CHINA MARKET UPDATE

A TIME FOR ACTIVE MANAGEMENT & DIVERSIFICATION

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SUMMARY

- While recent activity data from China beat expectations, conditions in the domestic property sector and household consumption mean there remain strong headwinds to growth.
- We maintain our 4.5% forecast for China's GDP growth in 2022 – below the 5.5% official forecast – while looking out for possible upside risk arising from more policy support.
- Chinese equities have underperformed global and emerging equities over the past 12 months. Economic slowdown, the launch of "common prosperity", property sector stress and zero-covid containment policy are reasons for the market weakness.
- At less than 11 times forward estimated earnings, the market valuation recently reached its lowest level since 2015, pricing quite a lot of bad news.
- It is difficult to see an immediate rebound in corporate profits due to challenging base effects and tough consumption conditions ahead.
- The recent promise of policy support by vice premier Liu He is encouraging. Yet a more sustainable rebound in equities requires concrete policy details and actual implementation. We remain cautious on China equities and prefer to stay on the side-lines.
- At this juncture, active management and diversified solutions are preferred to navigate uncertain markets. Investors looking to exploit current market weakness to increase exposure to China should consider stocks or funds that offer high quality, secular growth and diversified exposure.
- Furthermore, to avoid de-listing risk, investors holding China ADRs or listing on US stock exchanges should convert their stocks into HK listings when available.

China Macro

Activity data out of China for the first two months of the year beat market expectations, indicating some stabilisation in the economy. The improvement was especially evident in fixed asset investment (FAI) and industrial production. For example, investment in manufacturing was up 20.9% year-on-year (y-o-y) in the first two months of 2022, compared to 11.8% in December of 2021. In particular, FAI in carbon-intensive industries such as mining and metal smelting saw strong growth on the back of elevated materials prices and less stringently implemented decarbonisation policies.

However, strong headwinds to growth remain. As we highlighted in our 2022 outlook, the Chinese economy faces two main challenges this year – a property-sector downturn and muted household consumption due to containment measures introduced to deal with the latest outbreak of covid.

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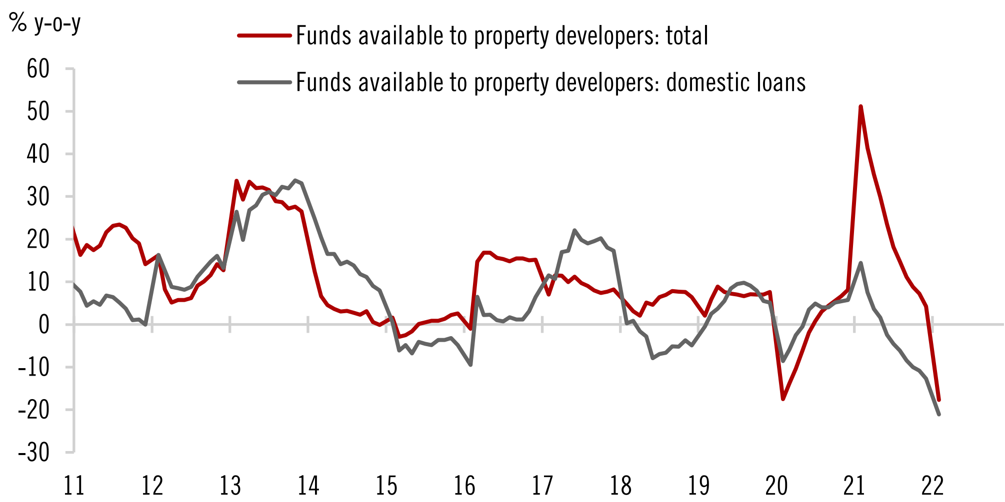
Latest data show that liquidity conditions for many property developers have continued to deteriorate, with total funding available to developers dropping by -17.7% y-o-y in the first two months of the year *(see Chart 1)*. On the covid front, an increasing number of cities, including Shanghai, are going through lockdowns as local governments try to curb the spread of the highly transmissible Omicron variant. These containment measures will likely put even more downward pressure on domestic demand.

CHART 1: GROWTH IN FUNDS AVAILABLE TO PROPERTY DEVELOPERS



Source: Pictet WM AA & MR, Wind, National Bureau of Statistics, 29 March 2022

To address mounting market concerns, Chinese vice premier Liu He recently chaired a high-level meeting where more policy support was promised to boost growth. The meeting also pledged to deal efficiently with risks in the property sector and urged relevant government agencies to complete the rectification work targeting large internet companies as soon as possible. These are the clearest indications so far from the Chinese government of its intention to stabilise growth and restore confidence in the economy.

While the messages from policymakers are encouraging, we are waiting for specific measures to be implemented, especially more decisive monetary and fiscal easing. After a cut in commercial banks' required reserve ratio (RRR) at the end of last year and a cut in its policy rate in January this year, we await further actions from the People's Bank of China. Also, measures need to be taken to address the ongoing liquidity crisis in the property sector, which is extremely important for the Chinese economy. Finally, given the increasing damage to the economy caused by the efforts to contain covid, an improvement in public health is necessary for us to turn more positive regarding consumption. For the time being, we are keeping our China GDP growth forecast for 2022 unchanged at 4.5%, while watching for possible upside risk as a result of enhanced policy support.

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Chinese equities

Chinese equities have underperformed global and emerging equities over the last 12 months. On a year-to-date basis, the MSCI China and Hang Seng indices have underperformed all other Asian equities indices. As usual in such a case, the underperformance can be attributed to many different factors; understanding their dynamics will allow us to determine whether we can become more optimistic at current valuation levels.

First and foremost, the Chinese equity market reflects the economic slowdown over the last 12 months. This slowdown was natural after a very strong 2021 rebound post-Covid 19 pandemic that took place in 2020. Hence, the year-over-year base effect became less favourable and the economic momentum lost steam last year.

Second, starting in mid-2021 the launch of the “common prosperity” policy resulted in a much more uncertain environment for the large tech companies that were present in most investors’ portfolios. Faced with a rapidly changing environment, investors had to constantly revise lower their earnings and margin estimates in the wake of the new, tougher regulations that are part of the “common prosperity” package.

Third, the rules limiting leverage in the property sector generated severe financial stress among the mostly indebted companies in the industry. The offshore bond market became quite illiquid, resulting in difficulties for some issuers looking to refinance. As the situation kept deteriorating, consumer sentiment towards property purchase became more cautious, resulting in a fall in sales.

Last, the implementation of the zero-covid policy has proved to be damaging for both consumer sentiment and household spending.

Given the large correction is equity prices, market valuations recently hit their lowest level since 2015. At slightly less than 11 times forward estimated earnings, the Chinese market has already discounted quite a lot of bad news. Moreover, authorities have recently taken note of weak equity prices and have announced measures that aim to address market concerns. We are nevertheless remaining on the side-lines as we think conditions for a genuine turnaround are not yet in place.

Major Chinese cities are in lockdown, resulting in headwinds for consumption and property purchases: hence, we are keeping our 2022 growth GDP growth forecast of 4.5% unchanged. As for corporate earnings, it remains difficult to see an immediate rebound as base effects are challenging and private consumption remains weak. The promise of greater visibility on regulations is welcome, but we need to see implementation. The same goes for the promise to improve liquidity in the property sector as the fixed-income market remains essentially closed, prolonging the current liquidity crisis.

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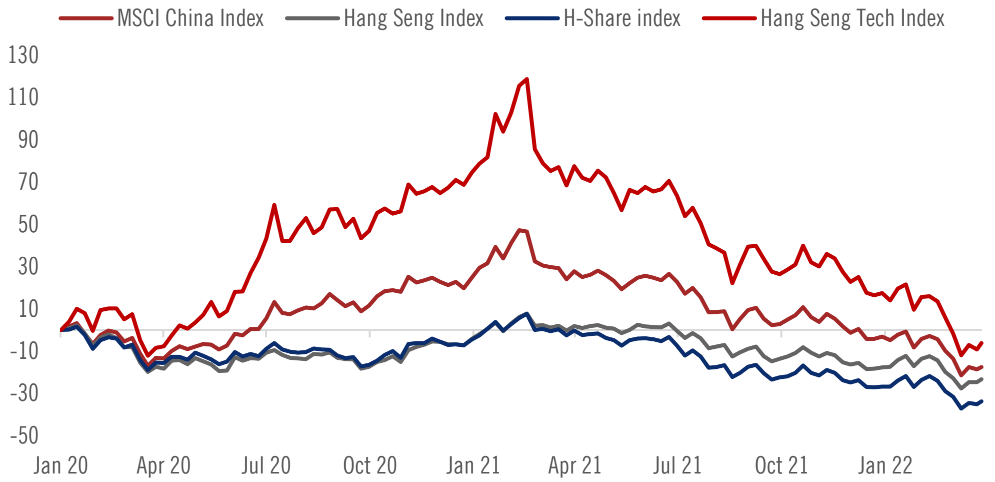
Overall, however, we view the current situation more favourably than a few months ago as valuations have reached a multi-year low level. The recent announcement by the vice premier probably put a floor under market valuations. But for equity prices to rebound on a sustained basis, we need concrete implementation of the promised measures, but especially a rebound in the domestic part of the economy. For now, credit to households remains in contraction; any rebound would be a first indication that the trend is becoming more positive.

CHART 2: CHINESE EQUITY INDICES' PERFORMANCE SINCE 2020



Source: Pictet as of 29.03.2022

Investment Solutions

Investors with a long-term horizon looking to add exposure to China at current weakened levels should consider investment solutions in stocks or funds that offer high-quality, secular growth and diversified exposure. In this regard, we prefer active management and diversified solutions.

We believe the key to equity investing is to focus on companies with pricing power and free cashflow generation as well as those that stand to benefit from secular growth in clean energy. Companies with a solid balance sheet, strong brand and a competitive edge are in a better position to secure their profit margin. Businesses with steady free cashflow generation can fund their dividend payments or share buybacks – an important element of returns to shareholders. With China committing to carbon neutrality by 2060, we find companies offering renewable energy or electric vehicles attractive.

At the same time, we see an increasing risk that China ADRs will be delisted from US stock exchanges. The Securities and Exchange Commission (SEC) in the US has added five Chinese ADRs to their audit watchlist in recent weeks. Companies failing to comply with requirements for three consecutive years will face the risk of delisting by 2024. To avoid this risk, investors should consider switching from ADRs into Hong Kong-listed shares when available.

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Conclusion

The sell-off over the past year has brought Chinese equities to their lowest valuation since 2015, but by now they have priced in a lot of the bad news and recent announcement of policy support is encouraging. However, with growth headwinds across the property sector and household spending sluggish following the surge in covid infections and city lockdowns, we remain cautious and prefer to stay on the side-lines when it comes to Chinese equities. Investors looking for entry opportunities should consider active management and diversified exposure.

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