TRANSCRIPT

What Happened to China?

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Everyone's asking about China. The country is one of the worst performing equity markets in 2021 and the economic rebound appears to have stalled. What happened? Our answer is nothing and everything. Let's deal with the nothing first. The country was the first to feel the effects of COVID-19, contained it reasonably well and sustained a recovery in the middle of 2020. Not surprisingly, it was one of the better performing equity markets. It was also one of the few countries to recognize economic growth and an earnings recovery.

This placed China six months ahead of the U.S. and nine to twelve months ahead of other developed countries around the world. During the Global Financial Crisis, China over-stimulated the economy and is still feeling the effects. Not this time.

Prior to the pandemic, China was moving in the direction of establishing more balance in the growth of the economy emphasizing consumption and services and investment in next-generation technologies. They were moving away from fixed asset investment as a primary source of growth. The Central Government also was intent on reducing the very large stock of debt in the economy. The result: rein in Local Government Finance Vehicles (LGFVs), which had long been used as off-balance sheet sources of revenue by local governments and with that temper and reduce the level of ill-conceived property and construction projects.

The result was a tightening of fiscal and monetary policy at the beginning of this year. The impact was relatively quick with credit growth moderating, consumption and production data weakening through the second quarter. With the desired effects realized and with the Chinese Communist Party beginning to celebrate their 100th anniversary, which began on July 1st. We would expect fiscal and monetary policy to become less restricted in the second half. In fact, the People's Bank of China (PBOC) announced a cut in the Reserve Requirement Ratio (RRR) of banks of 50 basis points.

The everything is a little more complicated and must be thought of in terms of years rather than quarters. The China today involves a decade-long shift from manufacturer-to-the-world to consumer-of-the world; from dependent to self-reliant; from brand seeker to brand creator. According to the World Bank, in purchasing power parity terms, at the end of 2020 China was already recognized as the largest economy in the world at 18% of the total with the US a few points behind. In nominal terms, China sits number two at 15%, 10 points below the US. In equity market size terms the gap remains as large as ever, with China at 6% of the MSCI All Country World Index and the United states at nearly 59%.

China no longer competes on the basis of low wages. Instead, their advantage comes from: clustering, supply chain management, productivity growth and research and development. The goal of the current government is to move up the value-added chain and to lead in next generation technologies, China 2025. That includes AI and smart manufacturing, biotechnology, aeronautics, electric vehicles. In addition, the goal is to be less dependent on others for semiconductors. Over the last 30 years, they've focused on icons of wealth and success: foreign prestigious brands. Now it is with a source of pride that they look local and buy domestic homegrown brands.

In the short-term, we have a recovery of the economy and the earnings cycle underway. It will be measured. However, we believe that earnings will be strong through 2022. The government has made a concerted effort to rein in the largest internet enterprises, reminding them that the interest of the Chinese people and the Chinese Communist Party comes first. While this comes across to the rest of the world as being 'heavy-handed' and manipulative, in many respects similar efforts are underway in Europe and the United States. To ring-fence the largest internet companies.

The reaction by the Chinese internet companies has been the same across the board, increase investment, tamp down short term profits, increase social and philanthropic spending.

As foreign investors, we are left with the quandary of the appropriate discount to apply to Chinese equities. We also need to consider the ill effects of continuing tensions between China and the United States with regards to trade, human rights and geo-political disputes. In addition, the continuing lack of detail, clarity and assistance on the part of the Chinese with regards to the origin of the virus is concerning and needs to be weighed in the equation. Notwithstanding all of this, it does appear that the economy will enjoy a healthy economic recovery during the balance of 2021 and 2022 and that China will enjoy robust earnings through 2022..

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