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CIO Strategy Bulletin

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China's Reopening Rally, Part 2

SUMMARY

- The MSCI China index has recovered a quarter of the bear market's losses. This initial gain, a 52% lift off from the bottom of Oct. 31, is due to the complete abandonment of China's zero-Covid policy and the economic reopening underway. This turn of events caught many global investors by surprise. Some observers wonder if the bull market is already over. **We believe there remains substantial potential for further solid gains over the coming months.**
- Renewed lockdowns or a reversal of policy is unlikely. China may have already reached herd immunity across the country after the surge in infections over the past two months. Neither policymakers nor the public would tolerate a return to mass quarantines. Though mortalities have risen sharply, the hospital system looks likely to withstand the surge.
- China's economic recovery may be notably stronger than previously expected. Consumption is being fueled by a record 15 trillion yuan of savings added last year. The political priority has also returned to growth and development. Monetary and fiscal policies have both been ramping up, particularly for property developer financing. This is essential given that it contributes 20-30% of China's GDP.
- Economic reopening, broad and targeted stimulus and personal savings are more than likely to offset expected weakness in China's exports. GDP growth likely rose 2.5-3.0% in 2022, weaker than we expected during the most intense lockdown phase. The reopening will likely boost growth in 2023 to around 5.5%, higher than our previous forecasts.
- Long-term growth issues remain for China. In the near-term, China's economy is likely to rebound sharply while the rest of the world is still likely to slow down. This divergence is likely to sustain Chinese equity outperformance. We expect 15% earnings growth and a rerating of stocks back to a 13x PE this year. These conservative assumptions suggest a further 20-30% gain in share prices is possible in 2023.

China's Reopening Rally, Part 2

China's unexpected and complete Covid policy reversal and its economic reopening have caught many global investors by surprise. Health experts believe China has already reached herd immunity across the country and policymakers have comprehensively refocused efforts on restoring economic activity and bolstering market sentiment. These factors have produced a sharp equity rally off the bottom. Some observers wonder if the bull market is already over.

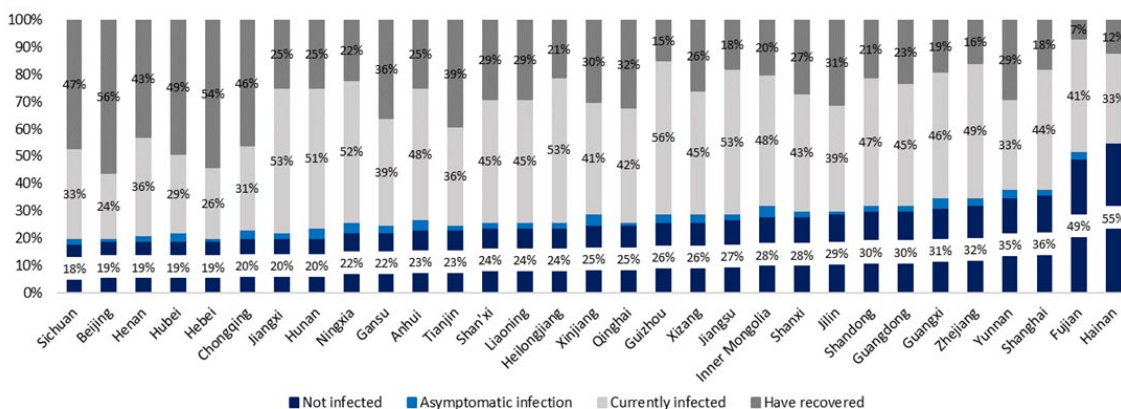
As we noted most recently, long-term questions about China's demographics and policy approach remain (see our [Asia Bulletin-- China's Property Market at a Crossroads](#)). With that said, we believe that substantial appreciation potential remains for Chinese shares as revenue growth and earnings are likely to exceed modest expectations. Analyst upgrades are probable for the first half of 2023 when full mobility returns to over a billion people for the first time in three years. The policy backdrop also remains highly supportive, with money and credit growth still robust. Further fiscal stimulus is likely, as well. The mix of policy and economic direction is a powerful combination fueling equity returns.

China may have reached herd immunity and passed infection peak

After China's reversal of its Covid-zero policy on Dec. 7, 2022, infection cases have surged. Although daily infection data is no longer published, the National Health Commission estimated that close to 300 million people were infected by end-December. Hospitals are still overwhelmed, running far above capacity. However, the number of new patients visiting hospitals has stabilized, and in Guangzhou, the number has been declining since Dec. 23 (Nanfang Daily, Jan. 9, 2023).

Meanwhile, survey data published by various provincial health authorities suggested some large provinces (over 100mn population) such as Sichuan, Henan and Guangdong have seen their infection rates reach 70-80%, as of Dec. 26 (Figure 1). Megacities with large populations, such as Shanghai (23mn) and Beijing (22mn), also reported over 60% and 80% infection rates, respectively. Continued rapid spread of the virus since the time of the survey would suggest China may have already reached herd immunity. Though there may be further waves of infections in the future, the people who have been infected and then recovered have already begun to travel and spend.

Figure 1: Survey statistics for 31 provinces show herd immunity had already been reached in many of the largest provinces by late December 2022



Source: Survey conducted by Renshetong (Ministry of Human Resources and Social Security), as of 26 Dec 2022.

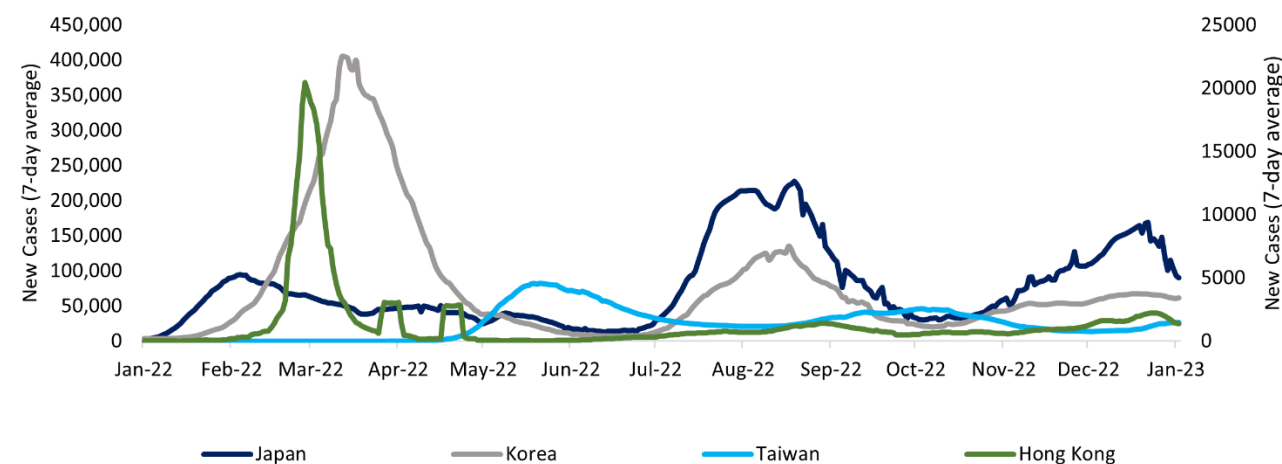
The medical system is stressed, but not broken

Chinese social media are filled with pictures and short videos of hospitals crowded, mainly with the elderly. Many medical staff have been infected but continued to care for patients. Surprisingly, though, the feared medical disaster

in China's poor and rural areas—used as an important justification for earlier Covid-zero policy—has not occurred. The Omicron variants spreading across China are highly contagious, but less lethal than expected.

China is likely experiencing a huge initial wave of infections and subsequent waves are likely smaller (Figure 2). According to Hong Kong University's experts, high stress in medical resources is likely to persist for months, but if a country can weather through that peak, future waves are tolerable.

Figure 2: Covid-19 outbreak and recovery experiences of China's neighboring economies



Source: WHO, Wind and Citi Private Bank, as of 6 Jan 2023

What is the likely mortality toll?

China has changed the criteria for identifying Covid deaths. People with chronic pre-existing illnesses who died of Covid are no longer classified as Covid deaths. Nonetheless, Chinese urban crematoriums are working overtime. One crematorium in Beijing reserved for people of high social status, such as retired high-rank officials and well known academics, saw its daily cremation number surge four-fold, from 150 to 600.

From another perspective, the number of obituary announcements in Tsinghua and Beijing Universities in 2022 rose by 92% and 25%, respectively. In December 2022 alone, Tsinghua University had 71 obituaries, a 10-fold increase from seven in December 2021¹.

Given the absence of official data, we are unlikely to ever know how many people died from Covid and Covid-related illnesses. For the whole year of 2022, when Omicron had been the predominant variant across the globe, reported Covid deaths outside China amounted to 0.02% of the world's population ex-China (Bloomberg). If we apply this ratio to China's 1.4 billion population, there may potentially be 276,000 Covid deaths in China this year. For perspective, China's natural rate of death is 0.71% of population in 2019, or 10 million deaths from all causes.

A robust recovery is underway and is likely to accelerate

There are many signs of a rapid "return to normal" among China's population. Mobility data has been improving sharply in January. Subway ridership and road traffic congestion indicators have recovered to near normal levels since late December across major cities. The pace of recovery shows that people who were recently infected and recovered have left their homes and are reinvigorating a dormant economy.

As of Jan. 12, 2023, before the Lunar New Year holiday, overall travel bookings of mainland Chinese tourists to Southeast Asian countries increased by 1026% compared with the same period last year. The number of air ticket

¹ HK01, Dec. 31, 2022.

bookings from mainland China to Southeast Asia increased by 864% year-on-year, and the most popular destination countries for mainland Chinese tourists going to Southeast Asia during the Lunar New Year holiday are Thailand, Singapore, Malaysia, Cambodia, and Indonesia (data from Trip.com, Jan. 13, 2023). Some countries have tightened entry rules for visitors from China, but we expect these policies to be temporary and likely to be lifted once China's Covid profile is better understood.

Figure 3: Chinese households added 15 trillion yuan in new deposits in 2022. A small amount of this wealth could generate a consumption boom, as happened in 2021.



Source: Haver Analytics as of Jan. 6, 2023.

Numerous and simultaneous reasons for lifting 2023 growth expectations

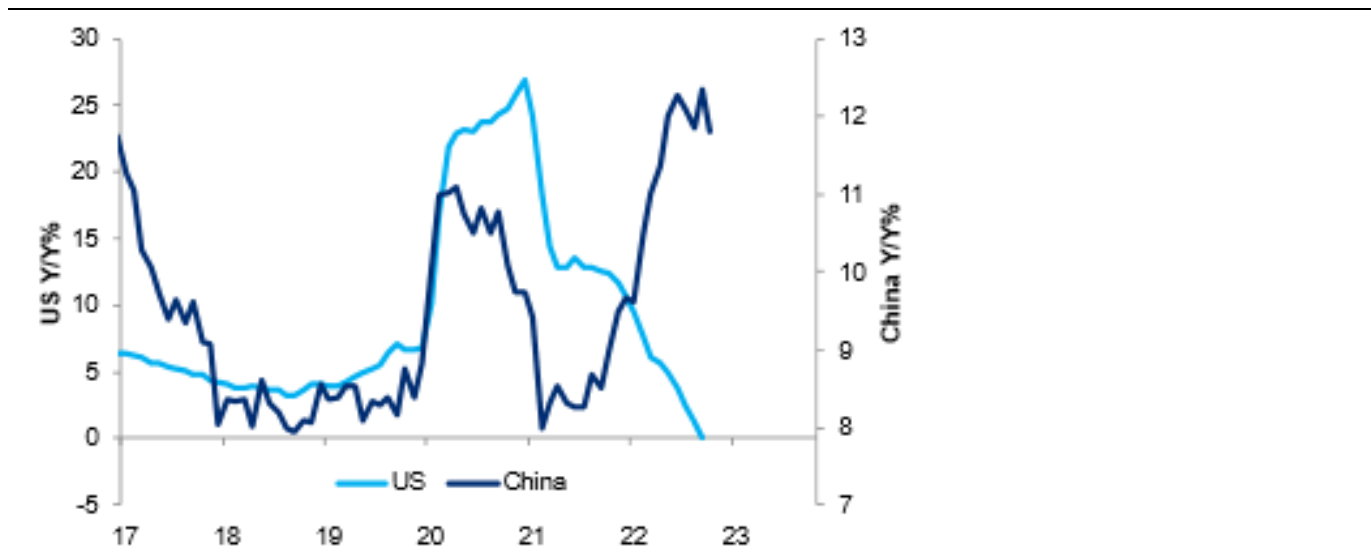
China's GDP growth in 2023 is likely to materially exceed our original GDP growth forecast of 4.5%. We see five key drivers:

- **Much faster than expected re-opening from Covid-zero.** Consumption recovery in 2023 may match or exceed that seen in 2021. Chinese households have accumulated CNY 15 trillion worth of new deposits in 2022, or a record 14% of GDP (Figure 3). In 2021, when just a small portion of prior year savings was spent, consumption contributed 5.3% to real GDP growth.
- **Major fiscal and monetary easing for the property market.** The central bank and the banking regulator have reopened both credit and equity channels for developer financing – not just to complete projects, but also to service onshore and offshore debt. If this enables faster restructuring of defaulted private developers, China can avoid further declines in the property sector. As we wrote in our Jan. 10 [Asia Bulletin -- China's Property Market at a Crossroads](#), long-term prospects for the property sector remain dim, but the key for 2023 is that the sector likely will not be a major drag, sufficient to stabilize fixed investment.
- **Money supply growth in China remains elevated,** a sharp contrast to that in the US (Figure 4). Together with a recovery in consumption, domestic demand growth is likely to more than offset the expected contraction in the trade surplus from weaker external demand and more expected imports.
- **The Central Economic Work Conference refocused on economic development and growth.** The government vowed to unwaveringly support both state-owned and private-owned enterprises, with fiscal, monetary, industrial, technology, innovation and social policies to engineer an economic recovery post-pandemic. This serves as a commitment to leave Covid behind. Moreover, regulations have stabilized, enabling greater capital market activity to begin anew.

- **Easier comparisons to a weaker Q4 2022.** Economic data has not improved for Q4 because of tightening surrounding the Party Congress followed by the surge in infections after lifting Covid-zero abruptly. In December, both manufacturing and non-manufacturing PMIs fell sharply to 47.0 and 41.6, both lower than the Shanghai lockdown period in April. It is likely that real GDP shrunk sequentially in Q4, taking the full-year GDP growth to 2.5-3.0%, below our earlier expectation of 3.5%.

But now we see the opposite effect likely in Q1 2023 and beyond, with factories reopening and people returning to their job sites. As a result, we may see China's real GDP growth rise from 2.5-3.0% in 2022 to around 5.5% in 2023. ***Given the dimmer global economic outlook, this divergence is likely to continue Chinese equity outperformance.***

Figure 4: Money supply growth in China remains elevated, while US money supply is still tightening after excess growth in 2020-21



Source: Haver Analytics as of Jan. 6, 2023.

Addressing lingering concerns over geopolitics and regulation

As we've pointed out, **China is progressively addressing every driver of the bear market, including Covid-zero, property, geopolitical tensions, ADR delisting and regulations** (see our [Asia Bulletin—Scaling the Great Wall of Worries](#) from Sept. 6, 2022). Yet, the market had not yet reclaimed earlier levels (Figure 5).

On the geopolitical front, the strategic competition between US and China would likely continue for many years to come. However, recently, China has taken a few steps to tone down confrontation, including replacing the combative foreign ministry spokesperson and naming a milder official as the ambassador to the US. Even though we do not expect major improvement in the relationship, serious escalations may be avoidable in a year without major elections on either side. We suspect that geopolitical risks will return in the future but are unlikely to become an immediate hurdle to economic recovery in 2023.

On the regulation side, several significant corporate developments may be notable. Various parts of government had taken small but "golden" shares in major internet platform companies. This may be seen as a sign of rising state influence, but it could also be seen as a prerequisite for maintaining access to capital markets. One ride hailing app was restored in the app store. The timing of much anticipated IPOs may still be uncertain, but there had been a steady flow of deals coming to Hong Kong, amounting to \$10.5bn in the second half, more than double the \$4bn IPOs in the US (Bloomberg).

Portfolio guidance

After a sharp 50% rally in the MSCI China index since last November, some observers wonder if the bull market is already over. The reasons for the rally are numerous but the combined impact of the stimulus, policies and consumer demand are just beginning and are likely to be long-lived. The recent equity rally is likely to be extended as confidence returns and the end to all Covid restrictions is made clear. Lockdowns are unlikely to return, which stood in stark contrast with the market reaction to the last surge in cases in March-April (Figure 6).

But this rally had only recovered one-quarter of the 20-month bear market. We believe Chinese equities will eventually recover most of the bear market losses because there are sustained drivers for revenue growth and earnings upgrades. December was the first time in 10 months when MSCI index EPS was revised up. The revisions accelerated in January. The strong rally had not yet caught up with upward earnings revisions, implying further upside, as more accurate estimates will be made as the recovery in industrial activity becomes clear (Figure 7).

We will watch these three themes play out in China's industries, many of which still trade well below historical mean valuations after a recent rally (Figure 8).

- **Consumption recovery:** This would enable companies to restore capacity (including jobs) and pricing power, such as travel and tourism, airlines, retail, and food and beverage.
- **Financial and real estate stabilization:** The real estate sector may see some recovery in 2023, but lacks favorable long-term prospects. The insurance, securities and wealth industries will recover faster as defaults and asset quality problems abate. They are likely to benefit from a rebound in asset values, trading volume and long-term demand.
- **Core technology development is a national priority:** Though e-commerce and internet platforms represent bigger beta opportunities this year, the longer-term beneficiaries of policy support are elements of our unstoppable trends, such as core tech, green, telecom, AI, and biotech (see the Unstoppable Trends section of our [Wealth Outlook 2023](#)).

The time is now

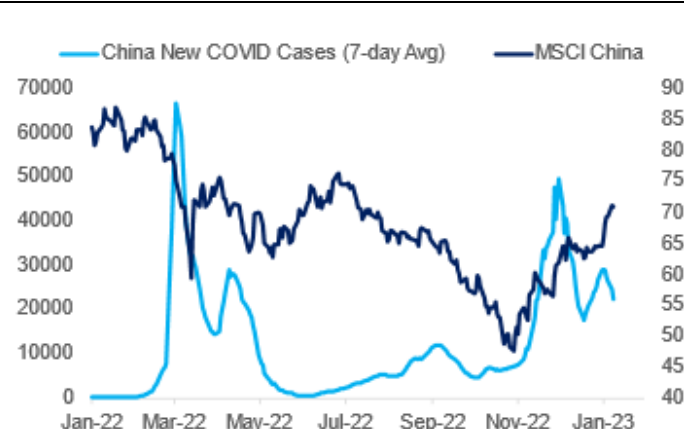
The strongest phase of the turnaround in expectations and sentiment is likely to be in the first half of 2023 when full mobility returns to over a billion people for the first time in three years. Taking the 2009 period as an example, China's stimulus plan caused aggressive upward earnings revisions. The equity performance initially lagged, similar to this cycle, but accelerated once earnings revisions matched corporate momentum. But we note that the strongest phase of performance lasted about half a year.

We expect the MSCI China index EPS to recover by 15% and for the PE ratio to return to 13x in 2023. These assumptions would bring EPS back to 2019 levels and for PE multiples to return to a level consistent with the economic recovery seen in 2017 (Figure 9). In other words, these assumptions remain relatively conservative. If borne out, this would imply 20-30% returns in 2023. Even if this occurs, the MSCI China would have recovered about 60% of the 2021-22 bear market decline.

Figure 5: The rally so far had only reclaimed a quarter of the losses seen in 2021-22 bear market in MSCI China index



Figure 6: Unlike the March-April surge in cases, the current surge is not expected to bring lockdowns and market reaction is entirely different



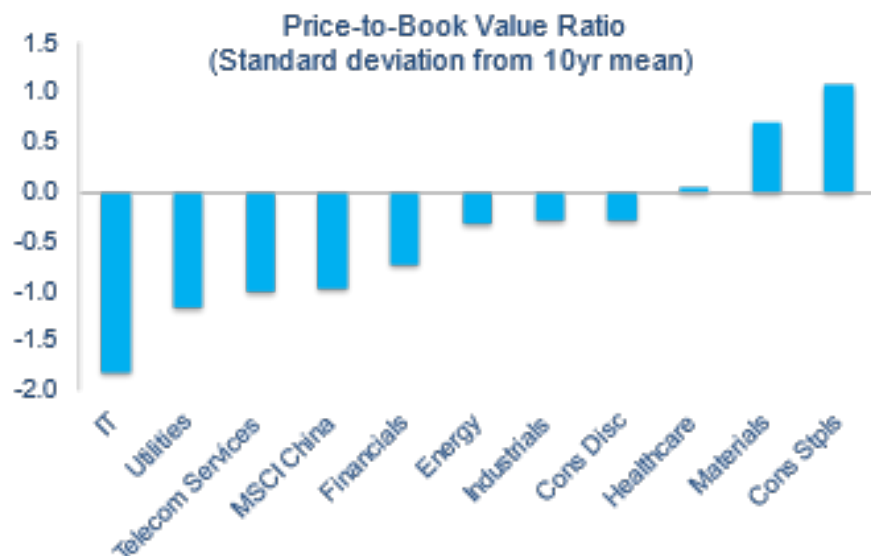
Source: Bloomberg as of Jan. 10, 2023. Past performance is no guarantee of future returns. Real results may vary. Indices are unmanaged. An investor cannot invest directly in
Pelosi refers to Rep. Nancy Pelosi's visit to
Taiwan in August 2022. NPC is the National Communist Party Congress in October 2022. Common prosperity refers to a set of policies aimed at narrowing the wealth gap
announced in July 2021. Regulation refers to a series of antitrust and information security policies implemented in 2Q-3Q 2021. Bubble burst refers to the initial correction in 1Q
2021 after Chinese equities peaked.

Figure 7: Earnings revisions turned positive in December and gained momentum in January, while index performance is still lagging here



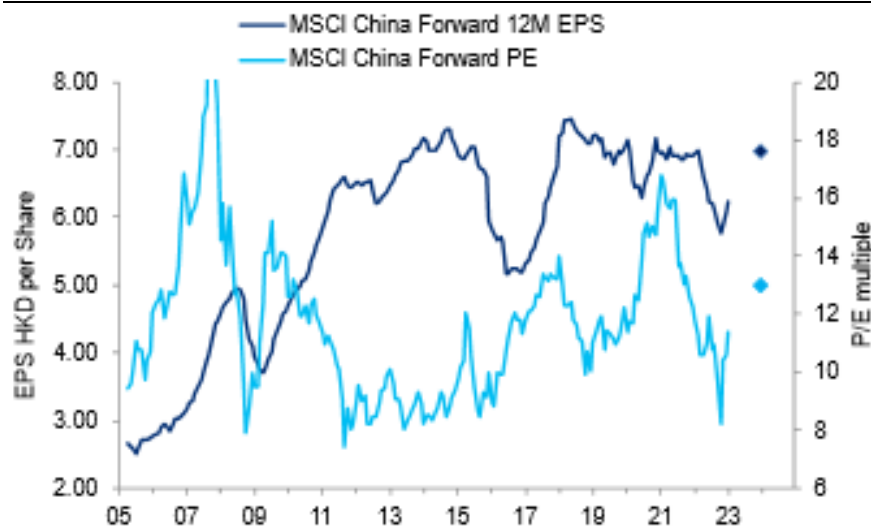
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an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. All views/ forecasts are expressions of opinion and are
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Figure 8: Most sectors in the MSCI China Index remain below historical mean valuations after recent rally



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Figure 9: Conservative estimates for earnings and valuations would still point to over 20% returns



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