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Avoid standing naked when the tide goes out

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THE years 2020 and 2021 have been extraordinary. Ravaged by an unprecedented pandemic, major economies pumped in massive liquidity into their respective financial systems to save themselves from deeper stagnation. However, liquidity shots into the arms of industry and consumers for far too long can, and have, created the unintended consequences of inflation. Prices spiralled up across financial assets, wages, consumer goods, commodities, precious metals, cryptocurrencies, real estate and more. The Ukraine crisis has added fuel to the fire, with energy and grain prices soaring to new highs.

Feedback

These inflationary challenges need to be tackled in 2022 by policymakers and central bankers. Economists in recent weeks are debating the number of times the US Federal Reserve must hike rates. I think the more meaningful debate should be around the appropriate real bond yield that would entice investors to the US Treasury market, and the time left for the US Fed to act decisively before it is too late.

Before the global financial crisis of 2008-9, US 10-year Treasury bonds rewarded investors with a 2 per cent real return. Today, with inflation running as high as 7 per cent, these investors are punished with a negative 5 per cent real return. Comparatively, China's real rate is hovering at around 2 per cent. While some central banks have hiked rates in recent months, Fed chair Jerome Powell has chosen to stay doggedly behind the curve, despite ample evidence of rising inflation. Is he in a bind now? Will he have to pull off a Houdini act to keep the economy humming, and to save financial markets from meltdowns?

It is bizarre that investors are still willing to hold on to or even purchase Treasuries under such adverse risk-return profiles. Such actions had been rewarding - there was a willing Fed and "Fed devotees" to buy Treasuries at higher prices, implying the "greater fool" theory was at work. But will this theory still hold in 2022? In an environment of rising rates, will there be new "greater fools"? When the Fed contracts its US$9 trillion balance sheet, as it said it will do, who will be the willing buyers?

We thus think rates must rise substantially in some countries in 2022 and possibly beyond to contain consumer price and financial asset inflation. Liquidity will consequently be reined in. If declining rates had powered equities higher, the corollary is that rising rates must drive equities lower - thus dictates the dividend discount model. A mix of higher rates and shrinking liquidity can have devastating effects on most asset classes. The Nasdaq index is already down 12 per cent two months into the year. Rising rates can trigger the equivalent of a financial nuclear strike in 2022.

Yet not all is doom and gloom. China, the world's second-largest economy, has been gently easing monetary and fiscal policy in recent months. The People's Bank of China (PBOC) can afford to ease as it had tightened considerably from the autumn of 2020, when they introduced their "three red lines" policy targeting the property sector. The policy caused enormous pain and will lead to a dramatic slowdown in China's economy in the first half of 2022. We can reasonably expect more rate cuts in the coming months. The "three red lines" may be blurred to become three orange lines.

On the geopolitical front, the Ukraine crisis has led to the US-led West and its allies to impose further sanctions on Russia. Yet these actions will only nudge Russia and other countries closer to China's orbit. The more sanctions are imposed, the more the world will converge into a bipolar world order.

China can thus be an interesting market for investors in 2022. President Xi Jinping and his team seem determined to rejuvenate and modernise the Chinese economy, minimise systemic risk, and further improve worker productivity, income, and welfare. The Ukraine crisis is also encouraging China's government to spend more on strategically important industries. Given this backdrop, we have several tilts embedded in our portfolios for 2022.

Underweight Internet, overweight manufacturing, software, defence

One big question is whether China portfolios should overweight Internet stocks that were hurt badly in the past year. Prominent China managers seem hopeful of a rebound and still own large holdings of these stocks. On this factor alone, one should be cautious. Yet what makes us bearish on Internet stocks are regulatory headwinds and impaired business models. As influential and mighty Alibaba and Tencent may still be, we believe their days of monopolistic profits and taking stakes in companies in almost every industry at favourable terms are all but over.

Second, US investors seem to be shifting from growth stocks to value stocks as they deem a rising rate environment would hurt growth stocks more. While we have increased our exposure to value stocks from more than a year ago, we still believe growth stocks have a meaningful place in China portfolios. The country is still at a stage of development where many industries can still grow at 20 per cent per annum for many more years. Our internal debate is not about a major tilt to either growth or value, but what an appropriate mix is.

Our portfolio has a major tilt towards high value-add manufacturing industries which we believe will do exceptionally well in the next decade. The US has urged their companies to shift their manufacturing plants from China to back home, as well as to countries like India and Vietnam. However, that strategy has not succeeded, partly due to Covid and partly due to the challenges faced in rebuilding an entire manufacturing ecosystem in new locations. As a result, China enjoyed its largest-ever trade surplus in 2021, the highest since records started in 1950.

On the ground, we are noticing substantial progress for manufacturing firms. Industrial software and automation company Zhejiang Supcon Technology has indicated that they are doing brisk business after their technology caught up with foreign competitors. Industrial plants and factories will need Supcon to improve productivity, increase product and service quality, minimise human error, and enhance safety standards. Another Zhejiang company, solar panel equipment maker Zhejiang Jingsheng Mechanical and Electrical, indicated that its order backlog is as healthy as it has ever seen.

We are also bullish on software. The government has declared countless times that the digitalisation of the economy is one of the pillars of a super-modern 21st century China. The government is encouraging almost every economic activity that can be digitalised, to digitalise. It has even created a digital renminbi, a low-key initiative with a big ambition. China is probably only in the early stages of the monumental effort to digitalise its society. To this end, we have added China's largest core hospital IT provider, Winning Health.

Finally, we like defence stocks. Until President Xi came to power in 2012, China might have underinvested in defence from as far back as the last Qing dynasty. China now believes it must accelerate its efforts to modernise its military. We have added the stock of a key aircraft component maker, Beijing Bei Mo Gao Ke Friction Material, to our portfolios. Another promising software and defence-related stock is Geovis Technology, which uses satellite and artificial intelligence technology to provide topography platforms for the military and the private sector.

Global liquidity might recede in 2022, but in all these growth stocks, we catch a glimpse of China's promising future.

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