14th November 2022

The Chinese pivot may have just taken place

We wrote on 31st October about the extreme pessimism of the global investment community towards China on the back of the 20th Communist Party Congress as it was made clear that hard-line policies were to remain for the foreseeable future.

We also wrote that pessimism was so widespread and markets so downbeat that it looked like capitulation to us. We adopted a contrarian view stating that we were cautiously optimistic for the medium term and that we were expecting a policy inflection by the leadership on the zero-Covid policy given the fast-deteriorating state of the Chinese economy.

We did not have to wait long. In a matter of days, we started seeing more and more concrete signs that something was about to happen. As always with China, it was first some interviews given by former senior civil servants as well as some unverified rumours that fuelled optimism, even though they were quickly denied. Then came last week two official announcements on the two most critical issues that China needs to urgently address: material changes to its zero-Covid policy, and a resolution to the property crisis that brought most developers to the ground.

The impact was spectacular. The MSCI China index rebounded by 20.7% between 31st October and 14th November, the Hang Seng China Enterprise index by 21.1%, and the CSI 300 index that tracks A shares by 8.1%. The steep correction we saw in October and that was largely due to the outcome of the Party Congress was entirely recouped.

It is looking today very clear to us that China is in the process of adjusting its zero-Covid policy, if not rethinking it to reduce the economic and social impact. Of course, it cannot ditch it altogether, especially in the middle of winter. Changing the mindset of a population that has been told for three years that Covid was a deadly virus that needed to be eradicated at all costs will take time. Convincing 25 million people aged more than 60 years old to get vaccinated in the first place, and another 59 million to get a booster shot won't be easy. It is estimated that approximately 200 million people have not received any vaccine at all.

Still, despite the number of cases throughout the country being at its highest since last April (approximately 15,000 per day in 203 cities), quarantine measures were relaxed, close contacts saw their isolation period cut from ten to eight days, close contacts of close contacts no longer need to isolate, local authorities can no longer close schools, offices and highways without the approval of higher authorities, entire districts will no longer be designated as high risk each time a positive case is identified (only one building will), airlines will no longer be penalised for bringing infected passengers into the country. These are just a sample of the 20 different measures that were announced on 11th November.

The same trend can be seen in Hong Kong as well, the city where JK Capital is located. Almost every other day specific restrictions that had been adopted throughout the past three years are being removed one after the other.

On the property front, a joint announcement by the People's Bank of China (PBoC) and the China Banking and Insurance Regulatory Commission (CBIRC) was published on 11th November. It detailed a sweeping revitalisation plan to shore up the country's struggling real estate sector. The scheme outlined sixteen specific measures to support the sector, including initiatives to improve funding access for developers, ensure stable residential project completion and support defaulted company resolution through financing, asset sales and M&A.

Although we have observed that the Chinese authorities have turned more supportive on real estate policy in recent months, this announcement appears to be the most comprehensive and sector specific to date. Admittedly the plan did not provide any quantitative details of the scale of support, nor did it concretely address the challenges in physical contract sales which continue to show tepid demand after last month's property sales were down 37.7% YoY according to one of China's largest real estate brokers, CRIC.

However, the tone of the announcement was unambiguous in its commitment to provide a robust stimulus to this failing sector. It is in stark contrast to the long held "properties are for living and not for speculation" narrative of the central government in the past. Alongside all Chinese equity indices, the news unsurprisingly fueled a sharp rebound in the real estate's equity and bond prices.

Of course, as with previous market optimism, the longevity of the rally of the property sector will depend on the degree to which authorities back up the latest announcement with firm action. This will likely depend on the scope of support and whether foreign creditors specifically can benefit from any new financial support. This uncertainty likely explains why the bond price rebound so far has been highly concentrated in a short list of perceived 'financially stronger' developers. Defaulted names meanwhile have yet to see any meaningful reaction to the news. We are cautiously optimistic this could be a first step toward a sector recovery but there is a long road ahead. In the upcoming few months, we will closely look for signs of a recovery in the physical buyers' market, for any changes in funding conditions for developers and we will look for signs that authorities are prepared to step in to mediate the current impasse between foreign investors and defaulted companies which has stalled the restructuring process and left many offshore bonds trading well below theoretical liquidation values.

Nevertheless, it did not take more than these two latest announcements about the zero-Covid policy and the property sector to bring optimism back, and maybe it is only the beginning. Even though we do not expect Covid-related restrictions in China to be all lifted before at least one year, we believe the direction is set. The inflection point we had been eagerly waiting for may have finally happened. And the market has started reacting accordingly.