



16th August 2021

Much to Ponder on, particularly in China

- **US Inflation still flying high, but markets concerned with impact of delta variant**
- **US inflation data appears to understate inflation in residential rents**
- **Europe providing leadership in equity markets**
- **China announces a five-year plan of broadening regulation**
- **We see potential material risks to the downside for Chinese equities if China is bracketed as problem emerging market**
- **China's bond market looks better protected from government action**

Last week, the noise on inflation and growth on the Street had the market appear a shade more sanguine on inflation and just a little more concerned about the overall outlook for growth. One constant was the markets' concerns over the direction of Chinese asset markets.

US consumer price inflation came in ahead of market expectations, but the market focussed on the lower expected inflation excluding energy and food. Of course, consumers need food and energy! Also, the data on rent was somewhat puzzling, with data collectors reporting a 1.9% year-on-year growth in residential rents and yet, anecdotally, residential REITS are announcing rental growth of 5-10%. At the headline level, producer price inflation hit 7.8%, the highest on record.

With fresh lockdowns in China and Australasia, a further spike in cases in Japan, and angst in the United States, policymakers across the world are fretting about the delta version of COVID. In the US, the University of Michigan's consumer confidence survey was significantly below expectations, with analysts concerned that consumers were losing some confidence in the wake of the delta version's impact on the pace of the reopening of the US economy.

Nevertheless, the aggregate reaction of markets was to leave equities relatively unchanged at higher and bond yields at lower levels. European equity markets continue to show good momentum with the reopening of the European markets being more consistent.

China's evolution

The financial markets continue to try to decipher the drip feed of news from China on the tightening of regulations across several industries. Last week saw the release of a policy document by the CCP's Central Committee and the State Council to strengthen regulatory control on key sectors over the next five years. In their own (translated) words they aim to "meet people's every growing demand for a good life". Given such a general aim, it remains very difficult for international investors to gauge the potential scope and scale of future regulatory changes.

It is tough to frame the potential regulatory changes into something that resonates with western investors who wonder if there is transparency on the likely changes. The answer to that question will take time and likely come in a piecemeal way. What the investors also worry about is, is there the prospect of better profitability? Unlikely, as corporate managements now have to optimise their businesses for factors other than just pure profit growth. We sense that a decision has been taken at a very high level to expedite a significant change in corporate direction. It may take many months, if not years for China's corporate sector to adjust accordingly. It could also cause significant problems for western companies operating in and trading with China.

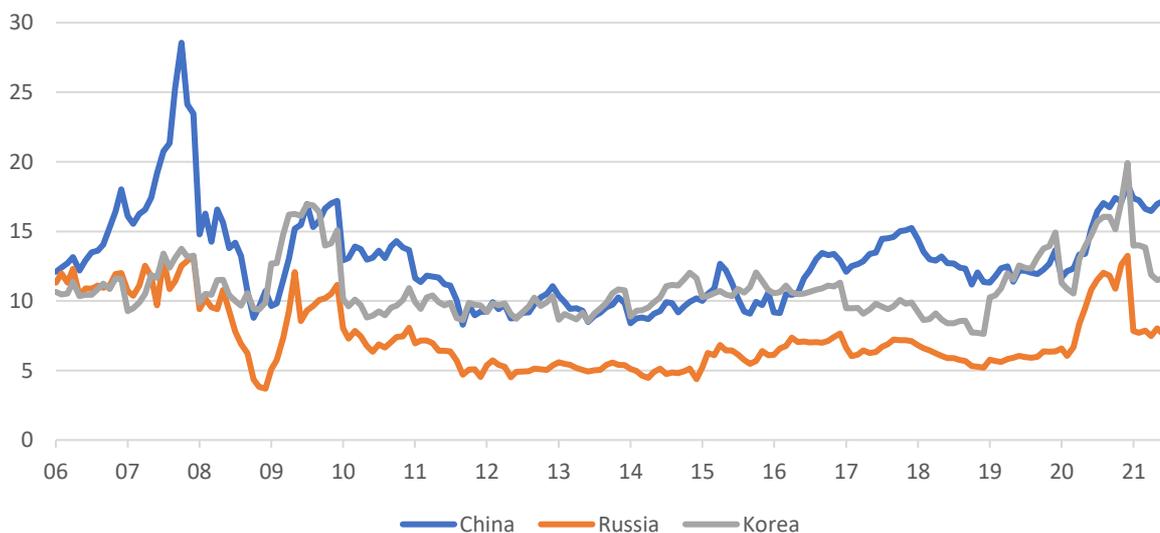
The reforms potentially leave Chinese equity markets in no man's land. An investor in Chinese equities is no longer just tapping into the prospects of strong economic growth but also into a regime change that is centred on socialist ideals. It will be interesting to see how local and international investors react over the medium term to the recent volatile performance of the market and the obvious challenges ahead. According to the Institute of International Finance, Chinese retail investors own about 22% of the equity market but account for 80% of daily traded volumes. Foreigners, by contrast, at the end of 2020 accounted for 4.3% of the total market cap of China but around 9% of the freely traded shares. The market share of Chinese institutional investors had risen to 78% of the market as at the end of 2020.

The downside risk in Chinese equities

Some investors are already citing the Russian and Korean equity markets as a potential model for how the Chinese equities could be valued in the future. Russian equities with perennial investor concerns about a lack of corporate governance and ongoing trade wars and sanctions trade on a PE multiple of just 7.2x forecast earnings. Korean equities trade at 10.6x forward earnings because of the perception of poor corporate governance and sub-optimal capital allocations. China, by contrast, trades at 15x forward earnings (Chart x). However, note that from 2011 to 2015 the Chinese market slipped to Korean-like valuations. A similar slip at this juncture would represent downside risk of one third from current levels.

Chart 1: China at risk of a further derating

Forward PE multiples of Chinese, Korean and Russian equity markets



Source: Bloomberg

For the moment global retail investors have been bottom-fishing in the Chinese equity market. However, global retail investors are not always the best judge of future performance. There is a good measure of pent-up demand for Chinese assets from international private equity and venture capital funds who have raised large sums of liquidity in the past year. The Prequin reports that 43 China-focussed funds have already raised \$49 bn this year, close to last year's total of \$50 bn. However, these funds may also be scratching their heads trying to work out where they are going to deploy the cash given the crackdown on previous growth sectors of internet, semiconductor, and Edutech.

Bond market downside self-inflicted

Unlike the sharp underperformance seen in equity markets, the poor performance in the credit market appears mostly self-inflicted. The issues besetting the firms in question are well-known to credit investors and are not unique to Chinese companies: poor asset quality and highly leveraged business models. What is important in the current context is how the government will respond to another feature known to global credit investors: the too-big-to-fail conundrum.

Huarong and Evergrande are a risk for bond investors and an opportunity for the government to establish important precedents. Running in parallel with the much-discussed Chinese government crackdown on various industries are some game-changing events in the fixed income markets. The outcome of the debt woes faced by these two names is likely to shape the outlook for the Chinese credit market for some time to come.

Huarong and Evergrande have been the main factors behind the underperformance of Chinese high yield bonds against the global indices in recent months. Bloomberg estimates that Evergrande has around \$29 billion of outstanding debt, split almost evenly between secured and unsecured debt. Such scale made it one of the major issuers in the market, and about 7% of some bond indices. However, the weight has dropped by half as the market price of the bonds has fallen to 55 cents in the dollar. Huarong, an asset management company, has seen a similar fall in its bond prices.

Due to the losses suffered in these two bonds, and some sporadic losses in other bonds, **USD-denominated Chinese high yield bonds have racked up losses of as much as 10% from the peak at the end of May this year.** The broader bond indices are down around 5% over the same period. The Chinese government bond market has fared better and more in line with other global bond markets, dropping a mere 20 basis points over the past month compared with the flat outcome for the Global Aggregate Index.

Chinese Government support in obvious places

In State-Owned Enterprises (SOE), government policy is likely to focus on the strategic versus commercial aspect. Government policy will likely focus on supporting strategic significance over simple commercial interests. The broader effort to streamline policy in the SOE sector appears likely to proceed along these lines. In the case of Huarong, that process of change could be the creation of a template for further reforms. It is potentially bad news for the holders of non-strategic assets that are impaired or badly managed. Policymakers are likely to view this as a small price to pay to effect the required reforms in this sector.

Elsewhere, we expect market-related outcomes. In the property sector, regulatory focus became transparent with the so-called “three red lines” issued by the government recently. It aims to send a clear message to property companies about their general management. It should come as no surprise that Evergrande is among the worst performers in this context. Investors should expect no special favours from the government. There could be some moral suasion going on in the background by the authorities to help prevent a chaotic outcome. However, we expect the precedent that will be set to be quite aligned to a market-related outcome. This should be the lesson for investors in the property sector for the immediate future and all other commercial sectors for the future.

Gary Dugan

Johan Jooste

Bill O’Neill (Consultant)