Hong Kong Trip Report

China under Pressure – But Rising to a Global Superpower

October 29 - 30, 2018

Executive Summary

The Chinese government initiated its deleveraging policy in 2017 when the global economy grew in sync, stock markets were strong, and the CNY stable

The outbreak of the trade war, a strong USD, falling stock markets, and the troubles in EM caught them by surprise, hurting growth and deleveraging

Most fund managers expect to see a structural slowdown in economic growth from today's c. 6% GDP growth to about 4.5% over the next few years as well as a significant setback in the real estate sector

Yet China's structural growth story remains intact, as the consumption upgrade for the middle class, the environmental clean-up, the push for leadership in selected industries (EVs/batteries, biotech, 5G, aviation, robotics/automation, etc.) as well the goal to create a technological superpower is offering attractive investment opportunities in the mid-term

China's domestic A-share market has substantially de-rated as it was affected both by self-inflicted domestic factors (collapse of the P2P lending space, overhang of share pledges, deleveraging, and a new tax regime) as well as by international issues (trade war, EM malus), eroding sentiment and earnings

Chinese stocks trade between 7.5x and 9.5x P/E, while the increase of the inclusion factor in the MSCI EM Index will provide a strong structural tailwind

Weak earnings growth until 1Q 2019 is not yet fully priced in, but managers expect the domestic markets to bounce back in early summer 2019

Made in China 2025

1. Historical and political background

Long-term planning and forward-looking strategic thinking seem to be a distinctive feature of China's social, political and economic model. China is in the midst of a 100 year plan to challenge and replace the U.S. by 2050 as the lead power in a new world order. Perennial President Xi Jinping has widely discussed and promoted the "Chinese Dream" of rejuvenation since his ascent to power. His overriding goal is to remedy the injustice of the "century of humiliation" by achieving the great rejuvenation of the Chinese nation. In China's history, the "Century of Humiliation" describes the period from the mid-19th to mid-20th century (i.e. the end of the Chinese Civil War and the establishment of the Chinese Communist Party) when the country was - in the view of the Chinese leaders - diplomatically and militarily dominated by Western colonial powers. Xi's goal is to overcome the humiliating handicaps of colonial history and to restore the Middle Kingdom to greatness as a (or, the) world power.

The strategy is based on military, political, and economic development. In order to achieve their strategic goals, they have come up with three key initiatives:

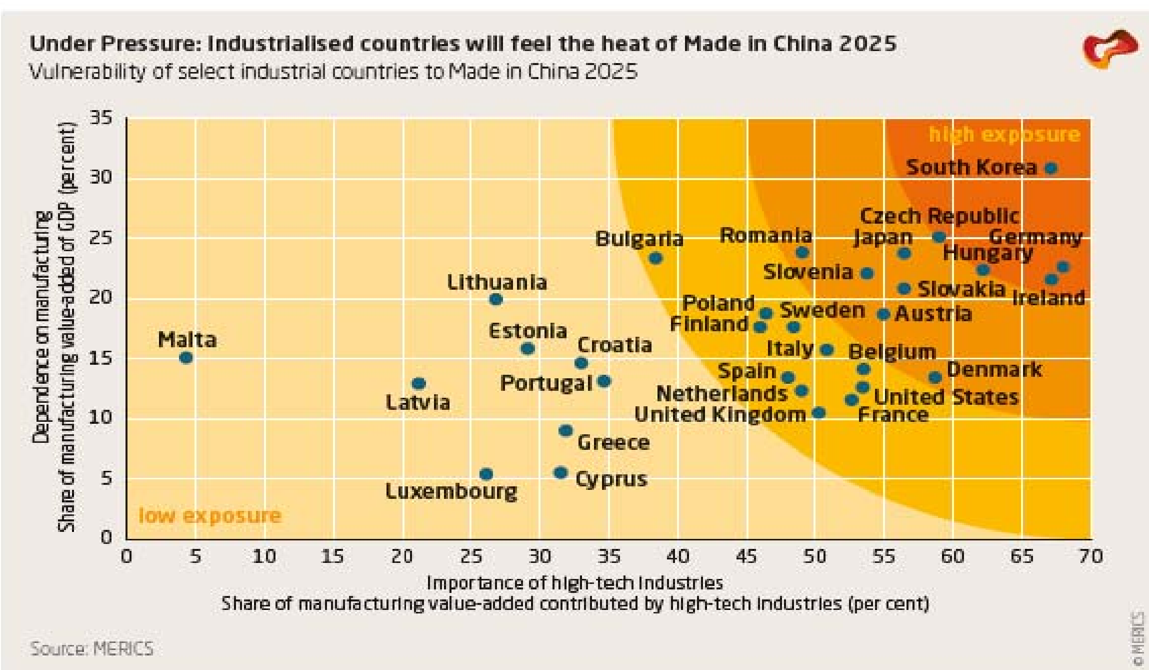
- **Military-civil fusion**: China already has a large defence industry, but it is dominated by poorly run state-owned enterprises. Xi heads the Central Commission for Military and Civilian Development, which was founded in 2017. The ultimate goal is to make China's military-industrial complex a match for America's by cross-fertilising the state-owned enterprises with high tech from private companies and by encouraging cross-ownership between defence SOEs with private tech firms. This is the missing link that should translate their economic and technical edge into military power.
- **Belt and Road Initiative ("BRI")**: The BRI is not just a wish list of infrastructure projects, but a strategic masterplan for promoting economic integration (first regionally, then globally) through physical connectivity and for gradually fostering and extending China's political and economic sphere of influence. It is considered to be an alternative to the US model developed after World War II which is predicated on economic integration via trade and investment agreements. Unlike the US model which is governed by rules and multilateral agreements, the BRI is based on physical integration and bilateral agreements with its partners where China's sheer economic and political size always gives it an edge.
- **Made in China 2025**: China's state driven industrial policy with the goal of moving the country's industries up the (technological) value chain, replacing imports with local products, and building global champions able to take on Western tech giants in cutting-edge technologies. As the initiative "Made in China 2025" is the most promising and investable theme in the near future, we will have a closer look at it in the next section.

To sum up: It is evident against this backdrop hat China's ambitions to regain supremacy shirtfronts the U.S. as the incumbent superpower. Made in China 2025 is therefore seen as a threat to the West, since China's growth plans and behaviour is also combined with unfair competition, heavy state subsidies and strong protectionism. Beijing's strong arm tactics for technology transfers and intellectual property theft is only one aspect of the overall issue. But even if Donald Trump and Xi Jinping were to resolve the current trade dispute at the next G20 meeting, the two nations will continue to content with each other for supremacy and investors will therefore have to live with the fact that the underlying issue will not go away. It is a strategic reality that the US strives to contain the pace at which Chinese manufacturing will catch up, while hoping to even maintain or widen the gap.

2. Made in China 2025

The initiative "Made in China 2025" (hereafter "MIC2025") is a state-driven masterplan for industrial leadership and import substitution unveiled in 2015. It aims to turn the country into a manufacturing superpower over the coming years, leaping ahead in the global competition and challenging both current market leaders in relevant industries as well as the globally dominant industrial countries of today. The strategic goal of MIC2025 is to build one of the world's most advanced and competitive economies with the help of innovative manufacturing technologies ("smart manufacturing"). The strategy targets virtually all high-tech industries that strongly contribute to economic growth in advanced economies. MIC2025 sets the agenda in 10 production areas: automotive, aviation and space, machinery, robotics, high-tech maritime and railway equipment, energy-saving vehicles, medical devices, new materials, semiconductors and information technology. Countries in which these high-tech industries contribute a large share of economic growth are most vulnerable to China's plans. MIC2025 will also be supported by a separate AI initiative.

Figure 1



Source: Mercator Institute for China Studies, 2016

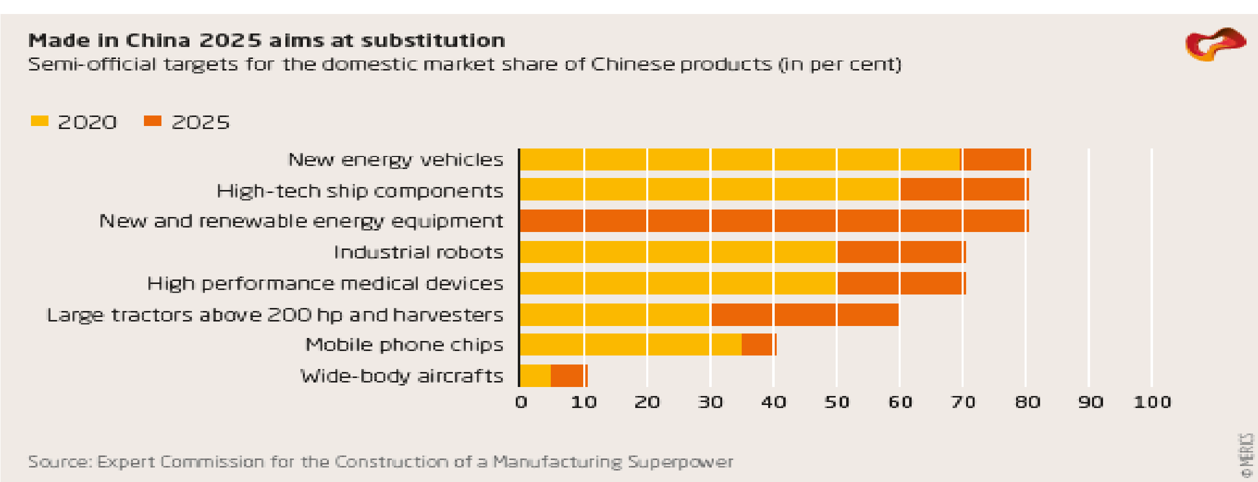
According to the Mercator Institute, MIC2025 is a top-down strategy that is strongly inspired by Germany's concept of "Industry 4.0" and pushes specifically smart manufacturing - the centrepiece of the strategy.

Some of the ambitious goals by 2025 are, to name just a few:

- In Robotics, they seek to own intellectual property rights of key parts, to develop next generation robots, and to have one or two companies to rank in the global top five. And they hope to supply 70% of the domestic robotics market with Chinese products, while today c. 62% are imported from Japan and c. 18% from Germany.
- In new generation IT: To supply most of the domestic demand for mobile communications equipment and about half of the demand in international markets. They also want to establish a handful of semiconductor companies that are recognised as top-tier. And they plan to enter the 14-20 nm process phase. Today, c. 56% of the products are imported from the US, 23% from France, and 16% from Germany.
- In energy equipment: To have established globally competitive companies; to produce advanced large-scale thermal, hydro, and nuclear equipment; renewable energy equipment to account for 80% of the market, and to dominate the formation of global standards for high-voltage transmission.
- In energy vehicles: Domestic products with intellectual property rights to supply half of domestic market; self-sufficiency rate for key parts to exceed 60%; export 20% of commercial vehicles, and three companies to rank in top 5 by international sales.

Import substitution is another key goal of MIC2025, as the Chinese government seeks to gradually replace international high tech with Chinese technology – first in the domestic market and later on also in exports. President Xi recently stressed that China must develop its own industry and technology to become a strong country. How vulnerable China is became clear in April when the U.S. slapped a seven year ban on the telecom equipment provider ZTE in response to ZTE violating sanctions on Iran and North Korea. For three months, ZTE had been unable to obtain critical parts and software from U.S. companies, putting ZTE temporarily virtually out of business. After three months, President Trump agreed to lift the ban after ZTE had replaced its board, paid a fine of USD 1bn, and put USD 400mn in an escrow account if they were not compliant in the future.

In order to substitute foreign technology by national technology, the government utilizes a broad set of measures, such as subsidizing Chinese products while excluding foreign alternatives as in the fields of electric vehicles and, to a lesser extent – in robotics.

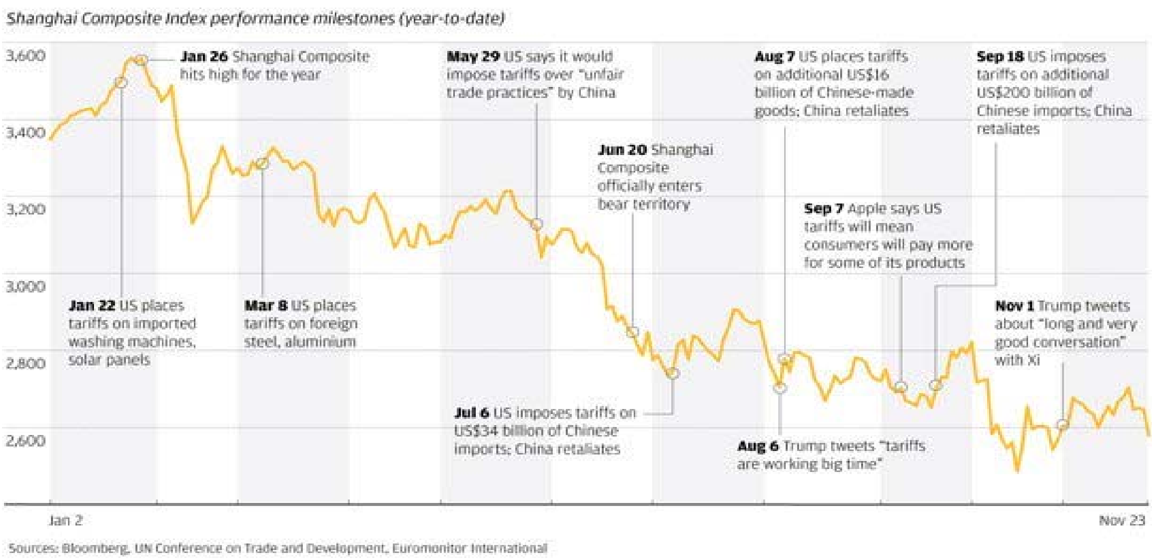


Source: Mercator Institute for China Studies, 2016

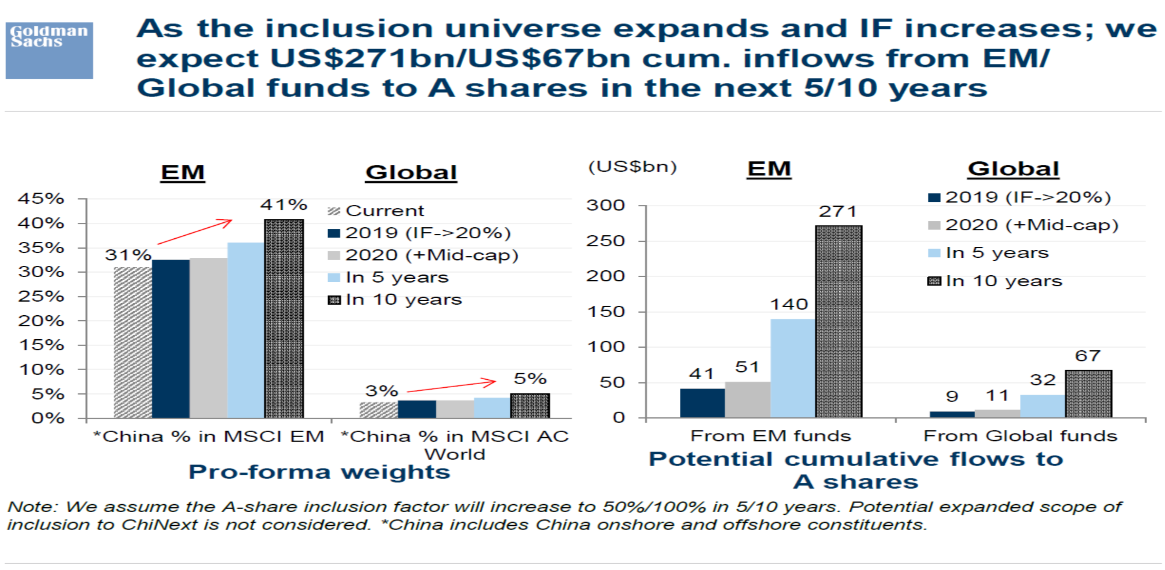
The government also supports enterprises with direct capital injections and preferential loans in many industries.

3. Outlook for Chinese Stock Markets in 2019

Hedge funds managers are deeply divided on the outlook for mainland stocks next year, as the potential escalation of the trade war looms large on the horizon, while Chinese policymakers boost efforts to buoy the economy, reversing the austerity and deleveraging that hit asset prices this year.



Fundamentally driven managers are therefore quite bullish on Chinese stocks on the back of appealing valuations and the policy easing pledged by the government which will boost earnings and market confidence over time. Most managers believe that stocks are likely to trend higher in Q2 in 2019, propelled by a recovery in earnings that are expected to hit the nadir in Q1. In addition, fund managers are excited about the prospects that the MSCI inclusion factor in the MSCI Emerging Market Index is just 5% and could reach more than 40% over the next five years.



As the inclusion universe expands and the Chinese reforms address transparency, governance, and structural issues, foreign investors will (have to) allocate more capital to mainland China. Goldman Sachs has recently calculated that A shares could see more than USD 200 bn in cumulative inflows from Emerging Market and Global Funds in the next five years. As the government focuses on the quality of economic growth by accelerating reforms of the state-owned enterprises and on opening up more industries to foreign investors, stocks are likely to move higher, propelled by a recovery in earnings. And, what is more, by historical standards, valuations are quite appealing. The Shanghai Composite Index trades with a P/E 2018 of less than 8x, while the MSCI China Index has P/E of less than 10x. Hedge fund managers noted that long-term investors such as Sovereign Wealth Funds and Family Offices have already started to allocate capital to mainland China after the A share market has declined c. 30% this year.

By contrast, macro-aware managers are more cautious. They believe that China is in a structural decline and that GDP growth will inevitably drop to less than 5% over time. Some of them also believe that the real estate market will undergo a severe market correction in the next two to three years. While they were surprised by the impact of the deleveraging campaign on earnings, they de-risked their portfolio already in 2Q 2018 and reduced portfolio concentration, as their conviction level in macro dropped. While the supply-side remains strong, they had initially underestimated the impact of the trade war, the collapse of the P2P lending space, the deleveraging and how the political changes (i.e. taxes and the lack of credit) hit the private sector. Their macro insights show that the economic cycle is slowing down, sentiment is dented, and trust is lost (no capex due to low visibility). Earnings expectations are therefore too high and revisions have not yet come through. They also believe that CNY will have to adjust. If Trump slaps taxes of 25% on USD 200 bn of Chinese goods, we will see a global recession and a global equity market rout, as this event is not fully priced in. They expect to see weak Q4 earnings and remain therefore cautiously positioned for the foreseeable future even though markets are cheap in terms of valuations. They also believe that the market will trough in 2019 on the back of Beijing’s policy measures, but that a quick bounce back is not in sight, as any rebound will be hampered by the trade dispute. An A-share trough can be protracted until both domestic and international investors return to the space. They expect to see muted returns in 2019, as risk appetite among investors will remain weak and earnings growth will also be contained around 6-8% (vs 12% in 2018) due to the worsening macro fundamentals for the economy.

In sum, risk-conscious long-term investors have started to allocate to the A share space, while investors with a shorter-term view stay on the sideline until earnings have troughed in 2019 and visibility will have improved.