

VIEWS

Beholding the fundamentals

BY WONG KOK HOI

In a matter of days, the mood of China equities investors has swung from extreme despair and pessimism to rising positivity, fresh hopes, and even scattered euphoria.

China's economy, policymaking, property market, stock market, business expectations and investor expectations have entered a new phase. This is not another false dawn. We believe there is a 70% or higher chance that we are on the cusp of "The" inflection from a bearish hibernation into a bull run that has more legs, with earnings likely growing 10%–20% a year for the next three years from a low base, with P/E ratios rising to 15x–18x from just over 10x currently.

The forgotten fundamentals

Investors will soon realise, if they have not, that China's strong fundamentals remain intact — the competitiveness of its industrial base, as well as the resourcefulness, productivity and diligence of its workforce, and more, which I reinforced in my piece "The Forgotten Fundamentals" for October's APS China Monthly. In that piece, I argued that China's three major problems — the property bubble, the stock market doldrums, and local government debt — can be dealt with by the stroke of a pen, at the risk of putting it too simplistically. I listed some tested, realistic, uncomplicated solutions for China's current problems, which are not Gordian Knots. The confluence of those cyclical headwinds has unfortunately resulted in a major storm battering China's economy, leading to one of the most extended slowdowns in China's recent history. Still, the fundamentals of the country that powered the past economic miracle remained largely intact.

PBOC's unprecedented move

This storm can be weathered and overcome by bold, resolute, and imaginative action.

A key short-term rate, the medium-term lending facility rate, the loan prime rate and deposit rates were all lowered by People's Bank of China (PBOC) governor Pan Gongsheng. The PBOC also cut banks' reserve requirement ratio (RRR) by 50 basis points, the lowest level since at least 2018, freeing up about RMB1 trillion (\$184.5 billion). The RRR may be further lowered by 0.25–0.5 percentage points, Pan said in a Sept 24 briefing.

That marked the first time both reductions were revealed on the same day since at least 2015, while Pan's Sept 24 briefing in Beijing was also rare insofar as appearing alongside securities regulator Wu Qing, and Li Yunze, head of the National Financial Regulatory Administration. Borrowing costs on as much as US\$5.3 trillion (\$4.6 trillion) in mortgages will also be lowered and rules eased for second-home purchases.

In addition, the PBOC will provide at least RMB800 billion of liquidity support for stocks, where listed companies and owners of listed companies can draw on the funds to buy back their "undervalued stocks". It looks like Pan is going a step further than Jerome Powell during the Covid years. An old friend Martin told me half in jest over the weekend that the PBOC is now acting as the "banker for the stock market". Non-bank financial institutions can also use their Treasury bonds as collateral for loans to buy stocks. No wonder some Chinese investors and hedge funds have turned so bullish. They believe they now have a solid floor with the PBOC Put.



Some investors believe that a new phase is dawning on China and its stock markets

Sense of crisis

Just days later, President Xi Jinping's huddle of the 24-man Politburo concluded with a promise to hit the country's annual economic targets, pledging action to stop the real estate market decline, in their most forceful pronouncement yet to stabilise the crucial sector. Addressing oversupply, the government will strictly limit the construction of new residential projects, the Politburo said. Though the real estate market has fallen 30%–50% in this healthy albeit hair-raising correction, prices are still high relative to domestic incomes.

President Xi and his team have finally realised that the economy was spiralling rapidly downwards, hence the urgency in putting a floor on the deceleration and breaking the negative feedback loop of poor sentiment as well as slowing income and job growth. A failure to swiftly execute a resolute, comprehensive plan that tackles China's multiple problems risks mirroring the world's second largest economy in a chronic, intractable economic malaise, rather than a mere temporary, cyclical downturn.

The focus on the economy at September's Politburo meeting was unusual as that agenda is usually reserved for the Politburo's April, July, and December meetings. This deviation, measured in months rather than weeks, reflects the sense of urgency at the very top. Leaders urged for "calm" in handling the challenges, while seemingly acknowledging it was time to shift gears. Officials were given clear instructions to "face up to difficulties, strengthen confidence, and earnestly enhance the sense of responsibility and urgency of doing economic work well."

Biting dogs

Xi personally exhorted local government officials to be bold in coming up with innovative measures to address economic problems, and to not fear making some mistakes. Metaphorically speaking, Xi is urging action, immediate action, like urging his guard dog to bite first. Even if it bites his guest, it will be

forgiven. A dog that can bite is a good dog. Deng has his "good cat theory" and Xi his "good dog theory".

Uncorking genies

In my Aug 13 CIO Note, "China — Genie Re-bottled?", I wrote that China's economic miracle over the last four decades must be attributed to its millions of ingenious, dynamic, hardworking, and "never-say-die" businesspeople. In my view, the critical turning point took place during the late paramount leader Deng Xiaoping's Nánxún (南巡, Southern Tour) in 1992 when he exhorted them to go out to build their businesses and make money, in any way they think best. Deng made two grand declarations: "To get rich is glorious" and "I don't care whether the cat is black or white for as long as it catches the mice". These two assuring statements unleashed the "entrepreneurial genie in the Communist bottle" that was confined during Mao Zedong's regime.

During Deng's time, China took a pragmatic approach and had not cared about the colour of the cat. But in today's regime, the colour of the cat matters. Red and white are preferred. Black, brown, and blue, caveat emptor! Making millions by degrading the environment, adopting improper business practices such as employing monopolistic tactics or selling unsafe food products, ruining the future of the youth by promoting video games, bribing officials, and such are disallowed by Xi and his party.

Most Chinese — students and ordinary folks alike — support China's anti-corruption campaign because they are convinced that corruption must be weeded out. My August CIO Note recognised that 11 years ago, when Xi was first anointed as President, he took on the bold task of addressing the excesses, particularly corruption arising from the last 40 years of unbridled, rapid growth. The harsh three red lines policy to deliberately deflate China's property bubble, while concurrently preventing corruption from becoming truly

deep seated and endemic, were the right things to do for a sustainable path to equitable economic growth. Likewise, the focus on higher productivity from rapidly climbing the technological ladder across several areas, with the Made in China 2025 plan melding into the new productive forces that will propel China powerfully into the next decade and beyond.

In an unusual twist, leaders also called for helping private sector companies overcome difficulties and further standardise law enforcement and regulatory behaviours involving enterprises (要帮助企业渡过难关, 进一步规范涉企执法、监管行为). Local governments are also instructed to not investigate private companies at their own discretion, and without the rule of law. Two founders of listed companies whom I know well have been arm-twisted recently to pay back-taxes, based on allegations or suspicions. The warning of "you pay up or we launch a full investigation into your company's improprieties as far back as 30 years" is enough to browbeat any business owner into settling. Our interpretation is that this means that the broad, deep multi-year anti-corruption sweep will be ratcheted down. This may be a game-changer that will uncork the bottle currently trapping China's entrepreneurial spirits. We will have to watch this closely.

Direction of travel

Metaphorically speaking, this round of stimulus measures is a howitzer barrage compared to the post-Covid policy's baby bazooka, in that this time there is a more comprehensive plan that is also far greater in scale. International fund flows seem to concur, with shares in South Korea, Indonesia, Malaysia and Thailand posting net outflows in the week of Pan's announcement. The MSCI China Index has risen more than 30% from a recent low while trading turnover in both China and Hong Kong hit a record high on Sept 30. Even with the recent rally, the MSCI

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CAPITAL

GLOBAL REVIEW

Arnault's US\$37 bil wealth loss comes as luxury dims in China

EIGHTEEN months ago, LVMH shares were trading at a record high and the group's controlling shareholder, Bernard Arnault, was the world's wealthiest person.

Fast-forward to Oct 16 and a slump in Chinese demand for Louis Vuitton bags, Dior gowns and other high-end fashion has wiped out more than EUR150 billion (\$213.67 billion) in LVMH market capitalisation. Arnault's fortune has been relegated to fifth place on the Bloomberg Billionaires Index, which also shows that he has lost more money — US\$37 billion — during the period than anyone else on the ranking of the world's 500 richest people.

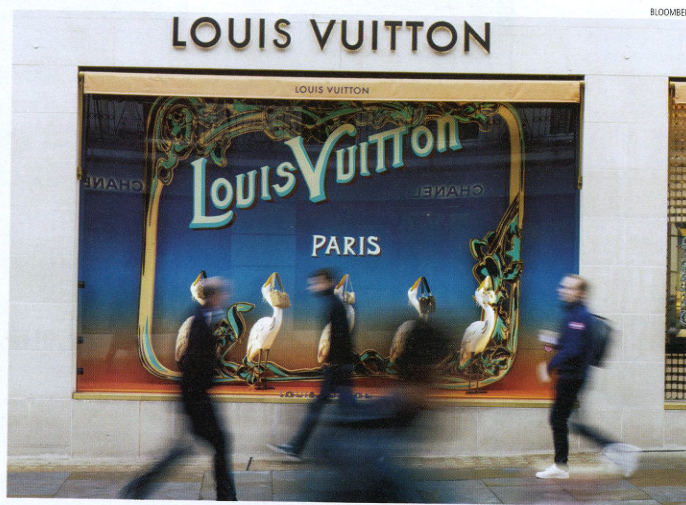
The 75-year-old French founder's net worth stood at about US\$174.5 billion, according to the index, ahead of Bill Gates but well behind No. 1 Elon Musk and other mostly tech industry billionaires in the top 10 whose fortunes have all swelled by double-digit billions this year.

The downturn has dashed any prospect of a soft landing in luxury and the questions for investors have become how long the slump will last and whether the recovery will look anything like the good times that preceded it.

For the first time since the second quarter of 2020, when the world went into lockdown, LVMH's fashion and leather goods unit posted a drop in quarterly organic sales.

Since LVMH Moët Hennessy Louis Vuitton is generally considered a bellwether for the wider sector, its sales potentially presage weaker results from smaller rivals such as Brunello Cucinelli, Hermes International, Kering and L'Oreal, which will publish revenue updates this week and next. LVMH shares dropped as much as 7.5% on Oct 16 to a two-year low, leaving its competitors lower.

The geographical zone that includes China was the worst performer for LVMH,



A slump in Chinese demand for Louis Vuitton bags and other high-end fashion has wiped out more than EUR150 billion in LVMH market capitalisation

but the lack of growth in the US, the group's second-largest region, shows the trouble is widespread. The company spooked investors with vague guidance amid risks ranging from Chinese economic growth to trade tensions.

"I've no idea," LVMH chief financial officer Jean-Jacques Guiony said on Oct 15 when asked about the outlook. "The visibility of our business is as good as yesterday's sales. We've been through ups and downs. The only thing we know, when the business is bad, usually it's good thereafter. It's a cyclical business."

Asia excluding Japan, the region that includes China, saw organic sales tumble 16% in the third quarter, a bigger decline

than expected. That was the third negative quarterly performance in a row.

Consumers in China in particular have curbed spending amid worries related to a weak property market and uncertain employment outlook. These concerns have prompted the Chinese authorities to launch a stimulus package last month that has yet to show a positive impact on consumers' appetite.

"Consumer confidence in mainland China today is back in line with the all-time low reached during Covid," Guiony said. It is currently hard to assess the potential impact on demand of such measures, he added, but "it shows that they are taking the issue very seriously".

There are no signs the recent moves have changed the behaviour of consumers, Citigroup said in a note, basing its conclusions on activity at a luxury mall in eastern China during the Golden Week holiday this month. The mall saw a low-teens percentage sales decline during the holiday, with middle-class shoppers failing to turn up in numbers as they suffer the negative wealth effects of China's weaker property prices, the note said.

Brands will now be looking at Singles' Day, China's biggest annual bargains extravaganza built around a Nov 11 event that Alibaba Group Holding popularised more than a decade ago.

The downturn in China is increasing the relative importance of the US for LVMH. A year ago, the US represented 24% of total revenue for the French conglomerate, with Asia excluding Japan generating 32%. The numbers are now 25% and 29% respectively.

In addition to the slowdown, Arnault and LVMH have also been caught up in political crossfire both internationally and at home. Donald Trump, the Republican candidate for president of the US, has vowed to impose dramatic tariff increases that could further stoke trade tensions that are already hurting the outlook for Hennessy, the LVMH cognac label. The firm is among French producers of the spirit that have been targeted by China in an escalating trade dispute.

Arnault and LVMH are also in the crosshairs of the French government and lawmakers trying to pass a 2025 budget to claw back the country's widening deficit. LVMH is expected to pay as much as EUR800 million in additional taxes next year as part of Prime Minister Michel Barnier's plan to raise levies on the country's biggest companies.

Taxes on the wealthy are also slated to rise, with Arnault a prominent target among opposition lawmakers who have called for more "tax justice". — Bloomberg

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China gauge is still trading below its five-year average of 11.7x forward earnings.

China now seems willing to forgo fiscal and monetary austerity and learn from other countries in injecting much more liquidity into the economy to stimulate everything, if necessary, as has been successfully executed, at least thus far, in those countries. Extraordinary risks call for extraordinary measures. During the Covid period, China had barely turned to printing money to help small businesses and workers. It could comfortably print a US\$1 trillion war chest that is just shy of 6% of China's GDP, if it wishes, which would be enough to solve most of its problems.

What is different from the past dawns is that the direction of travel is now both clear and correct. These moves and future moves will be big, seismic ones, rather than the incrementalism that has characterised policy actions in the past. This is critical in signalling to local officials, businesspeople, consumers, and workers that this is now "The" direction of travel with a capital T — massive and responsive intervention. This has also triggered a change of direction of confidence, and should drive the economy upwards and onwards.

Hitherto, government officials were sitting on their hands as they were waiting for clear, strong signals from the national leadership, and in the absence of such clarity, they

adopted a risk-averse approach that led to policy paralysis in the system.

The recent strong stock market recovery is being taken by consumers and businessmen as a beacon at the start of the road to recovery, a leading indicator for higher consumption and for some potential homebuyers to commit. Sentiment will likely continue improving from here and the negative wealth effect will soon be reversed. Talk of the "Japanification" of the Chinese economy and the end of China's economic miracle will also go in silent mode for now, or most likely forever.

For many months, the no brainer, sure-win money-making bet that was the "short China, long Japan" trade is now a nightmare that has left traders licking their wounds, having lost 13% in one unforgettable day on Sept 30. "Short China and long Japan" or any other asset class will likely go on a long sabbatical.

Investment implications: Maginot Line

Investors, both international and domestic, have hunkered down, positioning their portfolios behind colossal defensive fortifications. This swift 30% rebound that unfolded in just two weeks will hurt their performance for sure, making their defensive positions looking more and more like the tragically static French Maginot Line.

Some investors remain unconvinced that a new phase is dawning on China and its stock

markets, believing this to be another false dawn. They have worries like "whether in the next 12 months the fundamentals will be as good as before", "additional policy steps would be needed to boost economic activity and confidence...balance-sheet repairing would still need to take place", and "more significant fiscal easing is still needed to sustain the recovery momentum". One manager wants to see that "this policy blitz is effective in stabilising the downward trajectory of the housing market and not just result in a rush of hot money to equities". Among the most pessimistic of the spectrum of views on China's stock market is the warning from a Japanese financial institution that the rally may quickly turn from boom to bust, that "a stock market mania would be followed by a crash, similar to what happened in 2015".

What will be massively risky for the China bears is that the underperformance will be more pronounced should the stock market continue to power ahead in coming months and years, which we believe has a more than 70% likelihood. Still a minority among professional investors, some China bulls can see that "valuations are still below mean and could run further from a technical view. This could have more legs". Except for several hedge funds and a few bullish long-only funds, most investors are significantly underweight or had virtually no exposure to the stock market of the world's second largest

economy, which in and of itself is bizarre.

This is even more bizarre for those who advocate diversification. How can a fundamentalist investor defend his/her strategy of significantly underweighting or excluding China to trustees and asset owners, when China offers such compelling value? This time, in a scenario of an improving macroeconomic environment and recovering earnings, which we believe is the case, the decision of underweighting China would hurt if the stock market continues to price this recovery judiciously.

While this massive tide has lifted all boats, admittedly, not all sectors offer strong long-term value. In the next phase of recovery, investors should be more discerning. Not all stocks can sustain their recovery if they benefit less in this recovery. We would underweight banks, e-commerce, real estate, and other businesses with low entry barriers. We like hard-tech sectors like semiconductors, electric vehicle components, software, cybersecurity, consumption, tourism, financial leasing, and businesses that own strong brands.

Wong Kok Hoi is the founder and co-CIO of APS Asset Management. He has 43 years of investment experience, including CIO at Cititrust Japan, senior PM at Citibank HK and senior investment officer of GIC. Wong is a CFA charter holder. For more information, please contact cs@aps.com.sg