CHINA MONTHLY

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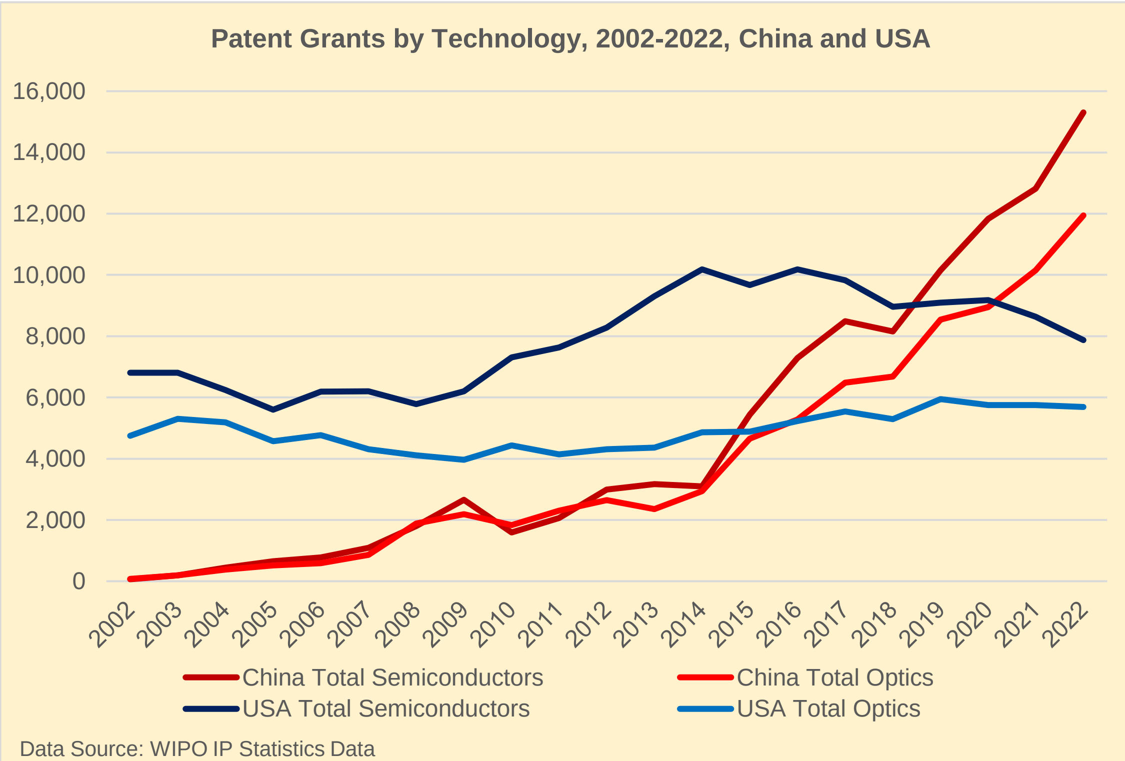
The Big Picture



China has been steadily building up patents in semiconductor technology as well as that for optics, which can drive advancements in lithography, a crucial process in semiconductor manufacturing.

THE BRIEFING

Third Plenum

China's highly anticipated Third Plenum is set for mid-July. The gathering of the nation's top leaders is expected to address key issues such as rebalancing the country's revenue base in the face of weakness in the property sector. The third plenum is often seen as the most important of the seven party gatherings held over the Central Committee's five-year cycle, and this year's meeting is expected to introduce further supportive measures for the economy.

New Quality Productive Forces

All seven of China's Politburo Standing Committee attended a conference that gave the nation's top science and technology awards to laureates. Premier Li Qiang presided over the conference while President Xi Jinping again stressed the importance of developing "new quality productive forces", marrying innovation in science and technology with production.

CSRC to Expedite Offshore IPOs

China Securities Regulatory Commission (CSRC) vice-chairman Dr Fang Xinghai said it is working to further expedite approvals for offshore initial public offerings. "We need to accelerate the pace further because there are still many companies in the queue," Fang said at the Lujiazui Forum in Shanghai in June. The wait list reflects the dynamism and scale of Chinese companies, he said. "They absolutely aim to grow bigger and better, and we should strongly support that," he added.

Escalating Trade Friction With EU

The European Union plans to impose provisional tariffs of around 17% to 38% on EVs from China for four months starting July, applicable to EVs exported to Europe by both Chinese and foreign brands, including Tesla. China's Commerce Ministry is opening an anti-dumping investigation into pork imports from the EU, which is expected to take a year, with a possible six-month extension.

Beijing Property Stimulus

Beijing is the last of China's major cities to relax property buying restrictions, announcing cuts in down payment ratios and minimum mortgage rates. A raft of supportive measures across the country were announced the previous month to counter the fall in property prices that continued in May.

CHINA EQUITIES –
LIGHT AT THE END OF THE TUNNEL

By Wang Kangning

For foreign investors in China equity markets, language has always been a major barrier to understanding what is really going on. Not only because Mandarin is a difficult language to learn, but in the Internet era, Mandarin itself is also evolving fast. Even China's native speakers need to make efforts to keep up, as new slang or phrases will emerge and go viral every year. One intriguing new viral phrase of 2024 was "泼天的富贵", meaning wondrous fortunes pouring from the sky.

It is amusing that the Chinese people, who are grappling with stagnant salaries and slumping property prices, would face such difficulties with ease. This surreal optimism will certainly not resonate with equity investors – both global and domestic alike – who hitherto have experienced one of China's longest and most distressing bear markets.

With some important developments in China's economy and financial markets over the recent quarters, there are incipient signs that the storm clouds are beginning to part, and we are seeing the light at the end of the tunnel.

Reforming the Capital Market

Stock market returns persistently failing to catch up to China's GDP growth has always been a major frustration among investors. This frustration intensified in recent years as a plethora of new companies, which varied greatly in quality, flooded into the market.

For many years, the mandate to raise capital for corporates has trumped other considerations in China's A-share market. This situation worsened further after a registration-based IPO system was introduced in late 2018. The average quality of IPOs gradually deteriorated since the criteria were relaxed in the registration-based system. Worse still, the easy availability of capital supplied financing to sub-scale corporations that would otherwise have been acquired or wiped out in the already matured market. The increasing number of new entrants into many crowded sectors only added to over-capacity and brought down the ROICs (return on invested capital) of entire sectors.

To tackle these issues, in February 2024, the newly appointed Chairman of the China Securities Regulatory Commission made major revisions to these policies. Wu Qing vowed to improve the quality of both IPOs and of existing listed companies through measures such as tightening listing standards, enhancing the supervision of listed companies, and demanding greater efforts to enhance shareholder returns. The results of this policy re-orientation were immediate. In the first quarter of 2024, the number of A-share IPOs and fund raising fell to historic lows, with many IPO candidates withdrawing their applications. In contrast, share buyback plans and dividend payouts rose sharply. Long-term investors such as insurers, social security funds, and pension funds also took heed of the changes and steadily increased their equities allocations.

An even more comprehensive revision of capital market policies was released in April 2024 in the State Council's "Nine-Point Guideline", outlining measures to enhance supervision as well as lift shareholder returns. Comparing these measures with the policies advocated by Japan's Tokyo Stock Exchange and Financial Services Agency, one can find many commonalities like the strengthening of corporate governance, the proper allocation of capital, and rewarding shareholders.

While the "Nine-Point Guideline" will likely lead to a gradual re-rating of China equities in the long term, in the short term it is equally important to boost investor sentiment. It will dispel market chatter that the government's mind is all on common prosperity at the expense of shareholders. Such chatter is way off the mark.

In the same spirit, the recent comprehensive, on-site inspections of the leading mutual fund firms by China's audit office should be interpreted as — despite the market jitters they caused — an effort to correct the fund management industry's misaligned incentive systems, instead of an effort to hinder the development of the stock market. Internally and externally, a stronger equity market is imperative for China to complete its transition from an infrastructure-investment driven economy into an innovation driven economy.

Executing a Soft-landing for Properties

China's new home sales dropped by 27% in 2022, 17% in 2023, and another 23% year-on-year in 1Q2024. Housing prices in China have dropped by an estimated 25% to 30% on average from their historical highs in 2020 and 2021. While there were also down cycles in the past, those turned out to be more like brief pull backs. It is for the first time throughout China's massive, decades-long urbanization, that the property sector is now undergoing a genuine downturn. Clearly most participants – running the gamut of home buyers, property developers, construction contractors, banks, and even local governments – were not prepared.

Many property developers and their suppliers went bankrupt. A lot more home buyers saw their balance sheets undermined and wealth destroyed by declining property prices. The negative effects are far-reaching and evident in unemployment, consumer spending, social financing demand, local government spending, business confidence, and more. If this downward spiral is left unchecked, more problems will emerge.

The good news is that after addressing much of the excesses accumulated during the extended property boom, a soft landing for the sector now looks very achievable.

In the second quarter of 2024, a series of easing policies were released to stimulate new and latent demand for properties, including a reduction in the minimum down-payment ratios for both first- and second-time home buyers, and a reduction in mortgage loan rates.

A CNY300 billion "relending" scheme will enable local state-owned enterprises to buy unsold homes from distressed developers at steep discounts that they can afterwards offer as affordable housing. This will be offered to 21 national lenders, from policy banks to state-owned commercial banks and joint-stock banks, at a rate of 1.75%, according to Tao Ling, deputy governor of the People's Bank of China.

The initial results of the stimulus policies were encouraging, with showroom visits and transaction volumes picking up by around 20% in Tier-1 cities and 10% in Tier-2 cities. The longer-term impact is yet to be seen, but the most important issue is the central government signaling that it is committed to stabilizing the property market and avoiding a vicious downward spiral.

Loosening Consumption Curbs

Ever since the onset of the Covid-19 pandemic, China's consumption growth has consistently fallen below the pre-2019 trend line, laboring under the negative wealth effect of declining property prices, falling stock markets, and uncertainties related to geopolitical pressure. On top of all that, there was also "self-inflicted damage" from drastic regulatory actions.

With hindsight, the regulatory crackdowns on after-school tutoring and restrictions on medical aesthetics services, for instance, proved to be too draconian and poorly coordinated. Although it is undeniable that private tutoring companies and plastic surgery clinics engaged in high-pressure, predatory sales tactics to inflame "education anxiety" or "beauty anxiety" among consumers, the blanket crackdowns on all such businesses was a much heavier blow to consumption than would have been expected. In fact, in the minds of the Chinese people, who generally have lower propensity to spend than consumers in most developed nations, education and beauty are more akin to investments, rather than consumption. So the crackdowns effectively cut them off from the few remaining "investments" that they still had appetite for. This situation was repeated in the abrupt restrictions on computer games, where approvals for new game titles were frozen for eight months, regardless of genres.

For gamers, it was month after month of waiting. For the programmers working at game developers, it meant pay cuts or even layoffs. These sudden crackdowns simultaneously cut off avenues for consumers to spend while costing thousands of tutors, healthcare workers, and programmers their jobs. The lack of coordination and expectation management in the implementation of new regulatory restrictions in many business segments inevitably led to poor consumer confidence.

Well, the silver lining is that the government has recognized this and is taking concrete steps to fix things. New policy measures are more wholistically considered and the overall policy stance has become more pro-business.

As an example, just one month after its release, a consultation paper on a policy meant to restrict spending on computer games was removed from the National Press and Publication Administration's website on 22 January 2024, and the draft policy has since disappeared. For after-school tutoring and medical aesthetics, the restrictions are visibly lifted. Offline advertisements are still forbidden, but the online marketing of these services is already flourishing.

Restoring consumer confidence will need more concerted efforts from policy makers. Giving consumers more freedom to spend, including lifting restrictions on buying apartments in first-tier cities, is a good start. Lower mortgage loan rates for housing, as well as subsidies and trade-in programs for big-ticket purchases like cars and home appliances, have also been already put in place.

Raising the incomes of middle- and low-income groups, plus improving social safety nets, could be among the next steps. A consistent implementation of these measures will gradually restore consumer confidence and stimulate consumption demand.

Preparing the New Growth Engines

It is very clear that the old growth model reliant on property and infrastructure investment is no longer fit for the purpose of propelling China's economy to greater heights. For China to keep growing at a sustainable pace and transition into a modern, high-tech economy, innovation is the answer.

One of the strengths of China's industrial base is that it has the world's most comprehensive production capabilities, ranging from toys and textiles to electronics and aircraft. China's manufacturing output is already 30% of the world total and still rising. But in terms of value-add, China still lags the developed economies.

For China, hitting the next level means manufacturing with more intellectual capital inputs, characterized by the relatively fresh term "New Productive Forces". The Chinese government is pushing for reforms to enhance China's innovation capacity, including incentives for higher R&D spending by private enterprises, modern Science, Technology, Engineering, and Mathematics education, greater collaboration between research institutes and businesses, as well as more effective protection of intellectual property rights.

The push for higher innovation content started more than 10 years ago with the May 2015 announcement of the "Made in China 2025" plan. Some of those initiatives are already having an impact in sectors like electric vehicles, gene technology, 5G communications, and various forms of renewable energy, just to name a few.

More time would be needed for other new growth engines to take effect. From artificial intelligence, semiconductors, and quantum computing to software, android robotics, as well as aeronautical and space technology, these research efforts and investments will span years or even decades. Heavy financial investments producing little to no financial gains for long periods result in a "J-curve" productivity and return profile. Immense patience and forbearance are requisites for the prolonged underwater periods at the start of this long J-curve, which is where many of China's new initiatives currently stand.

Beyond Dark Clouds…

The overhang of macro and geopolitical uncertainties has clearly crushed investors' confidence, both within and outside China over the last three years. Investor patience has been put to the test and many are almost worn out. The overly somber mood has frightened people from envisioning how things could develop in the future. When the pendulum of risk appetite swings to the extreme, rationality gives way to mispricing. This bear market has given us the opportunity to identify multiple Structural- and Economic-Alpha stocks.

Consumption upgrading and a modern lifestyle used to be a very popular investment theme a few years ago. But now, the spending power of the world's largest cohort of middle-class consumers has been called into question. Valuable brands seemingly lost their value overnight in the eyes of equity investors. But for savvy businessmen and equity investors wearing the APS "Businessman Hat", the value of branding is, in the first place, the ability to maintain market share and sustain profit margins in good times as well as bad times.

This is exactly what Chinese companies with strong brands experienced in the past few quarters: their top-line growth slowed down markedly, but their margins and cashflows remained stable.

From the renowned brewery brand Tsingtao, liquor producer Kweichow Moutai, sportswear maker Li Ning, to the nation's best retail banking franchise China Merchants Bank, all these strong brands have weathered this storm of weak economic conditions relatively well. Yet their share prices have slumped as most investors seem unable to look beyond the past three years.

We also find attractive Structural Alpha stocks in the electric vehicle supply chain, but not among the OEM manufacturers, which are still entangled in a brutal price war in China. Our focus is on the producers of automotive safety systems, a critical system that entails much higher entry barriers. For example, Bethel Automotive Safety Systems is China's leading domestic supplier, having accumulated experience as well as clients' trust in the reliability of its products over the last 20 years. We expect the company to be a beneficiary of the long-term trend of greater integration of safety control systems and higher penetration of driver assistance systems.

The healthcare sector as a whole has been hammered down over the last three years by rounds of volume-based procurement (VBP) programs and system-wide anti-corruption campaigns. Contrary to the market consensus that China's healthcare industry will become a commoditized, low-margin industry, we think the VBP programs and anti-corruption drive have actually squeezed much of the inefficiencies and redundancies out of the system, leaving greater room for the more competitive and innovative players to prosper. In this still very fragmented market, we think it is an opportune time for industry leaders such as China Resources Pharmaceutical and Shandong Weigao Medical to consolidate their respective markets and emerge stronger.

Renewable energy operators, in particular wind power operators, had been under pressure, owing to the uncertainty in the long-term return profile of their new projects. The labyrinth of China's electricity tariff structure, subsidy systems, and peak-trough power management has made investment decisions difficult, even for the industry participants themselves. In a recent energy conservation action plan for 2024-2025 published by the State Council, a clear energy intensity target was made public. A framework for a national sustainability disclosure standard is also expected to be put in place by 2030. The improved policy visibility for renewable energy will gradually lift the valuation of leading wind power producers such as Longyuan Power and Suntien Green Energy.

In conclusion, China is probably the only major country or region that has experienced a rise in equity risk premium since early 2021, in stark contrast to the rest of the world. With the silver lining of policy measures focused on supporting capital markets, housing, consumption, and innovation in view, we should soon see clear skies just over the horizon. Chinese stock valuations are never this compelling, suggesting that investors have by and large abandoned all hope and exited the market.

Wang Kangning, CFA, is the co-CIO of APS Asset Management. He has been with APS since April 2004 and has 21 years of experience in the fund management industry. He was previously with Philip Securities Pte Ltd as an analyst from January 2003 to April 2004. Mr. Wang has a Master's in Engineering from the National University of Singapore and a Bachelor's degree from Shanghai Jiaotong University.