MARKET COMMENTARY

China

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Charles Sunnucks, Fund Manager

Charles Sunnucks joined Jupiter in 2010 as an analyst and is currently a Fund Manager in the Emerging Markets team. He co-manages, alongside Ross Teverson, the Jupiter China Select fund (SICAV).

Before joining Jupiter, Charles lived in China and gained a degree in Economics & Trade from Beijing Language & Culture University.

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Bringing home the bacon in the year of the pig

According to myth, the pig, having overslept, was the last of the Zodiac animals to arrive for a meeting with the Jade Emperor. And, having arrived late, was relegated to last in the Chinese zodiac calendar cycle. Investors will be hoping that the markets aren't quite as sluggish as we enter the Year of The Pig in China in 2019. Indeed, the Year of the Pig is supposed to bring wealth and happiness.

Just like the pig however, China over recent quarters could also be characterised as 'slow' and 'unloved' when reflecting on GDP growth and investor sentiment. Indeed, the combination of a market that contracted approximately 14% in 2018 and 12% projected earnings growth over the year has brought valuation levels down to near multi-year lows. The outlook though is complex. Beyond the headline numbers; trade wars, disruption and reform in China have shaken corporate prospects, creating both evolving risks and substantial opportunity.

Trade conflict – opportunity in uncertainty
Since late 2016, when Trump was elected president on a platform which included redressing perceived Chinese anti-competitive trade practices, the outlook for Chinese exporters has been muddied. Already, out of the roughly $505 billion which China exported to the US in 2017(1), Trump in May/June 2018 imposed a 25% tariff on $50 billion of products, in August issued a 10% tariff on a further $200bn worth of goods, and is threatening to raise additional tariffs if by March a trade deal is not reached. This uncertainty has impacted not only exporters but corporate and consumer confidence too.

In terms of the listed Chinese exporters, there has been a wholesale sell down to reflect the likelihood of a protracted conflict with an adverse outcome. However, not all exporters are impacted the same, and indeed some firms like Hong Kong listed Crystal International have already shifted the bulk of production capacity to lower cost countries such as Vietnam. These firms should actually be positioned to benefit from tighter China trade terms with the US. This coupled with the indiscriminate nature of the sell down, has created some highly attractive buying opportunities.

Internet disruption – evolving implications
The level of online activity in China has been at a level well beyond many developed market peers. For instance, China ranks second globally in terms of time spent on smartphones and the level of online retail penetration is more than double the US level. The competitive landscape is also fast evolving, changing due to both a shift in preferences plus a number of recent policy adjustments. Strategically, the larger firms like US listed Baidu are also developing beyond a consumer-centric model to also catering more directly to corporates – for instance in areas such as autonomous vehicles and cloud services. More broadly, the evolution of online activity is effectively making some markets more fragmented, as an effective distribution network is no more a material barrier to entry. From drill-bits to computer docking stations, manufacturers such as Tiangong International and Bizlink are now able to sell far more directly to the end user, a development which is overhauling value creation within the supply-chain.

Financial reform – deflating risks
While Chinese financial service firms are often characterised as slow, state-owned monoliths; certain businesses have proven to be highly creative, innovatively circumnavigating regulation. This has ranged from fintech firms operating outside of the banking regulators scope, to the city banks often using alternative loan classifications to avoid onerous loan risk requirements and lending limits.

As a result of this though, material systemic risk had been building in China. Encouragingly for long-term investors however, has been the regulators recent determination to actively manage down developing risks. For instance, tighter oversite of online consumer lending sites has reduced the number of peer-to-peer lending firms from over 3,000 to below 1,000. While this has clearly created pockets of stress within the economy, it has also led to industry consolidation and increased market share for those firms already operating within regulation.

Supply side reform – out with the old, in with the new
Supply side reform is another important reform factor to consider. First introduced in 2015 to deflate some of the excesses created by the Rmb4tril 2008 stimulus package, it was initially focused on resolving the issue of 'zombie firms', with targets including reducing coal capacity by 250mil tonnes and 100-150 million metric tonnes in steel capacity. While this policy has clearly put heavy pressure on the capacity of some firms, it has been a margin tailwind for firms like Hong Kong listed Vinda which have already operating efficiently within environmental standards.

Moving forward, the emphasis is increasingly shifting to innovation and the promotion of higher-value added supply – this includes developing advanced manufacturing, big data and artificial intelligence. China is already producing more

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than double the US number of science/engineering graduates, and with a salary level for engineers in China roughly one third their US equivalents, new industries have a large and relatively cheap talent pool. The consequence of China developing beyond 'the worlds factory', will be that increasingly China becomes a more direct competitive threat to developed nations. Additionally, those firms within China without a culture of innovation, will increasingly fall behind; a phenomenon which will support the rise of private enterprise.

Seeking out positive change
Ultimately, China is vast, with an increasingly diverse economy, a population over double the entire size of the European Union and a land area almost 40 times larger than the UK, change has very wide implications across the corporate world there. While more supportive monetary and fiscal policy adjustments may well stabilise the economy over the year, 2019 Chinese equity returns are likely to be more characterised by the degree to which they decouple. Key for investors will be therefore avoiding the runts of the litter, and identifying those firms that have their head to the trough ready to embrace change.

Sources
(1) 2018 consensus profit growth: CLSA; 2018 market total return: Bloomberg
Trade with US: https://www.census.gov/foreign-trade/balance/c5700.html

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