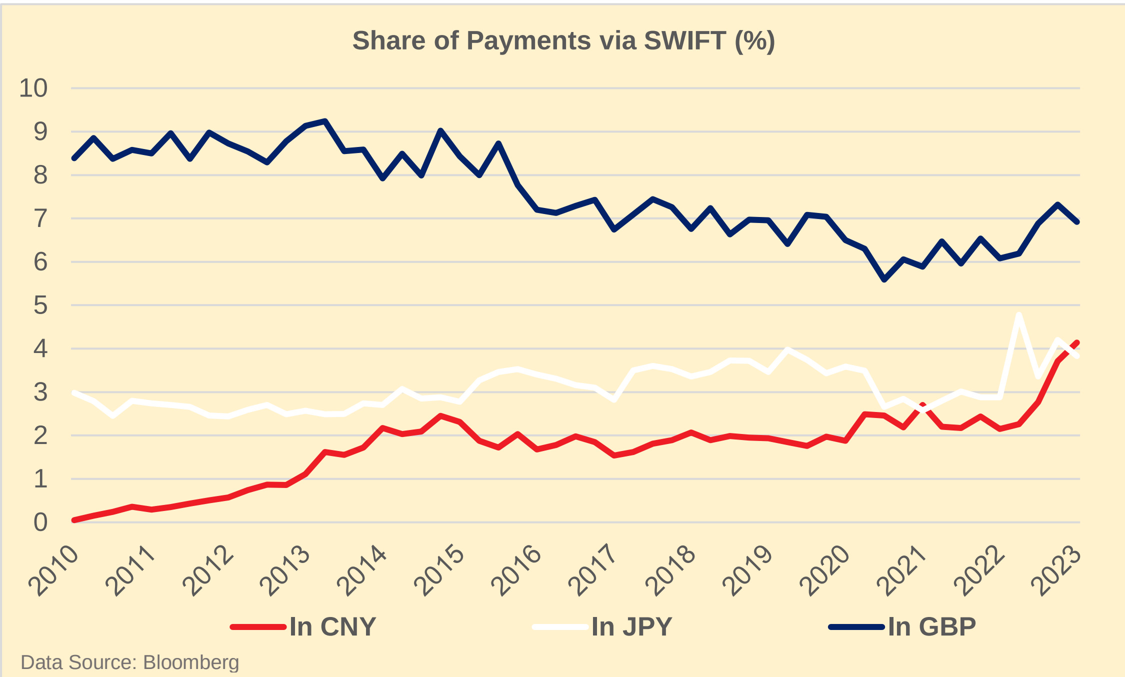
CHINA MONTHLY

MARCH 2024

The Big Picture



China's currency hit an all-time high share of 4.61% in global payments usage in November, nearly doubling from a year ago and overtaking the Japanese yen, while the US dollar's share dipped to 47.08% from 47.25%.

THE BRIEFING

Mandatory ESG Reporting for 2025

China’s three major stock markets, the Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE), and Beijing Stock Exchange (BSE), announced new sustainability reporting guidelines for listed companies, including a new requirement for hundreds of larger cap and dual-listed issuers to begin mandatory disclosure on a broad range of ESG topics in 2026 for the 2025 reporting period. Mandatory reporting requirements under the new guidelines will apply to more than 450 of the larger companies, representing around half of the market cap.

State Buying

China’s state-backed funds have poured more than CNY410 billion (USD57 bn) into onshore shares this year, according to estimates by UBS Group AG, which expects further purchases as the national team added CNY1.24 trillion of shares in 2015. A flurry of trading volume spikes across a number of ETFs suggest authorities have been actively buying both blue-chip and small-cap stocks. More than 75% of the inflows went into products tracking the benchmark CSI 300 Index while another 13% flowed to those mirroring the CSI 500 Index.

Quants Gone Haywire

Leading quants each managing over CNY10 bn (USD1.4 bn) lagged the CSI 500 Index by an average 12 percentage points in the two weeks ended 8 February, bringing the year-to-date excess return to -11.3%. It was compared with the "quant quake" that wreaked havoc on US managers in 2007. After defying the nation's stock slump in the past three years, quants were caught off guard by rapid market shifts and government intervention in the lead-up to the Lunar New Year holiday. It was described as the industry's "biggest black swan event" and one manager said its models "switched from doing it right to getting it wrong repeatedly."

China’s Low-Orbit 6G Test Satellite

China Mobile, the world's largest telecom carrier by mobile subscribers, has successfully launched the world's first satellite to test 6G architecture, utilizing domestic software and hardware. Jointly developed with the Chinese Academy of Sciences' Innovation Academy for Microsatellites, its low-Earth orbit at around 500 kilometers is to ensure transfer speeds of up to 1 TB per second and have near-zero latency.

PBOC Cuts Key Mortgage Reference Rate

The People’s Bank of China (PBOC) cut its five-year loan prime rate (LPR) from 4.2% to 3.95%, the biggest reduction since it revamped its LPR system in 2019, when it made the LPR the new reference rate for lending by Chinese banks. The latest cut was also the first reduction to the five-year LPR since June 2023. The LPR is the rate at which commercial banks lend to their best customers. The five-year rate usually serves as a reference for mortgages.

RIDING CHINA'S EQUITIES RERATING

By Stella Zhang

"The greatest danger in times of turbulence is not the turbulence; it is to act with yesterday's logic."

— Peter Drucker (1909-2005)

Many global investors have capitulated, or are on the brink, as China's equity markets remain in the bone-chilling grip of a brutal derating. The three straight years of decline is unprecedented, stretching on with another 10% slump in the first month of 2024. The MSCI China P/E multiple has slipped to its lowest in a decade. The China permabears are calling a permanent derating for Chinese stocks, with media outlets jumping on the "bearwagon".

As is often the case, we at APS Asset Management think it is instead time to rouse ourselves from the winter chill and sharpen our plowshares for the planting season.

Decaliters of proverbial ink has been spilt on the headwinds that President Xi Jinping's China finds itself flying into, so we shall touch on them briefly, before highlighting the tailwinds that will propel both China's sustained economic growth, as well as investor returns in an equities rerating.

Derating, Largely Done

China's draggy property crisis, persistent geopolitical tensions with the United States-led pack of nations spanning across Western Europe and East Asia, private and foreign investment in China contracting to their lowest levels in over a decade, a 14.9% of youth unemployment rate, and the CPI turning negative are at the core of widespread pessimism towards China's economic prospects.

Adding to the pessimism are Beijing's multi-year crackdowns on the property, financial, private tutoring, and internet platform sectors, to rein in the laissez-faire "blind expansion" and excesses driven by torrents of private capital and excessive leverage. Critics have characterized it as government suppression of the private sector, informed by party dogma and ideology, rather than Beijing pumping the brakes on runaway trains that threaten to derail the healthy long-term development of those sectors.

Since early in his first term, President Xi has been consistent on his insistence that corruption at all levels will not be tolerated and not go unpunished. China's path for financial sector development differs fundamentally from Western models, in that finance should not maximize short-term profits and over-financialize economies that might collapse one day under the weight of their systemic risks. We would argue that China's leadership realizes that in the previous rounds of government-led investment cycles, there was plenty of corruption and moral hazard from the implicit guarantees backed by state resources, such as land, infrastructure, and public utilities. These financing activities have fed inefficiency, NPL risks, and corruption.

China seems determined to do what it must to strike the right balance between economic development and growth on the one hand, with security and stability on the other. These long-term goals necessitate tough actions, inflicting much short-term pain on all stakeholders. When the bearishness out there feels like it is at its maximum, while P/E multiples are hovering at depressed depths, it might be time to sharpen your plows.

Rerating, To Come

As the government targets socialist modernization and GDP per capita reaching that of mid-level developed countries by 2035, non-SOEs are key to realizing this growth commitment. The most competitive Chinese companies globally and the leading players in EVs, solar panels, as well as lithium batteries are all private names, while privately owned enterprises (POEs) account for 45% of China's exports by value. The last POE entrepreneur symposium chaired by Xi was on 1 November 2018, when the Sino-US trade and tech war was running hot. The government's stance and policy of supporting POEs was clearly stated then. It has been consistent and unwavering ever since, albeit with doses of tough love every now and then.

"It's good to learn from your mistakes. It's better to learn from other people's mistakes."

— Warren Buffett

Keen to avoid a real-estate linked banking crisis of the likes that plagued the US and Europe in 2008, as well as Japan in the 1990s, Beijing enforced a painful deleveraging process on property developers and local governments, at the expense of a slower economy. It directly led to a liquidity crunch for upstream businesses in the real estate sector's supply chain, loan defaults, layoffs, and added to unemployment. However, this pre-emptive "de-bubbling" from the three red lines policy in 2020 has significantly reduced the risk of a systemic banking crisis.

In 2024, a rerating for China's beleaguered property sector may well be at hand. Housing demand seems to have started rousing from its slumber. Combining purchases of new homes and secondary transactions, China's 2023 property sales value stood at CNY16.4 trillion, an increase of 7.9% YoY. The main culprit for the reported decline of new home sales to CNY10.5 tn from CNY11 tn in 2022 was on the account of secondary market transactions gaining market share, jumping to 37% of total demand in 2023 from 27% in 2022 as buyers sought safety in homes that they could touch and feel, eschewing buying off building plans and scale models. The time is also ripe for local governments to transform into city infrastructure operators, away from being capital-intensive investors, with revenue models centered on taxes instead of land sales.

Beijing signaled last year that it would fine-tune policies to bolster the country's faltering post-pandemic economic recovery, starting with lifting the fiscal deficit ceiling from 3.0% to 3.8% and issuing a CNY1 tn special treasury bond in 4Q 2023.

The government's priority in 2024 is to restore business and consumer confidence. Policymakers have urged banks to provide commercial property loans to eligible developers, to ease the liquidity crunch and give firms in the entire property supply chain headroom to reduce their leverage in an orderly fashion. We think China has many more levers to pull compared to other countries, in terms of industrial policies as well as expansionary fiscal and monetary policies, in addition to the strong work ethic of China's 890-million-strong workforce, who are committed to the nation's modernization as they have tasted some of the fruits of this endeavor.

By 2035, when China is targeting per capita GDP exceeding USD20,000, which is that of a mid-level developed country, over 30% of China will likely be aged above 60, compared with 18.9% in 2021. However, it will remain a highly educated, healthy, experienced, and productive workforce, backed by world-class infrastructure.

While China's working-age (aged 15 to 59) population is projected to decline to 730 million by 2035, China is already investing in education and skills upgrading so that its relatively smaller workforce will still maintain or exceed current total output and productivity. Premier Li Qiang confidently said during his press conference from the last Two Sessions meeting in March 2023 that "every year more than 15 million people join the workforce…More importantly, we have more than 240 million people who have received higher education, and the average length of education received by new entrants into the workforce has increased to 14 years. Therefore, China's demographic dividend has not disappeared, and our talent dividend is in the making."

This workforce powers China's export sector, which is into its sixth year of being buffeted by the trade and tech war being waged by America. Nonetheless, China's exports still managed to rise 36.3% to USD3.38 tn in 2023, from USD2.48 tn in 2018! While 2023 was the first year that China was not America's top source of imports since 2009, trailing Mexico and Canada, China's goods trade was still in surplus. This was thanks to its products gaining strength in markets such as Southeast Asia, which imported more from China than the US did in 2023. In addition to the well-known competitiveness of China-made electric vehicles, its power plants, construction equipment, tractors, telecommunications switches, and machine tools are popular in the Middle East, Latin America, and India. Essentially, the Global South.

For China's less-trumpeted shipbuilding industry, 2023 was also a watershed year, as it became the only country capable of building aircraft carriers, Liquefied Natural Gas (LNG) carriers, as well as mega-ship cruise liners that exceed 300 meters in length, weigh over 100,000 tonnes, and carry over 5,000 passengers. After eight years of scientific research and five years of design and construction, the Adora Magic City was delivered in November 2023, at a construction cost of USD770 mn. China's shipbuilding industry also supersedes Korea's in terms of orders on hand, new orders, and work completion.

In high-tech industries, China is steadily marching on. EVs, solar energy, lithium batteries, and SMIC's 7-nanometer chips used in Huawei's 5G phones are well-known examples. By 2023, three Comac C919 passenger aircraft have been delivered, which is just the beginning. The narrowbody C919 is designed to take on the Boeing 737 and Airbus 320 to break the pair's duopoly – at least in China, where demand will continue to be robust. In December 2023, the first fourth-generation nuclear power plant globally with completely Chinese intellectual property was put into use in Shandong after continuously operating for 168 hours. The power plant has drawn global attention as it adopts a High Temperature Gas-Cooled Reactor-Pebble-bed Module (HTR-PM), which is claimed to be able to steer away from a meltdown or leak of radioactive materials even in extreme conditions. Other examples include super high-speed wind tunnels, commercial spaceships, cargo spacecraft, etc.

In most traditional industries where the US is not dominant, such as the machinery exports popular with the Global South listed earlier, China is catching up. China has learnt from Japanese companies having long lost out to TSMC and Samsung in semiconductors, as well as to Apple and Qualcomm in innovation. China's steady advancement in the tech sector in recent years has not been trumpeted within and outside China, for fear of strong reactions from Washington.

The Tasks Ahead and Alpha Opportunities

Policy makers are well aware of the need for affordable housing for young families, especially in first- and second-tier cities, where the housing price-to-income ratio has crossed 20 times, compared to 17.8 in Tokyo, 17.3 in Seoul, and 13.7 in Singapore for private housing, according to a 2023 Urban Land Institute (ULI) study. The same study cited ratios of 29.3 in Beijing, 35.0 in Shenzhen, and 26.5 in Hong Kong. That ratio for government-built HDB flats in Singapore was a mere 4.7.

While Beijing's policy details for affordable housing ownership have not been fully clarified, the Singapore model and Shenzhen's experience may provide some clues. One goal is to free up younger consumers' disposable income for consumption.

Beijing announced in January 2024 it is moving forward with the implementation plan for the piloting of comprehensive reforms in Shanghai's Pudong New Area. The plan, with a 2023-2027 timeframe, aims to support the high-level reform and opening up of Pudong New Area, as well as efforts to build Pudong into a leading area for socialist modernization.

Compared to Shenzhen's Socialist Preceding Demo District and Zhejiang's Socialist Common Prosperity District back in 2021, Pudong's focus is on modernization. Shenzhen's role is to showcase the system for Socialism with Chinese characteristics. Zhejiang, one of China's richest provinces, demonstrates that the wealth gap between rural and urban areas can be narrowed.

The incomes of Zhejiang province's rural citizens reach 60% of that in most of its cities. The nation's five wealthiest villages are from Zhejiang, where the province's average annual per capita disposable income reached CNY34,317 in the first half of 2023, the third highest among China's 31 provincial-level regions. This was only behind Shanghai's CNY42,870 and Beijing's CNY41,358.

From the highly detailed January 2024 implementation plan for Pudong New Area's pilot of comprehensive reforms, China's ambition to develop an innovative and technologically advanced nation is clear-eyed. We mention just three goals here:

1. High-standard market rules and regulations: Restrictions on market access for foreign players to be relaxed for the telecom and medical services sectors, while arbitration will be adopted for dispute resolution. Shipping futures will be launched, while the digital RMB will be piloted, etc.

2. Innovation in science and technology: Setting up science foundations, international pricing for innovative bio-drugs, launching option products for the STAR board, supportive policies for the setting up of venture capital and private equity firms, more protections for intellectual property rights, etc.

3. Talent reform: To better attract talents from all over the world, Pudong is given the authority to review and issue confirmation letters for foreign talents, who will be allowed to serve as legal representatives of public institutions and state-owned enterprises in Pudong. Foreign scientists who are permanent residents can lead national science and technology projects, as well as serve as legal representatives. State-owned science and technology enterprises are also encouraged to have equity and dividend incentives in their compensation policies, etc.

As an aside, the background of Shanghai's Party Secretary Chen Jining, who turned 60 in 2024, might be another hint of China's future strategic direction. He has a Ph.D. in Environmental Systems Analysis from London's Imperial College, was Tsinghua University president 2012-2015 and then became Beijing's mayor.

There is a Right Price for Everything

> "People often overestimate what will happen in the next two years and underestimate what will happen in ten."
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> — Bill Gates, "The Road Ahead", 1996

In China's transition to an economic model centered on high-quality growth, Chinese consumption power will be a super structural trend. Just as we observed during the recent 2024 Chinese New Year in third- and fourth-tier cities, consumption beat all estimates. Chinese spent lavishly, although the word seems out of place in this country, on travel, entertainment, jewelry, drinks, liquor, apparel, and duty-free goods. This new spending power could be a result of a smaller housing burden, which has dogged big-city dwellers. Amidst consumption downgrades for daily necessities, emerges a new upgrade trend for big-ticket items like automobiles. In spite of the economic slump we often read about in the newspapers, Chinese household savings amount to USD20 tn, where over 70% is parked in term deposits.

China is facing both headwinds and tailwinds in this economic transition. Some of the headwinds like the property slump are policy induced. Be that as it may, we believe there are gems to be picked after a three-year bear market.

Amongst the **Structural Alpha** stocks in our portfolio are leading companies in the industries that enjoy strong government policy support and are developing competitive products. Some past examples can be found in the solar and EV industries. Valuations are depressed, especially for the forgotten high-quality **Economic Alpha** stocks in sectors deemed strategic by Beijing. Some hold dominant market positions and therefore their businesses have been particularly resilient in times of economic uncertainty. In short, the risk-reward ratios for many of these stocks have never been this attractive.

There is a right price for everything.

Stella Zhang is one of the mainland Chinese pioneers to practice professional investment management overseas from the mid-1990s. She is among the earliest batch of CFA charter holders in mainland China. Ms. Zhang joined APS in October 1996 after working as an investment analyst with Shanghai International Securities, the then largest stock-broking firm in China. She is currently the Deputy CIO of APS Asset Management, with 30 years of experience investing in China equities including H-shares, B-shares and A-shares. Ms. Zhang graduated with Distinction in the Bachelor of Arts from Shanghai International Studies University.