ROBECO
The Investment Engineers

Chinese Equities

Constructive outlook for Chinese equities in 2023

- Pragmatic, pro-growth pivot demonstrates policy flexibility
- Confidence in the property market, and not Covid, the key swing factor
- Subdued valuations still offer a clear entry point for long-term investors

China's dramatic policy pivot in late-2022, embracing a pro-growth agenda and abandoning zero-Covid, has set up its battered equity markets for a sustained revival.

The move has shattered the narrative among China skeptics that political leaders had ushered in a repressive economic ice age. The flexibility demonstrated in the fourth quarter of 2022 has in our view set China up for growth in 2023, after three years of stagnation and uncertainty.

We are upgrading our outlook for China to constructive based on our five-factor model, with a confluence of macroeconomic pro-growth pivots such as expansionary fiscal policy, the potential for further monetary policy easing, China reopening, and comprehensive policy support for the property sector. With valuations in key sectors still at historical lows and investor sentiment recovering, we believe it's an appropriate time to increase exposure to Chinese equities, through an active investment strategy.

'The 2023 policy prescription has justified our confidence'

The road ahead remains challenging, with confidence in the property market still absent and the disruption caused by the country's sudden Covid exit strategy making headlines. Nevertheless the pragmatism and comprehensive nature of the 2023 policy prescription has justified our confidence that the worst was indeed over for China by Q3 2022.[1]

Outlook
For professional investors
January 2023

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Market outlook

This is how we summarize the current outlook for investors in China based on our five-factor model.

Factors	Rating	Comments
Macro	+1	> Zero-Covid policy comes to an end and China reopens > There are challenges, but likely to be offset by pro-growth policies in 2023 > Geopolitical risks and long-term US-China tension remain, but have de-escalated recently
Earnings revisions	-1	Earnings revisions may take some time to recover
Valuation	+1	Market valuation is still attractive
Sentiment	0	Sentiment is recovering
Technical	0	Bottoming out
Outlook	**+1**	**Constructive**

Macro: Fiscal & monetary policy supportive

With inflation in China low, hovering below 3%, and the CNY strengthening versus the USD as we entered 2023, we expect monetary policy to be biased toward easing through 2023 as the economy emerges from its Covid hibernation.

The need to stabilize the property sector reinforces this belief. The easing bias was reflected in December bank loan growth data from the PBoC. New loans came in at CNY 1.4 trillion in December versus consensus expectations of CNY 1.1 trillion,[2] with corporate loan growth particularly strong. The credit impulse will pick up, driven by the recovery of the private sector as well as policy impetus. Small and medium enterprises, green finance and technology will continue to enjoy support.

On the fiscal side, indications are that there will be steady infrastructure spending funded by increased provision for special local government bonds and potentially an expanded fiscal deficit target to support growth.[3]

Negative impact of Covid re-opening will be short term, offset by a boom in travel and consumption

Covid is currently exacting a serious toll on China's population and health system, with a sudden re-opening of China's transport network prompting a dramatic rise in cases across the country. On 9 January 2023, the BBC reported an official source saying nearly 90% of the population in Henan, China's third most populous province, or 88 million people in total, were Covid positive.[4]

Will this stymie China's economic recovery after three years of stagnation? No, we don't think so. First, the Covid strain that has been blazing a trail through China since December 2022 is virulent, but manifests with far less severe symptoms than the first variants in 2020. This means many cases will be asymptomatic or mild, putting less pressure on health systems.

Second, the primary vaccination rate (not boosters) in the elderly population (over 60) is projected to hit 90% in the first quarter of 2023,[5] which is similar to the rate in the EU and US when those regions opened up. If the China experience mirrors what happened in the rest of the world, the impact of extra healthcare costs and lost working days will be more than offset by an overall increase in economic activity.

The current outbreak may not yet have peaked with the Lunar New Year holiday approaching, a time when hundreds of millions of people travel internally to celebrate with friends and family. The number of people on the move is expected to approach pre-pandemic levels. This will place the burden of Covid directly on the elderly, the medically vulnerable, and healthcare workers, not only during. but also after the holiday period. We believe the economy, and ultimately equity markets, will be able to weather this storm.

At the initial stage of reopening, consumption could remain subdued, but the gradual easing of mobility restrictions in 2023 will see gathering momentum. Upon reopening, the surge in household savings accumulated in 2022 and improved household incomes could help release pent-up consumer demand, which will be felt in the services sector rather than the market for consumer goods. Consumption is likely to rebound strongly in 2023, given the low base in 2022, and will become the major driver of China's GDP growth.

Property market enjoying comprehensive support

In December 2022 the Chinese government initiated a set of top-down supportive policies to aid the property market, unlike the previously small-step loosening measures from local government. The government clearly wants a soft landing in the property market and this implies a need to save property developers too. Most of the policy focus is on the supply side, addressing liquidity issues through support for bond and equity financing and credit lines.

To support the demand side there has been relaxation of home purchase restrictions in Tier 2 cities, including Hangzhou, Xiamen, Nanjing, and Wuhan. This is likely to be followed by further measures, including lower deposit ratios and mortgage rates for first-time buyers, and a possible cap on broker commission rates. Nevertheless, the road ahead is tough with sales still well below long-term trend levels.

It will take time for home buyers' confidence to be restored, even with a better employment and income outlook, and the removal of the Covid overhang. We think sales values could stabilize after Q1 2023 and pick up MoM from Q2 2023. A combination of policy support specific to the property sector and looser monetary conditions will create a price floor in 2023. We think the property sector represents a much more significant swing factor for China's macroeconomic health than Covid.

China's digital growth to resume

The digital economy is a pillar of the Chinese economy and has played a vital role in boosting growth, promoting innovation, and lowering consumer prices in the past two decades. The importance of the industry is well-recognized and digitalization was identified as a key growth factor in the 14th Five-Year Plan.

Nevertheless, the regulatory crackdown launched in 2019 has impacted sectors including communications, e-commerce, education, gaming and fintech. The measures taken, including investigating and sanctioning individual company leaders, and restricting the provision and use of various services were, to foreign China watchers, draconian, and certainly hurt the interests of incumbent investors in listed names. You can argue though that, while China's approach was very different, it was prompted by the same concerns over market concentration and excess power in too few hands that is present in the US and the EU, where regulation is a slower, more legalistic process.

The regulatory storm is largely over, and we see early signs that the environment may be easing given the Chinese government's recent support for the private sector, particularly the platform economy.[6] The recent positive development from PCAOB auditing[7] also removed a major overhang in terms of a potential ADR delisting.

Although it remains to be seen what policymakers would do to boost the confidence among private companies, the regulation of platform economies is entering a more normal period with a better structured policy framework. As rational investors we are continuing to seek opportunities in the digital space in China, cognizant of the 'new normal' interventionist regulatory approach. China's digital economy accounts for 40% of economic growth, but its penetration still has significant scope for growth in key sectors compared to some leading tech nations.

Earnings revisions and valuations

Valuations are still close to historical lows despite the comprehensive policy pivot to support growth. This reflects the recent earnings trend in all sectors ex-energy, which are flat or for the most part lower. How quickly this situation turns around is another key swing factor for the market. Earnings revisions will be on a recovery path but could still take some time to stabilize. Despite Covid-policy easing, we expect earnings to recover in Q2 2023.

Valuations have rebounded since the November rally, but remained attractive from a historical average point of view with the MSCI China Index trading at 11.4x 12-month forward P/E and the MSCI China A Onshore Index trading at 10.2x 12-month forward P/E, as of January 2023.

Fund flows have reflected the subdued sentiment through 2022 with foreign outflows only partially offset by domestic inflows. With brokers and fund managers turning bullish on the China market we believe foreign inflows will soon resume.

Sentiment: roadblocks and risk factors

It's only been one quarter since foreign investor sentiment toward China hit absolute rock bottom, following President XI's unveiling of his new leadership group of loyalists at the CCP congress in October. That was seen by some as a signal that China was changing course from managed capitalism, to return to a form of strict central planning.

We did not agree with this assessment, given that stated economic objectives were unchanged; we also correctly anticipated the loosening of zero-Covid policies.[8] It's much more beneficial in our view to observe policy actions and make decisions based on that. Far from ideological rigidity, the comprehensive policy pivot that China has undertaken in the past quarter shows commendable pragmatism and purpose in our view.

One credible risk is geopolitical, with the long-term economic rivalry between the US and China intensifying in recent years, and trouble in the Taiwan Strait always a consideration. This is one area where we can only make short- to medium-term judgments and we are encouraged that President Xi Jinping met world leaders including President Biden during the G20 summit in November 2022. We also see a visit to China by US Secretary of State Blinken, slated for February 2023, as a positive sign.

One further risk, which China's policymakers can't do much about, is whether external demand is resilient given anticipated economic slowdown in the US and Europe. China's continuing success in building supply chains for emerging industries, most recently electric cars,[9] makes us hopeful for 2023, despite a potential global growth slowdown.

2023: a return to growth

Lunar New Year in January 2023 marks the start of the year of the rabbit. This is traditionally associated with peace and prosperity by astrological forecasters. We certainly hope that's the case and we think the recent policy moves in China should enable the country to get back on the growth path, potentially to more than 5%.

We are turning more constructive on the China market, and we have positioned with more reopening beneficiaries in the portfolio as we believe the economy is getting back onto a growth path. At the same time we focus on structural growth and reform drivers of the Chinese economy, selectively investing in structural winners within our chosen themes. The long-term themes where we believe value currently lies include consumption upgrade, the green economy, technology innovation, and the technological upgrade of China's industrial base. As previously mentioned, we also believe there will be opportunities in the digital space, where a rebound is already underway.

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[1] https://www.robeco.com/en-int/insights/2022/09/four-reasons-why-the-worst-is-over-for-china – September 2022

[2] https://www.wsj.com/articles/chinese-banks-issued-higher-than-expected-new-yuan-loans-in-december-11673343738

[3] https://www.bloomberg.com/news/articles/2023-01-09/china-considering-record-local-debt-quota-wider-budget-deficit

[4] China Covid: More than 88 million people in Henan infected, official says January 9 2023 - https://www.bbc.com/news/world-asia-china-64208127

[5] Source: China National Health Commission, as of Nov 28th, 2022

[6] 'China confirms pro-growth policy stance' – Robeco - December 2022

[7] https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-secures-complete-access-to-inspect-investigate-chinese-firms-for-first-time-in-history

[8] https://www.robeco.com/en-int/insights/2022/10/markets-swoon-on-xi-power-play-but-long-term-goals-intact

[9] https://www.bloomberg.com/news/articles/2022-12-28/china-s-electric-car-exports-surge-to-record-on-european-demand

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