PUBLIC EQUITIES

Hong Kong China Equities: Finding Value Amid the Reopening

INSIGHTS

An economic reopening, a recovery in fundamentals, and favorable policy support are creating a compelling, long-term case for Chinese equities.

William Fong, CFA
Head of Hong Kong China Equities

Robert Li
Senior Director,
Client Portfolio Manager, Equities

In 2023, many of the headwinds that have been dragging the Chinese equity market down over the last two years may turn into tailwinds. Indeed, Chinese equities have faced a number of challenges, from the self-induced, risk-focused regulatory tightening on certain sectors, to COVID outbreaks and resultant lockdowns hindering domestic activities, to weakness across the property markets.

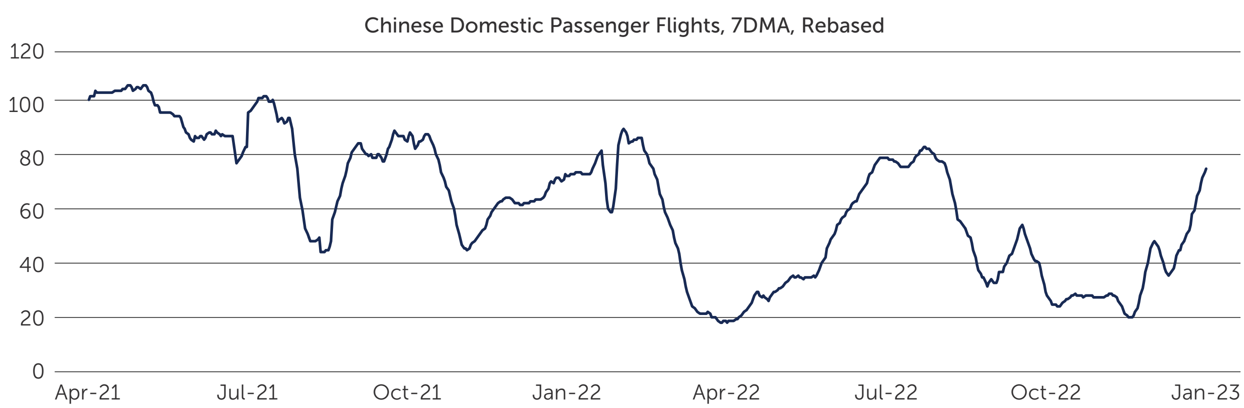
But with the reopening of the Chinese economy at the end of 2022, we believe the bear market has ended and the outlook for Chinese equities looks positive. In particular, China's government has committed to focusing on growth—suggesting that a number of supportive policies are likely to follow. Subsequently, the International Monetary Fund has forecast that China's economic growth could reach 5.2% in 2023, outpacing that of developed markets and making China one of the fastest growing major economies.[1]

Economic Reopening to Support Consumption

China's zero-COVID policy was a key factor in stalling the country's economic engine in 2022, with lockdowns disrupting domestic manufacturing and consumption activities. However, toward the end of the year, the government concluded that the lethality of COVID variants had fallen to acceptable levels and began efforts to rapidly unwind restrictions.

By January 2023, high-frequency mobility data showed that both intra-city and intercity traffic are rapidly recovering. Subway ridership in major cities has improved by around 50% from the trough, to approximately 30% below pre-pandemic levels, while national highway traffic mobility has exceeded the same period.[2] Recovery of air traffic has been staggered, with domestic flights returning to 96% by the end of January, while cross-regional flights recovered to 13% of the pre-pandemic level, led by flights to Greater China destinations, Southeast Asia and Europe.[3] This favorable backdrop, combined with the Chinese New Year holidays, has led to a rebound in domestic consumption. Over the Chinese New Year holidays, domestic tourism revenue grew by 30% year-over-year, reaching 73% of the 2019 level, while catering revenues grew by 16.4% year-over-year, or 73% of the pre-pandemic level.[4]

Figure 1: China Sees Recovery in Air Traffic

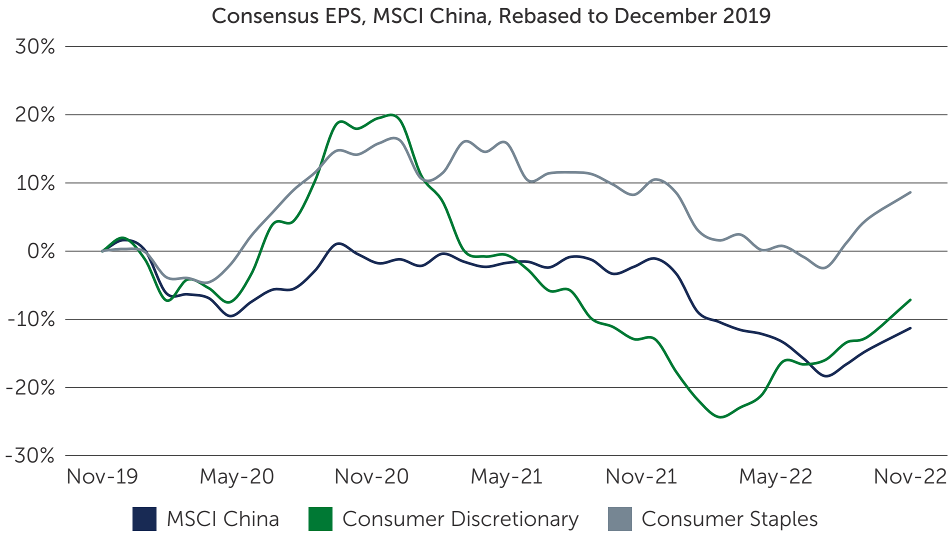


Source: J.P. Morgan Research. As of January 2023.

1. Source: International Monetary Fund; World Economic Outlook. As of January 2023.
2. Source: J.P. Morgan Research. As of January 2023.
3. Source: J.P. Morgan Research. As of January 2023.
4. Source: CLSA Research. As of January 2023.

Going forward, the recovery in Chinese consumption is likely to continue. Chinese household savings in 2022 grew by RMB17.8 trillion ($123.7 billion), and a sizable portion of this is likely to turn into pent-up consumer demand in the year ahead. Adding further support to the rebound, the Chinese government prioritized "increasing consumer demand" at the 2022 Central Economic Work Conference[5]—which suggests the potential for a variety of stimulus aimed at boosting consumer sentiment, from tax cuts and purchasing incentives, to the issuance of consumption vouchers. The focus of this consumption-related policy support is likely to be directed at the mass population, and will have a greater impact on households with lower disposable income. As a result, the consensus earnings estimate for consumer staples and consumer discretionary companies has outperformed the broader MSCI China Index, with earnings of consumer staples 8.6% above pre-pandemic levels **(Figure 2)**.

Figure 2: Consensus Earnings for Consumer Staples and Discretionaries Outperform



Source: FactSet; Barings. As of January 2023.

Regulatory Tailwinds for Property, Tech and Consumption

In addition to the favorable policy boost expected for the consumer sector, internet companies and property developers are likely to be supported by a potential easing of regulations going forward. This is another facet of the government's concerted efforts to bolster domestic activities and consumer sentiment. Prior to 2020, many internet and property sector companies relied heavily on external financing and high leverage, but with a low regard for the longer-term sustainability of their business models. While the current regulatory direction may seem to be a reversal of previous policies, we believe the regulatory tightening initiatives have improved the quality of the future competitive landscape, as the stronger companies with positive business practices remain.

5. Source: The State Council of People's Republic of China. As of December 2022.

For the property developers that survived the storm, their balance sheets are receiving much-needed lifelines in the form of credit provisions from Chinese banks. Nearly a dozen supportive policies have already been introduced since late 2022 to improve balance sheet quality and housing affordability. These measures include reducing the minimum mortgage lending rates for homebuyers, providing equity financing support for developers, and relaxing housing purchasing restrictions in certain regions. Homebuyer sentiment will likely improve as a result, along with valuations and fundamentals across the sector. Further, the property market is crucial to revitalizing consumption, as houses are typically the catalyst for large-ticket durable purchases such as automobiles and household appliances. Therefore, relaxing property market policies could have positive, knock-on effects for the consumer sector.

Similarly, the policy stance toward internet companies turned supportive in the second quarter of 2022 when approval of new gaming licenses resumed. However, due to the impact of the weakening consumption outlook at the time, many internet and platform companies had to resort to cost optimizations in order to protect profit margins. Looking ahead, as consumer sentiment gradually improves, platform companies could emerge with a higher wallet share of offline spending as well. This is largely because the lockdowns have increased consumer reliance on platform apps for their day-to-day activities, and businesses are leveraging online platforms to drive foot traffic toward their offline venues. While the growth of total retail sales in the first eleven months of 2022 was flat, online sales of goods grew by over 10%, with positive growth across dining, clothing and durables goods.[6] In our view, the market share of online platforms will likely continue to expand, and the linkage of online-offline consumption activities will strengthen.

Given a benign inflationary backdrop, monetary policy remains accommodative in China. This may be partly attributed to the mild demand in China, where suppressed consumption has kept costs grounded. Although China's reopening will likely increase overall demand, the pressure could be counterbalanced by cooling demand in developed markets and falling energy prices. At the same time, when interest rates in the U.S. approach their peak, pressure on the Renminbi exchange rate could also moderate, encouraging inflows from global investors and supporting exports.

Areas of Long-Term Opportunity

China's government recently highlighted the key strategic directions envisioned for the country—with objectives including the dual circulation model of economic development, sustainable development, innovation and modernization and improved social wellness.[7] Looking ahead, these initiatives will likely shape long-term investment opportunities in the companies and sectors that have exposure to the themes.

6. Source: National Bureau of Statistics, Barings. As of January 2023.
7. China published its "14th Five-Year-Plan for National Economic and Social Development and the Long-Term Objectives Through 2035" in 2021.

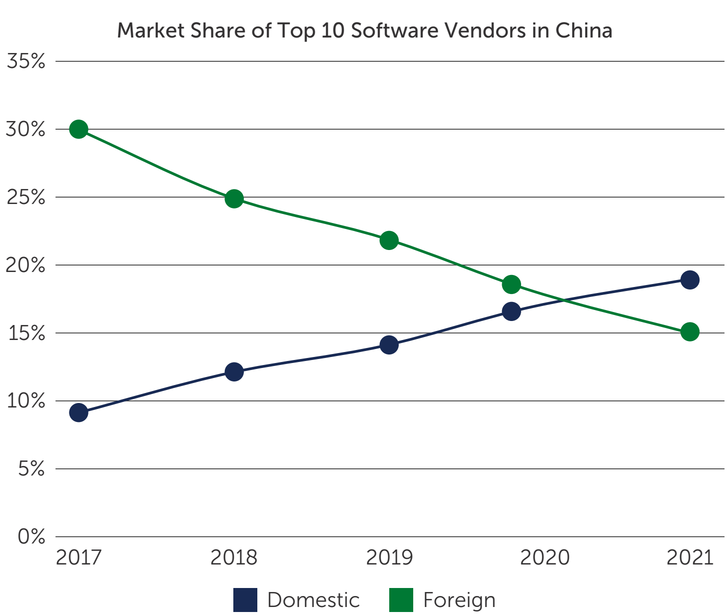
DOMESTIC BRANDS DOMINATE

One of the key priorities of the dual circulation model initiative—a centric piece of China's national strategy—is internal circulation, which aims to cultivate a strong domestic economy with locally produced goods and services comprising a significant portion of domestic consumption. As a result of these efforts, local brands have become more competitive through improved quality of products and services **(Figure 3)**. Domestic brands are also often better able to keep up with the evolving tastes of Chinese consumers and develop more suitable products for their lifestyle and preferences. For example, Chinese households typically prefer mopping the floor after sweeping. Local brands have produced cleaning robots with the added function for floor mopping, resulting in domestic companies dominating this product category. The trend for localization is likely to continue going forward—with an increasing number of local brands outperforming in areas such as sportswear, software, automobiles and consumer goods. The beneficiaries of this theme are likely unique to the Chinese market, which offers investors the potential for uncorrelated returns over global peers.

CHINESE COMPANIES INCREASE VALUE-ADD IN GLOBAL SUPPLY CHAINS

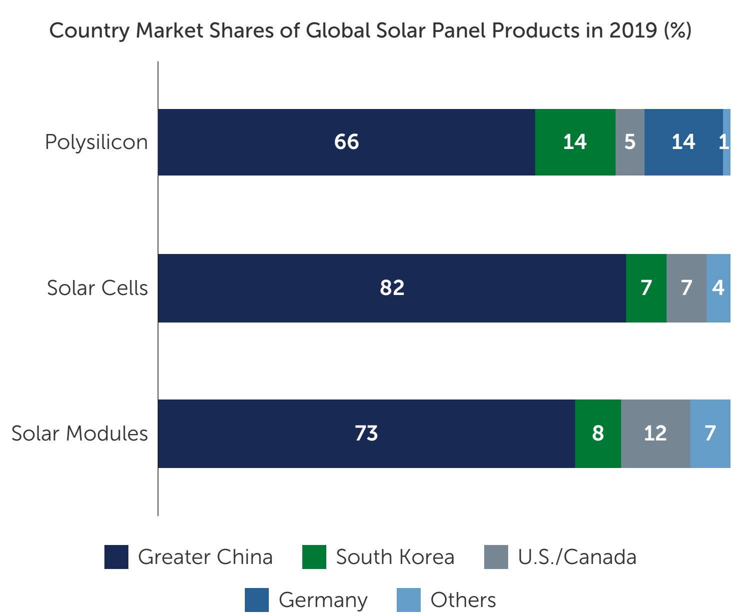
The external circulation aspect of the dual circulation initiative aims to enhance China's competitiveness within the global supply chain, and improve Chinese companies' entry into higher value-add segments through rigorous research and development. This requires leveraging China's supply chain advantage, as well as its position as the world's largest market, to foster innovation and broaden product distribution globally. In particular, China produces some of the largest cohorts of STEM graduates every year, enabling Chinese companies to dominate a number of forward-looking industries and products. For example, over two-thirds of the production within the global solar panels supply chain are manufactured in China **(Figure 4)**. Chinese hardware companies are also expanding toward emerging industries such as the manufacturing of AR/VR devices.

Figure 3: Domestic Brands Dominate China's Software Industry



Source: Morgan Stanley Research; IDC. As of January 2023.

Figure 4: Chinese Companies Lead Forward-Looking Industries

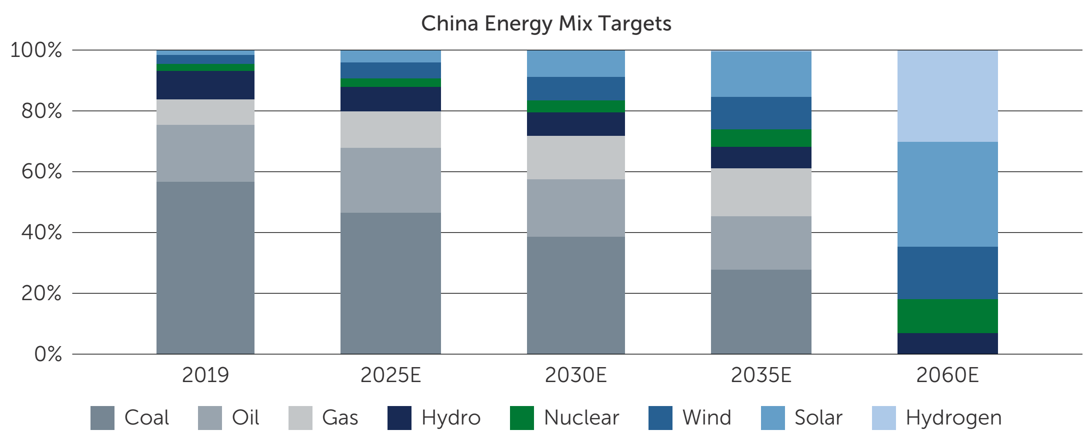


Source: Bloomberg NEF; Statista, by country of company headquarter. As of 2020. Totals measured in tons (polysilicon), gigawatts (cells, modules).

INCREASING FOCUS ON SUSTAINABILITY AND HIGH-QUALITY GROWTH

Another area that presents the potential for long-term opportunity is sustainability, which is a strategic priority for China. In particular, energy has been a key—but costly—import for China. In the past two decades, the Chinese economy, in many instances, compromised on efficiency in pursuit of stronger growth. As the focus is shifting from high-speed growth to high-quality growth, efficiency improvement and risk mitigation are becoming key priorities for optimization. As a result, there is a growing focus on sustainable development, including expanding the renewable energy infrastructure and reducing waste. While this will help mitigate climate-related physical and transitional risks, it will also likely decrease China's reliance on energy imports, and shape opportunities in companies that are drivers of the transition to a low carbon world.

Figure 5: China's Transitioning Energy Mix



Source: CICC. As of December 2020.

External Risks Remain

While there are indeed areas of long-term opportunity in China, the competitive environment in certain sectors could become difficult going forward. Technological protectionism, led by the U.S., has sanctioned China's access to advanced semiconductors and biotechnology. Although this suggests certain setbacks, more importantly, it also serves as a wakeup call for China to develop self-sufficiency in cutting-edge technologies. The catch-up process is likely to be challenging and capital intensive, but China's deep market could help to absorb part of the cost, while also creating unique investment opportunities.

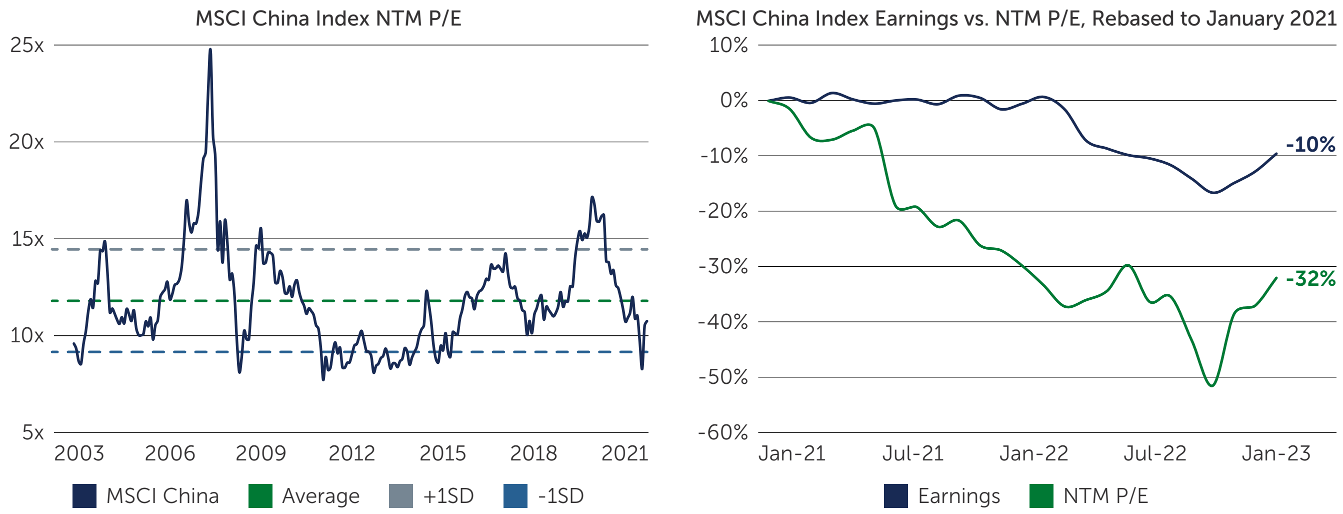
In particular, while many of the lower value-added industries are gradually migrating to India, Southeast Asia and even Latin America, Chinese companies are actually among the first to expand their supply chains and logistical networks. For instance, Chinese textile manufacturers began this process a decade ago, while Chinese semiconductor companies have started to diversify their supply chains since the pandemic. China's experience in capitalizing on its demographic dividend could be beneficial for Chinese companies looking to succeed in other developing Asian countries.

"The market consolidation is presenting attractive entry points for investors to gain exposure to the world's second largest economy and equity market."

Recovery of Fundamentals Expected to Continue

China's economic reopening has already resulted in a rally across Hong Kong China equities from November 2022 to January—but the market has yet to fully recover compared to previous peaks. In January, sentiment remained poor relative to fundamentals, resulting in attractive valuations for Chinese equities, which are still trading below the 20-year average. This represents a significant 32% discount from two years ago, while the earnings consensus only fell by 10% **(Figure 6)**.

Figure 6: Attractive Current Valuations



Source: FactSet; Barings. As of January 2023.

Looking ahead, with uncertainties such as company earnings announcements and global economic growth on the horizon, volatility is likely to remain elevated. But as the short and long-term factors shaping the Chinese economy continue to unfold—from an economic reopening, to a recovery in fundamentals, to favorable policy support—we believe the outlook for Hong Kong China equities is positive. In our view, the market consolidation is presenting attractive entry points for investors to gain exposure to the world's second largest economy and equity market.

Barings is a $347+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, Baring Asset Management Korea Limited, and Barings Singapore Pte. Ltd. each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

LEARN MORE AT BARINGS.COM

**As of December 31, 2022*

23-2733339