low correlation & volatility as well as attractive yields;
- Despite concerns about data quality, we remain confident in the data being released by the Chinese government.

Barry Gill, Head of Investments

On February 6th this year I participated in a podcast in which the host wanted to discuss the market's reaction to the unfolding coronavirus outbreak in China.

The Chinese A-share market had been formally closed over the end of January due to Chinese New Year, but the unfolding drama, including the quarantining of Hubei province, manifested in a 10% sell-off when it opened on February 3rd. By the time of my podcast it had recovered by 80% and then went on to hit a 12-month high in early March.

I framed my responses to the podcast questions in the context of the market focusing on the second derivative - forward looking indicators would trump real time poor economic data.

Ten weeks later I am struck by the simplicity and naïveté of my line of reasoning, particularly given the former option-trader in me fully understands the value of focusing on tail risks.

'When the US sneezes the rest of the world catches a cold'. But look at what has happened: from the start of the year, China A-shares are down a modest 5%, troughing down 14%, while the S&P 500 is down 12% having bottomed down 31%[1]. Why is this?

Barry Gill

[1] UBS Asset Management, April 17, 2020

Covid-19, China and the world economy

I had not factored in the contagion dynamics of the virus, nor the fact that Chinese share of global GDP had quadrupled since the SARS outbreak in 2003.

Furthermore, I had not fully considered that in many senses we had been riding our luck when it came to pandemics and that Covid-19 exposed the lack of preparedness for this type of tail event in the western healthcare system.

This illustrates how hard it is to forecast the market's moves in the short term. Remember, equity markets hit new highs later in February, although the bond market once again seems to have sniffed out a problem before the equity market.

In the same interview, though, I reiterated the bullish secular views we have held on Chinese equities and bonds at UBS.

We have witnessed lengthy quarantines around the world, which may structurally change how we work, play, learn and travel. We have also witnessed monetary and fiscal responses equal to or greater than what were experienced in the Great Recession after the 2008-2009 Global Financial Crisis.

China is different, but why?

The global mantra is one of acting quickly and forcefully, to avoid any rot taking hold. That is, everywhere except China. Policy responses in China stand out for how muted they have been, in contrast to the $4tn wall of money they spent from 2009-2011. Why is this?

Also, an old saw goes, 'When the US sneezes the rest of the world catches a cold'. But look at what has happened: from the start of the year, China A-shares are down a modest 5%, troughing down 14%, while the S&P500 is down 12% having bottomed down 31%.

Similarly, US 10 year Treasury yields have plummeted 120bps to generational lows, while Chinese government bonds of a similar maturity have lost half that amount and now yield 180bps more than US Treasuries.

> China led us into this current crisis - can it lead us out?
>
> Barry Gill

What is happening? How much of what is happening is a temporary aberration and how much is structural in nature? What are the big opportunities that investors are too hesitant to take advantage of? China led us into this current crisis - can it lead us out?

Bin Shi and Hayden Briscoe will each now seek to answer some of these questions.

Bin Shi, Head of China Equities

Covid-19 is a global issue, but if you observe some of the trends between countries the trajectory is similar.

Countries that took early action have been more successful at reducing the growth rate of new cases than those that delayed.

That's particularly true in China where the spread of Covid-19 virus has been brought under control.

> Looking at activity indicators like traffic and coal consumption levels we are seeing signs of incremental improvement.
>
> Bin Shi

Why has China been so successful?

Two factors are important.

Firstly, the Chinese government took drastic measures. People were locked down in their homes and they closely abided by government rules.

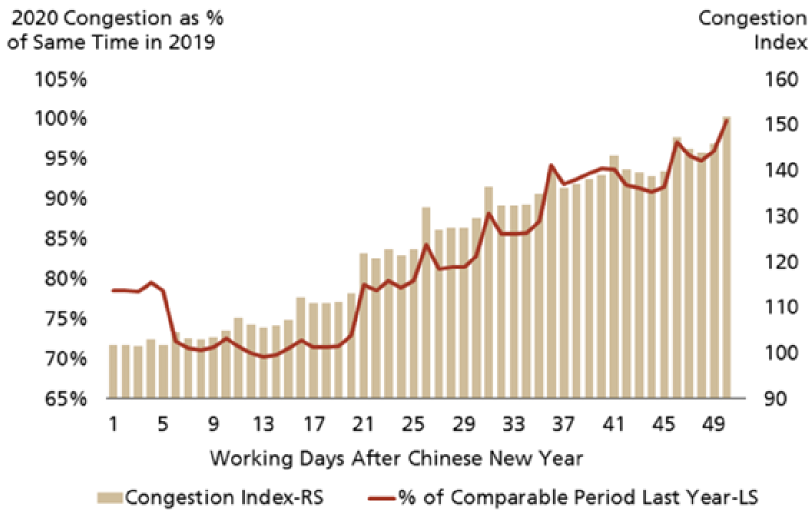
Secondly, the government has used new technology to help monitor population movements. Tencent - one of China's largest tech companies – developed health status QR codes that advised users on what to do and helped separate high risk people from low risk people by using big data to track whether users had been close to the site of an outbreak, or infected people.

Chinese tech companies are using big data and QR codes to help curb the spread of COVID-19

Source: UBS Asset Management, April 2020

But more traffic doesn't necessarily mean a 'return to normal'

Congestion data in Chinese cities show a return to 2019 levels



Note: the degree of congestion in 46 large cities and subway passenger traffic in 8 major cities since Lunar New Year

Source: AlphaWise, Morgan Stanley Research, as of 12 April 2020

Looking at activity indicators like traffic and coal consumption levels we are seeing signs of incremental improvement.

Take congestion for example, data show that levels have approached those in 2019.

However, we should take that with a grain of salt as few people are taking public transport to avoid travelling in groups, so urban roads are full of cars.

More broadly, inter-city car travel is still low, so it is not true to say that traffic indicators - which many say is a proxy for the economy - have returned to normal 100%.

Focus on behavioral changes and new innovations

What is important when making an equity investment strategy for China is to gauge the many behavioral changes brought about, and even accelerated by the Covid-19 outbreak.

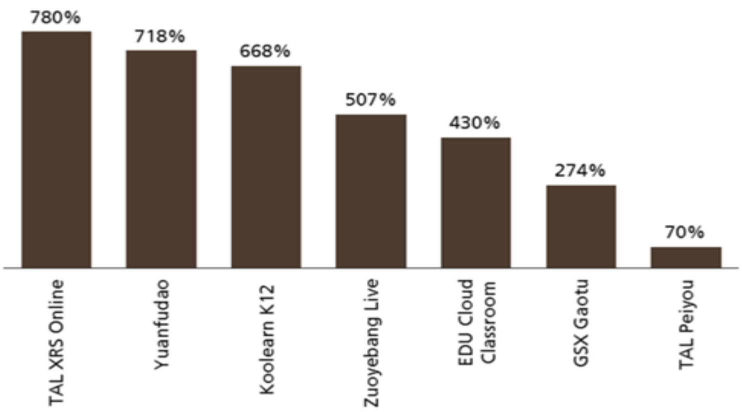
One of which is the shift from offline to online business in China.

Online education is one sector to benefit from a shift.

Top online education companies have seen a huge increase in downloads during the Covid-19 outbreak and we feel that the best companies in these spaces have the potential to grow market share from other online competitors.

Online games are another sector that has benefited from increased players during the outbreak period.

MOM (%) increase in daily active users in February 2020



Source: Questmobile as of Feb 2020

Premiumization thesis still holds

While retail numbers will have taken a hit in Q1, we feel that the premiumization thesis, i.e. strong demand for high-end, high-quality goods, remains intact.

One way to gauge this is to look at wholesale baijiu prices. If demand was weakening, wholesale prices would fall, but prices have remained firm during the past couple of months.

This is of course one indicator, but we haven't seen any convincing evidence yet to suggest that either demand or the willingness to pay premium prices for high-end goods has suffered as a result of the Covid-19 crisis.

Hayden Briscoe, Head of Fixed Income, Asia Pacific

I'll speak from a structural point of view about how Covid-19 is affecting both markets and the asset management industry, and what this means for investors.

Time to pick the countries

In the past, asset allocators would build bond portfolios by following indexes but now, because of the breakdown in the stock/bond correlation and the shift to zero or negative yields, they will have to spend a lot more time picking the countries for their portfolio.

In this context, the Chinese bond market has a place in everybody's portfolio today. Investors look for diversification and low volatility and Chinese bonds score well on these two measures.

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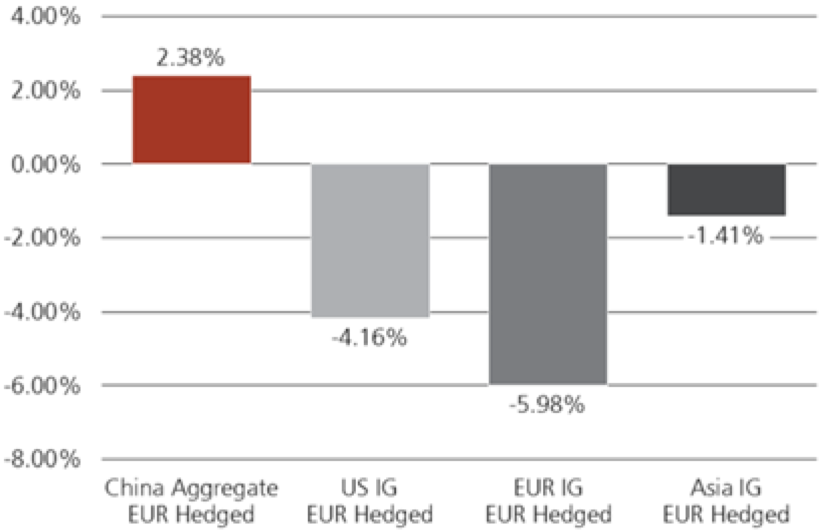
Hayden Briscoe

Total return



Source: Bloomberg, as of end March 2020
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Over the years, Western bond markets have become much more correlated with each other, but that's not really the case with China.

And it’s a similar picture when it comes to market volatility, which have stayed comparatively stable as volatility on world markets has ticked up.

China is a top performer, with attractive yields

These factors are bolstering the case for Chinese government bonds as a safe haven. And if we look at performance over the past year, China has outperformed in terms of total return.

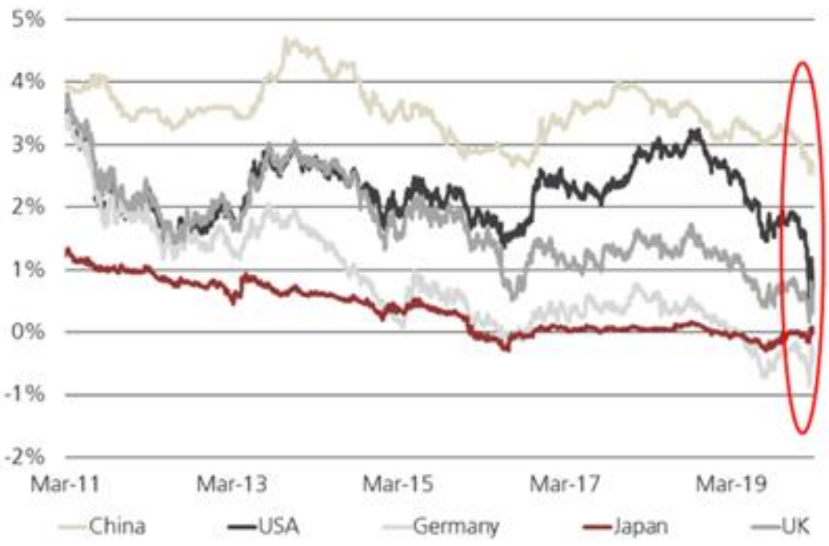
Additionally, yields of between 2% to 3% currently look highly attractive compared to the zero to negative yields available in most developed markets around the world.

No time to wait

Most people around the world have a zero to low allocation to Chinese bonds. If investors are waiting for global indexes to factor China bonds at the weight that reflects China's significance in the global economy at the proper, they will have a long time to wait.

That's why moving away from indices and picking the countries will become increasingly important and we believe China has to part of investors' global portfolios. And the case is strong: it offers diversification, low volatility, yield and low credit risk in the government space since China remains a net creditor nation.

Nominal yields on 10-year sovereign bonds



Source: Bloomberg, as of end March 2020

Additionally, if we do see a global recession, China is one of the best spaces to be invested in because it is a market that can rally by say 200bps, and there is limited scope to do that in many other developed markets.

Q&A:

1 How do the stimulus programs in China differ from the rest of the world?

Hayden Briscoe (HB): There are differences in terms of size, but what's different in China is the set-up. China's banking system has a long history of directly lending into sectors and getting money into the economy quickly.

Policy banks in China - China Development Bank, Export-Import Bank of China and Agricultural Development Bank of China – have been directly lending to support strategic initiatives, like Belt & Road, as well as stepping up to the plate during times of crisis and getting money into the economy quickly.

That's a key difference to say the US and Europe, where they don't have the same kind of plumbing to directly inject capital into the economy.

2 Why have Chinese equities outperformed US and Europe equities YTD?

Bin Shi (BS): Three main reasons. Firstly, valuations on China equity markets were cheap to start with compared with say US and European equities.

Secondly, leverage levels in China are comparatively lower, so there has been relatively less forced selling. Finally, blue chip stocks - which account for a large share of China's markets - have been relatively resilient.

UBS

3 How have you been managing your equity portfolio? Your cash levels are currently quite high, what does that say about your market view?

BS: We want to invest as much as we possibly can, but we have to invest with discipline and according to our own criteria on what makes a good investment or not. Recently, it is true to say that we feel that risks have not been properly discounted in many of the names in the opportunity set, so we have held a little more cash than usual.

That said, in many ways we have been as aggressive as possible in terms of our investments, given the current market environment. We have invested in companies that have the potential to benefit from the behavioral changes we have seen during the Covid-19 outbreak, particularly in sectors like e-commerce, online education, big data and cloud computing.

Additionally, we have put money to work in companies where we feel risks have been properly discounted. Finally, we have added to our positions in industry leaders in sectors we favour, particularly those that have strong balance sheets and who may benefit from industry consolidation.

4 What is your position on the cases of fraud uncovered in major US-listed Chinese companies recently?

BS: We had no position in the coffee company that recently caught the headlines, we looked at it in the past but it didn't meet our criteria.

As for the education company, that is a very different situation. We have been closely following it for nearly a decade and have done intensive channel checks on the company.

We believe that we have a good understanding of the company's corporate culture and credibility of the management and we see the news announcement as a small black spot on what is an otherwise healthy company.

5 Can we really be confident in the Covid-19 statistics coming out of China?

BS: There's no doubt that the outbreak was mismanaged at the beginning and that the true number of cases weren't fully reflected in the data, largely because it took a long time for testing practices to ramp up.

Over time, China's testing and tracking procedures have improved and we are not worried about the credibility of data being published. Furthermore, given the high sensitivity of the government, it is unlikely they would ease lockdown measures if they are not confident that the situation has been brought under control.

Talking to my friends in China, they are now out and about playing golf, going to restaurants etc, and that's just a sign of how things have changed on the ground in China.

6 What impact is this crisis having on China's move to open up capital markets?

HB: None at all. This is a long-term, multi-decade plan and we see no sign of China letting up on its policy direction.

Additionally, it will become even more important for China to open its capital markets in the coming years, that's because China is moving from being a current account surplus nation to one that runs a deficit, so the ability to attract international capital will be vital.

7 How easy is it to buy Chinese bonds and what duration do you recommend?

HB: With the opening of channels like Bond Connect and the China Interbank Market Direct, we are able to trade in and out of China's onshore bond markets as much we want.

As for duration, five years is about right for portfolio construction with Chinese bonds. In the West, the duration for all indexes is moving out to between seven to eight years.

8 Healthcare spending is about 5% of China's GDP, compared to 12% of GDP in the OECD. What is the outlook for China's healthcare sector?

BS: We remain positive on the healthcare sector. In part, that's because of fundamentals, like China's aging population and rising spending on healthcare treatment.

The top players in the sector are rapidly developing their R&D capabilities and we see that as a good indicator of their capacity to grow in the future.

In many ways, we see commonalities between the China healthcare sector now and China's IT sector ten years ago. IT was a small part of the market then, but it grew significantly with the rise of key companies like Tencent and Alibaba. We see a similar situation in healthcare and maybe we will see the emergence of a BAT[1] group of companies, like we did in the IT sector.

1 BAT: Baidu, Tencent and Alibaba – three of the largest and most successful China tech companies

9 How are Covid-19 controls impacting your ability to do 'on-the-ground' research?

BS: We have built a wide range of contacts in China over the course of our research in the past twenty years and we are in constant touch with them to understand the situation when we are not travelling as much. Additionally, as more activities move from offline to online we are finding more sources of online information which help us gauge trends effectively.

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