MOUNT MURRAY INVESTMENT

Blog
May 15th, 2024

Source: New York Times

**Is China investible?**

In a previous blog, we briefly posed the question “Is China investible?” and promised a more complete answer at a later date. A full accounting would probably need several hundred pages to cover all the relevant material, but here we aim to address what the key issues are for Mount Murray Investment and our clients.

**The opportunity**

Foreign merchants have long dreamed of the riches they could make in China. A 19th century UK mill owner is alleged to have claimed that if he “could add an inch of material to every Chinaman's shirttail, the mills of Lancashire could be kept busy for a generation”. In the modern era, China’s accession into the World Trade Organization in 2001 was met with equal excitement. Suddenly, foreign corporations had to have a China market strategy. Car makers signed joint venture agreements with local partners. The western manufacturers gave away years of intellectual property just so they could get into the market, dreaming of adding a Chevy or Golf to the driveway of every Chinese household.

For a while, US automakers made more profits in China than they did in the US. Now they, and the Europeans, are busily building barriers to keep Chinese made EVs out of their domestic driveways.

The World Bank estimates the Chinese economy was the world's largest in 2022 in PPP terms at $30.3 T, compared to the US at $25.5 T. India was the next largest, at $11.9 T. China is the world's largest car market. Pre-pandemic, it was the world's largest internal tourism market, and was the world's third most visited country by foreigners. Anyone who has been to the Great Wall or seen the Terracotta Army can attest to how spectacular they are. The old Portuguese enclave of Macau always seems like a more "exciting" place to attract gamblers than Singapore.

**The problem**

By any measure, the Chinese stock market has had a disastrous three years. The local CSI 300 Index peaked in early 2021 and it has been downhill ever since. In January of this year, it reached a new low. Since then, we have enjoyed a small bounce, but is it sustainable? We have had several false dawns lately.

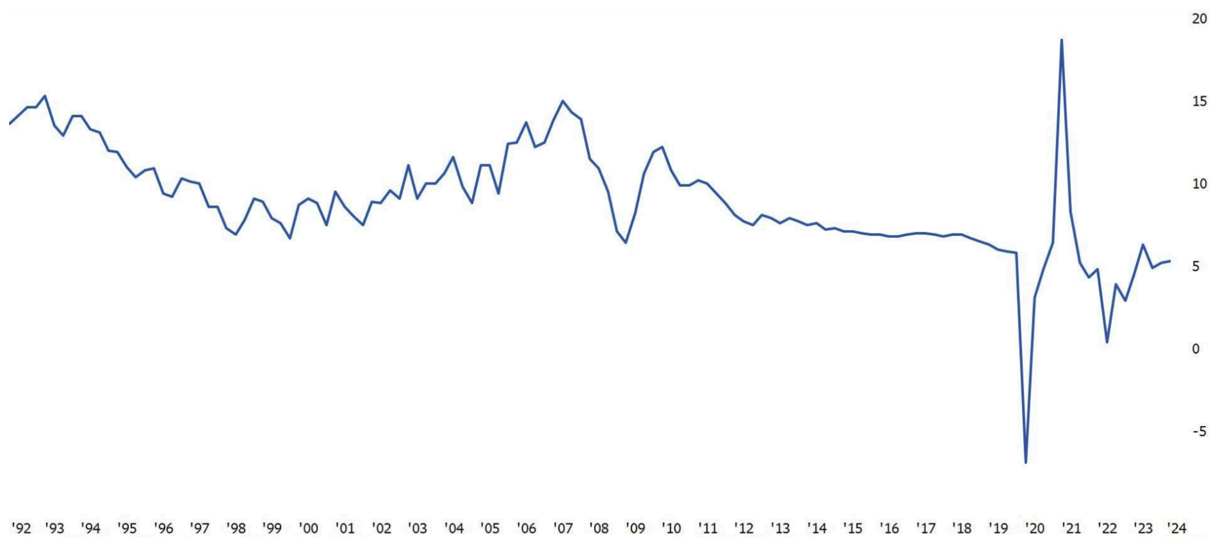
Shanghai CSI 300 Index

Source: Bloomberg, May 2024

China faces a demographic decline, more pronounced than ours, local governments are mired in debt, and the property sector has been in a major slump for three years. Problems that could previously be outrun by high levels of economic growth are now existential threats.

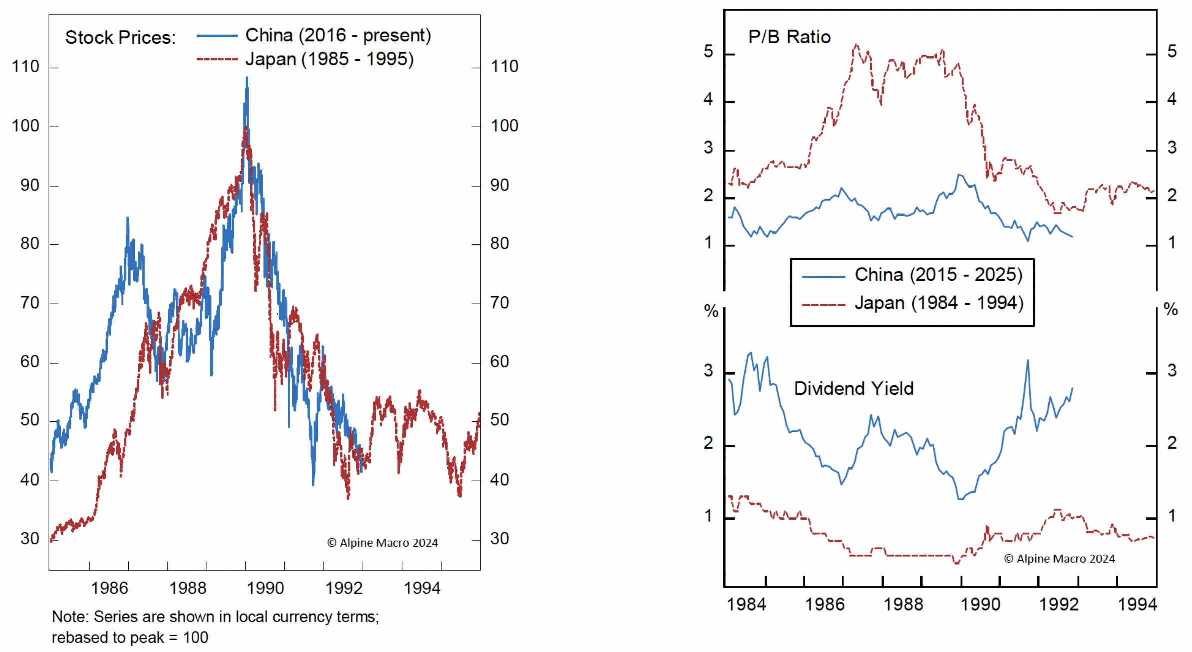
As the chart below shows, China's rate of growth has been slowing down for years. In our longer-term outlooks, we have been using an approximation that trend growth would fall by 25 to 35 bps a year. J.P. Morgan recently updated their assessment, suggesting a potential growth rate of 3.5 - 4% in 2025.

China GDP Growth



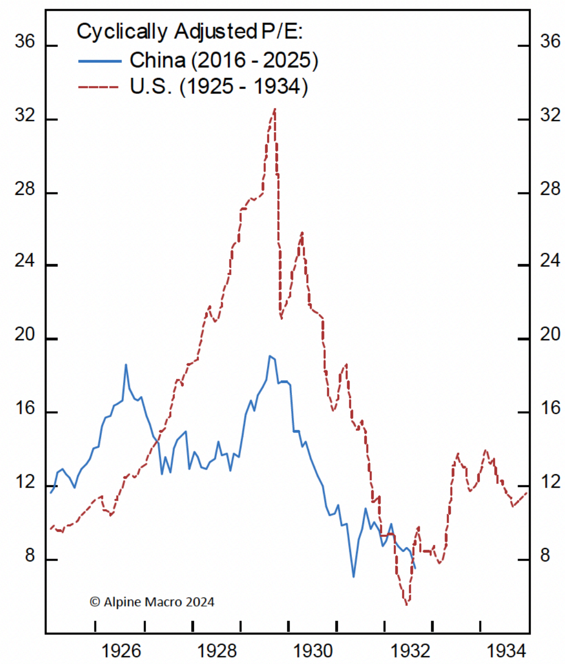

Source: Bloomberg, May 2024

In March 2022, JP Morgan described China Internet stocks as "uninvestable", although they did walk the comment back as an "error" a few days later. Comparisons are being made to Japan's "Lost Decades". Two charts from our friends at Alpine Macro highlight the similarities (and the differences).




Source: Alpine Macro, February 2024

From peak-to-trough, the fall in share prices does look remarkably similar in China recently than in Japan decades ago, but Chinese stocks never reached the excessive valuations seen during "Peak Japan".




Source: Alpine Macro, Feb 2024

Chinese valuations in January were apparently comparable to the trough of the Great Depression, again without having "enjoyed" any real bubble beforehand.

Anecdotally, many international pension funds have been reducing their exposure to China as a response to political pressure. Given their heavy exposure to illiquid assets such as real estate and private equity, they have been forced to sell down their public market exposure to get to their targets quickly. This would certainly explain some of the extreme low valuations we have seen, as well as the record premium that China A shares traded over their H share equivalents (see chart below). At some point, that selling pressure ends.

China A - H premium

Source: Bloomberg, May 2024

**The bad**

There are some signs of recovery in the wider Chinese economy as foreign tourists return, Q1 2024 GDP beat estimates and manufacturing production expanded in April. So why the disconnect between the stock market discounting an apocalypse, and an economy that is "not great"? First of all, China hasn't done itself any favors. The long, slow death of the property developer Evergrande has been a major overhang that can be traced back to the introduction of the "Three red lines" policy in 2020 (which stated property should adhere to the rules of 1 -liabilities not exceeding 70% of assets 2- net debt lower than equity 3- cash at least equal to short term debt). This policy was designed to squeeze out the excess lending to, and over reliance on, China's property sector. But despite missed bond payments and a ratings downgrade, Evergande festers on.

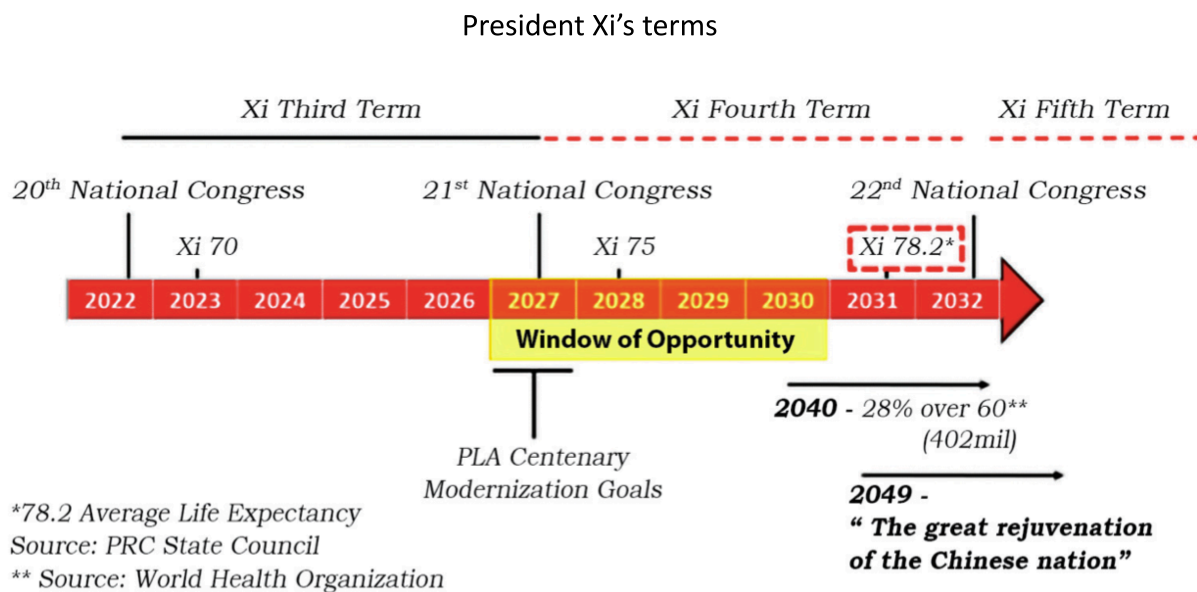
Chinese policy making is handicapped by fear of association with a failed policy. One of the best China analysts we know recommends the film "Death of Stalin" as an allegory for the

dysfunction this fear causes. After the Hainan Island incident, the US suggested that they set up a "hotLine" with China to de-escalate any such future incident. A sensible idea, but insiders have suggested that it would never work because the Chinese would never answer the phone when it really mattered, for fear of being associated with the problem.

For the government's three red lines policy to work, property developers had to feel pain. Ideally, at least one would go bankrupt if only "pour encourager les autres". Even if the intention was merely a near-death experience rather than outright bankruptcy, the risk of such a draconian policy having serious unintended consequences was real. Given how large the problem was, there should have been some kind of plan to deal with the fallout. Any plan would almost certainly have been better than the obvious lack of one. Nevertheless, it appears to have reached the point where no one wants to propose a solution in case they are made responsible for the initial failure. The collapse in the property market has thus become self-fulfilling, with Chinese consumers expecting house prices to continue to fall further, sapping consumer confidence further. Why buy a property now if you may be able to buy it cheaper in 6 months?

Secondly, China's increased bellicose stance over Taiwan has raised fears of an invasion, especially after Russia's invasion of Ukraine. Increased tensions over the nine-dash line, and the militarization of disputed islands in the South China Seas, have only added to fears. The 2027-2030 period is cited as a window for China to forcibly annex Taiwan, based on China's military capabilities, her demographics, and Xi's age. Such speculation appears to have backing from the Pentagon.

President Xi's terms




Source: Journal of Indo-Pacific Affairs, March 2024

The risks of confrontation have almost certainly risen, but according to Ian Bremmer of Eurasia Group, it is still unlikely. It doesn't fit with Xi's attempts to project an image of

himself as a statesman and peacemaker. Xi clearly likes people to know he is the boss, but he doesn't appear to crave the macho image that President Putin does. Meanwhile, the mess Russia finds itself in in Ukraine offers a salutary lesson in the riskiness of such ventures. Is Xi in a rush to annex Taiwan? We don't know. He has certainly ramped up the rhetoric, but so has the US. Nancy Pelosi's 2022 visit to Taiwan was intended to be confrontational and it succeeded. More recently, President Biden has stated very clearly that the US would come to Taiwan's aid if it were attacked, a step his predecessors have refused to take. So yes, China will be stronger in 2027, but so will Taiwan, and the costs will be much higher.

Lastly, let's turn to the economy itself. We all know the numbers are fixed, so no one trusts the numbers, right? We do indeed know data series have been canceled when the information was less than positive, and other series are questionable in their accuracy. The Youth Unemployment series was canceled in June 2023 when it showed a rate over 21%. It "reappeared" in Jan 2024 with a new rate for December 2023 of 14.9%. It would be great to think that all those young people had actually found jobs, but it is unlikely. According to the National Bureau of Statistics, the difference was due to the exclusion of high school students looking for part-time work. That might even be true. We have known for years Chinese stats are a problem. The St. Louis Fed produced a great paper in 2017 that addresses some of those issues. If the GDP number for 2023 was too high, how about the previous year? We know that early estimates of GDP growth were on average too low, requiring an upward revision of GDP prior to the Great Recession. The use of alternative measures, such as power consumption, to "cross reference" the official numbers, has been common practice for a while.

Government policies to address the slower growth, such as lower mortgage rates, mortgage down payment reductions, and lower reserve ratios for banks have all been equally unsuccessful. These measures are just "pushing on a piece of string". The cost of credit isn't the problem, it is the lack of confidence from the Chinese consumer. It is also the lack of "animal spirits" from entrepreneurs who see the government's interference in any business as their biggest obstacle. The actions the authorities have taken so far have been useless, possibly even worse than useless, giving the impression the authorities are lost. They betray the same dysfunctional decision making evident elsewhere in the economy. They treat the symptom, not the disease. Replacing the head of the China Securities Regulatory Commission (CSRC) with a more aggressive "Wolf-Warrior" doesn't address the underlying issues.

Despite the uselessness, they have a bright side. Someone somewhere has recognized something is wrong. The first part of fixing any problem is to understand you have one, and it is that recognition that brings us hope. We know Xi will never admit to a mistake. There will be no Liz Truss style reckoning, but that does not mean that change won't be coming. For instance, last December, regulators brought in new rules for mobile gaming that appeared to contradict previous commitments to the sector, causing a major sell off. But in January, the government walked back the new rules, promising better coordination going

forwards, and demoted the regulator. That reaction was quite the step forwards, even if it was after one or two steps backwards. Things simply not getting worse is not a reason to go overweight a market, but it does suggest there will be opportunities for the careful investor.

**The change**

What needs to change to make China anything more than a tactical overweight? Front and center for us would be a clear indication that the government understands that the old, command economy approach isn’t going to work. That would require the introduction of a clear policy that improves the lot of consumers. Why consumers? Because consumption is a bigger part of the economy than manufacturing. Simply boosting manufacturing capacity, then exporting the excess supply, isn’t going to work anymore. Domestic demand needs to rise, and for that you need consumers who want to consume.

We were stunned in April last year to know Evergrande’s EV business was still operational and seriously negotiating a recapitalization. What was a property developer even doing developing an EV? The simple answer is following government guidance. There are around 30 EV “producers” in China, with large “non-auto” firms Xiaomi and Huawei recently expanding their presence. The world doesn’t need 30 EV producers, let alone China. The local market can’t absorb the supply, and certainly won’t while consumers lack the confidence for large scale purchases. Local governments throwing capital at them so they can export, often at a loss, would be throwing good money after bad. A subsidy war with the US and EU will only exacerbate systemically high debt for all parties.

A recent McKinsey report highlights the importance of services and consumption to growth. Supporting consumption will boost domestic demand, and it is a necessary step to breaking the feedback loop between low growth and low demand.

China macroeconomic and consumption indicators (January-September 2023)

**Macroeconomic indicators**
YoY growth in percent[1]

| | vs. 2022 Q3[2] | YTD[3] |
|---|---|---|
| Real GDP growth | 4.9 | 5.2% |
| Retail sales (goods) | 3.1 | 5.5% |
| Retail sales (foodservice) | 14.0 | 18.7% |
| Air passengers | 108.2 | 126.7% |

**Growth of key consumer product categories**
YoY growth in percent[1]

| | vs. 2022 Q3[2] | YTD[3] |
|---|---|---|
| Food | 5.2 | 5.3% |
| Cosmetics | 3.0 | 6.8% |
| Clothing | 3.7 | 10.6% |
| Home Appliances | 0.8 | -0.6% |
| Auto | 3.4 All vehicles<br>+28% EVs | 6.7% All vehicles<br>37% EVs |

Source: McKinsey & Company, November 2023

Foreign manufacturers aren't abandoning China. Yes, many are pursuing China +1 strategies that will see other countries increase their manufacturing capacity and become bigger players in global supply chains, but Vietnam can't absorb all that manufacturing capacity. Nor can India, or Mexico… For 2022, only the US received more foreign direct investment (FDI) than China. For 2023, FDI was dramatically down in China, but still net positive by $33BN.

Finally, Chinese authorities have taken notice of the stock market's performance, hence the replacement of the head of the CSRC. We don't think this is out of concern for foreign investors nursing painful losses on their positions. The role of foreign investors in China's stock market is limited, with overall foreign participation below 3% and a lot of that mostly from Hong Kong[1]. But their influence on domestic investors is likely larger, when considering companies and industries in a government-directed economy. Nevertheless, the government's focus has been on the domestic investor.

From a practical perspective, if the authorities wish to encourage Chinese savers to reduce their reliance on property, they need to support a viable alternative. A stock market that is a one-way bet down won't cut it. We have seen pointless formal and informal bans on short selling, bans on selling at the close, bans on selling before the Luna New Year Holiday. We have seen the "National Team'' of state-controlled funds buying up shares to support the market. Often, the rally that follows quickly fizzles as investors sell into them. Once again, they treat the symptom, but not the disease.

[1] FinanceAsia, May 2024

Getting rid of zombies, such as Evergrande or the smaller EV manufacturers, and encouraging consolidation would be a step forwards. It's not about creating national champions, it's about allocating capital to firms that can grow. Better corporate governance, with large successful firms encouraged to return excess capital to minority shareholders via dividends would be a significant step forwards - not unlike the reforms that are lifting the Japanese and Korean markets currently.

Finally, all of this would require Xi to recognize that a wealthier, more dynamic China is more secure than a poor, isolationist one. Misallocation of domestic capital and mispriced interest rates due to government-directed lending benefit from foreign capital mitigation.

**Last word**

It was Churchill who famously said of the Americans that they were always sure to do the right thing, after they had exhausted every other possibility. We believe that China will get there too, hopefully in fewer steps.

Best regards,

*Mount Murray Investment*