2021 China Equity Outlook: Optimistic prospects

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A review of 2020

To say that 2020 was an eventful year for China would be an understatement. Having endured an onslaught of political sanctions from the US through 2019 and beyond, China was hit early in the year by the COVID-19 outbreak. This initially seemed similar to the 2003 SARS pandemic, but turned out to be much more severe. Seemingly in denial at the beginning, China's government finally acknowledged the outbreak and rallied the nation to contain the virus. China's lockdown was far more draconian than measures imposed by most other governments, but it allowed the country to contain the virus far more effectively than the rest of the world. By the middle of the year, China appeared to have completely bounced back from the pandemic with its economy in recovery, and it could be the only major economy to register positive growth in 2020.

Despite the pandemic, markets in China were resilient and we believe that they will continue to reach new highs in 2021. Structural factors that drove the Chinese markets in 2019 and 2020 remain intact and strong leadership enabled the Chinese markets to be among the best performing (if not the best performing) markets in the world. In addition to the structural factors that we have highlighted repeatedly over the past few years, such as import substitution trends, high value-added manufacturing and deep penetration and consumption of e-commerce, new structural factors have started to emerge that stoke our optimism towards the Chinese markets.

Outlook for 2021: New structural factors

New structural factors that have emerged from the pandemic include intensifying nationalism and patriotism in China. These trends were already emerging in 2018 when China was perceived to have been bullied by the Trump administration. But the pandemic took the nationalistic and patriotic fervour to another level, as the Chinese were impressed to see their economy recovering far faster relative to other major economies, with Western nations, long revered in China, struggling to contain the pandemic.

This has led to pride in everything Chinese. Belief is growing that China's products and brands are no longer inferior to those of other major developed economies, with only a few exceptions. Chinese brands are gaining significant market share in literally all market segments. We believe that this trend has significant momentum and Chinese brands, which had dominated only the domestic markets in decades past, will gain a higher profile in international markets. This trend is no longer just being enjoyed by visible consumer brands but is also extending to industrial goods, traditionally dominated by north Asian, European and US brands. These industrial sectors are still trading at a significant discount to the market and have long-term appreciation potential.

China's manufacturing prowess

In our outlook for 2020, we repeatedly emphasised that China's manufacturing prowess deserves more attention despite the obsession with its transformation from an export-oriented to a consumer-based economy. China's manufacturing muscle did indeed shine through the pandemic and is seen as major contributing factor to the

country's solid performance in 2020. Such strength was in display when manufacturers across the country rallied under the government's guidance and went into full production of personal protective equipment (PPE) needed to fight the pandemic. The manufacturers' ability to flexibly adjust their production apparatus to meet immediate demand contributed significantly to China's recovery. The manufacturing sector subsequently made a significant contribution to a surge in exports, as China became the default source of much-need goods for the rest of the world stuck in lockdowns. The manufacturing sector has been penalised strongly in the last decade as investors took the view that China's exports have peaked, but we believe that it is will come back strongly in 2021.

Five-year plan

One of the reasons that China emerged stronger from the pandemic is that the government can mobilise the nation into concerted action. At least within China (international reaction to China's handling of the pandemic has been mixed), the markets were impressed with the country's ability to absorb extreme pain and bounce back strongly.

Domestically, confidence in the government has never been stronger. It is almost impossible not to scour through the government's much quoted "dual circulation" initiative and the 14th five-year plan when trying to determine the direction of the stock market. Dual circulation could be President Xi Jinping's most talked about initiative since the Belt and Road and it could have huge implications for the Chinese economy and equity market. The initiative revolves around developing China's giant-scale consumer demand and potential domestic demand to sustain economic growth while drawing in foreign investment and trade in order to integrate the country into the international economy.

The first pillar of the dual circulation strategy has been reflected in the markets with consumer stocks trading at premium valuations. These stocks will likely remain elevated well into the next decade as the government explores more regulations to encourage consumption. Within the second pillar, we think the most important aspect with investment implications is the plan to open up the capital markets further. This would be a significant development as foreign access to Chinese capital and financial markets could open up opportunities in areas such as wealth management, pension investing, insurance investing and even in simple traditional banking products. In the longer run, this could also mean full internationalisation of China's capital markets, although the chances of that happening in the short term appear limited.

The 14th five-year plan, which established goals well into 2035, also provides good insight into the government's thinking. Two objectives that could have significant implications for the markets are anti-monopoly practices and specific renewable energy targets. Since 2018, we have repeatedly discussed the weaponisation of corporates in China—describing a situation in which the government is more lenient with private sector regulations as they need the private sector investments to tackle US sanctions. Between 2013 and 2017, during a period of very strong markets and growth in China, the government had taken a tougher stance towards the corporate sector. That changed between 2018 and 2020 as the government became locked in a trade conflict with the US and needed the private sector to be on its side. Some cracks have appeared in this cosy relationship, although we believe that a return to the 2016–2017 period is unlikely. The anti-monopoly law is the first sign that the government is uncomfortable about giving too much authority and autonomy to the private sector, but we are hopeful that the government will be selective and that the private sector can still thrive.

The renewable energy targets set by China are far more interesting than many of the rehashed goals we have seen in previous five-year plans. The targets for renewables could have far-reaching implications, potentially creating a gigantic renewable industry encompassing electric vehicles (EV); EV components and automation; solar manufacturing and utilities; offshore and onshore wind sectors; and ESG investing.

Remaining challenges

China is not without its challenges though. Chief among them is the continued sanctions and restrictions that the US is placing on China's government and its corporations. The outgoing Trump administration will no longer be a threat. However, it could be difficult for Joe Biden, the next US president, to reverse the extensive executive orders signed by Donald Trump in the last few months of his presidency, as doing so could make Biden appear too pro-China. Restrictions on technology imports, removal of Chinese companies from indices, delisting of Chinese corporations from US stock markets and sanctions on individuals are some the prominent measures imposed by the US.

We, however, take a more optimistic view of these restrictions and sanctions. We believe these measures will only prompt Chinese corporations and the government to be more self-sustaining and independent of the US economy. We are also comforted by the fact that increasingly China is becoming a more important investment destination, having enjoyed record inflows from foreign investors in 2020. We believe this trend will continue despite passive outflows due to the removal of corporations from indices and a delay by MSCI to further increase its weighting of China's markets. China has handled everything that the US has thrown at them. For example, more Chinese companies are returning home to list in Hong Kong and Shanghai; Beijing has placed reciprocal (but in comparison relatively mild) sanctions on certain US corporations and individuals; and it has penetrated new markets in Asia, aggressively finding an alternative supply chain source. We believe that China will emerge stronger in the coming years and that its relative dependence on the US economy will diminish over time.

Two other risks (or challenges) worth highlighting in China are the credit defaults that have gained media attention and geopolitical risks arising from tensions with Taiwan and India (the list could also include Vietnam, North Korea and South Korea; Hong Kong is also a potential flashpoint).

We see some positive aspects regarding credit defaults. Investors are now more aware of the risks and will no longer blindly invest in government-linked companies. The government has spent more than four years educating investors that government-linked companies are not eligible for implicit guarantees and the message finally appears to be getting across. Looking through the numbers, the defaults and refinancing needs still seem relatively manageable relative to the size of the capital market. In our view, the Chinese government is capable maintaining control.

Geopolitical developments are much more unpredictable. Our base case is that many of the regional frictions involving China have been limited to posturing, as Beijing would not want to willingly trade its prosperity for conflict. China's regional relations, however, need to be observed vigilantly as geopolitical risks can flare up with little warning.

Summary

We are optimistic in our outlook for China's economy and equity markets. However, the last several years have shown that alpha can only be generated through active investing as index biases towards China's financials, cyclicals and the internet sector mean that market performance will be uneven.

China's internet sector, dominated by Tencent and Alibaba, might face challenges going into 2021. Financials still have their challenges while cyclicals remain mired in low returns. As we highlighted earlier, we have much to be positive about sectors related to renewables, semiconductors, the cloud, artificial intelligence, big data, EVs, automation and consumers.

On the economic front, China still has significant structural drivers such as urbanisation, HuKou reforms, domestic demand generation from pension reforms, saving-spending balance strategy, higher value-added manufacturing and import substitution trends. China could potentially enter a blue-sky scenario in 2021 as the low base in the first half of 2020 will make comparison easier while momentum could be prolonged into the second half of 2021 as COVID-19 vaccines may help international economies recover. We are optimistic on China in 2021.

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