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March 2022

Latest Views on China

Views as of March 17th, 2022

- Alongside recent dramatic moves in Russian assets and, relatedly, many commodities, there have also been very significant declines in many Chinese financial markets. This update aims to discuss some of the causes for this, and to examine potential future developments. It may be worth comparing to our December 2020 note explaining why we had turned markedly negative on Chinese equities.
- Year-to-date, MSCI China has returned -25.3% (to 14 March 2022) in CNY terms. Since the peak in October 2021, the return in CNY is -42.7%. Within that, though, losses have been strongly concentrated in a couple of key sectors. Chinese technology companies have been very weak since they peaked in February 2021 – the CNY return for the Hang Seng Technology Index since the peak is -66.2%, with half of that decline coming since the start of 2022. Similarly, since February 2021, MSCI China Real Estate is down 51.1% in CNY terms.
- The Renminbi has strengthened against the US dollar since the 2020 equity market peak, but weakened since global financial markets became more volatile in late February 2022.
- Chinese government bonds have been largely stable during the period, but there have been some major dislocations in the corporate bond market. The pain in corporate bonds is particularly in the (large) real estate industry. Many major real estate developers, such as Evergrande, Sunac and Guangzhou R&F now have bonds that trade at cents on the dollar.

There are number of reasons for the ongoing sell-off in China:

- Firstly, it seems that current variants of Covid-19 have broken through China's zero-Covid policies. Hong Kong is currently seeing vary high case rates and death rates, and outbreaks have been seen in a dozen Chinese provinces and in major cities including Beijing, Shanghai, and Shenzhen. The Chinese government has done a good job of vaccination, with 87.4% vaccinated, but the economic implications of strict lockdowns in major urban and industrial areas (which is what current policy calls for) are serious, and Chinese equities are trying to price this in. This has led to Chinese stocks in the 're-opening' industries such as aviation, travel, tourism and leisure being particularly hard-hit in recent weeks.
- Secondly, because of tighter monetary policies and the industry-specific crackdown on borrowing in the real-estate development industry, the slowdown in activity that we flagged in 2020 continues. PMI numbers have been just above 50, indicating a mild overall expansion in the economy, but the surging trade surplus shows domestic demand undershooting production, and the property sector data remains very difficult.
- Real estate investment growth picked up to +3.7% yoy in February (but

still below nominal GDP growth), but new project starts were -12%yoy, the area of land purchased declined to a 22-year low (8.4m sqm, a level last seen in 2000), housing sales were -19% yoy (and -32% yoy in the 36 key cities and housing completions were -10% yoy.

- This weakness in real estate is because of the national-level crackdown on heavily-levered property developers, and also because of local-level interventions, especially restricting the amount by which property prices are allowed to fall, which makes the market illiquid. There is evidence of spreading distress in many real estate companies, including heavyweight Evergrande which defaulted in December 2021.
- Thirdly, domestic policy towards specific sectors has been a major driver of falls in share prices in those sectors. By far the most important one of these the tech sector, where a major crackdown on competitive and other business practices began after Alibaba founder Jack Ma's speech in October 2020 in which he criticized Chinese regulators. This hostile regulatory environment has significantly weakened investor sentiment and led to a dramatic re-rating in the names. At the time of writing, 16 March 2022, there has been a bounce back in some of the tech names that had performed poorly – this has been partly attributed to Vice Premier Liu He indicating Chinese policymakers desire a stable stock market. We shall have to see how actual policy progresses.
- Fourthly, another medium-term challenge for Chinese equities has been the US government steadily increasing restrictions on US investors investing in Chinese companies. A presidential executive order in November 2020 prohibited new investments in securities of Chinese businesses that the US government believes have links to the Chinese military. Accelerating the concern, a March 2022 order identified 39 US-listed Chinese companies that need to resolve US regulatory issues or delist from US exchanges, and five of those have only weeks to comply. Although switching to Hong Kong primary listings is an established route to solve this, the prospect of many of the shares currently held by US and international investors being forcibly sold has driven share prices lower.
- Finally, the most recent, and potentially most destabilizing development is the request by Russia for Chinese economic and military aid in its war with Ukraine. This raises the possibility that the US and its European and other allies might sanction China along the same lines (but presumably to a lower degree) to the Russian sanctions that have proved so catastrophic for Russian capital markets. This is clearly a risk with a very small probability of a very large impact, which is difficult for markets to price.

Our portfolio positioning towards China has been consistent through this period: underweight, and largely defensively positioned (both with regards to balance sheet positioning, and by sector/industry). We have held exposure to companies in more cyclical sectors but with stronger balance sheets and cashflow, including real estate developers and cement producers, and more defensive sectors such as utilities and mid-range consumer staples.

Sources for all data JOHCM/Bloomberg (unless otherwise stated)

Securities mentioned were not held in the mutual fund as of February 28th, 2022.

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Emerging Markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity.

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