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2023 China equity outlook

Zero-COVID policy, property sector support in focus

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By the Asian Equity Team
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2022 in review: Deja vu

China's situation in 2022 was eerily similar to that of 2021, with its markets on track to become one of the worst-performers among the major economies for the second year running. Much of the world has gone on to fully re-open but China has vehemently stuck to its zero-COVID policy (ZCP) and it is in its third year of lockdowns and extensive testing. The government has changed its tone and shifted to a "dynamic" ZCP. But despite the "dynamic" buzzword, not much has changed for the Chinese people. In fact China recently implemented its most significant lockdowns since the 2020 Wuhan outbreak. Shanghai, a metropolis of more than 25 million people, was locked down for more than a month. Economic activity was disrupted significantly as Shanghai is China's largest economic zone accounting for more than 4% of economic output. The ramifications were far-reaching as other economic zones in China lost access to crucial value-added parts from Shanghai. The situation highlighted the fragility of the ecosystem involving industries such as technology, healthcare, automation and automotives. Although the lockdowns were subsequently lifted in June 2022, the damage had been done as China's GDP contracted for the first time since the beginning of the pandemic. As a result, China is unlikely to meet the official GDP growth target of 5%, which in recent months has been greatly de-emphasised in the country. Lockdowns across different provinces and cities were common in 2022, pressuring all aspects of the economy like consumption and manufacturing. Perhaps the only bright spot was the export sector but its growth is quickly losing momentum due to a slowing global economy.

The property sector also provided a moment of déjà vu in 2022. In 2021, the sector faced a triple challenge of slowing pre-sales, bond defaults and a downturn in share prices. A similar story was repeated in 2022, although the decline in pre-sales did slow thanks to a low base effect. There were some key changes in 2022 as the government, which had seemingly refrained from rescuing the market, has finally shown a change in stance. In the last quarter of 2022, the government announced a series of financing measures and support for the property sector. Although these measures were generally narrower in focus (e.g., targeting only developers which had not defaulted) relative to the past, they were still seen as important steps with the government seemingly recognising the importance of the property sector within the economy. The latest measures were also considered much more resolute compared to actions undertaken in 2021.

Hopes that geopolitical tensions between the US and China would ease were dashed in 2022 as Washington imposed more sanctions on Chinese semiconductor and defence companies and initiated coordinated action in response to alleged human rights abuses in Xinjiang. Taiwan became another potential flashpoint between the two countries after a visit by US House Speaker Nancy Pelosi, who became the highest-ranked US official to set foot on the island since the 1970s. Although US President Joe Biden met Chinese President Xi Jinping at the G20 summit in November 2022 and discussed topics such as climate change and the Russia-Ukraine war, the talks did not appear to signal a thawing of broader relations.

An encouraging development in 2022 was that the all-important 20th National Congress of the Chinese Communist Party proceeded smoothly with President Xi securing an unprecedented third term as expected. This may depend on one's view but a potentially more significant development was that the Politburo Central Committee and the Politburo Standing Committee are now comprised by Xi loyalists. International investors seem to view such a

composition negatively, concerned about a lack of balancing voices and views within the top levels of government. On the other hand, domestic investors appear to be more optimistic, with the new composition seen enabling a quicker execution of policies. Although the markets sold off immediately after the Congress, they bounced back quickly as several policies were announced and bolstered confidence.

All in all, investors were buffeted as a tug of war ensued with domestic and international liquidity and earnings on one end and policy uncertainties on the other. Nevertheless, a case for investing in structural growth sectors within China still exists in our view with sectors such as renewable energy, new materials, energy-beneficiaries and electric vehicle (EV) parts delivering alpha returns.

Strategy: Zero-COVID and property sector support key to market uptrend

The dynamic ZCP may be the biggest obstacle to China's economic recovery. It not only obstructs logistical functioning in all aspects of the manufacturing economy but also hinder consumption and investments. Not knowing when lockdowns might take place and fears of being quarantined with little notice will likely limit both investment and consumption, thereby constraining GDP growth. The easing or lifting of the ZCP will likely provide a significant psychological boost. As an example, the market has risen more than 20% since 11 November 2022 when the government announced tweaks to the ZCP. As such, monitoring when the government could further ease the ZCP will be a critical part of strategy in 2023. Early in 2023, any easing of the ZCP could come in small increments with a more significant relaxing of regulations not happening until 3Q. However, even incremental easing could be enough to boost the markets. Considering the massive sell-off which have taken place over the past two years, the markets could be poised to enter an uptrend in 2023 if given the right incentive.

Our view on the property sector is more sanguine. After more than 20 years of growth in price and volume, investors may become more selective towards the sector. The Chinese government might be taking the right approach by trying to tone down the sector's leverage, but the execution of actual policies will be key. Having a targeted approach could work, but excessive fine tuning might have a negative effect as the sector accounts for more than 25% of China's GDP. The government may need to take decisive action to prevent the sector from becoming the Achilles' heel of the economy. The three arrows of financing—developer loan financing, bond financing and equity financing—will be crucial for the sector to turn around.

Focus on consolidated sectors, investments with "Chinese characteristics"

Much of the world's recent experience with innovative technology has been a bumpy one. In 2020, investors were seemingly willing to forgive companies with no earnings, but in 2022 they appear to have reversed their approach. The situation is no different in China. We view companies with high valuations and sporadic earnings with caution. Technology companies in China are general are profitable and do not have significant cashflow issues that some US start-ups face. But the valuations of Chinese technology companies can be high, and they face more regulatory uncertainties. The software internet sector faces domestic regulatory issues while the hardware sector grapples with geopolitical uncertainties. However, we see significant upside opportunities in many sub-sectors after two years of significant corrections, and an earnings recovery could be on the horizon. The rationale supporting these sectors—namely domestic substitution trends and the difficulty in replacing China as a main manufacturing base globally for technology hardware—has remained unchanged for the last three years. Many consolidated industrial sub-sectors also exist which present very interesting opportunities for investors if the macroeconomic environment improves. We like the logistics, transportation, automation, light industries and materials components sectors.

During the 20th National Congress, President Xi focused on the economy with "Chinese characteristics". Subsequently, various ministries have been talking about companies with Chinese characteristics. In light of such developments, the government is trying to bring attention to state-owned enterprises (SOE) in a bid to play a much more significant role in the economy. We are not a fan of SOEs due to their lower returns and higher risks related to corporate governance; that said, our research shows that some of these enterprises have consistently delivered good returns and are in positions of advantage within their markets. Such SOEs tend to be either industrial-related manufacturing sectors or infrastructure owners. Coupled with the fact that these companies on an average trade at 5x PER compared to the market average of 11x, these stocks could find themselves in a bull market scenario if investors realise their value and acknowledge that not all SOEs are the same.

ESG: Is decarbonisation taking a back seat?

Sectors that were popular in 2021 and early 2022—such as renewables, EVs and those linked to environmental plays—have suffered a setback due to factors such as oversupply and geopolitical sanctions (solar panels manufactured in Xinjiang have come under scrutiny). In addition, these sectors have also suffered as the pursuit of renewables by overzealous local governments resulted in power shortages. However, decarbonisation still remains a strong investment theme. Decarbonisation could mount a strong comeback in 2023, albeit in a different form. Decarbonisation sectors enjoyed a broad rally in 2021-2022 regardless of their fundamentals but investors in 2023 could be more discriminating, assessing which subsectors will likely be beneficiaries. We believe that investors could favour subsectors such as upstream materials and energy storage. Selective sectors, such as solar, will likely benefit from global trends, especially from Europe. Wind, on the other hand, is expected to benefit from stronger offshore demand in China.

Geopolitical risk

Geopolitical risk is likely a top concern for every investor focused on China with Taiwan, Xinjiang, Sino-US diplomatic tensions and the semiconductors/technology race heating up between the two global powers being the main themes. In 2022 tensions heightened in the Taiwan Strait following Russia's invasion of Ukraine and investors grappled with the possibility of war breaking out between Beijing and Taipei. Reaching out across the globe, President Biden strengthened Washington's relations with its allies such as Australia and Japan while reinforcing its presence in the Asia Pacific. Furthermore, Washington's relationship with its European allies is seen to be stronger than it was during the Trump era. However, Taiwan's opposition party Kuomintang (seen to traditionally favour warmer ties with Beijing) did surprisingly well in the November 2022 Taipei mayoral election. As such, tensions over Taiwan may go on a slightly lower boil until the 2024 presidential election. Sino-US relations are stuck at a low ebb, but recent events suggest that European countries, especially Germany, in addition to Japan and South Korea, want to chart their own course regarding semiconductor sanctions. Political tensions may have peaked in 2022 but we believe risks will persist.

COVID, property and economy

Although the Chinese government appears to be putting aside its ideological beliefs in an attempt to get the economy back on track, it may not all go according to plan. COVID controls have proven to be tricky, with the virus surprising even the most sophisticated scientists. Given China's geographic and demographic size, bringing COVID under control might take longer than expected, triggering significant volatility and generating uncertainty. What if coronavirus-related death rates rise? What if the virus continues mutating? What if the healthcare system cannot cope? There are many "what ifs" with COVID and it could be a case of one step forward, two steps back for the government. There is much uncertainty ahead for China's economy and its property sectors with the global economy slowing down. Inflation may also grip China as it has in many countries which have lifted COVID restrictions.

Summary

We believe that the rewards will outweigh the risks related to China amid an existence of enough cyclical, thematic and structural trends that could enable the country to outperform in 2023. Valuations have also become very attractive, with the MSCI China Index having declined by roughly 50% over the last two years, and even a moderately positive factor or development could help the market outperform.

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