INVESTMENT INSIGHT

Janus Henderson
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# Emerging Market Equities: China in uncharted territory

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Following a recent research visit, Emerging Market Equity Portfolio Manager Daniel Graña provides his views on China and believes that the golden age of the Chinese economic boom is over. As a result he believes that investor expectations should be reset lower and that infrastructure investment remains the last reliable lever that the Chinese policymakers have to manage the economy's trajectory.

## Key takeaways:

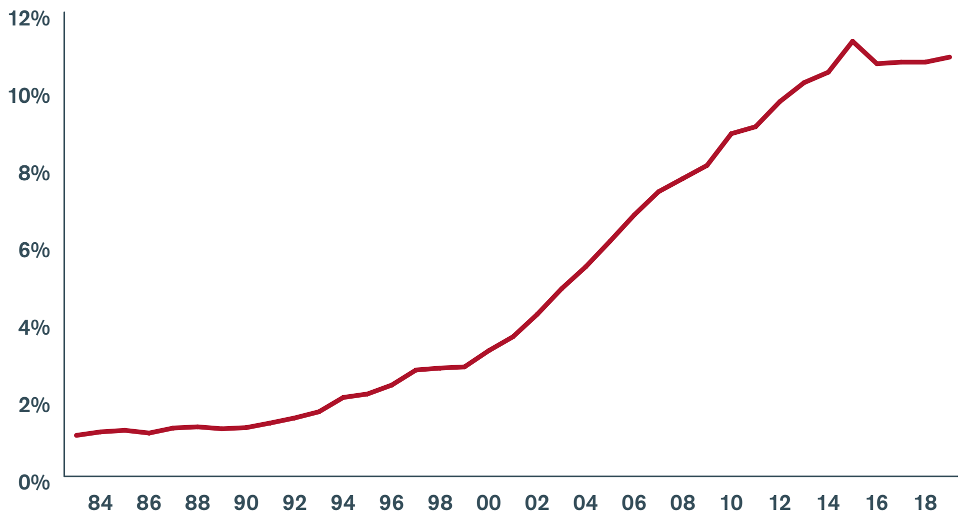
- While China and the US were keen to sign a ceasefire agreement ('phase one') to the trade war, substantive issues have been deferred until after the US election in November 2020. We should not expect significant stimulus from China unless there is a material escalation in the trade war or a deterioration in the property market
- China's leadership has embarked on a path of self-sufficiency in technology, which will likely be met with mixed results; Daniel believes that US technology restrictions to China are likely to toughen as national security concerns come to the fore
- The Chinese government is encouraging consolidation across many industries, creating interesting investment opportunities

## Macroeconomics

Since January 2019 we have believed that the policy options available to Chinese policymakers to stabilise and reaccelerate gross domestic product (GDP) growth have been dwindling. Income tax cuts and other consumption-friendly measures do not have the same multiplier effect in China that they do elsewhere, given the limited number of income taxpayers relative to the size of the population, a high marginal propensity to save and weak consumer sentiment.

We also believe that currency depreciation will not substantially help, given China's already very high global export market share, shown in the chart below, and rising global protectionism.

## China's share of world exports




Source: OECD, Janus Henderson Investors, as at 31 December 2019.

Cuts to interest rates are unlikely to help much either because creditors are reluctant to lend and borrowers reluctant to borrow. We believe this is because of diminished growth expectations, high economy-wide leverage and tougher consequences for state-owned enterprise (SOE) management teams for rising leverage.

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## Golden age of economic boom is over

Arguably, the most effective policy measures to grow the economy since the Global Financial Crisis have been leverage-intensive infrastructure investment and residential property investment. However, stimulating residential property is no longer a preferred lever. Given highly-elevated home ownership levels, unfavourable demographics, concerns about social stability – due to problematic affordability and high system-wide leverage – Chinese officials worry that the property policies that stimulated real demand in the past will now only stimulate unproductive speculative demand and exacerbate leverage levels. Concerns about medium-term financial stability now outweigh the perceived diminished benefits of stimulating the property market. As a result, Chinese policymakers now accept lower and falling GDP growth rates that in the past would have induced a stronger policy response. We believe that the golden age of the Chinese economic boom is over, and investors should reset expectations lower.

## Leverage risk

A number of market commentators we spoke to on our trip indicated that China's current sovereign debt rating would not be relevant if another large stimulus package was implemented, given the higher level of leverage placed on the economy.

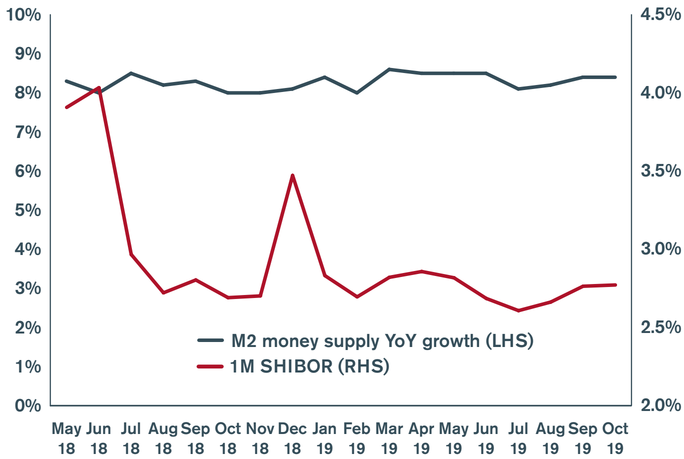
According to the World Bank, China is carefully balancing downside risks to growth with the risks of misallocating resources and the financial instability that came with prior stimulus measures. Chinese officials are willing to tolerate lower growth – authorities now talk about 5.5% GDP growth, which was inconceivable only a year ago. A contact from the World Bank that we spoke to during our visit believed that in the medium-term annual growth could decline to 3% without the reforms that would improve productivity, or to 4.5% with such reforms. Unlike reforms in other emerging market (EM) countries, we think that Chinese reforms would not increase potential GDP growth but avert a slower growth path along with the associated risks such a trajectory would entail.

## Infrastructure investment

All of this leaves infrastructure investment as the last reliable lever that the Chinese policymakers have to manage the economy's trajectory. The general consensus view is that China's 2020 GDP growth rate will be slightly lower than that of 2019 and will be driven by a moderate recovery of infrastructure investment and, to a lesser extent, manufacturing investment. We believe that consumption growth in China will likely continue to decelerate, given the working population's high propensity to save for property, a soft but expensive property market and the effects of the rapid increase in consumer leverage.

More liquidity injections and reserve ratio requirement cuts by the People's Bank of China all help to reduce interest rates modestly, as shown by the overall fall since May 2018 in the Shanghai Interbank Offered Rate (SHIBOR) of interest on loans. The monetary transmission of lower rates, however, is now less effective as highlighted by the stagnation in M2 money supply growth over the same period.

## Interest rate cuts have not increased money supply




Source: People's Bank of China, Bloomberg, as at 31 December 2019. M2 is a measure of the money supply that includes cash, checking deposits, and easily convertible near money. The graph details year-on-year (YoY) growth. SHIBOR = Shanghai Interbank Offered Rate (SHIBOR), the daily average interest rate for unsecured loans on the Shanghai wholesale market.

## Stability in uncertain times

Stability is a word that we heard repeatedly during our visit. In this time of uncertainty, Chinese government authorities prefer to make small tweaks to all available dials and increase infrastructure investment rather than make drastic changes to the overall economic model. They appear unwilling to increase economy-wide leverage materially unless the trade war substantially escalates, which would negatively affect consumer and business sentiment. A collapsing property market would be another reason to reverse course given that residential property represents more than 70% of Chinese household wealth. Conversely, a rapidly-bursting rather than slowly-deflating property market would represent an existential threat to the Chinese Communist Party.

## Trade war endgame

2019 was a dizzying year of twists, turns and tweets on the US-Chinese trade talks. Relatively quick resolutions to trade disagreements with Korea, Canada and Mexico raised market expectations in early 2019 about the speed of finding a solution to the Sino-American trade talks.

However, the fundamental issues are more intractable and politically more toxic for both sides. For example, those blue-collar voters in Michigan, Wisconsin and Pennsylvania, who indirectly provided the crucial Electoral College votes to Trump in 2016, will again play a vital role in his re-election in 2020. A substandard trade agreement with China could damage Trump's ability to secure those votes again. The problem is that the US economic objectives in relation to China – intellectual property protection, broad market access, end of forced technology transfers and the end of SOE preferential treatment – are not issues with easy solutions. The last one is especially unlikely to be resolved because preferential SOE treatment is core to President Xi Jinping's economic philosophy that SOEs and the government should drive Chinese investment in next generation areas such as artificial intelligence and robotics.

It could be argued that China was not in a rush to make concessions because the authorities felt comfortable about their ability to weather the pressure and the rising possibility that Trump may not be President for long. The collateral damage to the Chinese economy and the attacks on Chinese tech companies did not weaken Xi Jinping but actually strengthened his standing with the people. In the absence of polls or an independent media, monitored social media clearly indicated a broad nationalist defiance of US pressure and support for Xi.

With further escalation bound to affect the US stock market, economy and his chances for re-election, Trump changed tact and proposed a 'skinny' deal. Both sides are eager to prevent further escalation so the phase one agreement is effectively an extremely modest agreement and a ceasefire. We believe that a phase two agreement is unlikely to happen before the US election in November 2020 because aid to SOEs and national security issues related to technology are very sticky issues. Buying time suits China's interest because it helps with the government's newfound quest to be technologically self-reliant from the US.

Last year, some believed that we were seeing the beginning of a new Cold War, whereas others were of the opinion that rivalry is not inevitable but can be managed by the leadership of both nations. Trade is just the tip of the iceberg; trust and technology are the key issues.

## Technology

The ability to weaponise US technology exports as part of trade talks and the resulting 'near death' experience of Chinese telecommunications firm ZTE have convinced the Chinese policymakers that self-reliance in technology must be pursued regardless of how Sino-US trade talks evolve. There are two likely possibilities: a 'phase two' agreement could be signed, which would allow China a chance to gradually become self-reliant, or trade talks break down and two poles are created ('decoupling'). Given China's strong ideological view that state aid to SOEs and national service from Chinese private sector companies are crucial to leap from middle income status to upper income status, and that US national security concerns on Chinese technology are rising, it would be foolish to fully discount the decoupling possibility.

Yet, the pursuit of technological independence will not be easy. In certain technology verticals (companies which offer niche goods and services specific to an industry) like telecom equipment, Chinese firms are globally competitive and relatively independent from US intellectual property. Some companies are already seeing more orders from Chinese customers, likely due to the localisation drive. In others, Chinese competitiveness would disappear without access to equipment, materials and chips from the US.

## Lack of IT-based research

The problem extends to a lack of primary research in materials and equipment. Substrate and other consumables, innovative materials and tools are substantially under-researched in Chinese companies. The problem is particularly acute in semiconductor capital equipment where 95% is imported, with a significant proportion coming from the US. Incentives are also wrong at universities where research is focused on what is immediately commercially viable rather than primary research. There is a rising number of Chinese semiconductor wafer makers but none have gone to mass production yet and certainly not at 12 inch (silicon wafers are available in a range of diameters from 25.4 mm / 1 inch to 300 mm / approximately 12 inches. Semiconductor production plants are defined by the diameter of wafers that they can produce). It was also very telling that China's most advanced semiconductor manufacturing foundry spent most of a meeting talking about business in lagging nodes rather than leading ones. As a result, the Chinese foundry industry seems destined to remain no better than two generational nodes behind global semiconductor leaders like Intel.

An additional wrinkle to the technological symbiotic relationship between the US and China now is the national security angle. We should expect US tech restrictions to China to strengthen over time. The degree and scope of restrictions will play out in Congress between the lobbying efforts of Intel, Xilinx, QCOM, Applied Materials, Apple and other US tech companies on the one hand and the national security hawks on the other. Even non-US tech companies like ASML and Tokyo Electron will have to worry about the extraterritoriality of any potential US tech export restrictions.

If technology decoupling becomes a reality, the end market for Western technology companies will shrink as China is one of the largest consumers of seemingly everything in the tech 'food chain'. Such a loss would mean investment and research and development would be spread over a much smaller revenue base, likely translating into less investment, a slower rate of innovation and eventually slower growth. National security concerns will still play out regardless of who is the US President after November 2020 so the competing interests in Congress will decide the issue.

## Consolidators

The Chinese government is keen to concentrate industries around winners in order to improve efficiency (good), reduce wasteful capex spending (good), improve environmental compliance (good), improve regulatory oversight (good) and coordinate national service requests as needed (bad). China is not a rule of law country but a rule of party. This means that investors in Chinese companies should ask corporate and political governance questions, such as the likelihood of the company having to perform 'national service' requirements, so that we as minority shareholders are not surprised. We should not blindly focus on the attractive implications of industry consolidation without considering what it might mean for shareholders when the government or the regulator comes knocking on the door.

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**Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested.**


Contact us
General enquiries: **+44 (0) 20 7818 2135**
Email: **institutionalsalessupport@janushenderson.com**
Website: **janushenderson.com**


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