

# 2022 CHINA EQUITY OUTLOOK: CROUCHING TIGER, HIDDEN DRAGON

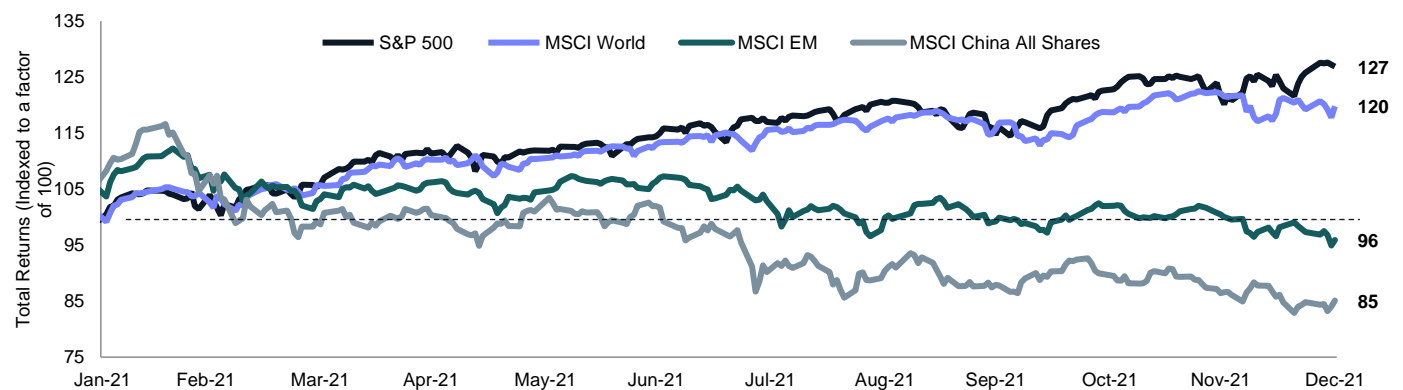
## EXECUTIVE SUMMARY

After a stellar 2020, 2021 was bound to be a different year for the Chinese economy. Equity performance lagged, sweeping regulations were introduced while COVID-19, liquidity concerns in the property sector as well as climate and energy headwinds posed challenges. Faced with a multitude of near-term headwinds in 2022, we believe policymakers will:

- Focus on stability of growth around the concept of “Common prosperity” while engineering a soft-landing in the property sector while taking an easing policy stance to alleviate growth concerns and;
- Continue to drive sustainability and innovation over the long-term, especially in areas of clean energy & new energy vehicles (“NEV’s”), IT software & hardware and healthcare

In an increasingly policy-divergent world, we remain constructive on Chinese equities and believe the long-term investment case for the asset class, centered around consolidation, collaboration of offline & online business models and a broad-based technological catch-up remain intact, albeit with new risk-return possibilities. With that said, risks continue to prevail and we remain cautious of ensuing headwinds from evolving US-China relations, further downturns in the property sector and a potential resurgence in COVID-19 cases.

### Exhibit 1: China equities have been underperforming since February 2021<sup>1</sup>



## POLICYMAKERS ARE FOCUSED ON STABILIZATION IN THE SHORT-TERM

Following a rebound in 2021, China’s GDP growth is expected to moderate in 2022. Given the slowdown was in part engineered by macro policy normalization, growth for 2022 rests highly on policy decisions, especially those targeting the property market, consumption, infrastructure, and Fixed Asset Investment (“FAI”).

### “Common Prosperity” will likely be central to policymaking.

2022 marks the 2<sup>nd</sup> year of the 14<sup>th</sup> Five Year Plan (“FYP”) and the introduction of “Dual Circulation”. In line with policy objectives, advocacy for “common prosperity”, a strategic socioeconomic aspiration aimed at boosting consumption by improving the social safety net and total output, has increased. For the Chinese middle class, housing, education and healthcare are perceived as three major burdens. This, coupled with a record low birth-rate,<sup>2</sup> led policymakers to tighten policies around property, gaming and education while calling for the acceleration of social infrastructure in key areas such as low-cost housing, availability & affordability of healthcare services and greater access to education. Thus, in our view, **“common prosperity” is a growth-oriented strategy at its core and**

<sup>1</sup> Source: FactSet, as of December 2021.

<sup>2</sup> Source: 7<sup>th</sup> National Population Census. As of 31-Dec-2020.

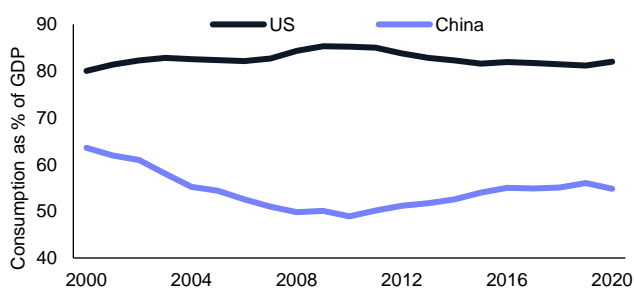
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a comprehensive plan aimed at promoting balanced & sustainable growth while supporting innovation. Moreover, **Consumption is the backbone of the concept of “common prosperity”**. Currently, China’s consumption/GDP ratio remained at the mid-50s in 2020 (vs US’ ~80%) while overall spending on hospitality, healthcare, and professional services is disproportionately lower. Within a reality of constrained income growth, we expect policymakers would likely place more emphasis on sustaining economic and household income growth in 2022 with measures including a progressive taxation system while boosting social security measures. With that said, tighter restrictions around the Chinese New Year holidays and Winter Olympics suggest a meaningful consumption recovery can only be seen from the second quarter onwards. As a result, the government has introduced a set of more proactive countercyclical policy measures to offset the “saving bias” and restore growth. However, we believe any ease in COVID-related restrictions will help spur a domestic consumption recovery, especially in services.

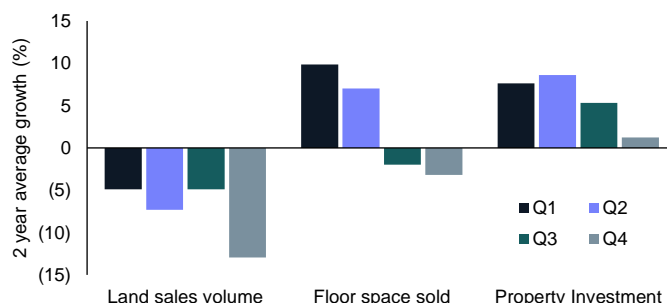
#### A property sector “soft-landing” is in the interest of the broader economy.

The property sector is arguably the most important sector in the Chinese economy driving an estimated 25% of GDP growth with deep linkages to numerous sectors.<sup>3</sup> In 2021, the outlook for the Chinese property sector changed rapidly — monthly activity data indicated dipping mortgage loans, deteriorating household expectations and lower demand. Coupled with increasing macro-prudential oversight, this collection of headwinds has become increasingly apparent and has raised policymakers’ sense of urgency to reverse the downward trajectory. Beijing is signaling it is prepared to do more to stabilize the market and policymakers have reiterated their support for housing affordability and demand,<sup>4</sup> sending a green light to potentially relax property restrictions in some cities. Moreover, the Ministry of Housing and Urban-Rural Development (“MOHURD”) has committed to construct 2.4 million units of public rental housing this year to meet the demand in cities with large population inflows and high home prices.<sup>5</sup> With that said, we believe prospects for full-blown easing remains remote and potentially counterproductive to deleveraging efforts. Simply put – policymakers have been trying to reduce financial leverage in the system, and any sudden jump up in debt would reverse that progress.

**Exhibit 2: China’s Share of Consumption in Total GDP Lags behind US<sup>6</sup>**



**Exhibit 3: Property Weakened Materially in 2H’21<sup>3</sup>**



#### Policy easing would likely accelerate with transmission being the key.

The December Central Economic Work Conference (“CEWC”) acknowledged downward pressures and sent a clear easing signal for macro policies and the property sector. In response, the People’s Bank of China (“PBoC”) has cut RRR and policy rates in an attempt to counter slowing growth momentum.<sup>7</sup> As household leverage and interest burden has trended upward, lower interest rates could serve more to boost consumption relative to a boost in investment. Greater liquidity is also favorable to equity markets as it could flow to sectors which have experienced excessive correction and now present attractive valuations. While China has ample policy room in rates – inflation softened towards the end of 2021 – monetary policy seems to be prudent and flexible, with adequate liquidity for markets but no big easing.

**We believe fiscal policies are key to support aggregate demand and expect more targeted macro policy support to stabilize growth.** For example, local governments (“LG’s”) may play a bigger role in boosting SMEs, rolling out localized tax/fee breaks, and providing financing for infrastructure projects. Indeed, the State Council called for accelerating infrastructure building and the government front-loaded RMB 1.46 trillion (~US \$230bn) of special LG bond quotas to sustain growth and finance key projects in areas including transport & logistics, renewable energy, urban facilities & industrial parks, social welfare, and housing, etc. At the

<sup>3</sup> Source: UBS Research, 30-Nov-2021.

<sup>4</sup> Source: The National Development and Reform Commission (NDRC), “10 measures to boost consumption”, as of 17-Jan-2022.

<sup>5</sup> Source: Goldman Sachs Global Investment Research, The Ministry of Housing and Urban-Rural Development (MOHURD), as of 20-Jan-2022.

<sup>6</sup> Source: CEIC, UBS Research, as of 28-Jan-2022.

<sup>7</sup> Source: Bloomberg, as of 17-Jan-2022. The PBOC announced a 10bp cut to the one-year MLF rate (from 2.95% to 2.85%) and 7-day reverse repo open market operation rate (from 2.20% to 2.10%).

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same time, the growing need to build a more complete supply chain domestically to withstand potential external restrictions could support manufacturing capex in areas of technology and green development. Whether these measures lead to a strong activity pickup depends on how provincial governments decide on different priorities in a political turnover year,<sup>8</sup> but the ultimate trade-off is between the long-term objectives of housing deleveraging & local debt control and near-term objective of stabilizing growth.

## LONG-TERM GOALS REMAIN CENTERED ON SUSTAINABILITY & INNOVATION

### De-carbonization – Driving leadership in renewables and clean energy

Since 2020, policymakers have set stringent targets for de-carbonization including a roadmap for reducing carbon emissions and supporting non-fossil energy development in order to achieve China's goal of carbon neutrality by 2060. Globally, driven by policy support and ambitious climate target announcements, renewable electricity capacity is forecasted to increase by more than 60% between 2020-26.<sup>9</sup> In China's case, the government is aiming for a 13.5% reduction in energy consumption per unit of GDP and an 18% reduction in CO2 emissions by 2030.<sup>10</sup> It also plans to provide support for new energy sectors, including further "Green Financing" solutions. However, the recent power crunch suggests that cutting coal production alone will not be enough to help China achieve these ambitious goals. The International Energy Agency ("IEA") estimates that China needs to expand capacity of wind & solar power by 9x and 7x respectively by 2060, while reducing coal usage by 80%.<sup>11</sup> Thus, investing in the transformation of the energy and industrial sectors will play an essential role in achieving a "green economy". With that said, China's "green" future remains on track. China's total renewable energy capacity exceeded 1,000GW in 2021, accounting for 43.5% of total power generation capacity.<sup>12</sup> From an investment point of view, we expect this to usher new investment avenues across supply chains and propel clean energy innovation, especially within renewable energy product manufacturing and new energy vehicles ("NEV").

*Fun Fact: In 2021, China accounted for ~50% of total renewable energy capacity growth, ~80% of lithium refining and ~77% of NEV cell capacity globally.<sup>13</sup> Moreover, for every 1 battery "mega factory" active in the US today, China has over 24.<sup>14</sup>*

### Tech-advancement – Value creation through innovation

With greater investment into existing supply chains and a diverse pool of engineers at its behest, the country has made significant advancement in the manufacture of semiconductors, Integrated Circuits ("IC"), and industrial automation equipment. In fact, China is the world's largest market for automation products, accounting for roughly 20% of the global supply of industrial robots, and the fastest-growing market with a ~20% CAGR in the last 5 years. In terms of industrial robot usage density, China now ranks 9<sup>th</sup> globally, with density increasing by ~5x over the 5-year period.<sup>15</sup>

While relatively nascent, Chinese semiconductor manufacturers have made steady inroads into the global market, accounting for ~7.6% of global semiconductor sales and ~16% of wafer fabrication & fabless semiconductor sales in 2020.<sup>16</sup> Backed by broad-based innovation, domestic demand and policy support, **semiconductors are likely to represent one of the core investment themes for investors**, especially within A-Share markets. Meanwhile, realizing the importance of developing the domestic software industry, policymakers have launched numerous incentive programs offering free office space, high-tech incubators, and other economic subsidies to stimulate the growth of the software industry. **In conjunction with a strong funding environment, an ever-growing talent pool and the advent of 5G, we expect demand for software applications to increase substantially over the long-term.** Moreover, driven by an upward trend towards digitalization and further accelerated by COVID-19, we view the empowerment of traditional sectors via cloud and private domain traffic as a long-term secular growth story. More specifically, smart retail, development of fintech systems, cloud computing and an increasing focus on network & cybersecurity represent some of the core opportunities in Chinese equities.

### Health Care Innovation – Secular tailwinds present a long-term defensive opportunity

<sup>8</sup> Source: Goldman Sachs Global Investment Research, as of 21-Jan-2022.

<sup>9</sup> Source: IEA via South China Morning Post ("SCMP"). As of 02-Jan-2022.

<sup>10</sup> Source: China Daily, China's 2021 Government Work Report, as of 9-Mar-2021.

<sup>11</sup> Source: International Energy Agency (IEA), HSBC Global Research, as of 15-Oct-2021.

<sup>12</sup> Source: National Energy Administration. As of 31-Dec-2021.

<sup>13</sup> Source: Bloomberg. As of 31-Dec-2021.

<sup>14</sup> Source: Benchmark Mineral Intelligence. As of 31-Dec-2021. A battery "megafactory" is a term used to describe a lithium ion battery cell production factory which is capable of producing over 1 GWH (gigawatt hour) of battery cells per year.

<sup>15</sup> Source: International Federation of Robotics. As of 31-Dec-2021. Density measures per 10,000 employees.

<sup>16</sup> Source: SIA Analysis. As of 31-Dec-21.

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Innovation in China has been broad-based, and the Healthcare sector has been a key area of focus. Rapid modernization in healthcare has been driven by the combination of availability of talent, supportive policy environment, consumption upgrade and heavy R&D spending. This, when combined with an aging demographic — China’s senior citizen population is expected to double to 480 million by 2050 (~35% of the population) — is driving secular growth across the sector. Underpinned by this backdrop, China’s pharmaceutical contract development and manufacturing organization (“CDMO”) and contract research organization (“CRO”) sectors have blossomed. Meanwhile, China is aiming to create a more affordable healthcare system by reforming the pricing of medical services in more traditional areas (i.e. public hospital and pharmaceutical supply chains). In the newly proposed reform plan, the National Healthcare Security Administration (“NHSA”) aims to carry out medical services pricing reform by 2025 with a goal to standardize medical services, introduce dynamic pricing of services, and ease the regulatory burden for new types of services.<sup>17</sup>

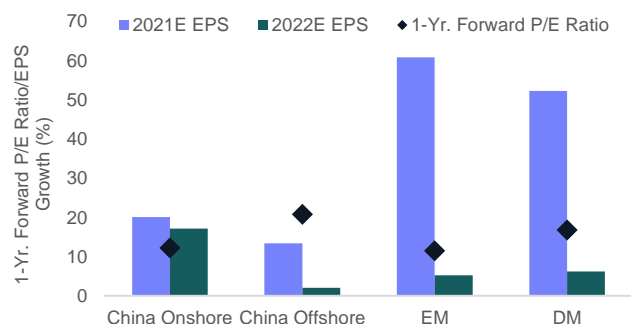
We aim to be selective given near-term risks around healthcare pricing reforms which might affect corporate profitability. However, in the medium term, we believe the CRO/CDMO subsector, despite the recent volatility, may be the fastest-growing healthcare subsector in China, providing exposure to drug invention and R&D from pharmaceutical & biotechnology companies, with little risk of price cuts. Chinese CRO/CDMOs have already started the diversification process by adding more non-US suppliers and pushing for localization of their supply chains. Additionally, global value chains have become increasingly entrenched over the past decade. Therefore, any disruption in the development of CRO/CDMO leaders and China biotech companies is likely to materially impact the operations of global biotech companies. Lastly, in case of more virulent COVID-19 strains transmitting globally, Chinese CRO/CDMOs can further benefit from increased R&D spending on COVID-19 related drugs, vaccines and diagnostics.

## THE RIGHT TIME TO REVISIT CHINA EXPOSURE

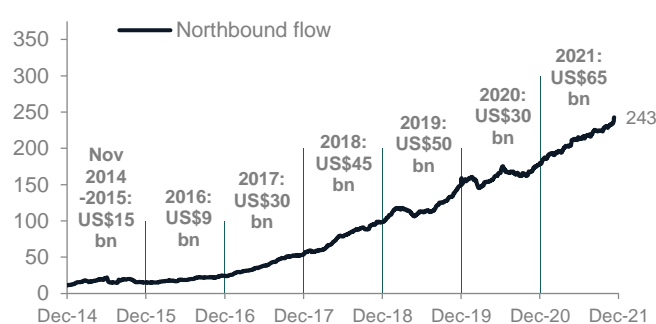
China has historically been a nirvana for active managers (100% of active managers have outperformed the MSCI China A Onshore and MSCI China Indices over the trailing 10-Year period<sup>18</sup>), and we believe the greatest opportunities to generate alpha lie with an active, fundamental-driven investment approach. For long-term investors, China equities merit a refreshed review given the unique exposure they offer to the structural transition of a continental-sized economy.

**China equities offer potential diversification benefits, attractive valuations, robust earnings and stand to benefit from increasing foreign investor flows.** In a policy-divergent world, allocation into Chinese equities might provide further potential diversification benefits given the historical low correlation with development market equities.<sup>19</sup> Moreover, Consensus EPS growth estimates remain healthy at ~20% for 2021 and ~17% for 2022<sup>20</sup> (A-Shares) while valuations are becoming increasingly attractive with China onshore/offshore equities’ forward 1-year P/E trading at a 19% and 36% discount to DM equities respectively.<sup>21</sup> Lastly, foreign investor flows in China remained quite strong in 2021 and YTD 2022, indicating conviction in the overall investability of China. With accommodative policy stance, China A-Shares look better positioned from a regulation perspective while foreign investor appetite remained robust with Northbound Stock Connect net flows topping \$65bn in 2021 (and \$5bn YTD),<sup>22</sup> surpassing annual flow in all previous years while China also saw \$36bn inflows from global funds, the highest level since 2015.<sup>23</sup>

**Exhibit 5: Valuation & Earnings of China Equities Remain Attractive vs Global Counterparties<sup>20,21</sup>**



**Exhibit 6: Foreign Investors Flows in China have Remained Strong<sup>22</sup>**



<sup>17</sup> Source: China Daily, Communique of the 6<sup>th</sup> Plenary Session of the 19<sup>th</sup> Central Committee of the Communist Party of China, as of 12-Nov-2021.

<sup>18</sup> Source: Mercer, as of 31-Dec-2021.

<sup>19</sup> Source: Bloomberg, as of 31-Dec-21. Correlations represented by weekly trailing 10-year returns. Past correlations are not indicative of future correlations, which may vary.

<sup>20</sup> Source: FactSet, I/B/E/S, Worldscope, MSCI China A Shares Onshore Index. As of 16-Dec-21.

<sup>21</sup> Source: Bloomberg. As of 31-Dec-21. Represented by BEst 1-Yr Forward Price to Earnings (P/E) Ratio.

<sup>22</sup> Source: Goldman Sachs Global Investment Research, Wind. Connect flows as of 22-Jan-2022.

<sup>23</sup> Source: Bernstein Research, as of Jan-2022.

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**The focus on ESG will create new alpha opportunities.** There has been significant uptick in policy support in China, evinced by climate transition goals, focus on establishing a green financial system as well as the commitment to improve company ESG disclosures. Moreover, the Hong Kong Securities Exchange has also made it mandatory for companies to disclose key social and governance metrics to better align practices with global counterparts. At the company level, we believe a greater focus on ESG disclosure and adoption of sustainable practices when combined with greater foreign flows and institutionalization of equity markets will lead to a plethora of alpha opportunities benefitting locally-based active managers with ESG integrated approaches.

**Long-term opportunity remains intact and stronger than before.** As mentioned in previous pieces, in spite of recent changes, the long-term opportunities in the asset class remain intact. As a reminder, **we have high conviction in the “Three C’s”**, or three key investment themes of China, which have withstood the stress test of 2020 & 2021 and are emerging on the other side stronger than before. We remain constructive on these key trends:

- Consolidation of “old economy” sectors
- Collaboration between online and offline economies
- Corporate innovation driving a technological “catch-up”

In our view, these themes will continue to provide compelling investment opportunities in China. The consolidation of more mature sectors may give rise to more well-run and dominant companies emerging as competitive brands on a global stage. The rapid digitalization of the Chinese economy, accelerated by COVID-19 and growing influence of over 400 million tech-savvy Millennials may spawn opportunities for improved operational efficiencies and growth. Policymakers’ emphasis on encouraging domestic innovation is spurring growth across a variety of segments, and a paradigm shift towards a sustainability-focused growth model could provide attractive secular growth trends for investors to tap into.

Finally, given the robust earnings potential, potential diversification benefits, attractive valuations and inherent inefficiencies, we highlight three main approaches to a China equity allocation:

- A “passive” approach, where China exposure comes through an allocation to a Global EM manager (benchmarked against the MSCI EM Index) and is about 5% in A-shares.
- A dedicated satellite or standalone 15-20% exposure to A-shares, on top of an existing EM allocation, to boost China onshore market representation to a level more in line with its economic importance.
- A combined EM ex-China and standalone China All-shares allocation to holistically capture investment opportunities across onshore and offshore markets while keeping in mind overall portfolio risks.

## KEY RISKS

### Risks: US-China Relations, Property Sector Downturn, New COVID Variants

Though muted in 2021, geopolitical tensions could remain an overarching headwind into 2022. A number of possible scenarios have emerged in the aftermath of the US-China trade friction with tensions extending to numerous areas including regional disputes, issues around human-rights, cybersecurity, intellectual property and even sports. For China the biggest concern was the potential sanctions of advanced technology which might impact its tech supply chain. **Although tensions could remain elevated in the medium term, true decoupling will be difficult given the significant integration that has occurred between the two economies. However, there are areas where cooperation can yield mutual benefits such as combating climate change and the pandemic.**

**Potentially sharper property sector downturn remains another key risk.** As mentioned above, recognizing the importance of stability in property markets, policymakers have introduced measures to alleviate the issue including directing banks to avoid overdoing curbs and maintain positive growth in outstanding development loans. It is important to closely monitor the magnitude and pace of the easing and the efficacy of these policies which can help to boost market confidence

Lastly, **the evolution of the pandemic and related restrictions will directly affect how quickly China’s 2022 growth stabilizes.** Although China has fully vaccinated ~86% of its population<sup>24</sup>, newer variants of COVID-19 that could evade vaccines remain a risk. Moreover, the rising economic cost of the Zero-COVID Policy in the form of travel curbs, long quarantine requirements and potential impact on foreign investment may further weigh on growth. However, immunity from vaccination as well as recent infections should lead to better control of the virus. Therefore, while new variants could pose hurdles to economic recovery, the overall impact is not expected to be as severe as the previous variants.

<sup>24</sup> Source: Goldman Sachs Global Investment Research, as of 28-Dec-2021.

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