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RICHARD SHEPHERD: Why China may be at an inflection point

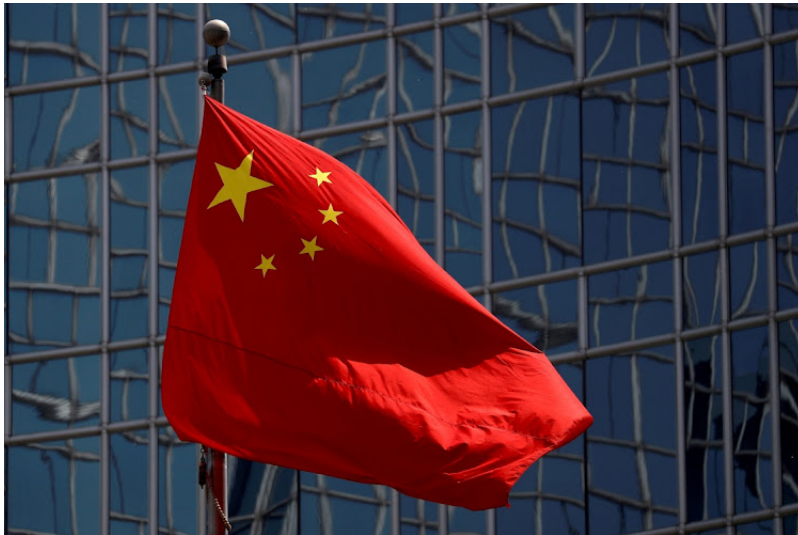
The country's role in global supply chains is intact and the Communist Party is pivoting from real estate to equities

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by RICHARD SHEPHERD

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Picture: REUTERS/THOMAS PETER

We are poised for the celebration of the Chinese new year on February 10, which will herald the Year of the Dragon. Dragons are mythical creatures that fly, breathe fire, and represent infinite possibilities due to their ability to transcend earthly rules.

China is a nation of contrasts and complexities, and based on the stream of bad news in the media you would believe that it stands at the edge of a precipice. Admittedly there are numerous hurdles that create uncertainties in the minds of investors, but sometimes you need only change perspective to see that the future also holds opportunities. John Cleese famously said “only at the precipice do we evolve”. This is apt for China today.

The relationship between China and the US has deteriorated since 2018 when we saw the imposition of tariffs and export restrictions, while the pandemic disrupted supply chains in 2020/21 and a heavy-handed regulatory cycle rattled investor confidence.

Beyond trade, a technological cold war started with the battleground in cutting-edge semiconductors; 5G networks; and artificial intelligence (AI). Companies with significant exposure to either nation, in any of these battleground areas, face heightened risks of doing business.



All Weather Capital's Richard Shepherd.

China's economy has also stuttered a little after reopening at the end of 2022 following the pandemic. Youth unemployment, real estate woes, and mounting debt pose challenges to the government's objective to structurally transition the country from an infrastructure and export-led economy to a consumption-driven one. This will take time and is likely to require fiscal stimulus from the government, which so far it has been reluctant to do.

Supply chains have always been deeply intertwined with China's economic growth strategy. Covid-19 highlighted a significant risk to globalisation, or specifically the offshoring of supply chains to only one destination. Out of this realisation were born the terms "nearshoring" and "friendshoring". Many US companies have turned to countries outside of China for "nearshoring" options. Mexico has been one of the favoured destinations, together with other beneficiaries such as Hungary, the Czech Republic, Turkey, Vietnam, Malaysia, Thailand, and Indonesia.

Deglobalisation and supply chain nearshoring are often pointed to as a risk for China, but the data shows that supply chains are simply lengthening, with China's role still very much intact, and that much of the discussed investments flowing into nearshoring beneficiaries are Chinese manufacturers creating an alternative supply chain for its customers.

China's policymakers have historically wielded stimulus tools judiciously in the areas of infrastructure spending, green initiatives and digital transformation. In its 14th five-year plan, issued in 2021, various areas of strategic development were targeted, and companies focused on these areas can be expected to be the recipients of continued stimulus: AI; quantum computing; semiconductors; neuroscience; biotechnology; clinical medicine and health; deep sea; deep space; and polar exploration.

In 2024 we have seen some stimulus and supportive actions from the government relating to significantly increasing liquidity in the country's equity market; and the withdrawal of draft rules relating to the mobile gaming sector and subsequent removal of the gaming regulatory official responsible for issuing them. Markets continue to expect broader economic stimulus in an effort to restore investor confidence and revive animal spirits.

Chinese policymakers are apparently also considering a sizable equity buying rescue package backed by about 2-trillion yuan (\$279bn), which could provide sentiment support to both onshore and offshore equity markets.

On February 7 Bloomberg reported that President Xi Jinping was talking with financial regulators about the stock market and the head of China's Securities Regulator had been replaced, a move that signals the president himself is taking this market rout seriously. The Chinese Communist Party has pivoted from real estate as a driver of wealth and intends to replace it with equities.

With China in the process of recalibrating its economic compass, the US economy is running smoothly for now. The US is also at the beginning of a presidential election year, one characterised by record political division and with two potential candidates equally unfit for office. US political risk is at multidecade highs but as usual is being completely ignored by the markets.

While the US-China relationship in 2024 has shown signs of stabilising due to a recent successful bilateral summit, mutual scepticism will remain as both sides view each other's actions through the lens of preserving national interests.

Chinese equity valuations make for a compelling story, with the market trading at a fraction of US market valuations. Chinese technology companies are AI contenders, yet trade at massive valuation discounts, compared to significant US AI valuation premiums. Should the Chinese government unleash a broad stimulus package, the valuation gap between China and the US is expected to narrow, offering a golden opportunity for investors. Data since 1970 shows that the average emerging market bull cycle runs for 110 months and has historically outperformed developed markets 17% a year during those cycles. We believe emerging markets are beneficiaries in a multipolar world.

This year will see investors pay close attention to the intricate dance between the two biggest economies. The China-US relationship, fraught with geopolitical tension, economic challenges, and policy manoeuvres, presents investors with both risks and opportunities.

While obvious risks exist, there is increasing evidence that this point marks the bottom in Chinese equity valuations.

• *Shepherd is a portfolio manager at All Weather Capital.*

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