

China, too big to ignore?

Globally, markets have been in a precarious place, one in which opportunities have been scarce and where we have watched economies walk the tight rope to recovery. Unfortunately, in 2022 China slipped. Weighed down by its stringent zero-Covid policy, distressed real estate sector, crackdown on tech firms, and geopolitical tensions with Taiwan. It's no doubt, that Investors fuelled with pessimism after an onslaught of jumbo rate hikes, and the anticipation of a global recession has also delivered another blow to Chinese equities. However, the rhetoric is changing, and some optimism is resurfacing. China's policy of zero tolerance toward COVID-19 ending and the government's renewed priority for growth give us reasons to be optimistic. As with every well-crafted boomerang, we expect the Chinese economy to return, and in full force.

Zero-Covid Policy

It's not so long ago we were all bound by nationwide lockdowns where bedrooms became our new offices, pyjamas were the choice of attire, and the desire to interact with people outside a zoom meeting grew. The consequence we saved more! China has been in lockdown for almost twice as long as the

western world. But now that zero-Covid policies have been abandoned, pent up savings should re-energise the economy, with consumption expected to drive growth. The International Monetary Fund forecasts approximately 5% growth in 2023, following only 3% seen in 2022.

China's sudden reopening will be the catalyst for a recovery in domestic consumption, with the services sector to be the biggest beneficiary from the loosening of Covid restrictions. Demand for air travel, hotels, and restaurants will all be supercharged as the Chinese indulge in recreational activities once again. Already, Chinese consumers have spent 5.6 trillion yuan (£681 billion) of savings accumulated during the pandemic. Inbound tourism has also spiked since they have opened their borders to quarantine-free tourism, with tourist numbers 23% higher than in 2022. These areas of increased domestic activity tee up the economy for a growth rebound, making the opportunity set for locally listed equities attractive.

Macro-economy

A major headwind for developed markets has been inflation which remains to be sticky. This becomes a problem when the cost-of-living increases and therefore real incomes are squeezed. When this happens, central banks tighten monetary conditions to sap runaway inflation. This is not a China problem, and in fact there seems to be no inflationary risks for China in the near term. The People's Bank of China reiterated its accommodative monetary policy stance which will be targeted and "forceful" to expand domestic demand, stabilise growth, and help improve the overall economy. A reversal in U.S. dollar strength should also be supportive of China's dollar denominated debt, providing more fiscal agility to support China's growth focused objectives.

Historically, Chinese production and manufacturing have helped them gain double-digit paced growth. However, as their economy evolves, China is moving further up the value chain allowing them to capture more growth from services and technology. As a result, they are on the verge of achieving middle income status, which could lead the shift to a consumer-led economy as incomes broaden.

Political Landscape

It has now been five months since China's 20th communist party congress, during which Xi Jinping secured an unprecedented third term as party leader. Posturing for the next five years, Xi placed new leaders, deeply loyal to him on the Politburo Standing Committee, his inner circle of top party officials. This political reshuffle and the historical ideological agenda left over from Deng Xiaoping's era of unbridled reform stoked scepticism initially, with confidence towards China already quivering in the face of its zero covid policy. However, Xi's 2022 Work Report released in December was less ideological than people were expecting, with a more expansive embrace of reform highlighting the need for improving market confidence, and economic policy which prioritises national self-sufficiency over global economic integration. Driven by this need to restore economic growth, Xi also shifted his focus towards the development of entrepreneurship and maximising China's innovative potential to enhance the role of domestic demand. This was all in stark contrast to the 19th party congress agenda which had no comparable language in the work report published in 2017. At the time, the party placed emphasis on a theoretical framework based on a people-centred development philosophy where an overall consideration to material and cultural aspects were given when constructing economic development

initiatives. The current language is now more pragmatic.

China's heavy-handed crackdown on tech firms has also eased. China had forged a path to reign in monopolistic behaviour in the technology sector which involved levying fines on giants Alibaba and Tencent etc. and increasing government monitoring. Many of these regulatory overhangs have been removed to alleviate investor concerns.

Does the name Evergrande sound familiar? This was China's second largest property developer and also the poster child of the property sector bubble in 2021 that eventually brought the economy to its knees. Fast forward to 2023, the Chinese government is also in motion to rescue its property sector, setting out measures to boost developer financing and wipe out negative sentiment., A signal that the property tightening cycle is finally over. This has certainly improved optimism for the Chinese economy as the sector represents roughly 25% of China's GDP.

Investment Opportunities

So far, we have articulated the current state of China's economy, but what does this all mean from an investment perspective? Well, "Like a bull in a China shop," China is too big to ignore. Chinese equity markets have already reacted favourably to the abandonment of zero-Covid policies, which has unleashed an onset of consumer activity in previously dormant sectors. China's task-focused agenda to restore economic growth and their easing of a regulatory crackdown has also helped reignite investor confidence and release the shackles which had shunned investors from pouring inflows into Chinese assets.

On a longer-term view, the increasingly consumer-led economy offers a deep and diverse pool of investment opportunities. China cradles an abundance of idiosyncratic and structural opportunities that focus on digitalisation, electrical vehicles, 5G infrastructure, and artificial intelligence, where companies are leading the charge in innovation and piercing global competition. Self-sufficiency is also on the Beijing government's agenda, especially within the software industry as it favours home-grown software companies and encourages Chinese companies to use domestically produced chips. This domestic bias over foreign peers creates an international moat where sectors that run alongside policy priorities should perform well.

Shifts in structural trends have also helped to vitalise the opportunities within China'. For instance, China's healthcare and wealth management sectors are likely to benefit from an ageing population over the medium to long-term. A sense of "national pride" is another theme that has begun to gain traction. At a point in time, Chinese consumers would pay a premium for foreign brands. However, these days are over. Today, domestic companies are able to offer products just as competitive, or sometimes superior to their foreign counterparts, which has accelerated the preference for local brands.

Headwinds

With optimism building and long-term believers already enjoying the spoils of China's market recovery, we still prescribe an overlay of caution. Although medium-term headwinds do not impair our conviction to China, it may mean a bumpy, stop-start trajectory to recovery. In a manoeuvre to consolidate its

power and control the home of the computer chip industry, China has vowed to bring Taiwan back under its control. Relations between the two nations have since deteriorated. However, we believe there are no immediate risks of tensions with Taiwan curtailing our investment case for China and see this narrative playing its course over the longer-term.

China's surveillance balloon shot down by US forces and speculation the nation may supply weapons to Russia, have also made relations with the US brittle. As we progress through 2023, we hope to see tensions with the US become more subdued and a clearer view of China's stance on aiding Russia. China has already played the role of 'middleman' to help pacify a global rout with Russia.

Conclusion

In our view, much of the pessimism around China is subsiding and we are beginning to see a sentiment change as the nation emerges from its zero-Covid policy and becomes more growth conscious. However, it's important that investors choose an investment partner with local knowledge to uncover China's idiosyncratic and structural opportunities. Our partnership and investment in Polar Capital China Stars have allowed us to capture approximately a 30% gain since the October 2022 trough.

With the abundance of attractive opportunities, we're optimistic; but what about you?

If you would like to speak with us about our approach to investing, our model portfolios, or to discuss our discretionary investment management services in general, please get in touch today.

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