CHINA MONTHLY

OCTOBER 2024

The Big Picture

A team in Shanghai in July successfully removed a cancerous lung tumour from a patient in Xinjiang province 5,000 kilometers away, remotely controlling a domestic surgical robot via China's high-speed, low-latency 5G network in the groundbreaking hour-long surgery.

THE BRIEFING

Retirement Age Reform

China will “gradually raise” its retirement age for the first time since the 1950s, hiking the statutory retirement age by 3-5 years. The changes begin 1 January 2025, with the respective retirement ages raised every few months over the next 15 years. China's current retirement ages are among the lowest in the world.

China Blasts Out Stimulus Package

People’s Bank of China governor Pan Gongsheng will cut the key short-term seven-day reverse repo rate by 0.2 percentage point to 1.5%, guiding the medium-term lending facility (MLF) rate lower by about 0.3 pct point, and the loan prime rate (LPR) and deposit rates lower by 0.2-0.25 pct point. The PBOC will also soon cut banks' reserve requirement ratio (RRR) by 50 basis points, the lowest level since at least 2018, freeing up about CNY1 trillion. The RRR may be further lowered by 0.25-0.5 percentage points, Pan said. That marked the first time both reductions were revealed on the same day since at least 2015, while Pan’s briefing was rare insofar as appearing alongside securities regulator Wu Qing, and Li Yunze, head of the National Financial Regulatory Administration in Beijing. Borrowing costs on as much as USD5.3 tn in mortgages will also be lowered and rules eased for second-home purchases. The PBOC will provide at least CNY800 billion of liquidity support for stocks, adding that officials were studying setting up a market stabilization fund, to expand liquidity for equities.

China Consumer Cheer

Chinese consumption edged up from pre-pandemic levels during the major three-day Mid-Autumn festival holiday in September, with domestic tourists’ spending rising 8% from 2019 to CNY51 bn, said the Ministry of Culture and Tourism. The number of trips increased 6.3% to 107 million. Per trip spending edged up 1.6% from five years ago to CNY477.

USA NSA Meets Xi in Beijing

During Chinese President Xi Jinping’s meeting with US national security adviser Jake Sullivan in Beijing in August, Xi said that China’s commitment to the goal of stable China-US relations remains unchanged and hopes that the US would see each other’s development as an opportunity rather than a challenge. Sullivan reiterated US President Joe Biden’s commitment to prevent China-US competition from veering into confrontation or conflict, and that Biden is looking forward to meeting with Xi again soon. Sullivan also met with General Zhang Youxia, vice-chairman of China’s Central Military Commission (CMC).

THE FORGOTTEN FUNDAMENTALS

By Wong Kok Hoi

Fading China Dreams

In my recent trip, after meeting 70-80 businesspeople in group meetings and group dinners, it is clear that their moods now occupy a narrow spectrum — pessimism, anxiety, exasperation, frustration, and anger — as their hopes for their China dreams rapidly fade!

Businessmen have been worried about bribery investigations for 10 years now. Coupled with the new tax evasion investigations that reportedly look as far back as 30 years, many businessmen's dreams of making more money have turned into nightmares about dual investigations. Such fears also increased after the legislature amended China's criminal law in December 2023 to impose higher penalties on bribe givers and bribe takers. Several businessmen echoed the general sentiment that making the extra million only increases the risk of investigation. Many seemed to have concluded that doing nothing is most prudent, that is, to 躺平 (tǎng píng, lie flat).

Fighting Corruption for Two Millennia

China's corruption problem dates as far as the Han dynasty more than 2,200 years ago. During his 54-year reign, Emperor Wu established China's first recorded major anti-corruption campaign. He implemented several measures to address this pervasive blight within the government and society. Emperor Wu introduced stricter laws and punishments for corruption, ensuring that officials found guilty of wrongdoing faced severe consequences. This helped deter potentially corrupt officials and maintain a sense of accountability as well as integrity. To oversee the conduct of officials and prevent corruption, Emperor Wu established the Censorate, a powerful government agency responsible for investigating and reporting on corruption cases. To ensure fair economic practices, Emperor Wu implemented regulations on various economic activities, such as trade and taxation, preventing monopolies and unfair practices that could lead to corruption. In the US, there was also the Progressive Movement (1890-1920s) to curb political corruption after revelations of the corruptness permeating big corporations and government.

Forty-five years ago, Deng Xiaoping saved the Communist Party of China from despair, gloom and madness by decisively and resolutely pushing forward his reform and opening-up policy. He made two grand declarations: "To get rich is glorious" and "I don't care whether the cat is black or white for as long as it catches the mice". These two assuring statements unleashed the "entrepreneurial genie in the Communist bottle" that was stifled during Mao Zedong's regime. However, it led to excesses, including inequality and endemic corruption.

Eleven years ago, when President Xi Jinping was first anointed as President, he took on the bold task of addressing the excesses, particularly corruption arising from the last 40 years of unbridled, rapid growth. According to APS Asset Management's Deputy Chairman Professor Tan Kong Yam, Xi — once described by the late Singaporean elder statesman Lee Kuan Yew as a man with an iron will — sees cleansing the Party and restoring its moral authority as one of his key missions. He is therefore willing to sacrifice some entrepreneurs and endure some capital flight to achieve this greater mission.

Sadly, businessmen's decisions, especially in the old economy sectors, to "lie flat" is hurting the economy. Not only are they not expanding, but they are also downsizing. Metaphorically speaking, they have sought refuge by **unwillingly returning into the genie bottle**. Job losses, pay cuts, and the fear of being the next victim of retrenchment have led to consumption downgrading since the post-Covid reopening. In addition, households have no desire for property upgrading or property investment, even if they have the means. On the latter, the opposite is happening — selling a second property and downgrading. **In short, the vicious cycle of extremely weak corporate investments leading to job losses that drive consumption downgrading as well as sluggish investments into property and financial assets, is afflicting China today.**

Fortunately, the entrepreneurs in the new economy, i.e. the hard tech and software sectors, are working around the clock to develop new technologies and products. They are China's white and red cats. Several tech company executives had told me that they and their engineers have had to sleep in their dormitories and factory floors for months during lockdowns. Should we be surprised by the seemingly unending, beautifully designed, high-quality new EV models streaming out of the production lines immediately after Covid? They figuratively caught their international peers with their pants down. From all the signs I can see, the EV war is already won by China.

The Forgotten Fundamentals

Many Chinese investors and businessmen are pessimistic about the future of China. The extreme pessimism is epitomized in this remark by one business owner, "This stock market has no floor, only new lows (股市没有最低，只有更低)."

From experience, value investors would jump at this overmuch bearish investor sentiment and compelling valuations to "bottom fish". This view was also echoed by a legendary US hedge fund manager during our recent meeting. However, there are two caveat emptors here. One is the small number of value investors. Two is the odd situation of an increasing number of businesspeople in 躺平 (tǎng píng, lying flat) mode.

When times are bad for too long, like the past four years, it is easy for us to be overly influenced by what we read, hear, and see. Most of the things we hear and read are about the present and the past. We do not hear and read much about the future. Therefore, it may be useful to review China's fundamentals, to see whether China's future is all doom and gloom, or the future is indeed one of optimism and hope.

1. Manufacturing Powerhouse — China has built an immensely productive and efficient manufacturing powerhouse that produces one-third of the world's manufactured products. I do not see this changing in the next 20 or even 50 years, despite calls by the West to decouple. Can India or Vietnam or Japan be the next manufacturing complex of the world? I do not think so. Building a manufacturing powerhouse is not just about building factories, but also constructing infrastructure such as airports, seaports, power plants, roads, building an entire supply chain — including materials, components, logistics, etc, nurturing and training millions of high-quality, industrious and resourceful engineers and technicians, a penchant for meticulousness, and so on and so forth. This colossal asset which China has painstakingly and exactingly built will serve the country well in the decades ahead. **It is not an exaggeration to assert that this massive, productive asset is superior and more robust than any of the ones China had built and owned 10 or 20 or 40 years ago, or during any period in China's 5,000-year history.**

   China's massive trade surplus in recent years is evidence of this prowess and competitiveness. Even when the world economy is sluggish and troubled by trade tensions, China enjoyed a trade surplus of USD600 billion in the first eight months of the year. Even when the Covid years are included, it posted a massive cumulative surplus of USD3.2 trillion! Even the punitive trade tariffs imposed by the US has not hobbled China's trade, thanks partly to its products selling increasingly well in the BRICS countries as well as the rest of the Global South.

2. Fast Catching Up Technology — Except for semiconductors and AI, China is leading or on par with the West. Furthermore, China produces five million STEM graduates a year, more than the next six countries combined, which can be seen as the harbinger of China's future technological capabilities. China has doubled down on R&D in most high-tech industries in recent years. The government-funded Australian Strategic Policy Institute think tank that tracks tech competitiveness in a September report said that during 2019-2023, China led the way in research into 57 out of 64 crucial, advanced technologies ranging from artificial intelligence, to biotechnology, cybersecurity, and defence. When China catches up in semiconductor technology, half or more of US semicon companies will likely face crises or disappear within three years. After Covid, China suddenly became the global EV leader. And the global auto market is the world's biggest product category at USD3 tn, five times larger than the smart phone market and equivalent to 18% of China's GDP. China's Ministry of Industry and Information Technology (MIIT) in September announced a major technological breakthrough: the development of a deep ultraviolet (DUV) lithography machine capable of producing advanced chips of 8 nanometers and below.

3. First-class Workforce — Chinese workers still share the same work ethos and mind-set and mentality that propel China's economic miracle. They are still hardworking; they still want to make more money. The new generation is better

educated, resourceful, disciplined and more skilled. Which countries' students frequently win the International Mathematical Olympiad competitions? This is an important ingredient for economic success, especially in this digital, high-tech world. Most of the successful entrepreneurs are still alive and are at the peak of their lives. Future entrepreneurs would make even better businessmen because they will be more educated, have a global outlook, some will have rich parents and therefore have access to capital from day one, and they also have a massive domestic market.

4. Forward-looking Technocrats — Say what you like, without their long-term meticulous planning and impeccable execution, China would not have gone this far. And many are still around.

5. Safe, Comfortable, Efficient Society — Living in China is safe, extremely convenient and efficient. When you want to buy your groceries, you can get them on the same day after a few clicks on your smartphone, when you are hungry you can get your food in 30 minutes, when you want to travel within the city, your Didi car arrives at your doorstep in minutes, when you travel intercity, you have your amazing high speed rail — cheap and comfortable. And China has built 45,000km of high-speed rail versus Japan's 2,400km. It is the first country to achieve a cash-less society. This list can go on and on.

6. Peace — China has enjoyed peace for a large part of the last 74 years, except for three brief wars — the Korean War, the Vietnam War and with India. This situation should continue. I also see no signs of civil war or domestic unrest arising from racial or religious issues. Public safety is also one of the best, partly because it has not got a drug and gun problem. This peaceful state is likely to continue, which is essential for China's or any country's continued prosperity.

For these reasons alone, it is inconceivable to believe that China has peaked and its future is bleak.

No Gordian Knots

Does China have serious problems? Of course, but they can be overcome with some imagination, decisiveness, and resoluteness.

1. Property market bubble— Do what the Americans did in 1989 to tackle their Savings and Loan crisis of the 1980s, or what the Swedish government did to tackle deflation arising from the 1990-94 property bubble.

2. Stock market doldrum — Set up a USD1 tn fund. Buying stocks at current depressed prices is not a bad idea at all. Setting up a small fund backfires because

investors would interpret it as the government's lack of confidence in the stock market recovery. Often, managing expectations well can by itself restore confidence. Consumer and business confidence has been dented by the negative wealth effect from the slump in property and stock prices. In normal times, governments should not intervene in markets but in a crisis, they must adopt bold, decisive measures.

3. Local government debt — Most economists have argued that local governments are bankrupt because of their massive debts. Is that so? Like companies and households, we must look at the asset side of the local governments before we draw such a conclusion. A cursory look will tell you that they have three valuable assets — land, infrastructure assets, and stakes in SOEs. Moutai, for instance, is 60%-owned by the local government whose stake is worth USD140 bn. Local governments can easily sell assets to raise funds, if they so wish. For example, selling land with 200- or 300-year leases, under the condition that they cannot be developed for say 10 years is one simple, creative solution. In Singapore, we have land with 999-year leases. Chinese households have stacked away USD18 tn of savings in bank deposits. Surely, land should yield higher returns than bank deposits over the medium-term. Privatising infrastructure assets is another form of raising revenue.

All these three major problems can be dealt with by the stroke of a pen. I might have put it too simplistically, but the point I want to make is that there are tested, realistic, uncomplicated solutions for China's current problems, which are not Gordian Knots.

All in all, China's future is not doom and gloom as painted by many. It is merely obscured by the fog of crisis. When the pessimistic winds blow over, China will see sunny days again, as surely as night turns to day. Or to put it in simple terms, bad times, just like good times, especially in the stock market, do not last forever.

A China "Paint Tax"?

What about corruption? According to public data, almost five million party cadres and government officials had been charged with corruption and a large number convicted. A simple arithmetic of 10 bribe givers per official would suggest that at least 50 million businessmen had colluded or cooperated with them. **To investigate all 50 million might take 100 years!** This is despite the Central Commission for Disciplinary Inspection boasting more than 200,000 staff.

Surely, no political and economic system can afford such a long investigation. For the vital interest of the country, surely this must not be allowed to happen.

Speaking with Chinese entrepreneurs, I get the strong sense that XI's anti-corruption campaign has drummed into their heads that bribery is wrong, and China's future must be a nation that is largely free of corruption, like Singapore. This sentiment surely must also be shared by the present party cadres and government officials.

Where do we go from here? One approach would be to dial down the investigations, which should ease the fears of businesspeople, but may not be enough to jumpstart the private-sector locomotive to turn around the economy swiftly and decisively.

One drastic approach worth studying is to deal with it decisively, once and for all, with a general amnesty program. In such an amnesty program, businessmen would declare their ill-gotten wealth and figuratively speaking pay a **"paint tax"**, where colourful cats would be painted white.

In return, they would receive a guarantee from the government that they would not be investigated for past violations. A very drastic proposition for sure, but extraordinary times call for extraordinary measures.

What to do about past violations? Surely, they must not be let off lightly. A penalty of a certain percentage of declared assets can be studied and imposed.

It had been done elsewhere. The tax amnesty implementation in South Africa and Italy (as seen in the table), allowed taxpayers to repatriate capital by paying 5% (or even nothing) of capital located outside their country (offshore capital). The decision (combined with other regulatory options) allowed South Africa to repatriate offshore assets worth 4.4 bn Rand (equivalent to 4.5% of Gross Domestic Product in the relevant year) and Italy to bring in capital worth USD60 bn (Baer & Le Borgne, 2008). Meanwhile, Mexico, which only provided the option of repatriating foreign assets at a rate of 8%, only managed to bring in USD90 million through its tax amnesty program (Brook, 2017). Indonesia has had five amnesty programs in the last 40 years!

Country	Application Period	Offshore Asset Repatriation	Offshore Asset Declaration
Italy	2001	0%	2.5%
South Africa	2003 – 2004	5%	10%
Mexico	2017	8%	Not an option

An enormous side benefit would be that the penalties and fines collected can be a major source of revenue for the local governments.

To avoid a repeat of the same old problems, this time, clear red lines on bribery must be drawn. Businesspeople can make their millions, create jobs, etc. in China's new productive business regime, but without breaking the law. And local governments can collect their tax revenue.

In short, signal to the resourceful, hardworking, savvy, and money-loving Chinese businessmen once again that, "To get rich is glorious." However, this time, they must be only white cats or red cats.

Investment Strategy

After a bear market lasting almost four years and counting, pessimism is widespread and the market’s valuation is very compelling. However, while there are still unresolved issues, one can argue that the market might have broadly discounted the worries. For instance, if the corruption issue can be resolutely resolved, a multi-year bull market would instantaneously take off.

On the other hand, if the fear of investigation continues to haunt the entrepreneurs of the old economy while stimulus measures are minimal, then the market may still have a slight downward bias until the hard-tech sector becomes a key driver of the economy. In this scenario, investors should run concentrated portfolios in three categories of stocks. Stocks in the hard tech sector, which will likely be China’s largest sector by 2026, will strongly outperform as they become increasingly stronger and profitable. The second category will be SOEs and central SOEs, as the government is unlikely to kill its “own sons and daughters”. The third category will be deep value stocks.

The third scenario will be more stimulus measures, including property stabilization actions, which should moderately drive the market upwards.

“When investing, pessimism is your friend, euphoria the enemy…price is what you pay; value is what you get...whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.”

— Warren E. Buffett

Wong Kok Hoi is the Founder and co-CIO of APS Asset Management. He has 43 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.