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Re-Assessing The China Opportunity

In this Issue

1 A History of Policy Reforms
2 Understanding Xi's Economic Thinking
3 Economic Policy Implications
4 Understanding the Regulatory Reset
5 Managing Property Sector Spill Over Risks
6 Government Policy Support in Question
7 FX & Rates Implications
8 Credit Market Implications
9 Equity Market Implications
10 Conclusion & Investment Implications

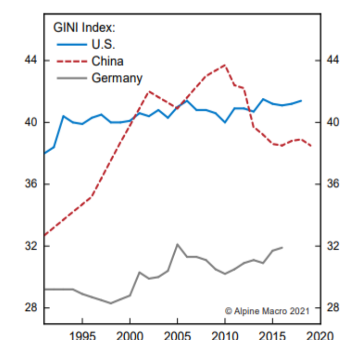
In a Financial Times article at the end of August, George Soros argued China's two-decade-long economic boom is coming to an end. In the piece, Soros warns how Xi Jinping's crackdown on Chinese tech and educational companies is signalling an impending reversal of policies that underpinned China's economic success. The Soros article got us thinking and somewhat questioning our allocation to the Chinese market. However, after spending time reflecting, researching, and discussing with local PMs, we drew out a different set of conclusions.

A History of Policy Reforms

In the past four decades, the economic doctrine of the Chinese Communist Party ("CCP") has been to place economic efficiency ahead of income equality. The policy produced stunning successes, but it came with major side-effects causing serious problems. To better understand contemporary China, we started looking at the country's reform history. China's economic policy history can roughly be deconstructed into three phases. Unsurprisingly, in each of these phases, leaders faced unique set of problems leading to different policy priorities.

The first phase ran from 1978 to 2003 under Deng Xiaoping (1978-1989) and his successor Jian Zemin (1989-2003). Facing an impoverished country with a rigid central-planning system, policy priorities were to de-control, de-centralize, and bring free market forces into the economy. The hyper pro-growth economic policy design was effective. The economy took off as GDP per capita soared. The largest labor migration began with hundreds of millions of farmers becoming industrial workers. However, income distribution rapidly became uneven with skilled workers and capital owners getting an increasing slice of the income pie. The divergence became evident with the surge in China's Gini Coefficient in the 1990s, surpassing the US in 2001 **(Chart 1)**.

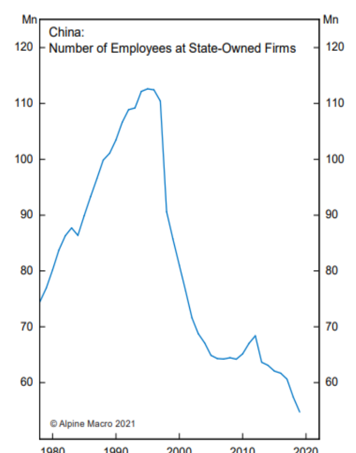
Chart 1. Gini Indices



Source. World Bank, Alpine Macro

The second phase ran from 2003 to 2013 under Hu Jintao. Suffice to say the country's society went through traumatic shifts, deep reforms, and tumultuous changes including the destruction of more than 50 million jobs in state owned enterprises **(Chart 2)**. Decentralization, privatization, and free market liberalization paired with periodic social upheavals characterized China's economic policy up to that point. Although he did little to advance free market reforms, realizing the increasing inequality and social tensions, Hu made the first attempt to address the widening income gap. He laid out the preliminary work on social safety, addressed workers' rights, built up a nationwide pension system, and implemented a national medicare scheme. However, in that time, corruption turned into a major problem to the point it was seen as an existential threat to the CCP rule.

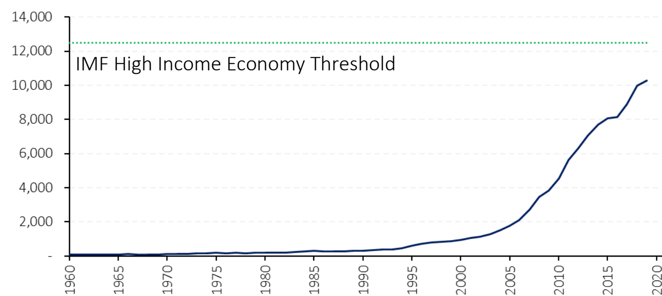
Chart 2. Job Destruction in SOE



Source. Alpine Macro

The third phase began in 2013 when Xi Jinping took over the office as General Secretary of the CCP. China was decisively different from the one his predecessor governed. Its economy had grown. On a GDP per capita basis, China is within striking distance of becoming a high-income economy **(Chart 3)**.

Chart 3. China GDP per Capita



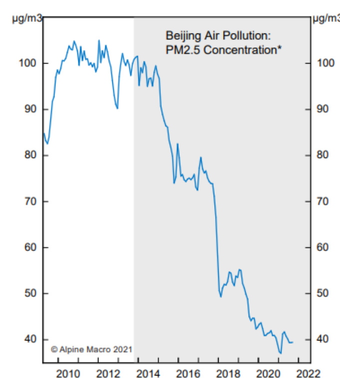
Source. World Bank, MAM Research

At the same time, the steady-state growth of the economy was much slower, and the country faced many new problems: an aging labor force, rampant corruption, an over-extended property sector, a damaged economy from the Global Financial Crisis, and a pervasive environment degradation. Xi quickly realized that demands from the population had shifted. It was no longer all about income growth, but rather corruption and the environment. A year into his mandate, Xi found his core priorities: clean government and clean air. He struck hard. The anti-graft campaign rounded up millions of corrupt officials while the environmental crusade led to the closure of many polluting industries. One must admit both campaigns have been highly effective with the public sector corruption index dropping precipitously **(Chart 4)** while the country's air pollution plunged **(Chart 5)**. Xi's government was able to cut PM2.5 pollution by more than 60%.

Chart 4. China Public Sector Corruption Index

Source. World Bank, Alpine Macro

Chart 5. Beijing Air Pollution PM2.5 Concentration



Source. Alpine Macro

In hindsight, Xi picked the right fights allowing him to win the hearts and mind of the Chinese population.

Understanding Xi's Economic Thinking

While both his anti-corruption campaign and environmental policies have largely been successful, it has not really been clear cut what Xi's economic philosophy or policy orientation is. Over the years, he spoke at length on various economic issues from a more balanced growth model, a more equitable system, anti-monopoly efforts, the importance of maintaining the dominance of state ownership, to the encouragement of small and medium-sized firms and more.

Looking through diverse published articles and speeches, five elements potentially characterize his economic thinking. First, economic stability remains a clear top policy priority through deleveraging, destocking, and supply-side reforms. Second, common prosperity to contain the widening income gap and protecting workers rights over the interest of capital owners (e.g., against "996 Rule" at Alibaba). Third, fair competition through the crackdown on *de facto* monopolies as they pose an increasing threat to the dominant role played by the state sector. Fourth, economic security over commercial interests as the Chinese increasingly find themselves in conflict with the West. Lastly, strengthening the role of SOEs as explicitly stated by Xi during a speech "State ownership must play the dominant role, while allowing other forms of ownership to grow", which diverges from the previous doctrine "All forms of ownership are equal and allowed to flourish".

Economic Policy Implications

The Chinese economy is advanced, but, in many ways, it is still operating in a 19th century Gilded Age environment. As such, policy adjustments to rebalance various policy objectives are all but unavoidable. Nevertheless, these adjustments have economic and financial market implications.

Keen to maintain economic stability, the Chinese government has consistently been on the lookout for potential trouble spots and continues to see excess-leverage as a key risk to the economy. The authorities failed on numerous occasions to bring down the country's debt-to-GDP ratio, instead causing stop-go cycles in the economy. Part of the reason behind the failure to bring down debt is the extraordinarily high savings rate paired with a bank-dominated financial system, thus leading to high leverage. Any attempt to squeeze credit creation resulted in financial disintermediation and a growth slump. A corollary to the Chinese government's deleveraging campaign is how its monetary policy has always been tighter than necessary and therefore why China's economy has been operating below its true potential. Should the deleveraging continue, China's GDP growth could slip towards 5%.

Keen to deliver on its common prosperity mandate, China has been actively working towards income re-distribution. While it attempted to reassure investors by distinguishing its policy from a Robinhood-style intervention "killing the rich to help the poor", it has become inevitable for China to tighten and streamline its tax collection rules, and work on eliminating loopholes. Arguably, China's economy is under-taxed. In fact, it has one of the most regressive tax regimes in the world. China is the only major economy not having either a property or school tax and imposing zero capital gains tax. Progressive income taxes were introduced less than a decade ago and tax collections remain inefficient. The effective personal tax rate in China is around 7% as opposed to over 22% in the US. Xi wants to build a modern society but doing so requires a substantial amount of capital. While the Chinese government is financially strained, the situation is nowhere close to the dire situation in most parts of the West. In reality, China has substantial room to raise taxes and redistribute income.

We believe the government could soon introduce the much delayed property tax to curb rising property prices but also force some capital reallocation as nearly 70% of the Chinese population's wealth is tied to property markets. However, the demise of Evergrande is likely to put plans on hold for now.

Understanding the Regulatory Reset

The central government's regulatory reset looks to achieve a more sustainable and healthy property market in the long term, and lessen the need for tightening and loosening cycles as seen in the past decade and discussed earlier.

Today, China has two major goals for the property sector. (1) Housing is for living, not for speculation. (2) Stabilizing land and property prices, and stabilizing expectations. In fine, the government decided to introduce regulations based on its experience of what worked well and not so well for the property sector in the past. The best way to look at it is from the lens of the different parties involved.

Local Governments. Insufficient land supply cause land prices to rise, leading to unprofitable and vulnerable projects. As a result, local governments have been increasing land supply to a reasonable level and improved land auction mechanisms to better control land auction premiums over opening prices.

Developers favored a high leverage for high growth business model and over-aggressive land acquisition strategies putting pressure on both gearing and margins. As a result, the three red lines were introduced to control the developers' leverage. Land acquisition caps were instated (<40% of sales value) and the CCP lets highly levered developers default to clean up.

The Three Red Lines. As a bit of introduction, in August 2020, the government launched the three red lines for developers. The goal is simple, deleverage property developers. To do so, they introduced a color system based on three criterion. (1) The liabilities/assets ratio (excl. pre-sale deposits) cannot be over 70%. (2) Net gearing to total equity ratio cannot be over 100%. (3) Net cash to short-term debt ratio cannot be less than 1x. Developers are placed into four categories based on the number of criterion they fail (red, orange, yellow, green). Red developers cannot increase their debt level, orange can increase debt by 5% each year, yellow can increase debt by 10% each year, and even the green can only increase debt by 15% each year. The pilot program has now expanded to 30 developers (estimate is 16 are ranked green, 3 red). They all have to reach the government's three red lines by June 2023.

Financial Institutions. Excessive liquidity for developers led to high leverage and land competition. The imprudent mortgage approvals facilitated speculative demand. As a result, the banks' two red lines were introduced to control development loans and mortgage quotas as well as regulation on multiple financing channels including bonds, trusts, private equity, etc.

The Two Red Lines. In December 2020, China's government launched the two red lines for banks including a cap on property related loans and mortgages. There are different caps for five types of banks.

Home Buyers. Speculative demand has been contributing to rising property prices. As a result, the government introduced home purchase restrictions, prudent mortgage quotas and a stricter approval process, and a potential property tax pilot program in the future.

Even with the pandemic and pressures on the economy last year, the government did not loosen its policies, exerting high pressure on the broader Chinese financial system.

Managing Property Sector Spill Over Risks

The regulatory reset in China as well as the near-term funding pressures on select property developers have led to extended market volatility. Until last year, credit investors' general view of China's property sector was one with low default rates. The view appeared justified when looking at past default rates and the amount of defaults from the local high yield property sector, to the exception of 2015 when defaults rose to 10%.

While defaults will increase in the high yield property sector, the systemic risk will remain manageable for several reasons. (1) Debt restructuring will be done at HoldCo level of a property developer in default. The OpCo or property projects will remain in operations during the restructuring with the

support of regulators and local governments. (2) Regulators and local governments have the experience and mechanisms in place to deal with Chinese property developers defaults in a way that reduces systemic risk. (3) The credit market has been pricing in a high default risk for China high yield already.

Then, property developers are increasingly on track to meet the three red lines. The total debt exposure of developers is similar to annual contracted sales. As such, the total leverage level seems manageable and hence so is the deleveraging.

The near-term outlook for the property market should remain relatively weak. However, early next year, as fresh mortgage quotas are activated, data should begin to show some signs of improvement in property sales. Although we expect a slow housing start, low inventory levels mean there will not be additional pressures stemming from an inventory overhang.

From an economic standpoint, the property sector's resetting is likely to drag on economic growth. Residential property investment accounts for 6.5% of GDP, while property-related services ad downstream good consumption (i.e., white goods) account for 7.3% and 1-1.5% of GDP, respectively. A 10ppt slowdown in residential property activity could drag down GDP growth by c.1ppt based on (1) 0.65ppt drag from a 10ppt slowdown in residential property investment, (2) a 0.22ppt drag on property services from a 10ppt slowdown in property sales, based on MS Research pass-through coefficient from regression analysis, and (3) 0.1-0.15ppt impact from property related consumption.

Arguably, a lot of the negative news is already out. There is a strong sense current property risks could be contagious. The missing link to avoid such an event at the moment is a lack of policy support, which we believe could come out soon.

Government Policy Support Coming

China's GDP growth is already tracking at 4.5% YoY in 3Q21 owning to Covid-related disruptions and a housing slowdown. Further spillover from the property sector would drag 4Q21 growth below 4% YoY (or below 5% 2-Year CAGR), far below the annual growth targets (>6% for 2021 and 5.5% next year). Historically, policymakers would provide meaningful counter-cyclical easing when quarterly GDP growth falls below the government target. It occurred in four of the last seven years.

The earliest signs of support could occur by December 2021 with faster fiscal spending to support infrastructure projects. Additionally, we could see another 50bps RRR cut, some form of easing on mortgage quotas and fine tuning in the pace of production cuts, and into next year a front-loading of loan quotas and local government special bonds.

What is the big picture plan? Xi Jinping is facing re-election. China will be hosting the winter Olympic and participating at the COP26 summit. Considering the list of high profile events coming up, China does not want to lose face. Instead, it will seek to show strength to the rest of the world. As such, we can expect some form of policy support to materialize some time by the end of the year or the first quarter of 2022.

FX & Rates Implications

Consensus appears to have a bearish bias towards CNY with many wondering whether the currency is underpricing the various risk including further equity selloff, possible credit default, and growth slowdown. CNY trades +1.5SD expensive on a REER basis **(Chart 6)**. However, the trade surplus remains strong while the service deficit is small. Bond inflows are much larger than equity outflows. The positive balance of payments has been a key supporting factor to the currency.

Chart 6. USD/CNY (Weekly)

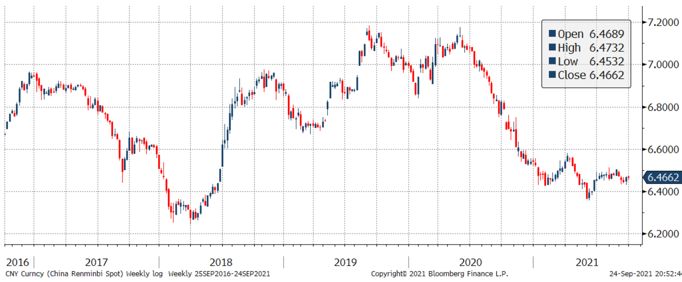
Source. Bloomberg, MAM Research

So how would a potential credit event affect the currency? Two channels can be considered. (1) It would slow down growth and prompt a tightening of interest rate differentials between China and the rest of the world thus working against the currency. (2) The policy uncertainty could trigger capital outflows. However, in the past, a dovish PBOC vs. Fed failed to trigger capital outflows. Rather, it encouraged foreign bond inflows. Equity outflows are limited since mainland investors selling H-shares are bringing their money to the mainland.

Considering the currency is expensive, the economy is not doing relatively well at the moment, and the PBOC is likely to cut rates at a time when global central banks are likely to begin their hiking cycle, the path of least resistance is for CNY to weaken vs. the USD **(Chart 7)**. As a net exporter, China's local economy may benefit from a weaker CNY longer-term.

In rates, the story is somewhat clearer. The slowdown should prompt the PBOC to stay dovish. The PBOC said a few weeks ago that liquidity is sufficient to support growth and large bond issuance. However, it could turn even more dovish if the service sector weakness spreads to the manufacturing sector. Considering the number of major events coming up, another RRR cut is more likely than not to support a growth bounce.

Chart 7. USD/CNY (Weekly)



Source. Bloomberg, MAM Research

Ultimately, this would support lower long-term rates meaning a relatively bullish picture for 10-Year bonds **(Chart 8)**.

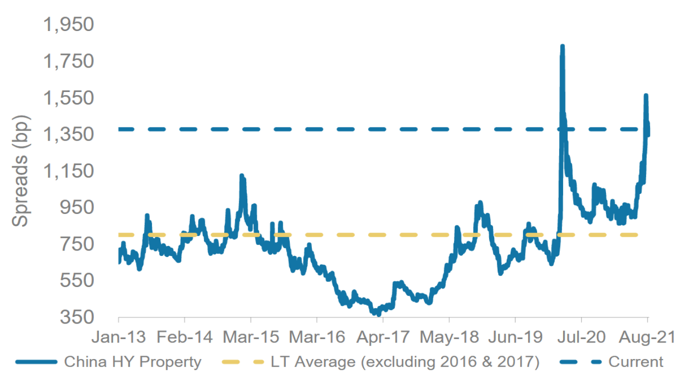
Chart 8. China 10-Year Bonds (Weekly)

Source. Bloomberg, MAM Research

Credit Market Implications

China HY spreads moved from 340bps to as wide as 1,190bps since May, the second widest spread level since '13 **(Chart 9)**. The March sell-off last year was the only time spreads were wider. Given the large contribution of the property sector to the index, it is not surprising HY spread performance between the two has been almost identical.

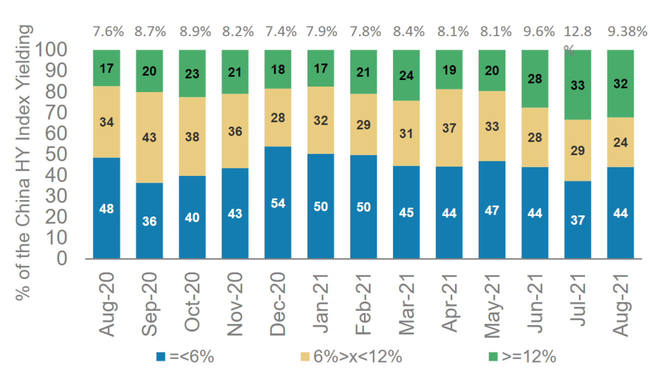
Chart 9. China HY Spreads



Source. MS Research

The cheapness of the index is skewed towards the bottom 32% **(Chart 10)**. Historically, spreads have been dependent on onshore financial conditions (e.g., credit growth). When credit growth rose, spreads tightened as a function of easy financial condition supporting HY property sector, a strong contributor to the index. When credit growth declined, spreads expanded and so did the share of the higher yielding bucket (>12%).

Chart 10. China HY Index % Split by Bond Yields



Source. MS Research

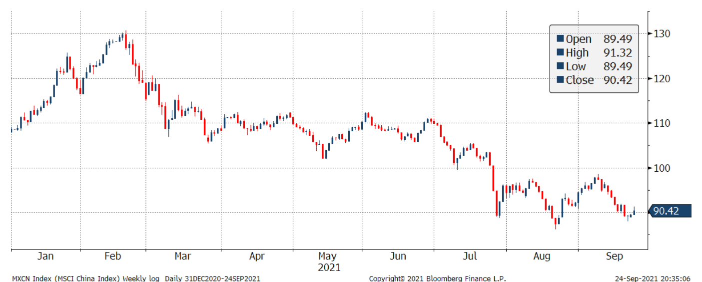
Arguably, coming out of the crisis, the relationship is unlikely to be as strong as it used to be given the regulatory reset in the property sector. Easy onshore financial conditions are no longer likely to translate into easy financial conditions given the tighter regulatory environment. One of the key goals of the recent regulatory changes was to reduce liquidity-driven speculative flows into China's property sector caused by an easing in onshore financial conditions. Nevertheless, the wave of policy support likely to come out over the next couple of quarters should prove to be supportive to the credit market.

Taking a medium-to-long term view (6-12 months), the asset class could become attractive with spreads likely to tighten later. Several factors would come into play as catalysts. (1) The lion share of the policy tightening could be behind us, level of uncertainty fades. (2) The market will be closer to the end of the property default cycle. (3) Capital inflows rise as investor sentiment towards China HY improves. We continue to asset whether credit spreads are close to a peak or not.

Equity Markets Implications

Chinese equity prices have been under pressure for the better part of the year and again recently with the MSCI China **(Chart 11)** and Hang Seng down 9% since September peak.

Chart 11. MSCI China Index (Daily)

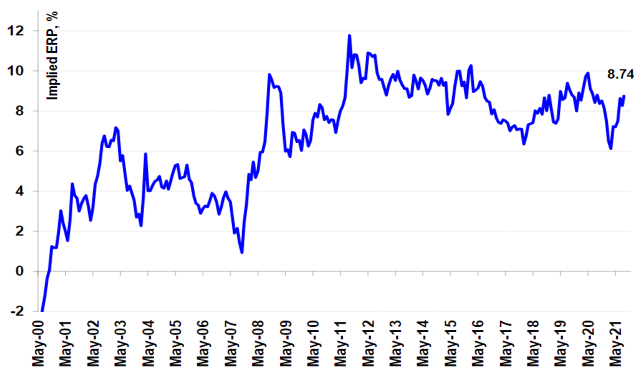


Source. Bloomberg, MAM Research

The risk-reward is skewed to the downside at the index level in the near-term. Credit and liquidity remain tight. Broad based weakening signs are showing up across retail, industrial

production, PMI, and total social financing. Elevated PPI keep adding pressure on margins and corporate investments. China is also expected to introduce an enterprise income tax hike from 10% to 15% on Internet firms, implying a 1.5-2.5ppt hit to annual EPS growth for 2021-2022 at the index level. Equity prices are at risk of further downside considering a lot of the regulatory uncertainty is not as quantifiable and clear-cut as the tax rate hike. It has been reflected through both lower valuations and a higher risk premium. The implied equity risk premium for MSCI China is currently sitting at 8.5% **(Chart 12)**. However, the expected upcoming policy support should soon set a ceiling over the equity risk premium and lift valuations.

Chart 12. MSCI China Implied Equity Risk Premium



Source. Factset

We remain cautious on the property sector since the current credit tightening measures are likely to keep the sector under pressure. The real estate sector underperformed the broader index by as much as 22% YTD earlier this month **(Chart 13)**. Market sentiment, albeit already low, could worsen before it stabilizes as investor concerns over the macro environment, policies, funding, and the timing of those events persists.

Chart 13. MSCI China Real Estate Sector Relative (Daily)

Source. Bloomberg, MAM Research

Banks exposure remains limited for now. Individual property developers' loan balances as a percentage of the banks' total loan balance is limited. Banks were focusing on collateralized project loans, which should lead to manageable losses. While, we see three potential risk factors. (1) A sizeable exposure to non-collateralized debt through trust products. (2) The credit exposure to firms with receivables from property developers is still hard to quantify. (3) High net worth individuals holding investment products with developer-issued commercial bills as underlying assets. Current risks seem to be much smaller than the P2P risks digested by the system in 2018 and 2019. From a systemic perspective, there is still room to deal with some emerging property risks thanks to an extensive risk digestion effort in other sectors over the past several years.

Ultimately, the potential knock-on effects from the property market continue to weigh on sentiment. Yet, actual risks are substantially lower. The lack of short-term visibility in policy easing and lasting credit tightness is doing little to ease concerns. The risk lies in negative headlines over the holidays (October 1-7). It could trigger a preemptive de-risking if the PBOC fails to communicate or take any further action by then.

We maintain a relatively more constructive outlook over the mid-to-long term. (1) Despite current headwinds, China is set to benefit from low base effects going into next year whereas the US will suffer from the opposite. (2) Chinese equities look cheap on both relative and absolute terms with substantially more attractive valuations than other regions. For instance, China trades at 12.8x on a forward P/E basis versus 22.7x for India and 21.9x for the US. (3) Next year is an important year, party congress election. Historically, the market performed better than the year after and non-election years **(Table 1)**. Volatility tends to increase the preceding year, reflecting the uncertainty before the election. (4) If the regulatory reset is successful, China will have a healthier real estate sector with low gearing and decent margins, hence prone to a re-rating. (5) Global equity funds have the lowest exposure to China and Hong Kong since 2017 **(Chart 14)**, meaning a substantial capital inflow could support equity prices in the future.

Table 1. Party Congress Election Year Returns

Year	SSE	Hang Seng	MSCI China
1997	30.2%	-20.3%	-26.3%
2002	-17.5%	-18.2%	-16.1%
2007	96.7%	39.3%	63.5%
2012	3.2%	22.9%	18.7%
2017	6.6%	36.0%	52.3%
Mean	**23.8%**	**11.9%**	**18.4%**

Source. Bloomberg, MAM Research

Chart 14. Average Investor Exposure to China and Hong Kong

Source. Financial Times

Conclusion & Investment Implications

China's economy has become increasingly complex, requiring policy adjustments more often "grey" rather than strict black and white solutions. The CCP's best interest is to grow the economy and allow private businesses to flourish. As such, it is not as bearish for equities as one might think, longer term.

We remain of the camp that a stock market panic and a broader financial crisis similar to the Lehman Brother events in China is unlikely to occur. However, the Evergrande crisis has shown us how serious Beijing is about cleaning up credit risks on the mainland, perhaps is it going too fast.

Although China's credit impulse has improved somewhat, more decisive actions are needed. Simultaneous monetary and fiscal tightening have pounded the Chinese economy, and the Evergrande fallout is further straining the liquidity conditions in the real estate sector.

Oddly enough, crackdown on *de facto* monopolies in China are not longer making the headlines. Yet, we doubt the story is behind us. It remains a risk investors need to keep in mind and a reason why to avoid broad index exposure which tends to be overweight large tech and service companies.

In terms of investment strategy, the headline risks will persist for a little while longer. That said, the risk of systemic failure is very low. Headwinds for the economy will force authorities to relax policy further to help support growth, setting the tone for a reflation trade. Contagion often creates good buying opportunities and some stocks have become interesting, but we remain patient.

We believe the real estate sector is unlikely to hold the same spot in the Chinese economy in the long-run. Instead, we think new sectors will take the lead underneath the surface such as clean energy leaders. For Chinese stocks, it should open up the door for an attractive buying opportunity soon.

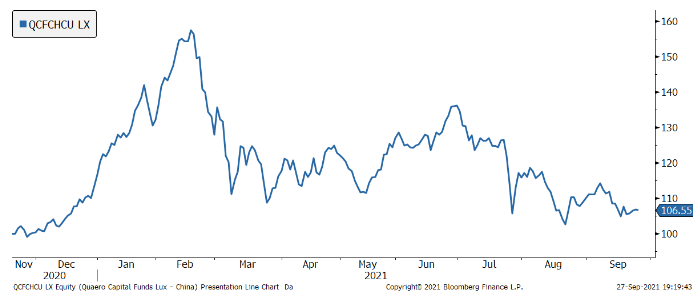
In fine, we draw two different sets of conclusions for different investors based on their investment horizon.

- Short-term (1-3 months). Several sector valuations are at attractive levels. However, near-term risks remain. Weak interim results, additional property developers default risk, pass through effect onto downstream contractors, and further policy tightening such as property tax could drive capital outflows and another decline in equity prices in the order of 5-10%.

- Long-term (1-3 years). We are more positive as downside risks gradually priced in. Xi has a successful track record when it comes to implementing policies. If the regulatory reset is successful, a couple years down the road, China will have a healthier property sector with low gearing and decent margins, supporting a re-rating.

The MSCI China will look very different 5-10 years from now with less internet and less discretionary. This year marks the beginning of the transition towards a different composition with more industrials, healthcare, and hard tech. The Quaero China Fund **(Chart 15)** is perfectly aligned with said transition and seeks to provide exposure not to the large tech names of today, but fundamentally attractive companies for tomorrow, which is why we continue to recommend an allocation to it. Considering it is practically impossible to pick a bottom, we recommend to gradually increase China exposure up to 5% of a portfolio through the Quaero China Fund.

Chart 15. Quaero China Fund (Daily)



Source. Bloomberg, MAM Research

Please feel free to reach out to us should you have any questions regarding this research.

Kind Regards,

MAM Investment Team.

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