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China – What comes after capitulation?

The ending of the 20th Communist Party Congress of China triggered a sharp correction of Chinese equity markets. Investors had been hoping for some relaxation of the zero-Covid policy, for a renewed focus on economic growth, and for the appointment to the Standing Committee of the Politburo of the future successor of Xi Jinping as the tradition goes. None of that happened.

Specifically, the 24 members of the Politburo and the seven members of the Standing Committee are all faithful devotees of the Xi doctrine. None of them would be at this position without having been ardent supporters of Xi throughout their career (with the possible exception of Wang Huning, the party's theoretician who served under Jiang Zemin and Hu Jintao, the two previous presidents). Those who were of different schools of thoughts, including former premier Li Keqiang, were pushed aside and replaced by loyalists. The youngest Standing Committee member is 60 years old. All members will be hit by age limit in five years, preventing all of them from becoming Xi's successor. The perspective of Xi staying in power for another ten years without any form of counterpower has suddenly become a very likely scenario. This is certainly not what investors were hoping for. Hence the market reaction.

The impact was brutal. Foreign investors sold $2.5bn worth of Chinese shares on the day that followed the closing of the Congress, a record, while the MSCI China index lost 8.2%. Domestic investors were not as critical since the CSI 300 index that tracks A shares lost "only" 2.9%. On the other hand, the Nasdaq Golden Dragon index that tracks down Chinese companies listed in the US lost 21% on the same day, also a record.

Over a longer timeframe, Chinese equity markets are displaying signs of capitulation. The MSCI China has dropped by 29.1% over the two months of September and October. It is down 43.6% year-to-date (as of 31st October 2022). These numbers are mind-blowing, and possibly the reflection of an extreme pessimism that we can understand but that we find increasingly difficult to justify even though we were as disappointed by the outcome of the Congress as everyone else in the investment community.

Despite the negativity that could be easily drawn from the above, we are surprisingly not so pessimistic about the medium-term prospects for China. Western media focused on their understanding that political ideology was more important than economic growth, which may not be untrue, but perhaps a bit simplistic. The focus of the speech Xi made when closing the Congress was on national security and on technological self-sufficiency, while also making the point that he wanted to "provide an enabling environment for private enterprises" and "bring per capita disposable income to new heights". We would argue that the direction of Chinese markets is essentially dictated by the evolution of the zero-Covid policy that has been in place for three years. It is by far the most important driver of the Chinese economy, of domestic consumption, of employment, and of companies' growth and profitability. Politics and ideology are not key market drivers.

Of course, geopolitics between the US-friendly block and the China-friendly block is going to play an important role in the coming years, but we would argue that we have already entered a new cold war era several years ago, under the Trump presidency. The permanent tensions between the US and China are the new normal under which the market has been operating for quite some time already. Most likely these tensions will only get worse, and the market has already priced them.

Unfortunately, the zero-Covid policy of China is not showing any sign of recess so far. As these lines are written, 207 million people in 28 cities are under some form of lockdown, according to Nomura. And only 67.3% of people aged 60 and above have received the three shots of vaccines that are needed to be protected. Twenty-five million people aged 60 years old and above have not received any vaccination at all. And the pace of vaccination is slowing down.

The situation has to evolve. Coercive measures will eventually be lifted, if only because there are more and more signs that the population cannot take it anymore. Recent events at the 200,000-worker strong Foxconn factory that makes the iPhone in Zhengzhou (the capital city of Henan province) have seen the public give open support to hundreds of factory workers who fled by foot to escape the latest lockdown. Such public support through social media would have never happened a year ago.

The zero-Covid policy of China cannot last much longer if the government wants to avoid major social unrest and a brutal hard landing of the economy. Although there is an easy western rhetoric that consists in believing that China is now an autocratic regime driven exclusively by ideology, that the zero-Covid policy is just a tool used to oppress citizens, we actually understand (and have written extensively about) the reasons why the zero-Covid policy is what it is, i.e. a very successful policy that has turned into a trap that is extremely difficult to extricate from.

We are eagerly waiting for signs of an inflection, be it in a softening of the official message or an acceleration of the vaccination campaign. In other words, we believe Xi is perfectly aware of the economic devastation his zero-Covid policy has brought. He has no choice than to focus his efforts on designing an exit route to prevent a catastrophic outcome. An economic rebound, as gradual as it may be, will necessarily follow, and markets will react accordingly.

In conclusion, despite the horrible sentiment that currently prevails and mindful as we are of our contrarian views, we are cautiously optimistic about the medium term for China. Patient investors will be rewarded, as is always the case following a market capitulation.