Whatever it takes, China

by Lorenz La Posta, CFA

This is not the first time I have written about Chinese equities and loyal readers will remember last August[1], when the media were calling it an "uninvestable" market, we were finding pockets of value and interesting opportunities. This year, a new wind is blowing under the Red Dragon's wings.

But let's rewind the tape and press play on February 2021. Valentine's Day had just gone, the stock market was at a peak, but no one knew what was coming. Chinese regulators tightened regulation around privacy and data protection, specifically targeting the hugely successful internet sector. Widely held stocks, such as Alibaba, Tencent and Meituan, started falling as markets marked down their growth expectations. The private education sector was made not-for-profit almost overnight and the main players such as TAL Education and New Oriental Education were wiped out. The real estate sector's excessive leverage was brought down through the "three red lines" regulatory guidelines, introduced in August 2020, aimed at making the sector less appealing for speculators and more stable for the population. As a result, one of the largest developers, Evergrande, moved toward default. All these actions were taken in the name of "common prosperity"; a political objective aimed at making sure China grows in a sustainable and socially responsible way, but global markets saw that as an attack to the private sector and a negative for the country's growth potential.

Now fast forward to the middle of March 2022 - the market was down more than 50%[2] from its peak and the People's Bank of China (PBOC) stepped in to avert this trend. It's not quite a "whatever it takes" moment[3], but certainly the central bank has loaded the big guns.

In a press conference in January, the PBOC had already stated that "after a few months, the downward pressure on the economy will become yesterday's story"[4]. The decline in the macro-leverage in the past five quarters has created room for a more proactive and front-loaded monetary policy and signals are that corporate lending rates are likely to be cut, following the December cut in the medium-term lending facility, and that a reduction in banks' reserve ratio requirements (RRR) could also be in play. The central bank is guiding markets towards a cautious stance on the Chinese Yuan and is willing to keep fighting excessive appreciation.

At the Financial Stability Committee special meeting in mid-March, a few more practical points were laid out[5]. Credit growth was again a priority; the transition to the new model for the housing sector outlined by the "three red lines" is to be smoothed; big technology names will face a more transparent and predictable regulatory environment; Beijing is to work with Hong Kong to stabilise the local market; economic and monetary policies will coordinate to prioritise financial stability; American Depositary Receipts (ADRs) are going to be audited jointly by China and the US; a balance is being struck between Covid-19 containment and economic growth.

Markets have got what they were hoping for. At the time of writing, Chinese equities are up more than 20%[6] from their lows and this could prove to be the inflection point. But there are some lingering questions. Is China going to try to take over Taiwan? Are the trade wars with the US going to escalate further? Is the PBOC going to change its mind and not go through with this accommodative policy? We warrant caution, as always, but we have been constructive on China for a while now, partly because of the cheaper valuation of local assets and partly because of the undeniable attractiveness of a deep equity market with the added tailwind of a more accommodative monetary policy.

1 Momentum Global Matters, "Experts' view on China", 23 August 2021
2 Source: Bloomberg Finance L.P., MSCI China Index
3 Former European Central Bank President Mario Draghi, 26 July 2012
4 Source: 1167 Capital, Morgan Stanley Research, "NPC: Unequivocal Reassurance on Growth", 06 March 2022
5 Source: 1167 Capital
6 Source: Bloomberg Finance L.P., MSCI China Index

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