CHINA MONTHLY

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The Big Picture

This magnetic levitation bullet train developed by China Railway Rolling Stock Corporation is considered the world's fastest train, able to hit 600 kilometers per hour.

THE BRIEFING

Forced Selling

According to China Merchants Securities, as of May 4, 1,069 onshore China private funds have been liquidated due to stop loss rules that require such funds to return capital to investors in the event of drawdowns of 20%-30% from the original NAVs. These forced liquidations exacerbate downside moves in the China markets and have traditionally been a factor in the bottoming process during past selloffs, such as in 2015. About 2,350 stock-related funds in April dropped below a threshold that typically activates clauses requiring them to slash exposures, with many headed toward a level that mandates liquidation. Such signs of stress were “close to the historical high,” according to China Merchants.

Stabilizing Economic Growth

Premier Li Keqiang held a teleconference on May 25 with provincial, county, and city level government officials on supporting the economy. This may be a sign that economic growth is running well below the 5.5% growth target set in March as Li urged for the implementation of policies such as tax rebates, credit support, and new infrastructure projects.

ADRs still Adrift

The Director of the US SEC delivered a speech on May 24 on developments related to the audit requirements of American Depositary Receipts. While there has been some progress, companies that hold sensitive information in areas such as financials, e-commerce, media, and healthcare still face a risk of delisting. The potential passing of the America COMPETES Act of 2022 would accelerate the delisting date to March 2023 and pose a near-term risk.

Record Cut

Chinese banks cut the five-year loan prime rate by 0.15 percentage point to 4.45%, the largest such move since 2019. This is the reference rate for residential mortgages and is thus seen as direct support for the property sector.

Back to Work

Shanghai plans to lift the city’s lockdown in phases starting on June 1. Around 90% of the city’s population are in areas that have been deemed “low risk” and factory production has started to resume. Shanghai’s deputy mayor Zhang Wei said daily container throughput at its ports hit 90% of the levels of a year ago, while Pudong Airport cargo throughput has reached 70% of last year's levels.

WHAT'S ON INVESTORS' MINDS?

FINDINGS FROM MY RECENT TRIP TO NORTH AMERICA

By Wong Kok Hoi

Number One Concern

Geopolitics, geopolitics, geopolitics. This is the number one worry on investors' minds during my recent trip to the United States and Canada. Amongst the issues, Sino-US relations is considered most important as both economies account for 42% of world GDP. In addition, China is viewed as the indispensable actor in the global supply chain. For instance, in a full-fledged trade war, Apple will go bankrupt within two years, half of US semiconductor companies will go down, and the rest will have limited funds for R&D and so on and so forth.

One CIO in New York told me that in his opinion, it is inconceivable for the world to substantially decouple because it would bring about colossal economic devastation to the US too. Instead, he sees the world evolving into a twin pillar world as opposed to a bi-polar world (a term I used in our debate). To his mind, in a twin pillar world, the two pillars would exist side by side and though not connected by an "umbilical cord", would work with each other in areas of mutual interest, while in a bi-polar world, the two poles would be so far apart to the extent that there would be almost no connection or relationship.

On further reflection, a two-sun system with its constellation of planets may better describe the future world. The two suns will exert opposing and complimentary gravitational forces, if you will, on each other and so will their constellation of planets. This is likely to be the new world order which we are ushering in.

For China to be the second sun, investors agree that China will have to open up its economy even more and further liberalize its financial markets. There was also no resistance to the suggestion that the internationalization of the yuan would be an inevitable consequence.

The head of asset allocation of a sizeable pension fund remarked in a separate meeting that he would not be looking for a winner or loser in a Sino-US geopolitical clash; he believes that it is more meaningful to find the relative winner.

The Potential Taiwan Disquiet

The other big geopolitical uneasiness is Taiwan. Will China take Taiwan by military force if the latter declares independence? My response was that the probability of a war has been reduced in recent years because China's number one priority today is to modernize the nation. A war, even a short one, is likely to jeopardize that national goal. Ten or 20 years ago, war would have been inevitable if Taiwan were to declare independence. In fact, former President Chen Shui-bian had contemplated a move for independence several times while he was in office during 2000-2008. Then US President George W. Bush was so alarmed by that reckless thought that he warned Chen that Taiwan would be on its own if Chen went ahead with it.

That said, China is unlikely to do nothing if the current or future Presidents of Taiwan were to declare independence. In my opinion, China can first declare a no-fly zone over Taiwan and enforce a naval blockade, cutting off all non-humanitarian imports and exports. If that punishment were not harsh enough for Taiwan and its citizenry, Beijing could nationalize all Taiwanese assets in China. This strategy would be superior to a full-fledged invasion because the latter would risk its critical national agenda amidst retaliation from all over the world.

One last point. Many Taiwanese businesspeople, its elite, and older citizens know that the status quo is best for the island. In fact, many Taiwanese elite and political commentators had publicly warned their fellow citizens and politicians in recent months that any move for independence would bring about unimaginable calamity and tragedy to Taiwan and its people. In short, upsetting the apple cart brings no benefit whatsoever to Taiwan, except for a few more young voters at election time.

For investors who are interested in the official positions of the US and China on the Taiwan issue spanning the decades, including Raymond Lim's analysis of the complex issues involved, please refer to our October 2021 ACM issue, "The Taiwan Question".

Tech (Internet) Stocks

Two frequent questions: "Is the sell-off near its end?" and "What improvements would I need to see before turning bullish?" I had written about the tech stock bubble in several of my ACM pieces. I will offer some views here but given the strong interest I will take a deeper dive in an upcoming ACM piece, tentatively titled, "Money, Money Game" where I am likely to contextualize the fundamentals in changing investor mindsets over the entire investment cycle. My thinking is to split it into four phases of the cycle: enchantment, awakening, denial, and disenchantment.

Some investors think that the regulatory clampdown has probably peaked but did not know that the revised anti-monopoly law is actually still in its consultation stage. Even after the law is legislated, it is fair to say that companies will need to reformulate their business strategies and recalibrate their business practices to be compliant. This process may require 2-3 years as the excesses had been built up over a decade or longer. The second part of regulations will be regulators' enforcement of the new regulations to ensure compliance. Enforcement is a year-round routine affair, so what would the end of regulatory clampdown mean in practice? What is certain is that the internet companies will not be allowed to return to the days of the old regulatory regime.

The other two key regulatory risks are the VIE structure and accounting disclosures of most China internet companies. What was surprising was that there were absolutely no media reports after the US SEC officials met with China's CSRC officials in the first week of May to address those concerns. We can only guess that no substantial agreement was reached.

Of much greater importance are fundamentals, which seem to have changed.

USD Millions

Company	Q2'21	Q3'21	Q4'21	Q1'22	ROA (%)*	PER*
Tencent	6,600	6,200	15,000	3,700	13.3	13
YOY	+40%	+10%	+67%	-50%		
Alibaba	2,800	7,000	521	-2,900	0.6	34
YOY	+4%	-86%	-72%	N.A.		
JD.com	123	-434	-833	-554	-2.1	NM
YOY	N.A.	N.A.	N.A.	N.A.		
PDD	374	254	1,036	420	7.3	29
YOY	N.A.	N.A.	N.A.	N.A.		
Meituan	-747	-1,100	-971	-895**	-9.8	NM
YOY	N.A.	N.A.	N.A.	N.A.		
SEA	-433	-569	-618	-580	-12.0	NM
YOY	N.A.	N.A.	N.A.	N.A.		

*Based on last four quarters reported earnings
**Estimate

In the latest hyped-up fad of group community buying businesses, where tens of billions of dollars had been ploughed into this segment just in the last 18 months, several mid-sized firms have already filed for bankruptcy. The segment leaders have been downsizing and continue to do so.

It should be noted that many "investor darlings" amongst them have yet to prove that they can produce a profit or sustainable profits, despite being in the business for many years. The established view that these digital growth stocks will eventually produce sizable profits to justify their lofty valuations seems to be standing on sand now. Let us examine some of these internet giants.

Tencent, which arguably has a stronger moat, reported a 50% drop in earnings for Q1. Its founder Pony Ma recently warned of the tougher times ahead. Alibaba, the juggernaut in e-commerce, suffered sharp drops in profits for four straight quarters and it is retrenching staff in almost every business sector. In its Calendar Year Q1 results, to an investor question on regulatory easing, Alibaba emphatically said that they will have to conduct business in full compliance with the law and regulations. JD.com, touted by many to be the strongest China e-commerce stock, saw losses for three straight quarters. In addition, the combined market cap of its listed subsidiaries declined USD38.2 billion in value last year and USD12.1 bn this year. Since their initial investments, they had incurred a total loss of USD18 bn for their shareholders! More than three years ago we had cautioned more than once that many of JD's investments looked odd and reckless to us. Its warehouse assets – touted to be its differentiating factor – are continually sold off to an investment fund which is majority owned by my previous employer, Singapore's sovereign wealth fund GIC. Would it not make business sense to keep rather than sell their prized assets, only to end up investing the proceeds in assets and companies that are unprofitable and unproductive?

Investors had been mesmerized by Pinduoduo's triple-digit top-line growth, a feat achieved by selling low-quality goods at losses. As recent as 15 months ago, it commanded a market cap of USD250 bn when its fixed assets amounted to a paltry figure of USD128 mn! Low fixed assets can only mean that the company was not building any long-term capabilities – even for an online retailer. In short, PDD was selling subsidized low-priced goods to consumers in the lower-tier cities using other company's capabilities, namely Tencent's WeChat platform and a third-party logistics company. Why investors thought it was worth so much at that time is a mystery. As capital was running down, the company changed strategy last year by reducing considerably its subsidy program. As a result, top-line growth contracted to single-digit for two straight quarters but profits turned the corner for the first time for four straight quarters. This strategy makes sense to me.

We have included SEA Ltd, touted at one time as the promising Alibaba of South-East Asia, because the same funds loaded it up in their portfolios on the same internet investment concept. As the region's largest internet company in e-commerce and gaming, investors chased up its market cap to USD200 bn just eight months ago, when it has yet to prove it can make a profit and with scant regard for its heavy subsidized ecommerce business model; its valuation has plummeted to USD44 bn today.

The table above shows that profits are falling fast. What is rarely discussed is that most internet companies have deployed their capital rather recklessly, as if they can have access to infinite capital, which was criticized by a senior Chinese government official last year. Based on the last four quarters of earnings, except for Tencent and PDD, ROAs of the rest were appalling. Some companies have only 2-3 years of cash left to burn!

What is also worrying is that all signs are pointing to even more challenging times over the next four quarters and beyond. Adding to the woes is intensifying competition amidst weak consumption. This has led management to resort to desperate measures to cut costs by retrenching staff aggressively in the last nine months. It is estimated by former staff, industry analysts, and reporters that layoffs ranged from 10%-30% of total headcount.

After stock price declines of 50%-80%, some investors think the correction is largely done. We disagree. Valuations are still lofty irrespective of the metric used – PER, PBR, or DCF.

Few investors have entertained the possibility that many internet companies are ex-growth. If they are ex-growth, the current lofty valuations cannot be justified and hence another substantial adjustment will be on the cards. To think that a stock is cheap just because its price has declined 50% or 80%, often begets more misery. Is it not better to ask in this instance, “Why and how the stock price can stage any sustainable recovery, should earnings for the next 4-8 quarters turn out to be disappointingly lackluster”?

At best, I think we will see dead-cat bounces, which we had already seen twice this year; it is difficult to envisage another wave of frenzied buying when global and China fund managers are still heavily positioned in these stocks.

APS Senior Investment Director Wang Kangning will address some of the sector’s structural headwinds in our next ACM.

China’s Dynamic Zero-Covid Strategy

Shanghai’s multi-week lockdown and mass testing have made investors wonder whether President Xi Jinping has taken too tough a position on battling the coronavirus. Some strongly believe that China’s zero-Covid strategy has been unnecessarily stringent, rigid, and impractical, which would eventually bring down its economy and its businesses to their knees. They asked, “What is the end game?”

I offered my differentiated take. Firstly, Beijing’s zero-Covid strategy should not be interpreted literally, that is, it is not to achieve zero infections before opening. Rather, it is about taking quick and decisive measures to uncover clusters, break up transmission chains and suppress transmission. China’s Covid experts believe that their Covid strategy in the last two-plus years has been successful – it has brought down the transmission rate or R-naught (R0) to below 1.0 in breakout areas, brought down the number of daily infections, and minimized the number of deaths. Their conviction is born out of the recent success in Shenzhen, where the two-week lockdown and mass testing suppressed the transmission. Amazingly, there were zero infections in the last three weeks. Its economy has been fully normalized even when it still reported 5-10 daily cases, not zero daily cases. Wuhan and Xi’an were also successes.

It is therefore not correct to jump to the conclusion that China’s zero-Covid strategy is failing, based on the recent dramatic video postings on social media about the frustrations, complaints, anger, and hardships by a relatively small number of Shanghai residents and reports in English-language media. I rhetorically asked, “Since the outbreak of the coronavirus, which economy amongst the major economies has done the best? Is it not China? In fact, it is the only major economy to have posted positive GDP growth in 2020, the first year of the outbreak. Its achievement is even more remarkable when you consider the fact that it was done with little handouts. Its trade surplus last year was the largest ever. Its Covid death per capita was amazingly low for a densely populated country. Mind you, China’s zero-Covid strategy has remained about the same for two and a half years now. What is the basis then for the claim in some quarters that its Covid strategy has flopped? Perhaps, there is legitimacy to assert that China has failed to clear the doubts and confusion surrounding its Covid strategy. Even many of my Chinese friends living in Singapore told me that China should have learned from Singapore's Covid strategy. I expressed surprise. On economic growth, lockdown days, monetary handouts (Singapore expects to draw on USD31 bn of its past reserves for its response to the fallout from the Covid-19 pandemic for the three financial years of 2020 to 2022, equivalent to 9% of its annual economic output), infection rate, and the mortality rate per capita Singapore did worse in all those criteria. Only on vaccination rates, did Singapore fare better. I think our perceptions of China's Covid strategy and its results are unduly influenced by media reports rather than hard facts.

At the time of writing, Shanghai seems to have largely overcome Covid-19. Its government has announced that it will ease most of its stringent measures and normalize its economy.

Notably, China's strategy is decided primarily by its Covid scientists and doctors who use epidemiology and Big Data to battle the coronavirus, and not by the Party cadres or its central and local government officials as perceived in some quarters. It is more correct to think that the latter conveys to its citizens the recommendations and decisions made by these Covid experts. That said, views within the government seem divided over the expert recommendations. Premier Li Keqiang, for instance, has stated a few times publicly that the economy has paid a dear price because of the stringent Covid measures.

Others

Surprisingly, few had expressed concern about President's Xi Jinping's common prosperity doctrine. One Canadian pension fund even surprised me with this comment, "I think it is much less about wealth redistribution than creating a bigger pie for all, as in the Quebec experience."

Investors were encouraged that China's monetary cycle is currently counter-cyclical to that of the US. They also asked about the potential size of China's fiscal stimulus plans for the second half of the year.

Conclusion

Interesting times, to say the least. Investors are still trying to wrap their heads around the big issues. Most believe that China is now too big of an elephant in the room to dismiss. Although sentiment was generally cautious because of the geopolitical headlines, Covid-19, and macro headwinds, most investors seem to like China's long-term growth prospects and are looking for a better timing to increase their exposure. Their views on China internet stocks – probably heavily colored by their China managers' views – seem markedly more positive than mine, which led me to think, respectfully, that we probably have not reached the disenchantment stage. I plan to address this issue in greater detail in my next piece.

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.