China – what's in store for 2021

Part 1

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This Q&A was adapted from a live webcast Martin did in January.

What will 2021 look like for China?

2021 will be a year of recovery. This is not surprising given last year's economic downturn. If vaccines are being rolled out gradually during the year, we believe the economy will recover, especially those sectors that have been hit hard like travel. Hong Kong's travel sector declined by 99.9% last year so there really isn't much room left to decline.

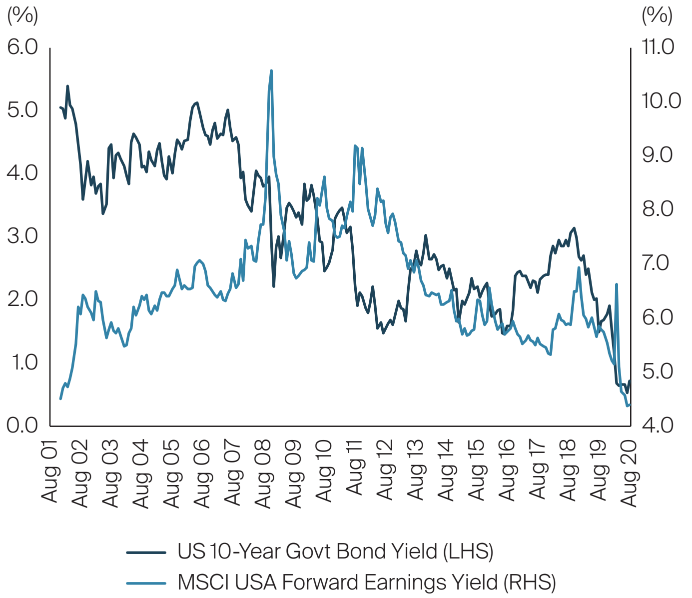
In terms of the overall market, we believe the year will provide an opportunity for more balanced market growth, including cyclical stocks and shares whose value took a hit last year. As the economy recovers, shares in other sectors will become more attractive and not restricted to just a few sectors like last year, where only a handful of shares accounted for the majority of the returns. We have started to see signs of change in the past two months, hence why we expect this year to be different.

Although we still expect the year to continue to be impacted by a complex political climate, new US President, Joe Biden, is more predictable than his predecessor and unlikely to resort to extreme policies. Having said that, we do not believe that Biden will cancel all the executive orders issued by Trump, as the Sino-US relationship is a sensitive political topic. I do not think any politician would be in a rush to make radical foreign policy changes during their first days in office.

As a team, we will take a more cautious approach this year. 2020 was slightly unusual in that investors were very confident in the market despite the high valuations. As companies whose prices have increased 80- to 100-fold – mostly new companies – release their earnings, it will be interesting to see if they do indeed meet the expectation. We do not necessarily think that we will see a fall in share prices, including in the Chinese markets, but do believe that the returns may be lower than last year; and as conservative investors, we need to be more cautious when deciding on which stocks to purchase.

The world is awash with cash at the moment, pushing stock prices up and making them very expensive. Would you say that bonds are better priced than equities?

US equities vs. bonds

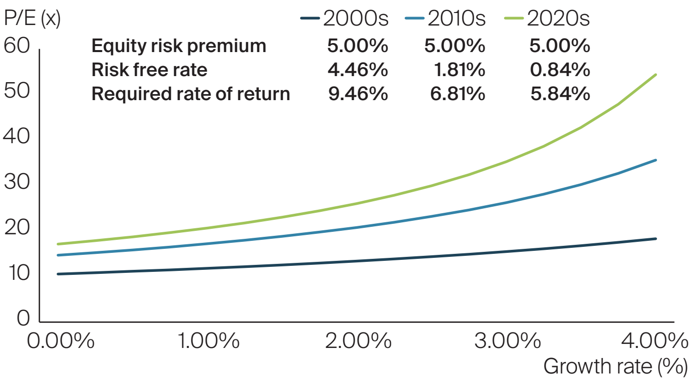


Source: Bloomberg, Datastream, FactSet, MSCI, Macquarie, as at 29 August 2020

If we look at the US bond yields, they are currently around 1%. During periods when anything can give a 1% return, you might think everything is cheap. Comparatively, if we look at Hong Kong properties, would you say that it is expensive? If cash deposit rates are at 0.2%, a rental property that could yield 2% is definitely better. Hence, it really depends on what happens to interest rates.

The one thing investors should be aware of is that despite the expected economic recovery, no one is predicting higher interest rates (unlike previous recoveries). This is because the economy is still in a precarious situation. Therefore, compared to bonds, I believe equities still offer better value for money. For example, the yield from a CK Hutchison Holdings (a blue chip company) bond is around 1.6% to 1.7%, but the dividend yield is more than 5%.

"Correct" P/E ratio at given rates of growth



Source: FactSet, FSSA IM, as at 29 August 2020. Risk free rates based on Hong Kong 10-yr bond rates.

This chart shows a different way to approach the issue: in an age of ultra-low interest rates, why have share prices increased so much? We call this an 'academic' approach, examining trends from a mathematical perspective. Assuming the risk premium stays constant at 5%, we can calculate a reasonable price-to-earnings ratio based on the different US 10-Year Treasury yields. The bright green line is 2020 – when the yield on US 10-Year Treasury bonds is 1%, and a company is growing at a rate of 4%, it can trade at a price-to-earnings ratio of 50. That might sound very high, but of course it's just a hypothetical scenario where the 10-year bond yield is 1%.

What do you see as China's long-term advantages?

How China stacks up against competitors

Indicator	China	India	Korea	Taiwan
Population (Mn people)	1,395	1,339	52	24
Education attainment (% higher degree among 25+)	3.58 (2010)	9.14 (2011)	26.68 (2015)	-
College graduate ('000 people)	7,533 (2018)	-	335 (2017)	289 (2018)
Manufacturing wage (USD per hr)	3.8	0.7	18.7	8.6
Infrastructure (Global competitiveness 2019)	36	70	6	16
Ease of doing business (Index rank 2019)	31	63	5	15

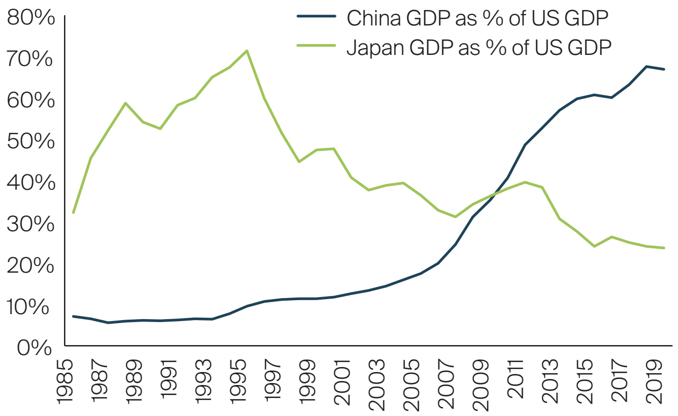
Source: Morgan Stanley, as at 2019.

China remains an attractive manufacturing base. One of the most important events last year was the completion of Tesla's largest manufacturing site in Shanghai, a project which took just a year to complete. Last year, almost one third of Tesla's vehicles were produced at its Shanghai factory. The significance of this event is not because it is Tesla, or because it relates to the electric vehicle market, but because in the past, China's manufacturing industry was mainly associated with shoes and textiles, and lately iPhones. People did not expect China to manufacture cars that would be exported to the European market, or that a Tesla factory could be built from scratch in just a year.

Another of China's long-term advantages is its 'engineering competitiveness'. The days of China as a cheap source of labour are gone – but at the same time, the salary of a well-qualified Chinese engineer may be just one-half or two-thirds of the salary of a US-based engineer. As a result, some sectors of the Chinese economy have started to grow quite rapidly, such as pharmaceuticals, software, semiconductors and the automotive industry. If we examine the reasons why Huawei has been so successful, it is essentially a reflection of China upgrading its manufacturing industry - a key aim of the latest and previous Five-Year Plans led by President Xi.

What do you think will happen to Sino-US relations, and how will it impact the Chinese economy?

China GDP now 67% of US GDP – similar to Japan in mid-90s



Source: US Department of Commerce, China's Ministry of Commerce, Bloomberg, FactSet, National Bureau of Statistics, World Bank, FSSA Investment Managers, as at 30 June 2020

There are historical precedents for the current political climate. Those who were around during the 1980s would know that the US and Japan were involved in numerous trade disputes during that time. The US levied high tariffs on Japanese car imports, which dealt a heavy blow to the Japanese automotive industry. China's gradual rise now places the country in a similar position, as its GDP is roughly 70% of the US's GDP. The US is the world's largest economy in terms of GDP, which has led to a political and economic wrestling match with its biggest rivals – previously Japan and now China. The US does not want to be overtaken - that is why it has imposed sanctions on companies such as Huawei, which has a 5G market share of more than 50%. As such, we can safely infer that the US will introduce further measures towards China.

Having said that, if we look at the impact of trade sanctions on the Japanese economy at the end of the 1980s and the beginning of the 1990s, in some respects they were good for the economy. Toyota is a case in point – it is still the world's largest car manufacturer, yet at the same time, produces its cars in the US. The company used local resources to support its global expansion and maintained its status as an industry leader. I am sure that some Chinese companies will be able to do the same and emerge stronger, despite the prospect of sanctions.

Any there any long-term trends that we should be aware of?

In response to the problems caused by globalisation, today we are faced with the threat of populism. People now have a different perception towards globalisation, both in the US and elsewhere. We will monitor how politicians respond, but I do not think that we will see a major change. I am particularly concerned about inequality, which the pandemic has escalated to greater levels. As long-term investors, we will be paying close attention to how governments respond to this issue over the next 5 to 10 years.

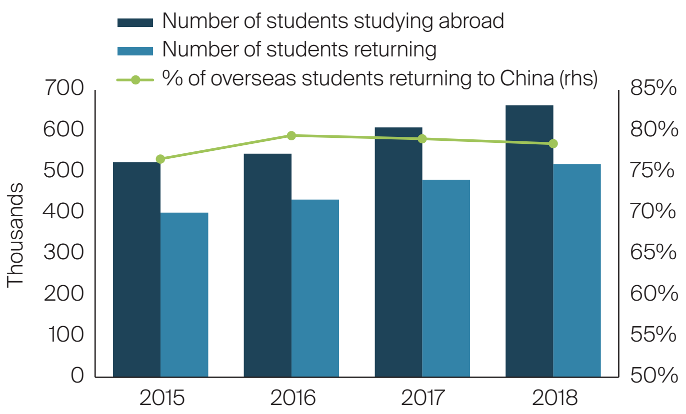
In the latest Five-Year Plan (China's fourteenth), the government has announced plans to reduce the country's vulnerability to and dependence on the global economy, achieve self-sufficiency and boost domestic consumption. The government has also introduced subsidies to boost purchases of home appliances and cars. We believe that this trend will continue over the next 5 to 10 years. As the Chinese economy develops and income rises, people will start to think how they can improve their quality of life. Hence, in sectors such as consumer spending, education and tourism, the potential for growth is clear even before the pandemic.

In line with that, we can also expect to see increasing average selling prices. China is home to some of the cheapest beers, and in the past, no one would buy instant noodles that cost more than 1 RMB. However, over the past three years, we have witnessed an interesting trend – the emergence of a market for high-end products. Now there are craft beers selling for 10 or even 20 RMB. In the past, a rice cooker would cost several hundred RMB, but following the arrival of smart technology, some smart appliances now cost much more. I believe this trend has the potential to have a direct impact on company profits and increase returns for shareholders.

Another trend that we are seeing is the increasing popularity of domestic brands. As the younger generations see their living standards and incomes improve, they will start to become more confident about Chinese brands. You can see this from the success of domestic sports brands such as Li-Ning and Anta or cosmetic brands such as Perfect Diary and Pechoin. We believe the trend will continue in the future and there will be more homegrown brands such as Huawei or Xiaomi.

Overseas students are returning to China

No. of Chinese students returning from overseas



Source: National Bureau of Statistics, Five IP Offices, Wind, FactSet, as at 30 June 2020

Lastly, there are now almost 600,000 Chinese graduates returning from overseas university each year. If you looked at the background of executive-level staff in Chinese-listed companies, you will see that many of them have worked or studied overseas before returning to China to start their own businesses. We believe this trend will help to boost China's technological capacity.

Huawei's R&D has tripled and now on par with global peers

	Huawei 2013	Huawei 2018	Apple 2018	Samsung 2018
R&D expenses (USD mil)	4,382	14,501	14,236	15,374
Revenue (USD mil)	34,146	103,029	265,809	221,506
R&D/revenue	12.8%	14.1%	5.4%	6.9%

Source: National Bureau of Statistics, Five IP Offices, Wind, FactSet, as at 30 June 2020

If we look at the R&D expenditure of Chinese tech companies, it has increased over the years and is becoming comparable to the likes of Apple and Samsung. Of course, not all R&D projects will be successful but from an investor's perspective, it is interesting to see where the focus is and what kind growth opportunities it entails.

We have invested in several Chinese tech companies but our tech investments are not restricted to just internet companies, because I believe that over the next few years, we will start to see new technologies being used in other sectors such as retail and food. Companies will use these new technologies to cut costs, and the definition of the tech sector will become increasingly broad.

Source: Company data, as at February 2021

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