CIO Memo

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Recovery continues, but headwinds are growing

Key takeaways

- At the 20th Chinese Communist Party Congress, economic policy remained characterized by accelerated change and reform as well as fiscal and credit support
- Weak market reaction to the outcome of the Congress
- We expect the recovery will continue over the rest of this year and into 2023, underpinned by macro policy support

1. What happened?

The 20th National Congress of the Chinese Communist Party (CCP) was focused on the re-election of President Xi Jinping as party leader and other leadership changes. Xi realigned its priorities, bringing technological innovation and national security (in economic terms) to the forefront of policy for the next 5 years.

China's structural problems certainly require policy realignment. A shrinking population is reducing the available workforce and state regulation is inhibiting private investment and leading to inefficient capital allocation. China's proposed "high-quality development" response aims to remedy such structural problems by increasing innovation, opening the economy, and promoting green development – but within tight political control. Further fiscal and credit support will be forthcoming to upgrade multiple sectors, and new (government-led) research efforts should feed through into higher corporate R&D spending. Rebalancing income distribution remains an important development objective and "common prosperity" is still featured as one characteristic of "Chinese modernisation". China remains committed to its climate goals but will also want to achieve energy security through further development of clean coal, oil, gas and nuclear power. The key question is to what extent such overall policy realignment goes in directions that, in the long term, prioritise essentially political objectives over conventional growth and market measures.

President Xi must also still negotiate two immediate economic problems – COVID and the property sector. He only briefly noted past achievements of the government's COVID policy in his speech and did not comment on the future. He did not repeat the "housing is for living in, not for speculation" phrase in his speech, but it was flagged in the work report published later, and while there is room for a further relaxation to stabilise housing property demand, an eventual recovery seems unlikely to be accompanied by rapidly rising house prices.

GDP grew 3.9% YoY in Q3, implying seasonally adjusted QoQ growth of 3.7%, beating the market consensus and our expectations. The growth was driven largely by final consumption expenditure. Gross capital formation and net exports also made positive (albeit smaller) contributions. Industrial output gathered pace in September and retail sales volumes improved in Q3 from Q2.

2. How did markets react?

On Tuesday, Hong Kong stocks were volatile while mainland China markets continued to slide after they plunged more than 7% on Monday - large Chinese internet-tech names lost a good 10% on average. Foreign investors exited mainland markets via Hong Kong trading links, leading to a nearly 3% loss in the CSI 300 Index, which tracks the largest A-shares by market capitalisation on the Shanghai and Shenzhen stock exchanges. The onshore yuan fell 0.6% to its weakest level since January 2008. Meanwhile today the Shanghai Composite was about flat at 2,976, while the Shenzhen Component lost 0.5% to 10,639.

3. What does it mean for investors?

We see the National People's Congress as a market clearing event, aligning market and government policy expectations – and thereby setting the stage for further policy change. The key challenge for investors is to identify and differentiate between medium-term and possible long-term impacts.

In the medium term, greater policy clarity will follow, but it will take time. In the case of COVID, for example, an immediate comprehensive switch is unlikely but step-by-step relaxation could usher in a gradual strategy change in the coming months. Tactical positioning for example in Chinese travel companies, hotel chains, airlines and airport operators could offer short-term opportunities for risk-taking investors. Chinese equities overall are likely to stay volatile in the medium term (due in part to geopolitical and growth worries, as well as U.S.-China tensions) but investors may still see structural growth opportunities in industries expected to receive strong policy support in line with Beijing's high-quality development strategy, e.g. companies benefiting from upgrading in digitalization, manufacturing, transportation, aerospace, as well biotech, clean coal technology, and clean energy.

With the MSCI China falling nearly 30% this year to its lowest levels since mid-2009, the index NTM P/E multiple declined to 8.9x which makes it one of the cheapest major stock markets globally. At current valuations, the index trades at a 20% discount to its 10-year median. The discount to the MSCI World stands at 38%, which represents the 12th percentile over the last 20 years. While cheap valuations do not provide immunity against further market weakness, we feel that they should provide some cushion against more downside.

That said, more clarity on the Zero-COVID policy, stabilisation of the property market, continued trading of Chinese stocks on U.S. exchanges, and a de-escalation of U.S.-China tensions are probably needed for Chinese stocks to move considerably higher. While we do not expect these headwinds to dissipate quickly, we are more optimistic on a medium-term horizon.

3. What does it mean for investors

We reiterate our preference for Chinese IT and internet stocks, which have capitalised on their superior market position and grown EPS at an annual rate of 15% since 2010. At current prices, the Chinese IT sector trades at a NTM P/E multiple of 11x, which is less than half of the 10-year median and compares to a P/E multiple of 19.5x that U.S. IT stocks are traded on. With earnings reports of large IT and internet names such as Baidu, Alibaba, Tencent and Meituan around the corner, the sector should soon move into investors' focus again. Upside developments on reported EPS would not only provide much needed support for individual stock prices but also to the MSCI China due to the high index weighting of these companies.

We believe that China's economic recovery story continues unnoticeably. In our base case, we expect China's recovery to continue into 2023, which should support market sentiment over the next 12 months. While the U.S. and the Eurozone could face recession risks in the near term, Chinese policymakers should implement stronger stimulus in the low domestic inflation environment to support the continual recovery. With a more certain political landscape in China in the next five years following this Party Congress, we think markets may eventually return their focus to economic fundamentals and corporate profitability.

Glossary

CCP is the Chinese Communist Party (CCP), officially the Communist Party of China (CPC). It is the founding and sole ruling party of the People's Republic of China.

CNY is the currency code for the Chinese yuan.

CSI 300 Index CSI 300 is a capitalization-weighted stock market index designed to replicate the performance of the top 300 stocks traded on the Shanghai Stock Exchange and the Shenzhen Stock Exchange.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

GDP Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Hang Seng Index (HSI) includes the 50 largest companies traded on the Hong Kong stock exchange.

The Hang Seng Tech Index tracks the 30 largest technology companies listed in Hong Kong.

NPC is The National People's Congress of the People's Republic of China, or simply the National People's Congress.

The People’s Bank of China (PBoC) is the central bank of the People's Republic of China.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

The Shanghai Composite Index contains all shares traded on the Shanghai exchange.

USD is the currency code for the U.S. Dollar.

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