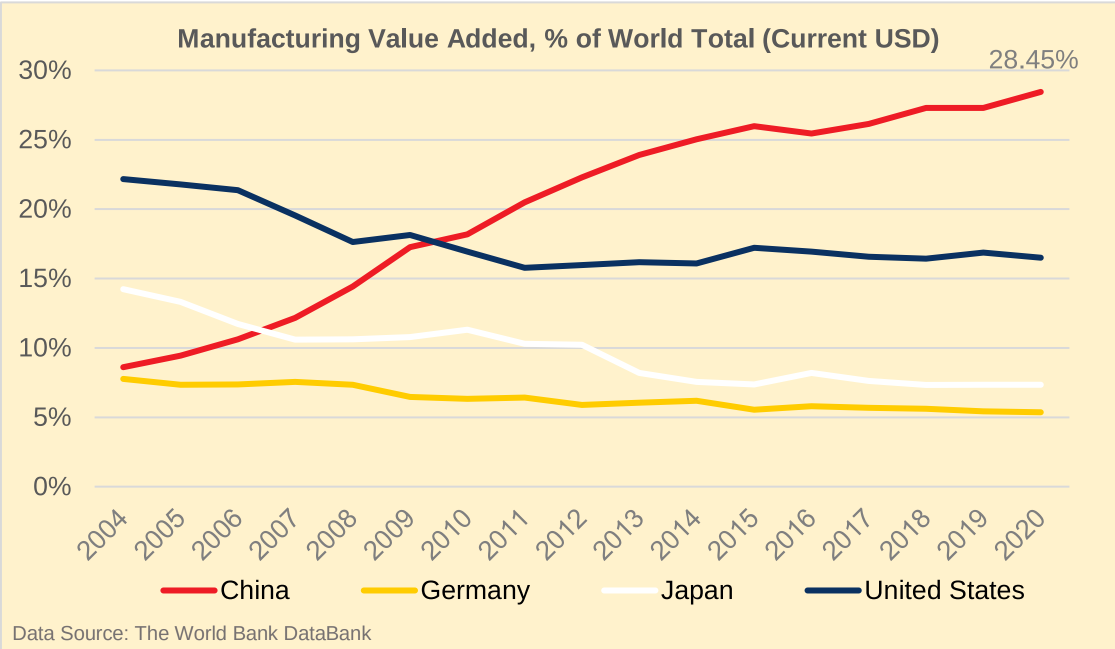
CHINA MONTHLY

JULY 2023

The Big Picture



China has built nearly a third of the world's manufacturing capacity, with value added equivalent to the next three largest countries combined.

THE BRIEFING

Blinken Upholds "One China" Policy

In a meeting between President Xi Jinping and US Secretary of State Antony Blinken in Beijing, Blinken said the US held a "One China" policy and told Chinese officials the US was not attempting to "contain" China's economic growth but is trying to guard "specific technologies" critical to national security. State Department officials noted that Blinken had made it very clear that the US does not want to decouple from China.

Li Qiang Visits France, Germany

In Li Qiang's first overseas visit as China's Premier, Li stressed that China will continue to open up and improve its business environment, and called on China and Europe to rise above differences. Li visited German companies in Bavaria, saying, "We don't think it's risky to drive in a Volkswagen, nor do we think it's unsafe to get a CT by Siemens equipment. We never regard these as risks, and China never means to "de-risk" from them."

Buoyant But Slower Dragon Boat Festival Domestic Tourism

Leisure trips in China during the three-day Dragon Boat Festival in June climbed 32.3% from a year ago to around 106 million, 12.8% above the pre-pandemic 2019 level. However, spending was soft, with average spending per trip about 16% lower than in 2019. This may imply either a weaker intention to spend or less purchasing power.

PBOC Cuts Two Key Rates After 10-month Pause

The People's Bank of China cut two more key lending rates for the first time in 10 months to prop up growth, trimming the one-year loan prime rate by 10 basis points from 3.65% to 3.55%, and pruning the five-year loan prime rate by 10 basis points from 4.3% to 4.2%. Most household and corporate loans in China are based on the PBOC's one-year loan prime rate, while mortgages are pegged to the five-year rate.

Old Friend

Bill Gates met President Xi Jinping in Beijing in June, his first known one-on-one meeting with a Western business figure in years, and Gates' first trip to the capital since 2019. Xi called on Gates to help promote US-China relations, greeting the tech tycoon warmly. "I am very happy to see you. We haven't seen each other for more than three years…and you are an old friend of ours." Xi went on to tell Gates that he was "the first American friend I've seen this year…I always believe that the foundation of the US-China relationship is in the people. I am placing my hope in the American people." Microsoft has a long history in China, having entered the market in 1992. Its software is widely used by the Chinese government and companies, and its Bing search engine is also accessible, while Google has been cut out for years.

THE 8 MYTHS OF CHINA INVESTING

By Wong Kok Hoi

When you stay long enough in your job or spend enough time in your house, you will surely find things strange and outlandish. When it comes to household affairs, only foolish men would suggest to their wife how things can be done better or done differently.

When it comes to investing, it is a separate matter; you should probe, ask why and be critical, because there might be opportunities for you to capitalize on. Be that as it may, I would like to share with you some of the things in the markets that I find baffling, some that I find amusing, and some that I find distasteful.

I have titled this essay: "The 8 Myths of China Investing". A tad strong perhaps?

Myth Number 1 — Common Prosperity is Wealth Redistribution

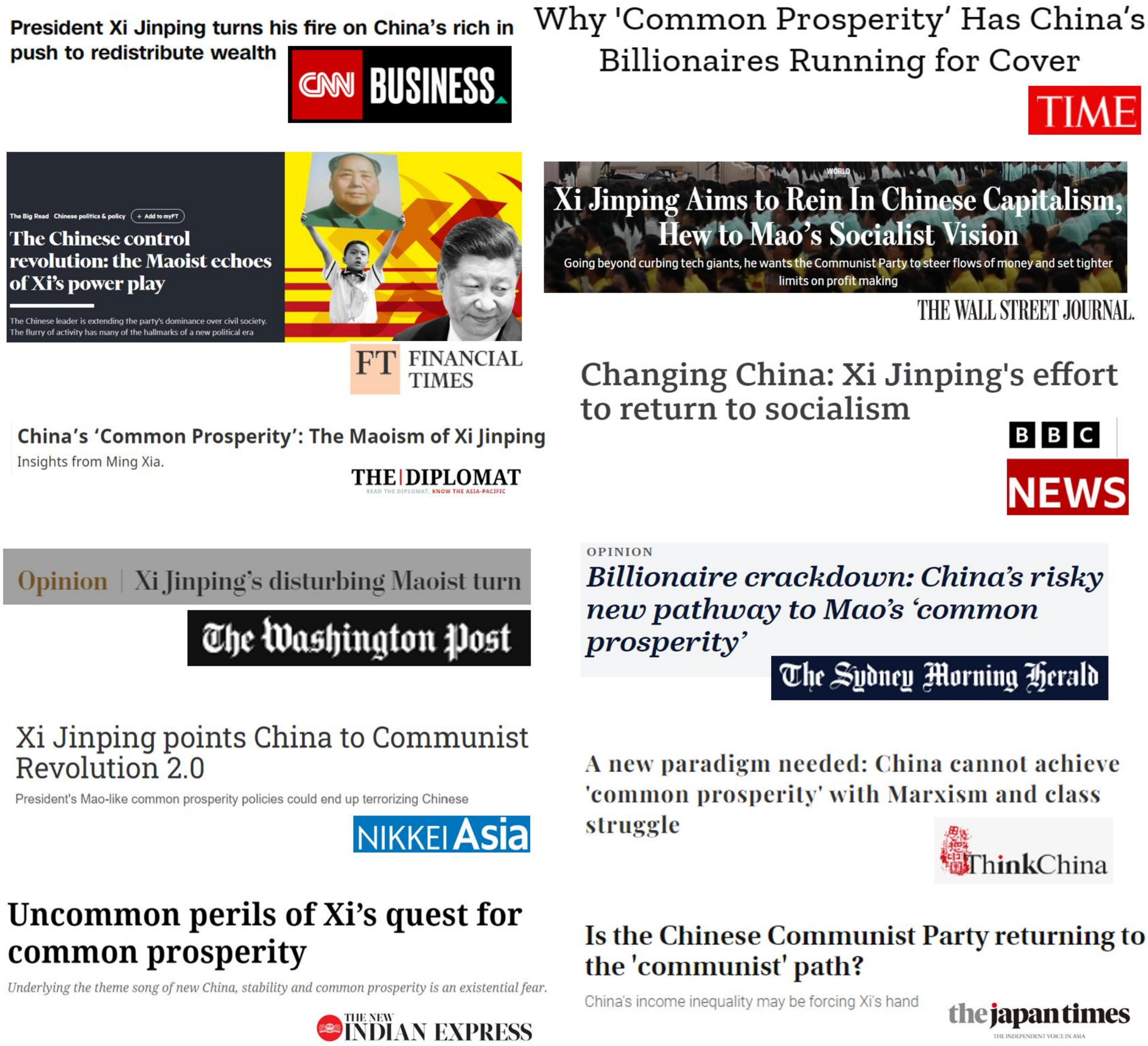
In the last two years, two words have caused immense confusion, anxiety, and grief amongst investors. The two mysterious words are "common prosperity", which attracted countless interpretations after they appeared in the title of an ambitious socio-economic blueprint, "The Zhejiang High Growth and Common Prosperity Plan" in June 2021.

For weeks, the mainstream media engaged in rigorous debates about what the future holds for China. Many of the conclusions were most preposterous, so crazy that it prompted me to write a note, titled, "Common Prosperity or Common Poverty", which you can find in my book "Annals of an Asian Investor".

This year, news coverage is again focusing on nagging suspicions that President Xi Jinping is intent on steering China back to his nostalgic days of Maoism or Marxism. It just never seems to go away.

The last straw for the China skeptics and China bears was the conclusion of the 20th Party Congress when six and a half of the 7-strong Politburo Standing Committee picked were deemed Xi's men. Even long-time China bulls like Stephen Roach turned negative.

Let us refresh ourselves on the titles used in English-language media articles at that time. I could list many more scary titles and assessments if I care to do so.



The strange thing is that there was almost no evidence in the last two years that President Xi is China's modern-day Robin Hood. Taxes on high-income earners were not increased, and a wealth tax and property tax were not introduced. Even if taxes were increased by 20%-30%, China taxes would still be lower than many capitalist countries. Apart from announcements of donations by three listed companies, I have not heard of any billionaire making any sizable personal donation, though that would not be the worst thing in the world.

What is the Zhejiang Plan? It is a 104,000-word document organized into nine categories covering 118 policy objectives.

The essence of it is to develop a globally competitive technologically advanced economy, create a harmonious, stable and happy society, protect and preserve a green and sustainable ecological environment, build a corruption-free and people-centered political system, correct the dislocations and excesses in the economy, as well as minimize systemic risk.

The two scary words "common prosperity" appears only six times in the lengthy document.

Think for a minute. Do you need a 104,000-word Plan to enact a Robin Hood program of taxing the rich to subsidize the poor, and to exhort your citizens to do philanthropy or more philanthropy? A three-page document should suffice. It is more of a plan to build more Huaweis, SMICs, Xiaomis, Venustechs, BYDs, and Geovises, as well as companies in other fields that will rise to become global leaders.

Having read both documents in Mandarin and English, I am confident enough to call it a Grand Vision or Grand Plan – a plan many, many times more ambitious than the Made in China 2025 Plan, probably a super-ambitious plan never attempted in the past or at least in recent history.

President Xi wants to create a larger pie to help poorer citizens, a pie with many more toppings of science and technology, creativity, innovation, etc. The failed experiment of Marxism over the four decades from 1949 is not lost on the Party, the government, and the Chinese citizenry.

Around the time the Zhejiang Plan was unveiled, many stock market shattering events took place, giving investors the impression that there had been a common thread running through them.

The seemingly ferocious, unrelenting, and high-profile attack on Ant Financial, after-school tuition, online gaming, Macau junket operators, and property developers, as well as their associated tycoons, media personalities, and so on, gave investors the impression that Xi has turned against capitalism. As far as I can tell, the causes that led to the precipitation of those five key events were rather disparate.

If there was a common thread, it was a reaction to excesses built up over many, many years.

The excesses were evident for all those who cared to see. And we had written on numerous occasions about the excesses, abuses and business improprieties in China's e-commerce industry, the Macau gaming concession retendering risk, VIE risk, and so on. Investors in liquidity-driven bull markets in particular, tend to ignore business excesses and their attendant risks. The chickens had finally come home to roost.

It is unthinkable to think that China now wants to abandon a system which combines the best elements of socialism and capitalism, that has brought phenomenal success and prosperity to the country and its 1.4 billion people in the last four decades – a feat probably unmatched in Chinese history.

One question is still left unanswered. Why was the term common prosperity used in a socio-economic Plan, when it is about building an ultra-modern 21st century China?

I think Chinese policymakers must have been worried that the Plan would alarm the Americans again, as the Made in China 2025 Plan did. It had caused many of their industries trouble, anguish, and misery.

Not long after the Made in China 2025 Plan was revealed, the US started to impose technology bans on Chinese companies one after another, launched a trade tariff war against their exports, ban some companies from selling in the US market, shut the doors of their top engineering colleges to Chinese students and so on.

Mind you, the Zhejiang Plan is many, many times more ambitious. In my opinion, the term could well be a red herring, cleverly designed to distract and deflect attention from China's long-term ambition.

If my supposition is correct, then this must be the "Bluff of the Decade". The market anxiety over whether CP takes Xi's China too far to the left is overdone. It is, to quote Shakespeare, "Much Ado About Nothing".

Myth Number 2 — The CCP is on an Anti-Capitalism Crusade

There had been much speculation about Jack Ma's 1-year disappearance from the public eye. Many had believed he left China because he was the natural Number One target of the CCP's crusade against the rich. This belief was based on widespread perceptions of the CP doctrine – that all citizens must be equally rich or equally poor, from birth, throughout their lives, until death – the Communist ideal of one class of people.

But the CCP since 1978 has been nothing but pragmatic, realistic, and business minded.

Many Chinese believe in Taoism's 财神爷, the Money God. And the typical Chinese New Year greeting is 新年快乐，恭喜发财. 恭喜发财 which literally means "congratulations on getting rich".

Deng had once said to get rich is glorious and almost every Chinese today wants to get rich. It might not be an exaggeration to assert that this is the single biggest factor behind China's 40-year 10% annual GDP growth rate.

In January 2023, when Jack Ma relinquished control of Ant Financial, the market was even more adamant that this regulatory move was another attempt to neutralize or clip the wings of Jack Ma.

Is that so?

Investors should ask this question: "Why should a shareholder owning 10% of a company be allowed to hold more than 50% of the voting rights?"

"Isn't the dual class share structure common in the internet industry an unhealthy deviation from the norm and bad corporate governance?"

In the case of Ant Financial, Jack Ma can have the ultimate say in the appointment of directors, and via his directors has the final say in the company's all-important matters.

Indeed, it actually happened in 2011. You may remember Jack Ma transferred Alipay to a company he controlled, without informing minority shareholders. He was subsequently sued by Yahoo and Softbank, and had to settle the suit at a cost of several billion dollars.

Some of the speculations about Jack Ma being targeted by the government have largely died down after his return in March. But the China skeptics still ask: "Wasn't the IPO of Ant Financial cancelled at the eleventh hour because the government had turned against capitalism and used his speech at the Bund Summit in Shanghai 2 ½ years ago as an excuse to punish him and cancelled his IPO?" Some still believe the IPO would have gone ahead if Jack Ma wasn't a billionaire businessman.

The party cadres and regulators present at the Bund Summit might have been offended by his harsh remarks, but I think the IPO was cancelled for the following three major reasons:

1. High interest rates of 30%-40% charged on its customers. The regulators must have been horrified to learn about the loan-shark rates in the IPO prospectus and must have decided there and then that it must be stopped;
2. Ant's capital adequacy ratio was appallingly low, less than 3% and hence the fear of systemic risk must have also worried the regulators;
3. Jack Ma's personal friends, including government officials and figures in the entertainment world, were pre-allocated the IPO shares, which infuriated the regulators.

Some may still argue that there had been numerous wealthy businessmen arrested and put behind bars because this government is anti-capitalism, anti-entrepreneurs, anti-private sector and so on.

Many of my Chinese business friends had told me that that they had to oil the wheels of the system in the past to buy state assets at their prices, obtain licenses ahead of their rivals, secure projects from government entities and SOEs, etc.

They admitted that whilst they yearn for the free wheeling and dealing years of former President Jiang Zemin's era, they conceded that President Xi and his team are doing the right things for China by tackling the excesses and improprieties.

The fact that Jack Ma returned to China safely in March showed that he had not been on the CCP's wanted list. Of course, we do not really know. But even if he were on the list, he must have been at the bottom of the list.

Myth Number 3 — Internet Companies are Tech Companies

It is absurd that internet companies are called tech companies when their business has little technological content, limited R&D spend, low entry barriers, earn low returns on capital, and must always face intense competition.

E-commerce companies come to mind. Selling 3C products, household appliances, apparel, groceries, and cosmetics via online platforms is merely a new format of selling and is hardly a techie business at all. For example, you cannot differentiate your products. You sell if you offer the lowest price.

Alibaba and JD have been losing customers and business to Douyin, Kuaishou, and Pinduoduo in the past year because the latter all sell at lower prices. To regain lost market share, JD announced a 10-billion-yuan subsidy program three months ago. Do real tech companies need to resort to such tactics to sell? The recent June 18 (6.18) e-commerce sales festival saw a ferocious price war.

There is also nothing novel or techie about express delivery either. What is needed is just a 3-wheeler and a delivery man to do the job. For example, PDD has barely invested in building any online platforms or warehouses, for its operating assets were a mere USD360 million in 2022. Investors had at one time valued it at USD250 bn.

Is it a surprise that the dominant player Alibaba had lost 34% market share in seven years when new players such as PDD, Douyin, and Kuaishou challenged its dominant market share?

Why then are e-commerce companies and other internet companies called tech companies? Is it an invention of the investment bankers or the companies themselves to get a richer valuation? I don't know. As an investor who has analyzed their business models quite thoroughly, I can tell you that there is nothing techie about them. Is it a surprise that investors lost a trillion dollars in the last two years?

Myth Number 4 — Beating Your Own Guidance Yet Again Shows Management Ability

Some companies have consistently beaten guidance, as if they had crystal balls and were super businessmen. I was impressed initially, but I soon found out they had resorted to a cheap trick.

What they would do is to provide analysts with a new guidance after the quarter had ended, which was a preview of the quarter's results. By then, the company's CFO would have known – possibly to the last decimal place – the actual results, and then marked down the numbers by a couple of percent.

How is it possible not to beat guidance?

When the company hosted the earnings call, they would proudly declare to investors that they had beaten guidance yet again. A standard commentary runs something like this:

"We're very pleased to report a solid second quarter with strong results across all key metrics. Our net revenues **exceeded the upper end of our guidance**…"

- Standard Management Ploy

"Hi, thanks management for taking my questions and congratulations on a very strong set of results."

- Typical Sell-side Analyst Bow

When you next read in the newspapers that a company has beaten guidance or consensus forecast, don't jump into the stock.

Myth Number 5 — China ADRs are Safer Than A Shares

There is scant evidence that China ADRs are safer than China A shares.

Please let me give you some of the facts and you can decide for yourself.

1. Most ADRs are structured as VIEs, which at best are greyish legally, and at worst, are outright illegal.

   I do not see this risk priced in at all.

2. Neither the SEC nor CSRC really regulate the ADRs.

   For the first time in 20 years, the Public Company Accounting Oversight Board (PCAOB) last year checked the audited notes of just five ADR companies, one company every four years on average!

3. Many ADRs had made the most outlandish statements to mislead investors and have gotten away without their knuckles even being rapped.

   JD for instance declared in 2017 that it would build a million convenience stores over five years and be profitable from day one. Six years have passed but I am not even sure if they have built 1% of their target. Believe it or not, China ADRs have had the best honeymoon in the last 20 years because they are barely regulated.

4. How many US investors will regularly visit China and make onsite visits and grill senior management?

Relying on public information and sell-side research reports is helpful up to a point. In my experience, many ADRs often move on concepts, stories, and rumors. China's Luckin Coffee is one example. The accounting fraud was exposed by a short seller. Dingdong Maicai (叮咚买菜), a fresh food community group buying company, crashed 90% within 18 months of its IPO.

Why should you think that your investments are safe when you do not conduct your deep fundamental research?

Myth Number 6 — Long-term Investing Does Not Work in China

Intuitively, this myth seems logical because the market is driven by short-term trading, which in turn is often driven by stories, rumors, and unpredictable investor sentiment. Adherents of this myth believe that only fools would do deep fundamental research, construct 10-year earnings models or DCF models, when the stock price will be swayed by the next rumor or next quarter's earnings.

Believe it or not, several founders of companies had even told me they are surprised that APS would hold their stock for so many years.

My belief is that the consequence of chasing short-term performance is underperformance for both the short-term and over the long-term. When you chase a popular stock, you will have to pay the market price but when you buy an unpopular stock, you buy at your price.

Alpha is a zero-sum game anyway, and if most market players are short-term traders, by definition, as a group they must underperform. Short-term trading does give one lots of thrill and if it can be rewarded with alphas, I will dump my current investment process and go for the thrill and alphas even if the alphas are small.

But the real investing world is not so sweet.

We have invested in China for 20 years. What is our experience? During that period, our annualized alpha was 7%. Twenty years may not be long enough to postulate anything earth shattering to win a Nobel prize, but for now, I have no doubt long-term investing works wonderfully in China. And I will lose sleep if one day short-term traders vanish from the markets.

Myth Number 7— China is Not Investable

Long-time observers must have noted that China has been called out as uninvestable for at least a dozen times in the past two decades. Different reasons had been cited at different times.

Some of the common ones were an economic implosion, a banking crisis, a debt crisis, a real estate collapse, a massive yuan devaluation, a power struggle leading to civil war and social chaos and so on and so forth. George Soros and Kyle Bass had predicted that both the economy and the market would crash several times in the past. Such doomsayers were joined by George Yang of Anatole Investments last year.

At the other end of the spectrum, Henry Kissinger, Ray Dalio, George Yeo, and Kishore Mahbubani have called China's economic success and modernization as the single biggest event of modern times.

In the last two years, scaremongers have cited Xi's common prosperity doctrine as their principal reason for their fears, although there has been almost no evidence thus far that common prosperity is about wealth distribution, anti-capitalism, or an encore of Marxist-Leninist extremism. Taxes on the wealthy had not been increased, either by a wealth tax or higher personal income tax rates.

What are my views? Dr Teh Kok Peng in his foreword for my book warned that forecasting is a risky business. He quoted an Arab proverb: "He who foretells the future lies, even if he speaks the truth."

Nonetheless, I would venture this: China's current macro conditions and growth potential are not worse off than those in the developed economies. Its GDP can still grow at 5% a year for the next five years. More importantly, we can still find companies growing by 30% a year for the next 5-10 years. By the end of this decade, China's GDP will likely surpass America's. The valuation of the broader market is a modest 13 times earnings. Liquidity is ample. I also like the fact that investor sentiment is bearish.

But the biggest reason I am positive on China is that many of the entrepreneurs I have met in recent years are very smart, ambitious, and still hungry. And there is also no shortage of entrepreneurs in this country. My experience has taught me that the single most important factor for a company's success is people.

Their odds of success are aided substantially by a vast domestic market, a supportive government, and an enormous talent pool who are willing to work 996 for more money, as part of China's common prosperity.

The last myth I will address in this essay will possibly be the "Mother of All Worries" and the "Cause of All Bear Markets", if this myth were to become reality. It may even lead to the end of humanity. It is Taiwan.

Myth Number 8 — China Will Surely Invade Taiwan

I have left it to the very end because it is a BIG, dangerous, explosive, controversial issue. APS Chairman Raymond Lim had addressed this explosive issue at length in his APS China Monthly piece, "The Taiwan Question", in 2021. You must read it if Taiwan is your BIG worry.

Many investors have jumped to the conclusion that China will surely invade Taiwan as soon as she declares independence. Several Pentagon officials had also made the same prediction, with or without Taiwan declaring independence.

Therefore, I was not surprised when a prominent investment advisor and friend who visited me in my office in April told me that most of his sovereign wealth, pension, endowment, and foundation clients are staying away from China or have a huge underweight position because they genuinely believe war is inevitable. This is also the impression you will get if you read the Western mainstream media narrative. Is a military conflict really inevitable?

There are conflicting viewpoints out there. I will offer four reasons why I think war is not necessarily inevitable.

Firstly, as much as the Chinese desire reunification, they know that an invasion is likely to set back the nation's modernization plan by at least a decade. Therefore, the question to ask should be: Is the prize of capturing Taiwan by military force worth the cost?

This is notwithstanding the fact that Taiwan has historically been a part of China and was ceded to Japan in the Shimonoseki Treaty signed on April 17th, 1895 and therefore, losing it again might go down in history as another episode of shame and loss of face for the country and its 1.4 bn people.

Twenty years ago, taking Taiwan by force might have been a worthwhile endeavor because the opportunity cost would have been low, but today the opportunity cost would be astronomically high.

To put this into context, the prize is an island with a population and GDP amounting to 20% and 70% respectively of Guangdong province.

Two, the same objective may be achieved without a military invasion. A full blockade – aerial and naval – might just do the job. A blockade is an act of war, some may say. Perhaps. Be that as it may, Taiwan would not be able to survive a blockade for more than a month and it would have no choice but to reverse the independence referendum, either by the Taiwanese leader's hand or by its people.

A Kuomintang victory at the island's election next year will surely eliminate the risk of an independence referendum.

Three, most Taiwanese do not want war. As much as some Taiwanese want independence, they know that a military confrontation, conventional or nuclear, is very likely to result in the near annihilation of the island.

Asians also do not want a war between two nuclear superpowers in their backyard. But what really counts in the final analysis: What will China's decision be when a crazy Taiwanese leader upsets the apple cart by declaring independence?

Four, the most relevant and profound official statement from Beijing over the issue of Taiwan was made in a press conference in September. Just eight words:

"China will exercise strategic composure and historic patience."

The statement was made by Qiu Kaiming, an official in China's Taiwan Affairs Office. This significant and insightful political statement was not carried by many newspapers.

I take it to mean that in the minds of the people who matter, immediate reunification is neither a top nor near-term priority.

Even before this statement was made, Raymond Lim offered his analysis in his essay that the invasion of Taiwan in the next four years is a low probability event. The inevitability of war, say in the next five years, is mere speculation. To draw an investment conclusion on that premise is as risky as the speculation itself.

In conclusion, in spite of the myths and misperceptions about China, if you can see China with an untainted lens, you will be already one up on your peers.

Wong Kok Hoi is the Founder and CIO of APS Asset Management. He has 42 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.