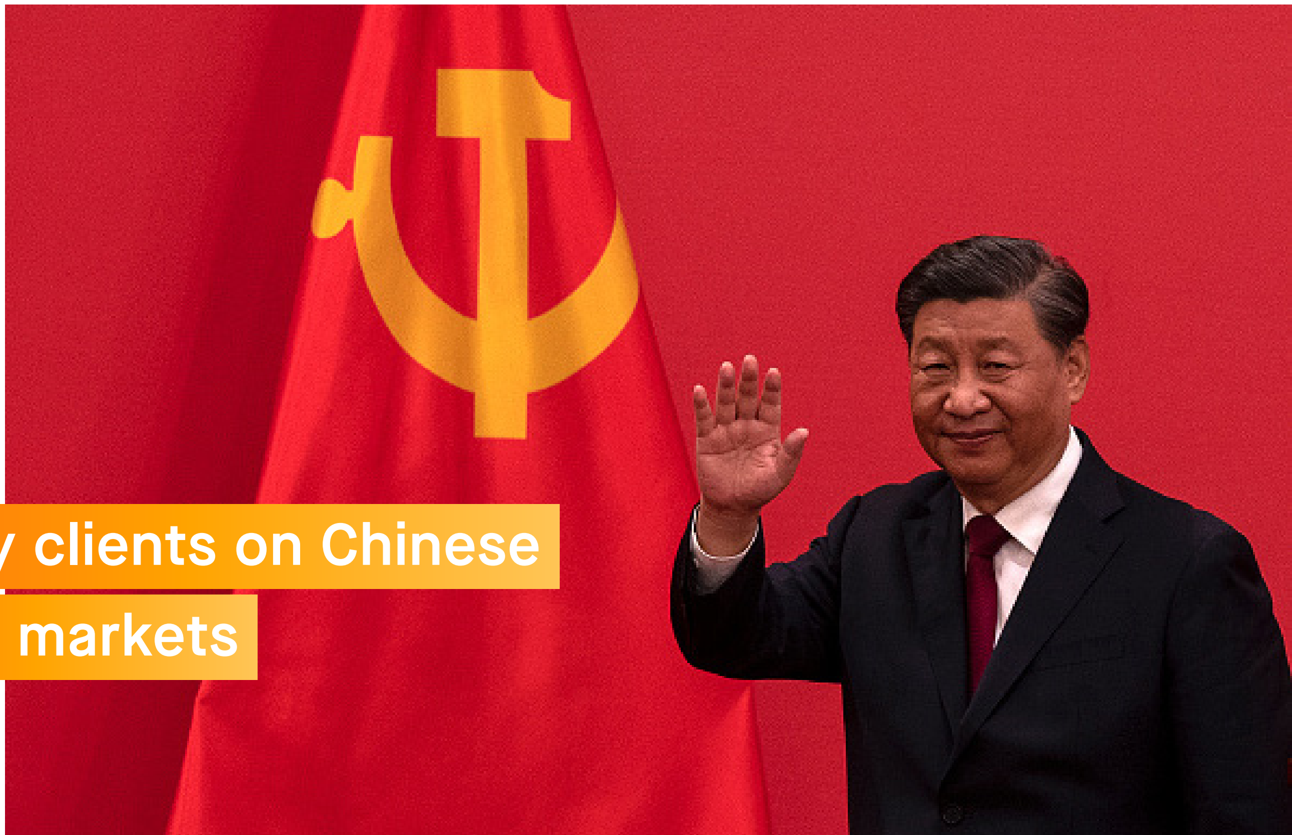

FAQ by clients on Chinese equity markets

While China's growth data surprised positively over the weekend, Hong Kong and US-listed Chinese stocks sold off on Monday in reaction to the conclusion of China's 20th Party Congress.

What is our take on the latest political and economic news? What are the consequences for China equity markets?

Charles-Henry Monchau *Chief Investment Officer*
Adrien Pichoud *Chief Economist & Senior Portfolio Manager*
Saïd Tazi *Senior Portfolio Manager & Head of Equity*
Christopher Kirsh *Investment Analyst*

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What is your main takeaway from the Party congress?

The 20th Party Congress concluded on October 22, and the new leadership team was announced on October 23. President Xi was elected for a third term as the Party leader. Six standing committee members of the Politburo were elected, as well as 17 other Politburo members, of which 13 are newly promoted ones. Qiang Li is likely to become the new premier.

President Xi's core leadership has been further strengthened at the 20th Party Congress. He is the first core leader after Chairman Mao to have a full third term and to gain prevailing dominance within the Party, and the promotion of his allies implies a concentration of power.

Many analysts and financial markets reacted negatively to these outcomes as they worry that President Xi Jinping's tightening grip on power will have negative consequences on free enterprise and economic growth. In his opening speech, President Xi mentioned "safety" or "security" 73 times, compared to 55 times in 2017, and said China will strengthen its ability to build a strategic deterrent capability. By comparison, Xi said "reforms" 16 times in the televised speech, far fewer than the 70 mentions five years ago.

Some of the other disappointments were:

- the fact that there was more emphasis on security issues rather than on the economy,
- the promotion of supporters of zero COVID policies (which suggests that the rollback of zero COVID policies could take longer than anticipated),
- the retirement of well-known leaders with previous good relationships with the West (which could lead to deterioration in US-China political relations),
- the confirmation of China's opposition to Taiwan's independence and
- the fact that Xi defended China's crackdown in Hong Kong.

The market appears to be assuming that the new political team increases the likelihood of more regulations, more lockdowns, more nationalisation and more tensions with the West, thus elevating the risk of investing in China.

However, we would like to highlight the fact that the market might have overreacted to some of these statements. First, the economy and the transition towards a new society for China also played a role in this Congress. President Xi's two-hour speech was encouraging to both the economy (mentioned 65 times during the speech) and modern Chinese society (mentioned 85 times during the speech).

Furthermore, some newly appointed leaders are not necessarily bad news for the economy. Li Qiang, who could become the next Premier, was indeed the one who presided over Shanghai's strict lockdown this past spring. However, he has played a key role in implementing pro-market policies over the years. He has decades of experience governing one of the most market-driven regions in China.

Overall, we believe that while the newly appointed team is not the most market-friendly, the negative effects on the economy and financial markets seem overstated. The Annual Central Economic Work conference which will take place in December might bring much awaited updates in terms of economic reforms as well as economic stimulus.

What is your view on China economic growth? Is there more pain ahead?

China finally published its 3Q economic growth numbers on Monday (rumored to have been delayed to not fall during the Congress) China's 3Q GDP came in above expectations, growing 3.9% yoy (vs 0.4% yoy in 2Q). September IP beat expectations, rising 6.3% yoy and was associated with stronger-than-expected exports. Production was strong in high-tech and manufacturing sectors, while construction-related sectors also improved.

The main disappointment came from retail sales growth which moderated to 2.5% yoy in September (lower than estimates), reflecting the drag from the latest Omicron clusters.

Real estate investment continued to register a double-digit decline. It remains very difficult to assess the consequences of the housing crash on the $55 trillion China banking sector.

We continue to believe that China will fail to reach its growth target in 2022 as the economy is likely to grow around 3% for the full-year. In the near-term, China's economic growth is expected to recover thanks to the gradual lifting of COVID-related restrictions, monetary and fiscal stimulus as well as exports. Faith in the Housing sector is likely to remain a key driver as well (positive or negative).

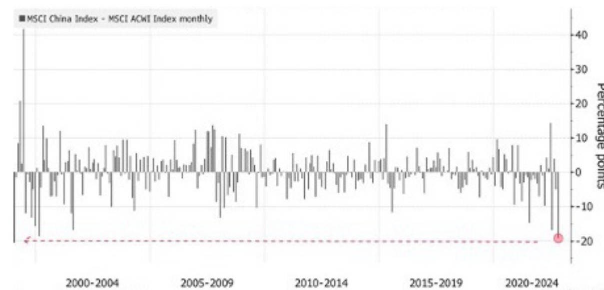
We should also keep in mind that China has some of the lowest interest rates in the world currently, a low inflation rate and ample room for fiscal support. A luxury few developed economies can afford these days.

In the long run, China continues to target the doubling of GDP per capita by 2035, as announced during the recent 5th Plenum back in March. To meet this target, China's GDP will have to grow by an average of 4% to 5% annually between now and 2035. This will require a strong private sector and consumer market. The Chinese government's initiative of Common Prosperity, which promotes policy to bolster social equality, first requires prosperity. We thus expect more stimulus and government support to be announced in the coming months.

Is there more downside for Chinese equity markets?

Monday was a bloodbath for Greater China stocks. Hong Kong's Hang Seng index spiraled down 6.36% to its lowest levels since April 2009. The Shanghai Composite and the Shenzhen Component in mainland China both lost about 2% as many international investors got reinforced in their view that stocks based in the world's second largest economy are 'uninvestable'. As shown on the chart below, the MSCI China index is trailing the MSCI World by the largest percentage since 1999 this month.

Historic underperformance - China stocks trailing the world's by the most since 1999 month



Source: Bloomberg, MSCI

Bank Syz's Asset Allocation committee has a cautious view on China stocks. We believe that market negative views about the 20th National Party and China's Growth outlook are exaggerated. Monday's market action looks like a capitulation with many investors selling indiscriminately. We are thus reluctant to become even more bearish on China stocks as this market might soon enter a bottoming process. Valuations are cheap, sentiment is overly pessimistic while long-term growth perspectives look attractive. We are reiterating our cautious view but are ready to revisit the case anytime soon.

Are Chinese Internet stocks a buying opportunity? Should we consider the ADRs?

Shares of Chinese companies listed in the U.S. dropped sharply on Monday, after Beijing tightened President Xi Jinping's grip on power, souring investor sentiment for non-state-driven companies. The Invesco Golden Dragon China ETF, which tracks the Nasdaq Goldman Dragon China Index, plunged 14.5% to hit its lowest level since 2009. The ETF slumped more than 20% at one point on Monday. The index holds 65 companies whose common stocks are publicly traded in the U.S. with most of their business being conducted within China.

Tech giant Alibaba was down more than 12% after earlier dropping over 19% to a new 52-week low. Tencent Music Entertainment fell 5%, paring an earlier decline of 18%. Another tech name Pinduoduo ended the day 24.6% lower after earlier falling a whopping 34% on Monday.

Ever since the regulatory crackdown started with the cancelation of Ant Group IPO, Chinese ADRs have been under intense stress, losing ~80% of their value. Overall, most of the decline so far is explained by geo-political factors and rather than by fundamentals, which makes our bottom-up view on these stocks rather appealing. China ADRs remain very cheap in comparison to their US counterparts and growth/margins are still attractive even if cut in half.

Based on our house view on Chinese equities, we would encourage investors to keep for now.

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com

Adrien Pichoud, Chief Economist & Senior Portfolio Manager
adrien.pichoud@syzgroup.com

Saïd Tazi, Senior Portfolio Manager & Head of Equity
said.tazi@syzgroup.com

Christopher Kirsh, Investment Analyst
christopher.kirsh@syzgroup.com

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