APS
Since 1995

CHINA MONTHLY

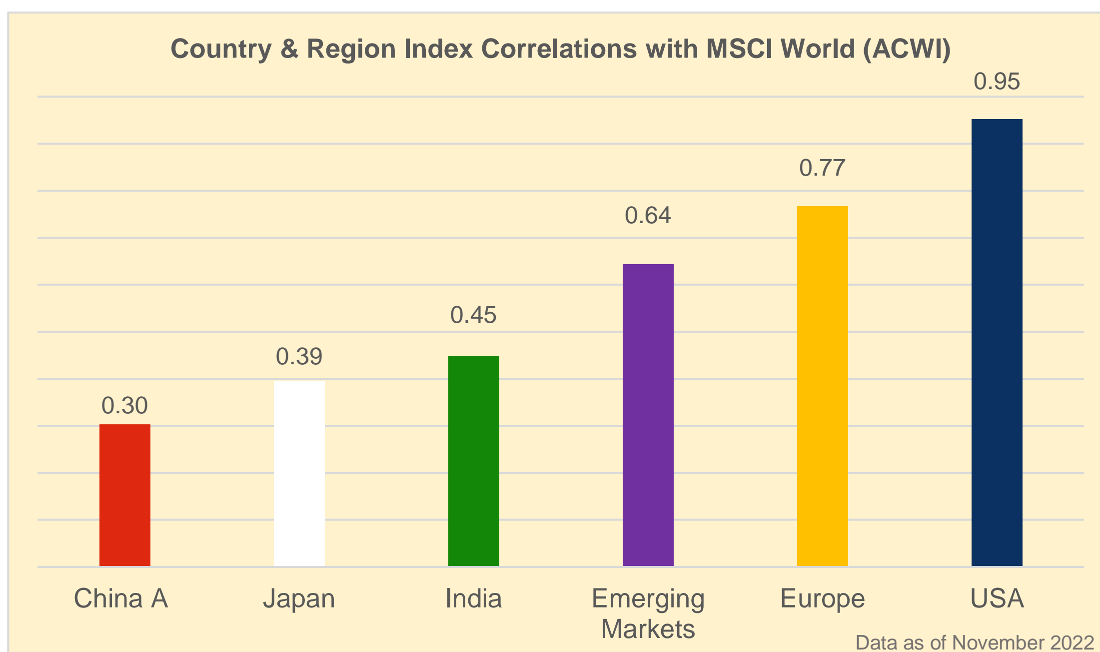
JANUARY 2023

The Briefing 1

The Essay 2

A Tale of Two Chinas

The Big Picture



China marching to the beat of its own drums*. Among major regional equity markets, China's domestic equities has the lowest correlation with global equities over the past five years.*

THE BRIEFING

Focus on the Economy

China's Politburo in early December said that efforts are needed to deepen reform, accelerate opening-up across the board, and boost market confidence. Special focus will be paid to steady growth in the coming year, while fiscal policy will be kept active with a focus on improving its efficiency, according to the Politburo statement, suggesting a ramping up of stimulus going into 2023.

Covid No Longer Zero

Beijing announced that people with non-severe Covid infections can isolate at home instead of in centralised government facilities, negative PCR test results and health QR codes will no longer be required for domestic travel and most public venues, and there will be a campaign to accelerate the vaccination rate for the elderly.

"A New Era"

President Xi Jinping's visit to Saudi Arabia for a bilateral summit has been described by China's Foreign Ministry as the "largest-scale diplomatic activity between China and the Arab world" since the People's Republic of China was founded. Saudi Crown Prince Mohammed bin Salman received President Xi last Thursday as the Chinese leader heralded "a new era" in Sino-Arab relations. President Xi said that China and Gulf nations should make full use of the Shanghai Petroleum and Natural Gas Exchange as a platform to settle oil and gas trade in the Chinese yuan.

ESG Evaluation for Green Projects

China's top economic planner in November published 21 policy guidelines to encourage private sector participation under China's 14th Five-Year Plan (2021-25). It encourages private sector investment and expertise to build and operate solar and wind power generation, biomass power generation, energy storage, and other energy-saving and carbon-reduction infrastructure projects. One of the National Development and Reform Commission's guidelines aims to improve project outcomes by implementing forward-looking evaluation and managing of ESG risk.

BSE Anniversary

The Beijing Stock Exchange launched its first index — the BSE 50 — and unveiled rules for margin trading and securities lending around its one-year anniversary. More than 80% of the companies listed on the exchange are concentrated in strategic emerging industries and advanced manufacturing.

A TALE OF TWO CHINAS

By Wong Kok Hoi

China Investors Through Dickens' Lens

Eminent economists, equity analysts, newspapers, and even academics have drawn such wildly divergent conclusions from China's 20th Party Congress that its stock market made a dramatic recovery after a meltdown once proceedings wrapped up. Confusingly, much of those views are at opposite ends of the spectrum — whether it is about President Xi Jinping and his Marxist-Leninist leanings, his China Dream, his political ideology, his socio-economic development model, his take on entrepreneurs such as Jack Ma, his stance on China's so-called "tech companies" and American Depositary Receipts, or on "common prosperity", and so on and so forth. Investors often bemoan and are perplexed by the diametrically opposing views they read about China. Is this more due to the jaundiced eyes of China observers and their unwillingness to understand China, as pointed out by the China Securities Regulatory Commission's Stanford-educated Deputy Chairman Fang Xinghai, who is a former World Bank senior economist. Or is China just too difficult to understand? In this curtain raiser for 2023, I will take up some of these issues, and hopefully not compound the confusion.

Inspired by a Charles Dickens quote, the following characterization is apposite here:

> **"China was the best of times, China was the worst of times, China was the age of wisdom, China was the age of foolishness, China was the epoch of belief, China was the epoch of incredulity, China was the season of light, China was the season of darkness, China was the spring of hope, China was the winter of despair."**

Today, one can paint a promising, modern, advanced China, or a bleak, back-pedaling, hopeless China; one can fear the return of Maoism or celebrate a successful, modern, Marxist nation harnessing capitalism's best traits while taming its dark side. One can view "common prosperity" as wealth redistribution, or more wealth creation so that more can be distributed; one can also confidently predict a bear market or a bull market, with compelling arguments for each case; one can make a case for either a rebound or a death spiral for "tech companies", and so on and so forth.

Figuratively speaking, China seems to exist in parallel worlds. In one world, China is in the best of times, and in another, the worst of times.

A Two-Sun System and Their Planets

There should be no controversy over the statement that "Sino-US relations will be the most critical relationship for peace, climate change, global trade, and economic growth for at least another decade." How the US and China will manage this multi-faceted, critical relationship, and how this relationship will evolve, can have many permutations. Be that as it may, there seems to be some optimism after the arduous 3 ½ hours meeting between President Xi Jinping and President Joe Biden at the G20 Summit in Bali. Talk is one thing; deeds are an entirely different matter. That said, many Asians can now take comfort in the fact that China is not about to use military force for Taiwan reunification, nor is the US likely — at least for the short term — to use Taiwan to provoke China. In fact, China had already subtly telegraphed its intention to the world through its Taiwan Affairs Office in September that China would exercise **"strategic composure and historic patience"** over Taiwan, not long after US House Speaker Nancy Pelosi's provocative visit. This seems to suggest that the best minds in Beijing believe that China's goal of modernization is far more important than the dream of immediate reunification, even with TSMC as a mouth-watering prize. At the time of writing, the thrashing of Tsai Ing-wen's Democratic Progressive Party in local elections seems to suggest that most Taiwanese prefer maintaining the status quo. Additionally, China's regular warnings to Taiwan about the risk of declaring independence and upsetting the apple cart is not lost on the Taiwanese electorate. At least in the short term, the prospect of Taiwan becoming a flash point for military conflict seems to have greatly diminished.

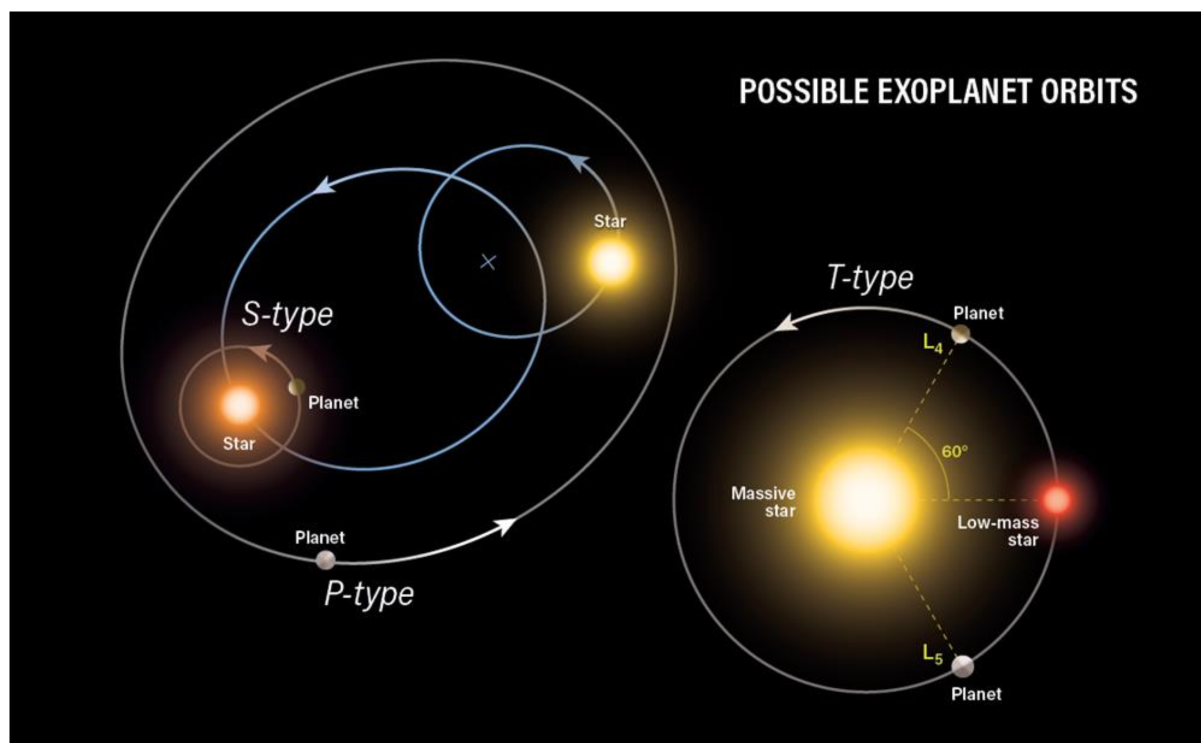
Xi and Biden might have agreed to collaborate in some less controversial areas like climate change, but in our view the nature of Sino-US relations will continue to be a troublesome one because Washington will continue to do what it can to slow or stop China's technological advancement. I expect this to continue until circa 2027, when China's GDP will likely achieve parity or exceed that of the US. Partly because China still enjoys a massive trade surplus with the US, in the region of USD400 billion a year, it will not want to escalate the economic fight unless it is pushed against the wall.

China knows that economic power and wealth is the overriding factor determining bilateral relations and military might. Take for instance Chancellor Olaf Scholz's visit to China soon after the party congress, with the CEOs of 12 industry titans such as Volkswagen, Deutsche Bank, Siemens, and BASF. Less than a week prior, Vietnam's Communist Party General Secretary Nguyen Phu Trong had made a visit too.

Investors will have to adjust and balance their portfolio strategy to the gravitational forces of this new **two-sun system** featuring stars of roughly equivalent mass, a metaphor APS uses in our internal discussions.

Each star will have their own set of orbiting planets. Naturally, the "US sun" will continue to be the "brighter sun" but the rising brightness as well as gravitational pull of "the other star" will make the US uncomfortable. The US will do what it can to stop it, but the imposition of sanctions against Russia for its invasion of Ukraine has actually accelerated the formation of a two-sun system where some planets will only orbit one sun or the other. Inevitably, many old equations will change. We are already seeing more and more

international trade, including oil, settled in non-dollars, while some countries like Israel have added China's yuan to their foreign exchange reserve for the first time.



When binary stars are similar in mass (left), the two stars orbit the system's center of mass (denoted here with an X). Planets in an S-type orbit circle just one star in the system, while planets in a P-type orbit revolve around both stars together. When one star far outweighs the other (right), the smaller star orbits the larger one. A planet in a T-type orbit would share the orbit of the smaller companion around the larger star, locked into one of two positions — the L4 or L5 Lagrangian points — either 60° ahead of, or 60° behind, the smaller star. Source: Astronomy.com, January 7, 2020

For China to be the second sun, it must maintain an even more open economic system, increasingly open its financial markets, and the holy grail would be to remove its capital controls. Short of these polices, it would not succeed as the second sun. In this new global order, the CNY will appreciate, which will negatively impact some of its less competitive export sectors. This will be a game changer for China, the US, and the world. A two-sun system will be negative for the global economy and trade, and will find itself more often in states of disequilibrium.

China — A Tale of Two Futures

One popular view commonly held in the West and by numerous Chinese citizens after Xi's consolidation of power is that he would steer China back to the days of Marxism-Leninism, where common prosperity will be at the heart of his political ideology—as it ought to be for any communist party leader, they argue.

In my view, as the term common prosperity conjures images of wealth distribution — robbing Peter to pay Paul, or some kind of Robin Hood-ism — where economic development and capitalists would be victims of such an ideological drive, many global investors quickly jumped to the conclusion that President Xi is now targeting entrepreneurs and the rich.

It is worth spelling out that any leader of a communist party or socialist party from time to time must mention in their speeches and writings their views on principles along the lines of common prosperity, suggest ideas on how to achieve it, and/or propose ways to create equal economic opportunities for all. Afterall, that is the genesis of the CCP. Therefore, from Zhao Ziyang to Deng Xiaoping to Jiang Zemin to Hu Jintao, and now Xi Jinping, the term "common prosperity" has been "on their lips and in their ink" for the last 44 years.

Why more and more China observers are postulating that Xi has a different take than his predecessors is perplexing. To shed light on the essence of this issue, I will highlight the key phrases from President Xi's "common prosperity speech" delivered in August 2021 at the 10th meeting of the Central Committee for Financial and Economic Affairs.

> "…To *increase total factor productivity* and reinforce the driving forces for high-quality development, which is the only way to promote common prosperity, and thereby raise the income of urban and rural residents…
>
> …A new round of *technological revolution and industrial transformation* is a powerful driving force for economic development… and income distribution…
>
> …Common prosperity is an essential requirement of socialism and a key feature of Chinese-style modernization. The common prosperity we are pursuing is for all, affluence both in material and spiritual life, but not for a small portion [sic] *nor for uniform egalitarianism*…
>
> …*By the middle of the 21st century*, we will basically achieve common prosperity for all and reduce the income and consumption gaps between urban and rural areas…
>
> …To realize common prosperity, we should adhere to the following principles:
>
> **Encouraging hard work and innovation.** Happiness is achieved through hard work...*common prosperity depends on hard work and wisdom*...give top priority to high-quality development...create more favorable and equitable conditions for the people to receive better education and improve their development capabilities, enhance human capital and professional skills...improve people's abilities to get employed

> and start a business...shape a development environment that provides chances for more people to become wealthy and avoid "involution" and "lying flat".
>
> **Adhering to the basic economic system**...allow a portion of people to become rich first, encourage them to help those still lagging behind and focus on encouraging entrepreneurial individuals who work hard, engage in lawful operations, and have the courage to start their own businesses. We do not advocate becoming rich through side doors…
>
> …A scientific public policy system should be established to *make the "cake" bigger* and form a pattern of equitable distribution for all…
>
> …Even if we become more developed and financially stronger in the future, we should not set excessively high goals and provide excessive guarantees, in order not to fall into the *trap of "welfarism" that encourages laziness*…
>
> *…Higher education graduates* are one important part of those who are expected to enter the middle-income group…Efforts should be stepped up to *train skilled talent*, raise their salaries…
>
> …We must attach importance to the protection of property rights, intellectual property rights and legitimate wealth acquisition, resolutely oppose the unlimited sprawl of capital…and *strengthen anti-monopoly supervision.*
>
> …comprehensively advance rural revitalization, speed up agricultural industrialization, make good use of rural assets and increase farmers' property income, thus helping more rural residents to *acquire wealth through hard work*…efforts should be made to develop rural infrastructure and public service systems…"

To President Xi Jinping's mind, the doctrine of common prosperity is far from wealth redistribution as envisaged by Karl Marx. To him, common prosperity must be achieved by upgrading skills and working hard in a nation that is advancing technologically, and by industrial upgrading. In fact, he warns China against walking down the path of a welfare state and "lying flat". His latest views on common prosperity also resonate with the Zhejiang Plan, the socio-economic blueprint released about 20 months ago.

There is no evidence in Xi's speeches or official documents from which one can deduce that Xi's doctrine of common prosperity is akin to communal economic organization, where you would be issued food vouchers based on the number of people in your household, rather than your contribution in the workplace. This economically egalitarian or "iron rice bowl"

approach was actually tried in Mao's time from 1949 to 1978, with disastrous economic consequences. The ruling elite and elder Chinese citizens still have fresh memories of the hungry days during that period. It is therefore unthinkable to think that Xi and his team have suddenly developed a nostalgia for those hungry egalitarian years. This is not to say that President Xi is not interested in the welfare of the peasants and blue-collar workers. He is, but he will not achieve common prosperity as envisaged by the Western media.

The other view of China, which is probably a minority view today, is that nothing of materiality has changed or will change after the party congress. I think Xi is still the same Xi whom we have gotten to know over the last 10 years; his views on the China Dream, economic development, common prosperity, corruption, property speculation, anti-trust behavior, and so on will remain largely the same. Why should Xi change, when China had done so well during his first two terms? Likewise, his new leadership team had also done exceedingly well, applying a **modernized Marxist model** of socio-economic development. They were promoted on the back of those immensely successful policies and track records, so why should they now change their ways of governance and socio-economic development policies? Have they found superior governance models or new economic development theories? Modern Marxism, or Marxism with Chinese characteristics, as coined by Deng Xiaoping, is dramatically different from the Marxism of old.

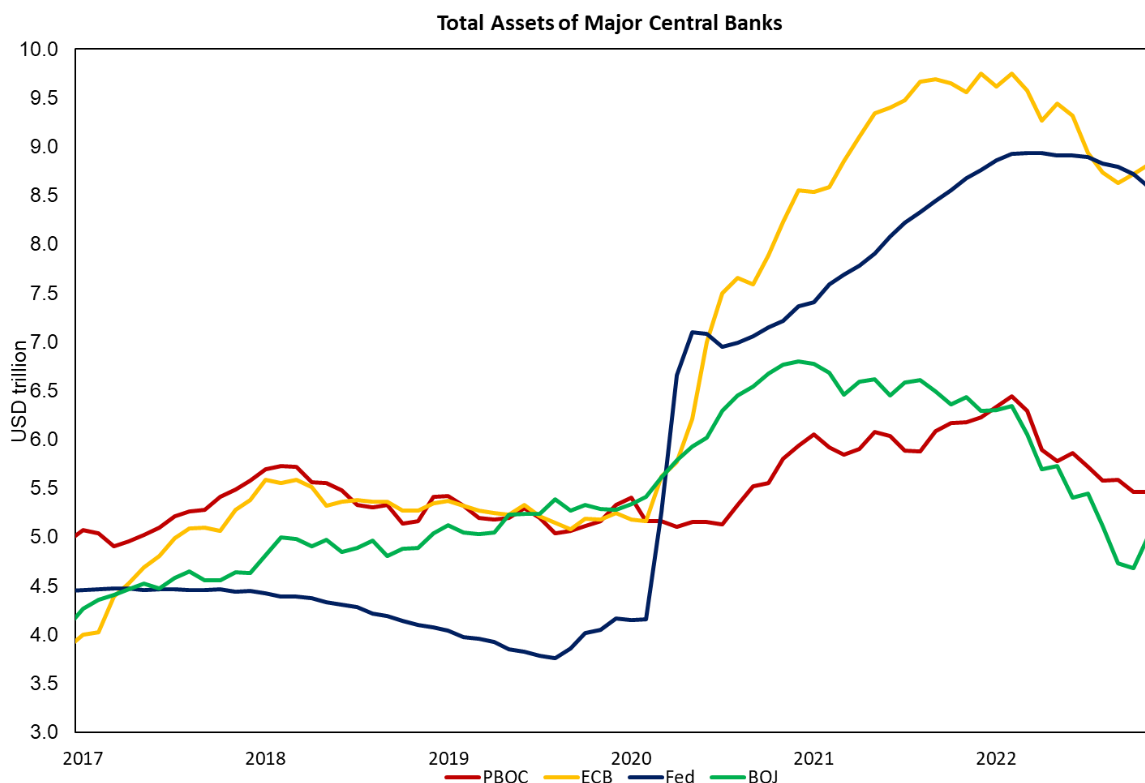
To Xi and his new leadership team, economic achievements will define their success or failure for their upcoming five-year term, both by history and by 1.4 billion Chinese citizens. The average Chinese today still cares much more about bread-and-butter issues than ideologies or whatever "-isms" there might be. Xi and his new team know this and therefore they know that their Number One KPI would still be economic growth. I would be surprised if the GDP target for 2023 would be set at markedly less than 5%.

The BOJ, PBOC, and the Fed — A Tale of Three Central Bankers

A central bank's (CB) monetary policies can have a multi-year impact on a country's economy and financial markets. The Bank of Japan's easy credit in the 1980s is illustrative. Who would have anticipated that five years of easy credit would cripple and debilitate what was at one time the most successful economy in the world, wiping out the equity of every leading bank and for a large part of the last three decades left its real estate market crushed, its equity market decimated, and hundreds of reputable firms bankrupted.

Three decades later, many central banks followed the BOJ's footsteps, albeit for different reasons. The US Federal Reserve's money printing machines in particular went into overdrive during the Covid-19 years, partly to minimize the devastating effects on the economy from the pandemic and perhaps partly to help win elections. The torrent of liquidity that was unleashed pumped almost every asset price to stratospheric levels. Until a year ago, the Fed believed its easy monetary policies would not bring about price inflation. Even when the Consumer Price Index (CPI) started sending ominous signals, Fed Chair Jerome Powell dismissed it as transitory inflation. I'm not sure whether he was influenced by Modern Monetary Theory, but this new theory certainly held sway amongst numerous economists,

investors, and even central bankers. For a short period, headline inflation exceeded many central bank's long-term targets by five to seven percentage points.



Between the Sober and the Others *– The PBOC has been relatively disciplined in its balance sheet management through the Covid-19 period.*

Across the Pacific Ocean, the People's Bank of China (PBOC) had different ideas on quantitative easing. In the autumn of 2020, it unleashed the draconian "three red lines" policy to force the banking system to reduce markedly its lending to the real estate sector, and for the latter to sharply reduce its leverage. Fearing a Minsky Moment rather than China's CPI, the PBOC's unexpected policies caught the developers with their pants down, figuratively speaking. It exposed the major flaw in the business models of the private developers, whereby their projects and survival had depended on easy loans from banks and funds raised from wealth management products. While the PBOC seems to have successfully lessened considerably the systemic risk from a real estate market meltdown, the economy was hit hard. Arguably more than a third of the country's property companies may not survive this onslaught. Even the survivors will be maimed for the foreseeable future. Damage was also done to local governments' fiscal positions. Realizing the cascading effects on the economy, the PBOC recently unleashed its "three arrows" to help the sector, namely to raise funds from the banks, from bond issuance, and from new equity issuance.

Debitio Americana

The late Dr Goh Keng Swee, Singapore's first Finance Minister whose brainchild was also the Government of Singapore Investment Corporation (GIC), issued a prophetic warning as far back as 1992: unlimited currency creation by a central bank to monetize government debt would bring about disastrous economic outcomes. Singapore also had to extend substantial financial aid to those affected by Covid-19 but it did so by drawing on its reserves, rather than turning to its minting machines. What is strange is that the SGD depreciated against the USD, which defies economic logic because Singapore's economic fundamentals and fiscal positions are stronger.

In fact, the mighty USD appreciated against almost every other currency this year despite its mega twin deficits and massive quantitative easing. Its fiscal year 2022 budget deficit of USD1.4 trillion is an astronomical figure, although it had declined by half from the previous year. Its estimated trade deficit for the calendar year of 2022 is close to USD1.0 trillion, which is not a small figure either. On the face of it, America's USD31 trillion national debt can only be repaid with newly minted greenbacks. Clearly, the USD has benefited from its status as the world's dominant reserve currency. The sixty-four-thousand-dollar question is whether investors will continue to hold dollars and dollar assets if the twin deficits and huge debt continue to rise or stay at current levels. I am not a currency analyst, but I think confidence must not be lost, but as soon as confidence is lost, the dollar will go into a long-term decline because investors will have much dollar assets to dump, including US Treasuries with negative real yields. In short, the almighty dollar is resting on confidence rather than on fundamentals.

Liquidity — A Double-Edged Sword

The world has been flush with liquidity over the last five years or longer. Almost every asset class has performed spectacularly in the past decade—equities, private equity, bonds, real estate, commodities, precious metals, energy, and most recently, cryptocurrencies. In the equities market, even junk stocks could soar to billions, loss-making companies had been chased up to USD100 bn in market cap! Although some of those stock prices have corrected this year, the excesses have yet to be flushed out. Meme investing had been worshipped more than fundamental investing. There is no doubt that the main culprit here had been cheap credit in abundance.

Like alcohol, liquidity blurs your mind, gives you false confidence, strengthens your fortitude, jacks up your greed, brings down your guardrails, and makes you part with your monies easily. Cryptocurrency investors are a good illustration of this point. It is clear by now most investors of cryptocurrency plays, including the marquee names, did not quite know what they had bought, were clueless about what kind of people own and run those plays, had no idea how those companies made their money, and what the embedded risks were. Few figured out why a new, unproven crypto company can be worth tens of billion dollars in a few short years.

Meme investing is another classic example of how investors with too much easy money play the "stock market". There are many more such excesses if one cares to look for them.

Cheap credit also encourages corporates and individuals to borrow to enhance their investment returns. For instance, Real Estate Investment Trusts use leverage to increase their returns. For many years, leveraged investments — when you were borrowing at costs close to zero — made sense, but with interest rates rising more than 400 basis points in less than a year and still rising, many will now pay the price.

Liquidity is like steroids. When you inject plenty of it into the system, you can boost muscle growth spectacularly. However, when you stop injecting the steroids after prolonged use, the entire body breaks down alarmingly.

Hard Truth Comes Home to Roost

In our January 2021 curtain raiser, "Hard Truths for 2021", we warned that China's e-commerce stocks are more bubble than magic, with a business model that is simply: Raise jumbo capital regularly, increase top-line growth prodigiously by selling at prices depressed by unstinting subsidies, reward your staff fulsomely with share-based compensation, rev up your investors with stories, your stock price surges, then you and your staff cash in.

I added,

> "(Investors awash in liquidity, but not savvy about the dynamics of the business, piled into the stock of companies like) Pinduoduo (PDD) and JD.com that operate in China, as well as Singapore-headquartered Sea Ltd. They are all run by current and former Chinese nationals. Sea Ltd. has never made a profit since inception and had made a loss of USD1.0 bn to USD1.4 bn a year for three straight years. This is due to huge losses in its e-commerce business, despite a profitable gaming business. Towards the end of 2020, its market capitalization of around USD100 bn at the time had surpassed that of the *combined* valuation of a quintet of iconic Singapore companies – OCBC (USD34 bn), Singtel (USD29 bn), Keppel Corp (USD7.5 bn), CapitaLand (USD13 bn), and Singapore Airlines (USD10 bn). Were investors at that point in time right to value the company thus, when it had yet, and still has yet, to earn a single dollar? Has any shareholder or even senior management figured out if such companies will make profits?"

The company lost USD2.0 bn last year and will lose a record USD2.5 bn this year! Shockingly, Sea founder Forrest Li has yet to publicly share a concrete timeline for profitability and had admitted that he did not know when, despite being asked repeatedly and while burning through billions of shareholder funds a year. Yet many investor convictions remained

rock solid, as if success is pre-ordained if a stock's popularity and media exposure are high enough for long enough.

The stock's gravity-defying rise could be attributed to liquidity-flushed investors willing to part with their money for a company which has a business model that defies business logic. Some investors realised their mistake, and rushed for the exits. The majority are hoping that the goose that has taken a dump all over them will soon lay "The Golden Egg".

Internet Stocks — Two Eras, Two Realities

Offshore China funds and hedge funds are still huge holders of internet stocks such as Alibaba, JD, PDD, Tencent, and Meituan, etc. Even high net worth investors are big holders because their private bankers had recommended those stocks. Top foreign securities companies have dedicated their best research talent to cover them. Media companies, big and small, have also covered the stocks regularly.

Many investors and analysts have argued in the past year that these internet stocks are undervalued and cheap, as stock prices had declined by more than half. They also argued that business will return to the good old days because regulators have gone gentle on them as the economy slows; if you think regulators have yet to soften, then they soon will, the argument goes.

Internet stocks are big components of the index and hence investors cannot afford to get them wrong.

First, labelling internet stocks as tech stocks is arguably the biggest bluff of the past decade because there is nothing "techie" at all about them. Most of these businesses, be it e-commerce, food delivery, video games, car sharing, or fintech, have low entry barriers. Any new aspirant with capital can start the business within a year! It is so true in the e-commerce industry, where new entrants such as Meituan, Douyin, and Kuaishou have already become worthy and formidable rivals to the incumbents within two years.

Let us peek into their future. I will use e-commerce stocks as an illustration.

To better understand their prospects, it is best to break their timeline into two: 2014 to 2020 and 2021 onwards.

The 2014-2020 period can be classified as a super-high growth period, as the e-commerce sector took market share from the offline (brick-and-mortar) stores by selling at losses and in the process burnt billions of dollars of capital. Losses and stratospheric valuations were explained away by companies and analysts as such: profits would be sloshing in, as soon as they enjoy economies of scale and operating leverage. Instead, most companies raised billions of dollars of fresh capital whenever they detected signs of willingness on the part of investors to part with their monies. Naturally, the investment banks helped to oil the process. For investors, as long as stock prices were rising, they were willing to take up the private placements. Even as recent as two years ago, placements were 5-10 times oversubscribed, at close-to-peak share prices.

The first period, which I call the golden period of China e-commerce, was from 2014 to 2020. During this golden period, e-commerce companies could practically do what they wanted. The regulators were not really regulating or watching them. Regulations on antitrust behavior were nascent and murky. The lax labor laws for blue collar workers allowed e-commerce companies to exploit contract and gig workers, by paying low wages for very long working hours, very little paid annual leave, as well as very minimal to non-existent medical, pension, and other social benefits like housing and so on. The ruthless pricing wars forced many of China's six million mom and pop stores out of business. Initially, the market structure in this space was a duopoly between Alibaba and JD.com, which became a triopoly when PDD entered the fray, with thousands of much smaller e-commerce companies making up a long tail. And then the shift from offline shopping to online shopping led to explosive growth, which is why we call it the golden period, where all e-commerce companies big and small were able to raise billions of dollars of capital to burn because during this period, especially during the first part of the golden period. Most of them, burning billions of dollars, sold products below cost or at very low margins in order to build up their brands and market shares. Investors liked the China e-commerce story and therefore were willing to give companies billions of dollars of capital. Share prices skyrocketed, and a good many founders became multi-billionaires and their senior management staff became multi-millionaires. As a result, their companies were valued at "super growth stock" valuations. Or maybe "super bubble" valuations is more accurate. This defined the first of two periods for China's e-commerce stocks.

The second period is the onset of what promises to be a long, dark winter, from 2020 to today. Regulators have now set the out-of-bounds lines very clearly. They will root out antitrust behavior and violators will be fined heavily, with Alibaba's regulatory woes from two years ago serving as an example. Ant Financial is likely to have its turn soon. Selling below cost is strictly not allowed and blue-collar workers must be provided with adequate medical, pension, and social benefits. These costs have only just started to kick in and will account for about 20% of wage costs. These costs could not have come at a worse time because China's e-commerce markets have reached very high penetration rates countrywide. Major e-commerce companies with 700 million to 800 million active subscribers are unable to make further increases, and therefore topline growth has slowed down significantly. The result is that from this year onwards, many have started to cut costs by retrenching staff for two to three rounds and shut down unprofitable businesses.

Instead of enjoying operating leverage and producing cash flows for shareholders in the last two years, profits had been under tremendous pressure. Valuations must reset from growth stock valuations to matured stock valuations. A good number of these valuations ought not to exceed that of telecom operators like China Mobile or the major banks, whose P/E multiples are in the 5x-8x range. For e-commerce companies, because their ROAs have been inferior and will continue to be very low, they see lower multiples going forward.

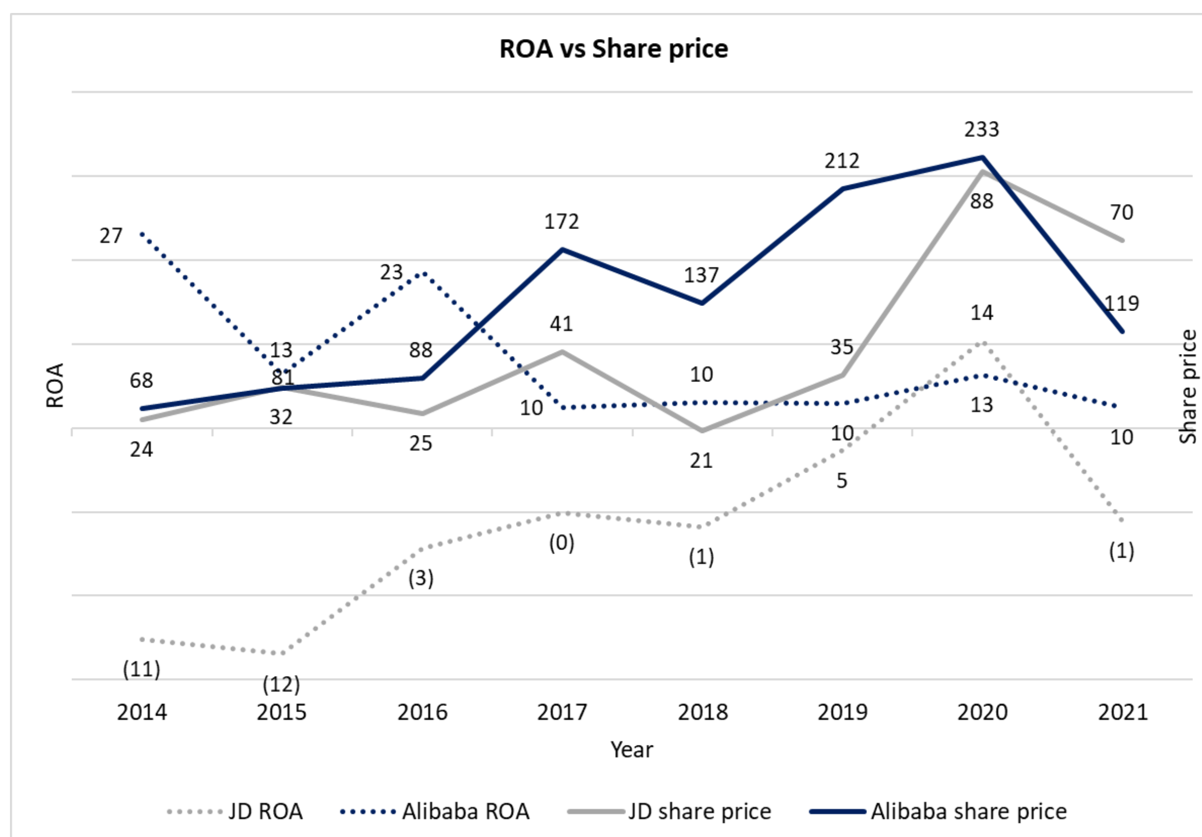
Investors' obsession with internet stocks is still strong. In the past month or so, euphoria seemed to have returned to these stocks, for the wrong reasons, in my view. One reason is that investors and analysts are seeing positive signs in Q3 results. They are also

expecting easing travel restrictions to spur increased online shopping. But this easing should be a negative for online shopping, as manifested in many other countries. After lockdowns are removed, ironically, the Chinese are scared of leaving their homes because of fears of infection. Therefore, in the very short term of two to three months, perhaps online shopping may continue as before, after which it will likely be negatively impacted.

Q3 results are a mixed bag, showing more concerns than positives. Let me explain. Alibaba showed a pretax profit of USD4.8 bn but a GAAP loss of USD3.0 bn. Investors should be worried that the company might have entered the ex-growth phase as revenue was largely flat. On the surface, its old arch-rival JD seemed to have done much better, but the reality is different. It reported a GAAP profit of USD870 million, but if the investment losses of its two key subsidiaries had been taken into account, it would have made a loss of USD5.8 bn!

Although accounting standards do not require JD to include the valuation losses because it owns a majority, nonetheless, the losses were humongous, which should be noted. What surprised most investors is PDD's sterling results. Revenue rose 65% and GAAP profits soared to USD1.5 bn. How is this possible when its competitors struggled in a soft market? On further investigation, we found out that the company had unilaterally compensated customers whenever they complained and charged the merchants. Customers did not have to give the reasons for their complaints, and also did not have to return the "defective" products. In the entire process, merchants were not consulted. As a result, "opportunists" exploited this policy and could take products for "free". This naturally infuriated the merchants, who are seeking legal advice. Lawyers have opined that this violated existing laws. It is interesting to see how this will play out for PDD in the coming weeks. Meanwhile, the stock price had doubled in the last two months and tripled from its low in March!

Various analysts have used various metrics to assess the business performance of e-commerce companies and also to make comparisons amongst them. Valuation metrics are very confusing for investors because analysts started off using price to Gross Merchandise Value ratios to value them because they were all loss making, then they moved to PEG ratios, then P/E ratios, and they also looked at the P/E bands to make judgments on whether an e-commerce stock is expensive or cheap. In my view, ROA, or Return on Assets, is probably the best metric to measure the performance of e-commerce businesses. Amongst the three major e-commerce companies — Alibaba, JD, and PDD — only Alibaba has made an ROA of about 10%, whereas JD has earned very low ROA except for the year JD Logistics and JD Health were listed. PDD made profits that may not be sustainable. They have deployed capital very poorly throughout the golden period as well as the ongoing "winter". Alibaba's profits have declined and will likely continue to decline because they are now no longer able to make monopolistic profits because of regulatory controls.



Investors in the stocks of the three leading Chinese e-commerce players need to face up to these three critical issues:

I. Alibaba

1) How will the erosion of monopolistic profits of both the e-commerce business and Ant Financial hurt Alibaba's future profits?

2) How can Alibaba use its overall strength – management team, strong foundations, brand, and scale – to fend off ferocious competition from the other two incumbents as well as the trio of newcomers Meituan, Douyin, and Kuaishou?

3) How much to pay for the stock when ROE will likely decline below 10%, while profits will also likely weaken in the years ahead?

II. JD.com

1) How will the return of Richard Liu for the third time affect the morale of the CEO and senior management staff after a 15% to 20% pay cut? We had pointed out the high attrition rate of JD's senior management staff in our 2016 paper "JD.com – Don't be Fooled by Shiny GMV", and this will likely remain an issue. So going forward, the retention of capable senior management staff will likely be another major challenge for the company.

2) How Richard Liu's new strategy of low price, high-quality products, to strengthen its image as a low-price retailer, affect future profitability?

3) How much do you pay for a very-low-single-digit ROA company?

III. Pinduoduo

1) Will angry small-and-medium-sized merchants respond to PDD's bullying tactics by banding together to take legal action against the company? Or will they abandon PDD's platform for other platforms?

2) How much will Temu, its new international business, lose over the next three years?

3) How much to pay for a company that is likely to see a large drop in profits over the next three or four quarters? PDD's CEO and CFO had repeatedly warned investors about this possibility.

Two Regulators, Two Dreams

Investors seemed to have believed that the ADR issue is resolved after the CSRC and PCAOB signed an agreement on August 26th. The reality is far from that perception. Let me explain. Firstly, the agreement was signed just a couple of hours before the PCAOB left for home, implying that many significant differences were not bridged despite signing an agreement. Secondly, the first point becomes clear when one analyses the viewpoints expressed by the regulators after the Agreement was signed. PCAOB had stated that it needs to have direct access to full audit papers and conduct its audit verification independently, but CSRC takes the position that all requested information must be obtained through them, and onsite audit verification work be conducted in the presence of their officials. PCAOB Chair Erica Y. Williams emphasized that "On paper, the agreement signed today grants the PCAOB complete access to the audit work papers, audit personnel, and other information we need to inspect and investigate any firm we choose, with no loopholes and no exceptions. But the real test will be whether the words agreed to on paper translate into complete access in practice."

Another major issue for the CSRC may be sensitive information in audit working papers? According to the CSRC, sensitive information such as personal data, client data, and business secrets should be protected, whilst the PCAOB argues that it has the right to "review, retain and share with the SEC" even "restricted data", because of the requirement that the audit working papers be "comprehensive, complete, and uncensored."

In my view, this thorny issue will not be easy to resolve and may not be resolved at all for many companies. It is therefore not surprising that both regulators have officially stated that the Agreement was only a first step towards the resolution of a complex issue, after numerous failed negotiations between the two sides for more than a decade!

In my view, ADR investors would benefit considerably if both regulators had discussed and agreed on the corporate governance and accounting issues that have afflicted so many

ADR companies for the last two decades. Truth be told, ADR companies have been very lightly regulated, if regulated at all. Many of those companies have accounting issues and some have serious corporate governance issues. Some have misled investors by making big claims that have no basis and have yet to be held accountable, when nothing has been done to achieve those claims. If anything was done, it was making yet another big claim. Sadly, politics seemed to have stood in the way of the noble intention of protecting the interests of minority shareholders.

We Have Only Just Begun

Investors must learn from Japan's experience and not underestimate the devastating effects of monetary tightening on asset prices, on how negative wealth effects will cascade down to consumer spending, and eventually to the overall economy, sparking a host of other problems within a year or so. In my view, investors must think hard about how the likely unravelling of excesses in 2023 will affect their portfolios. That said, some upbeat investors are already predicting the end of this adjustment and downdrift. My bet is that we are merely at the beginning, rather than at the end, of this cycle.

Wong Kok Hoi is the Founder and CIO of APS Asset Management. He has 41 years of investment experience, including CIO at Cititrust Japan, Senior PM at Citibank HK, and Senior Investment Officer of GIC. He was the recipient of the Monbusho Scholarship in Japan and graduated with a Bachelor of Commerce degree from the Hitotsubashi University (1981). Mr. Wong also completed the Investment Appraisal and Management Program at Harvard University (1990). Mr. Wong is a CFA charter holder.

IMPORTANT NOTICE: The views expressed in this article are solely those of the author in his private capacity and do not in any way represent the views of APS Asset Management Pte Ltd. This Publication is strictly for information and does not have regard to the specific objectives, financial situation and particular needs of any specific person. It is not, and should not be construed as, an offer or invitation to offer, whatsoever, to enter into any dealing of securities. Nothing contained herein constitutes investment advice and should not be relied upon as such. Past performance of the securities and any forecasts made or opinions expressed on the economy, stock market or economic trends of the markets are definitely not indicative of future or likely performance or any guarantee of returns. APS accepts no liability and responsibility, whatsoever, for any direct or consequential loss arising from any use of or reliance on this Publication. While APS believes the information for the Publication, which is based on certain assumptions, conditions and facts available, to be reliable, this Publication is provided on an "as is" and "as available" basis subject to change, of whatsoever form and nature, at any time without notice. **This advertisement has not been reviewed by the Monetary Authority of Singapore.** APS has not independently verified and does not make any representation or warranty as to the accuracy, adequacy, completeness, reasonableness or truth of the Publication. Distribution of this Publication to any person other than the recipient and its adviser(s) is unauthorized and any reproduction of the Publication, in whole or in part, or the disclosure of any of the contents, in each such instance is strictly prohibited.

APS, the CIO, or their connected or associated persons may directly or indirectly have interest in the acquisition or disposal of the securities. Neither APS, the CIO, nor their connected or associated persons have any interest in any corporate finance advisory relationship with the issuer or make a market in the securities. APS and the CIO do not receive any compensation, whether directly or indirectly, related to the specific views expressed in this Publication.

APS and its officers may cause certain funds which are managed or advised by APS to take positions in the securities mentioned in this Publication. APS has in place policies to mitigate potential conflicts of interests that may arise in connection with the production of this Publication.