FLASH NOTE

PICTET WEALTH MANAGEMENT
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CHINA - THE PATH TOWARDS YEAR END

REGULATORY RESET AND SLOWING GROWTH LIKELY TO WEIGH ON EQUITIES

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SUMMARY

- China's recovery remains uneven, with a dynamic external sector far outpacing a more sluggish recovery in domestic demand.
- The recent spread of the Delta variant has led to the imposition of restrictions, which will take a bigger toll on the economy than previous episodes, especially on services.
- In the presence of growing headwinds, the policy environment should turn more supportive in the second half of 2021. Monetary policy normalisation is likely over, and we expect an acceleration in fiscal spending.
- Recent regulatory action should be read through the prism of China's shift from the pure pursuit of economic growth to a wish to foster "common prosperity". Given the strategic nature of this shift, the current regulatory push is expected to last.
- China's swift regulatory actions have undoubtedly spooked financial markets even as tensions rise with the United States on US-listed Chinese firms.
- We expect the pressure on Chinese stocks' valuations to continue in the coming months as Chinese authorities have not yet signalled an end to their regulatory campaign.
- Prospects for earnings remain unexciting due to the slowing credit impulse in China, companies' efforts to comply with new regulations and the potentially negative impact of containment measures linked to the spread of the Delta variant.
- Despite investors' cautiousness towards overseas-listed Chinese stocks, there is still appetite for mainland-listed firms, which are less exposed to current regulatory action.
- As we struggle to see major upside for Chinese equities through to the end of this year, we are cutting our target for the MSCI China to HKD 100 (from a previous forecast of HKD 120).
- China's 14th five-year plan indicates where policy is heading. High-end manufacturing (e.g. semiconductors), technology (AI, quantum computing), green tech and health care (biotech) should benefit—but beware high valuations.

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Challenging environment despite trade dynamism

While China was the first major economy to emerge from the covid-19 crisis, the recovery there remains uneven, with growth in exports outpacing domestic demand. In June, Chinese exports expanded by 32.2% y-o-y, up from 27.8% in May, reflecting continued strong demand for Chinese goods abroad as production capacity in many other parts of the world has not fully recovered yet. By comparison, the rebound in domestic Chinese demand has been slower. For example, retail sales expanded by 12.1% y-o-y in June, or 5.3% on a two-year average basis, well below the pre-covid growth rate of about 8%.

The recent spread of the Delta variant of the coronavirus in China adds headwinds to the country's domestic recovery. While the daily number of new infections is still low (124 on 5 August), they are much more widely spread than in previous local outbreaks, with new cases reported in more than half of China's 32 provinces so far. Given the zero-case strategy pursued by the Chinese government, the current outbreak has forced many local authorities to tighten up hygiene policies and impose travel restrictions. Although we believe the outbreak will likely be brought under control, just like previous episodes, the much wider restrictive measures this time around will take a bigger toll on the economy nonetheless, especially on the already sluggish services sector.

Given growing headwinds, we expect a more supportive policy environment in the second half of 2021. The People's Bank of China's (PBoC) recent decision to cut banks' required-reserve ratios (RRR) indicates policymakers' desire to mitigate the impact of the sharp tightening of financial conditions on the domestic economy since early this year. While we do not interpret the move on the RRR as the start of a new easing cycle, it probably does indicate that policy 'normalisation' (i.e. tightening) by the PBoC is over and that its monetary policy stance is now back to neutral. We expect more fiscal stimulus in the second half of this year after a sluggish first half. Issuance of local government bonds will likely pick up, lending support to infrastructure investment.

In the meantime, the Chinese government is stepping up regulatory actions in a number of sectors, with the latest focus on after-school tutoring (AST). These actions, combined with the on-going scrutiny on Chinese internet giants' monopolistic behaviours and their treatment of employees, have sent shock waves through markets and shaken investors' confidence in Chinese equities.

In our view, tighter regulations may reflect the Chinese government's shifting policy priorities. Following President Xi Jinping's claim that the Communist Party had achieved its objective of building a 'moderately prosperous (*xiao kang*)' society, the emphasis may have started to move from a reckless pursuit of economic efficiency (i.e., growth) towards a more balanced approach where social equality has more importance. In addition, growing strategic competition and rising tensions with the US mean that issues of national security, which broadly include economic, financial and data security, have become more urgent. This has prompted Beijing to address some of the nation's vulnerabilities, such as elevated leverage and data security, with implications for sectors like property and internet services, for example. Given the strategic nature of such a shift in the policy paradigm, the current regulatory campaign is expected to last—but it will take some time for markets to adjust.

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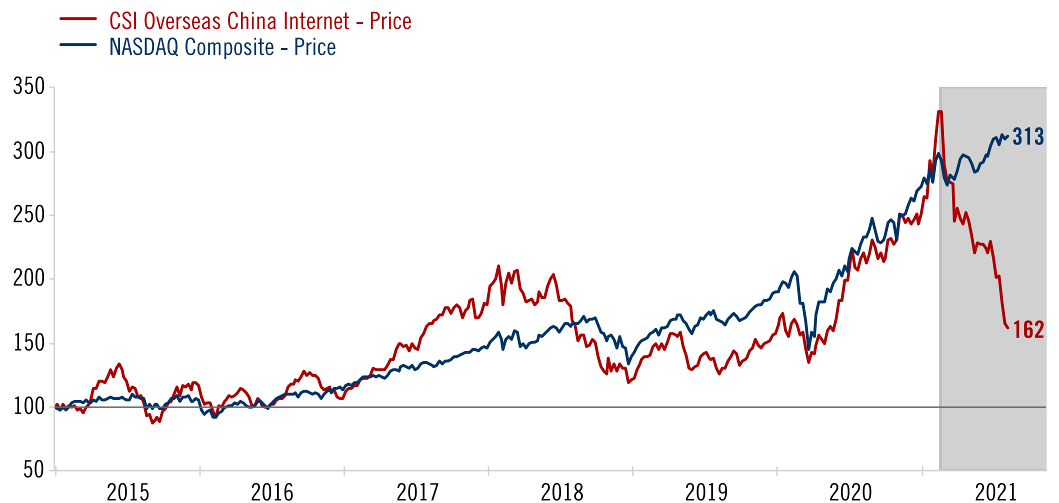
Pressure from both sides of the Pacific

China's regulatory drive has undoubtedly spooked financial markets of late. Concerns actually began to grow in November last year, when the State Administration of Market Regulation issued draft antitrust guidelines that impinged on the business models of leading internet platforms. At the same time, the regulators forced Ant Group to call off its IPO, putting additional pressure on the valuation of Alibaba, Ant's main shareholder (after Jack Ma).

Just as the antitrust guidelines were being confirmed in February, it became clear that regulation efforts were broadening to include large parts of China's 'new economy', with the launch of fresh antimonopoly investigations, closer scrutiny of e-commerce practices and the online tutoring sector, as well as supervisory reviews of fintech firms. Moreover, all these new regulatory measures come after the backdrop of rising tensions with the US, which has accelerated its efforts to cut US funding to Chinese firms linked to the military and threatened to delist Chinese firms from US stock exchanges via the Holding Foreign Companies Accountable Act (HFCA).

CHART 1: CHINA INTERNET VS US TECHNOLOGY STOCKS (USD, REBASED)



Source: PWM - AA&MR, Factset, 5 August 2021

Negative market action surrounding Chinese stocks accelerated recently. The opening of a cybersecurity investigation into ride-hailing group Didi Chuxing days after its New York listing, coupled with very harsh measures on the after-school tutoring (AST) sector, have led international investors to reconsider risks associated with Chinese technology stocks, particularly those listed overseas. The discrepancy between overseas and domestically listed Chinese technology stocks has been widening massively as a consequence: while the MSCI China and ChiNext (a Nasdaq-style index of Shenzhen-listed firms) indices were both roughly flat year to date in early May, the former is now down -12% year to date, whereas the latter is up 20% (both in CNY terms).

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Valuations should remain under pressure for months to come

While the underlying drivers of China's regulatory clampdown are understandable from a social (common prosperity), economic (antimonopoly), financial (stability) but also geopolitical (data security) standpoint, the intense pace and unpredictability of recent actions has clearly unnerved investors. As a consequence, sectors associated with negative newsflow have experienced swift corrections, as was the case with the gaming or tobacco industries this week.

Despite this, Chinese valuations are not depressed. The 12-month forward price-earnings ratio (PER) of the MSCI China currently stands at 13.9x, which is on the high end of its level in the past 10 years. On a relative basis, the 30% discount to developed equities is also broad in line with the past decade. The forward PER for onshore Chinese stocks (represented by the MSCI China A onshore), which were less hurt by recent events, stands at 15.6x, close to the long-term average.

CHART 2: P/E RATIO (12-MONTH FORWARD)

Source: PWM - AA&MR, Factset, 5 August 2021

CHART 3: P/E RATIO (12-MONTH FORWARD)

Source: PWM - AA&MR, Factset, 5 August 2021

We expect the pressure on valuations to continue in the months to come as the Chinese authorities have not yet signalled an end to their regulatory drive. For instance, China's Ministry of Industry and Information Technology (MIIT) launched a six-month campaign designed to tighten norms on data security in the technology industry in July.

Furthermore, tensions with the US regarding overseas-listed Chinese firms should persist. The US Senate recently voted to make the HFCA more stringent, reducing the number of years of non-compliance before firms can be delisted to two instead of three. On 30 July, the SEC announced new measures applicable to Chinese firms seeking listing on US exchanges, requiring significant additional disclosures on their legal structure and the potential related risk of non-compliance with Chinese authorities.

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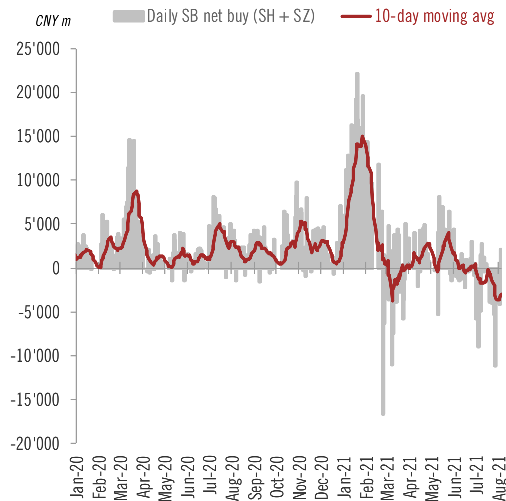
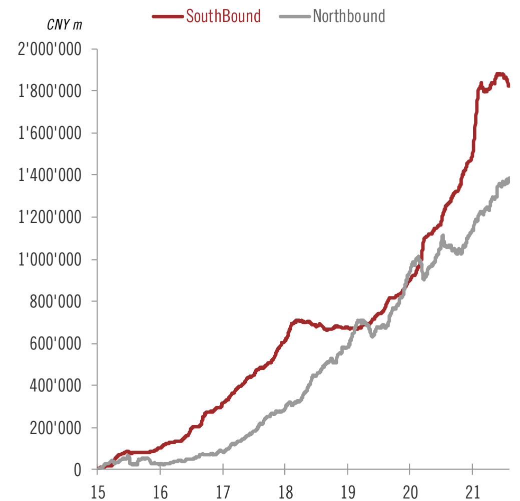
CHART 4: SOUTHBOUND NET BUYING VALUE



Source: PWM - AA&MR, Bloomberg, 5 August 2021

CHART 5: STOCKCONNECT CUMULATIVE NET BUYING



Source: PWM - AA&MR, Bloomberg, 5 August 2021

While there is a clear and understandable mistrust of Chinese technology firms by international investors currently, this is not necessarily the case for Chinese stocks in general. Analysis of StockConnect trades indicates that while mainland investors have been net sellers of Hong Kong-listed shares (many of which are large technology stocks targeted by the current regulatory drive), northbound flows, which reflect foreigners' buying into domestic Chinese exchanges, have remained steady. Overseas investors' continued appetite for Chinese stocks is corroborated by positive flows into Chinese equity funds.

Earnings are unlikely to provide much support

Corporate earnings in China tend to follow credit cycles, which means that credit impulse figures provide a useful leading indicator. As things stand, the slowdown in new credits in China observed at the turn of 2021 should continue to weigh on earnings in the months to come, especially if recent covid flare-ups generate additional mobility restrictions in the country.

The huge rise in China's foreign trade since the covid crisis reflects a temporary shift of global goods production to China rather than a boom in domestic demand. This explains the unusual gap that has opened between foreign trade and corporate earnings (for both offshore and onshore companies). Despite the dynamism of China's external sector, aggregate future earnings depend more on the domestic recovery.

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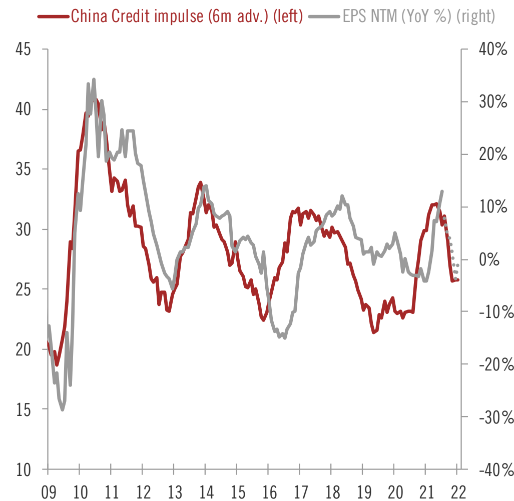
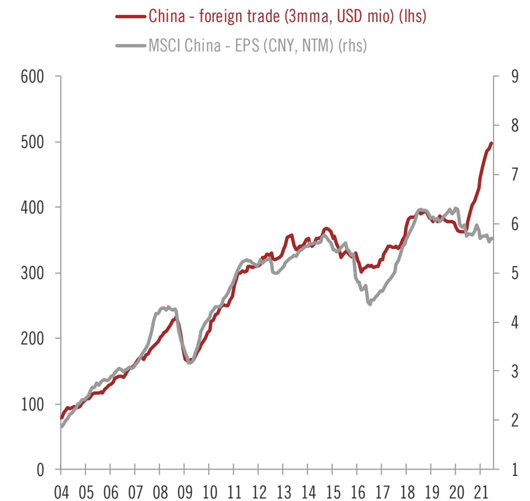
CHART 6: CREDIT IMPULSE VS MSCI CHINA A EPS



Source: PWM - AA&MR, Bloomberg, 5 August 2021

CHART 7: FOREIGN TRADE VS MSCI CHINA EPS



Source: PWM - AA&MR, Factset, 5 August 2021

Additionally, ongoing regulatory campaigns will inevitably impact profitability and bottom lines as companies scramble to adapt to a tighter regulatory framework. Some large and dominant internet companies may also be asked to contribute more to "national service", as illustrated by Alibaba's recent indication that may no longer benefit from favourable tax rebates. Earnings expectations for the MSCI China in 2021 have been revised downwards by more than 9% since the beginning of the year (in USD), whereas those for the MSCI China A Onshore index – which contains mainland-listed firms less impacted by regulatory crackdowns – have been revised slightly up by about 2%. Earnings growth expectations for 2022 are stable at ~15% in both cases.

Limited upside for the rest of the year

All things considered, we struggle to see major upside for Chinese equities through to the end of the year for the market as a whole. We therefore suggest remaining slightly underweight China versus the rest of EM. We refrained from revising our year-end forecast for the MSCI China when it reached HKD 130 in February, but have now decided to cut it from HKD 120 to HKD 100 in acknowledgement of the durable impact of recent events on valuations (and earnings to a lesser extent). The new forecast still implies 6% upside for the MSCI China from current levels.

While we advise caution in the short term for sectors that may be in the crosshairs of the authorities due to the refocus on "common prosperity" or for regulatory reasons (e.g. internet platforms, monopolistic companies or firms leveraging significant personal data, particularly in a cross-border context), the current crackdown does help understand how capital might be deployed in China to stay on the right side of regulators. The high-end manufacturing, green technology and biotech sectors, for instance, are less likely to become targets of government regulation. With this in mind, the China A-share market still appears relatively attractive at this juncture.

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