Week of 14th December 2020

What's on our mind this week?

What to expect for Chinese equity markets in 2021

As we are approaching the end of the year, it is time for us to stick our neck out and make some predictions for 2021, especially for our key investment universe that is China, which has been a star performer for the second year in a row (MSCI China gained 20.4% in 2019 and so far this year, as at 11th December 2020, another 23.3%).

The Chinese economy keeps on rebounding fast with a GDP growth in the third quarter of +4.9% YoY. November macro numbers were very strong, and all signs are pointing to another good month in December. But at some point growth will start plateauing as the post-COVID recovery of China has to come to an end. This plateau however may come later than initially foreseen as Europe and the US are fighting a difficult battle against the latest wave of infection. This is having a positive impact on Chinese exports. The same happened in the first half of the year when numerous European factories had to shut down.

Chinese exports jumped last month, from +11.4% YoY in October to +21.1% YoY in November in USD terms. China's trade surplus was USD75bn in November (or USD63bn when seasonally adjusted), its highest ever. One can easily draw the conclusion that all the trade tariffs imposed by the US against China did not have much of an impact on Chinese exports, if any at all.

This staggering acceleration of exports seen in 2020 and that can be visually observed in the graph below cannot last forever, especially as COVID vaccines will be made available next year and as the world will hopefully return to a steady state.

China's trade (Monthly, in USDbn, seasonally adjusted)

Source: Capital Economics

Li Keqiang, the Chinese premier said on 24th November that "[China] wanted to achieve a balance of trade and will absolutely not pursue a trade surplus". This is telling us that China will likely not prevent its currency from appreciating if there is indeed further upside pressure.

Why would the RMB keep on appreciating? And what would be the impact on Chinese equity markets? It largely depends on China's monetary policy on one hand and on the US's fiscal policy on the other hand.

There is no clear consensus among economist when it comes to anticipating China's monetary and fiscal policy in 2021. A minority of them believes that China should keep on running a loose fiscal policy as the economy needs further stimulation. The COVID crisis is not over, local clusters of infection still appear here and there, and certain sectors are still not fully back on track (transportation, hospitality).

Other economists seem to be equally split between those who believe in a status quo of the current monetary and fiscal policy stance and those who argue for China tightening in the first half of 2021. We tend to be more receptive to the latter camp.

Looking at the latest inflation numbers, we think there are reasons to believe in a forthcoming rise in interest rates. The consumer price index dropped to -0.5% YoY in November, but it was entirely driven by the very volatile price of pork and the high base effect a year ago when China was hit by swine flu. Pork price that is the largest component of the CPI index dropped by 12.5% YoY. In fact, core consumer prices are rising at the

pace of +0.5% YoY. The production price index that is an indicator of CPI's future trend rose by 0.5% MoM in November, its fastest acceleration since September 2018. In other words, despite misleading headline YoY numbers, inflation is indeed picking up in China, and is expected to accelerate further in the coming months. This will give reasons to the Chinese government to raise interest rates in 2021 which will help the trade surplus come down by pushing up the RMB. As an early sign, the Chinese government has already started pouring cold water on the overheating property sector by forcing the most overleveraged developers to sell inventory.

Why are we highlighting the US's fiscal policy? Because the left-leaning policies Joe Biden wants to implement and that revolve around the fight against climate change and improving social welfare will most likely deepen the fiscal deficit of the US and be negative for the US dollar and provide further upside pressure on the RMB's exchange rate. Whether Joe Biden will succeed largely depends on him taking control of the Senate. The answer will come from the state of Georgia on 5th January 2021. If he does, we can expect the RMB to steepen its rise in 2021 and China to attract even more capital, especially as China remains massively under-owned in the vast majority of investment portfolios.

The combination of interest spreads between the western world and China being at its widest ever with continued upside pressure on the RMB may push Chinese equities up for a third year in a row. An endless flow of liquidity looking for a home and driven by western Central banks' unprecedented quantitative easing is the obvious other driver.

The MSCI China currently trades at 15.1x 2021 expected earnings when profits in China are expected to grow by 19.3% in 2021 (Source: Bloomberg).

Bloomberg consensus for China's GDP growth stands at +2.0% in 2020 and +8.2% in 2021.

Chinese Bond Defaults – Focusing on the facts

In recent weeks there has been a notable pick-up in media attention regarding bond defaults in the Chinese domestic market. Recent high-profile defaults and commentaries regarding a decline of state support has given the impression of a domestic corporate sector facing significant repayment challenges. This fear is nothing new. In late 2018 and 2019 we recall very similar doomsday headlines as annual default statistics typically come

into focus at year end and investors reflect on long term trends. So, what are the actual statistics for 2020? According to Bloomberg calculations, as of 14th December, the total volume of Chinese RMB bond defaults YTD stands at RMB111bn. Given the total size of the RMB bond market outstanding is over RMB95trn, that is equivalent to an annualized default rate of ~0.1%, extremely low by international standards. Even if we strip out government and policy bank bonds, the default rate for credit bonds remains just 0.3%. Meanwhile on a trend basis, 2020 default levels appear little different to what we have seen in earlier years. Indeed, at the same point (mid-Dec) in 2019 and 2018, total defaults amounted to RMB127bn and RMB108bn respectively.

Admittedly defaults in the China USD offshore market (currently standing at $8.5bn in 2020) have seen a notable volume pick-up compared to 2018 & 2019, however again some context is needed. It should also be noted that the 2020 defaults are highly concentrated in 2-3 large issuers, Peking University Founder Group, Tsinghua Unigroup and Tahoe Group. The total number of dollar issuers defaulting so far in 2020 is 14 (just one more than the 13 which defaulted in 2019). Also, given the Chinese USD bond market has been growing rapidly in recent years it should not be surprising that default volumes will also increase as the number of bond maturities also increases. With USD640bn of Chinese corporate debt currently outstanding, the Chinese offshore default rate stands at ~1.2%, broadly in line with the latest published global default rates (according to S&P) which stood at 1.3% for 2019.

That is not to say we are not seeing some interesting new trends. The recent high-profile default of two local government owned entities in the onshore market, Yongcheng Coal & Electricity Holdings Co. Ltd. and Brilliance Auto Group Holdings Co. Ltd, has raised some market speculation that certain segments of the China state owned enterprise (SOE) sector may not enjoy the level of government financial support previously assumed. The fact that both these issuers were rated AAA by domestic rating agencies at the start of 2020, has raised further concern from some domestic investors that rely on local ratings for their credit analysis.

It should be noted however, we view this development as healthy, positive and a natural part of China's capital market development. Although in the media Chinese SOE's are frequently viewed as a homogeneous large investment universe, in reality this sector is a diverse spectrum of different levels of credit quality. From central government owned

state champions all the way down to local government held, non-strategic investments, the standalone credit quality and state importance of SOE's can vary tremendously.

Admittedly, China's poorly developed ratings agency sector, with its highly limited rating scale (majority of onshore bonds are rated AA- to AAA), does not help in the process of credit discrimination. However, it is precisely for this reason that credit analysis in China should not use local ratings as a consideration in any assessment process. Instead, credit due diligence should be based on standalone fundamentals of the issuers. When government linkage is relevant, it should adopt a highly conservative scrutiny in any assessment of state support and strategic importance. On 13th December 2020 the deputy governor of the People's Bank of China, Pan Gongsheng vowed that China's central bank will improve oversight of domestic rating agency companies to ensure better credit risk reflection in domestic ratings. Again, this is a healthy development.

In our view, by allowing certain SOE companies to default the government is trying to ensure that a higher level of investor due diligence is undertaken in order to reduce moral hazard and stop investors from assuming that every government owned company will always enjoy a full government bailout if needed. Does that mean that the government has abandoned the SOE sector? Certainly not. It is important to remember that SOE's are the largest employers in China, that they control China's most strategically important sectors and that the majority of SOE bonds (including weaker LGFV's and local government owned SOE's) are primarily owned by Chinese government banks. Nevertheless the process of credit repricing could lead to some periods of increased volatility.

In summary, yes there are defaults happening in the Chinese domestic market and yes, some of the companies defaulting are SOE's, but this has happened before and it is certainly going to happen again. We should see this simply as part of China's bond market evolution as it develops into a globally recognised and investible asset class.

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