Fidelity Connects

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Voiceover: Hello and welcome to FidelityConnects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

We're joined today by Catherine Yeung, Investment Director with Fidelity International, who is based in Hong Kong.

As overall growth in China has slowed, what is on the horizon? What should advisors brace for over the next few months, and how can they make the most of their investments in the world's second largest economy?

Catherine provides her on the ground perspectives today with host Pamela Ritchie, unpacking several topics including the property market in China, the healthcare sector, policy changes, and the country's zero-COVID policy which has led to various lockdowns as well as entertainment and leisure closed.

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Pamela Ritchie: Catherine, great to see you. How are you?

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Catherine Yeung: I'm well, thanks, Pamela. How are you?

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Pamela Ritchie: I'm very well, thanks. It's always nice to see you. Very happy to get caught up with you. And I wonder if we could, in fact, get caught up on something that we've spoken about perhaps over the years, really, the past couple of years: the policy of economic prosperity, sort of the goals, where China's policy is trying to take it and the term itself. If you could just break it down, and then we can perhaps go through some of the data.

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Catherine Yeung: In terms of a key area of focus for the senior government officials is what we call common prosperity, and within common prosperity this was a big topic last year in particular, is focusing on households and their budget and what they need to spend in terms of three key areas: property, health care and education. Last year we saw a lot of regulatory reforms relating to online education and basically students and family being able to access education and platforms. Property remains the backbone of the Chinese economy. We are still seeing a lot of risk, Pamela, in the property sector itself. Already today we saw some weaker data in terms of property sales down about 29%. So still very cautious on the sector.

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Pamela Ritchie: Let's follow up on that, if that's okay. Because as you say, there's been containment; we've seen that there's been a great effort to make sure that what has gone on in the property market in China has not sort of spread to other parts of the globe, and there's been, it looks like a successful effort to sort of manage that. What more is there to be done ultimately?

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Catherine Yeung: The situation is whilst we've seen this long-term growth set in terms of urbanization, growth of the middle class, the need for property. What's also happened over the years is that China has created somewhat of a property bubble. In fact, if we look at the U.S. property bubble in 2006 - 2007, it equates to around 6-6.5% of GDP. Last year the same situation in China was close to 20% [of the] Chinese GDP. As a result, what we are expecting … again, some of these companies, these property developers, have really been flourishing in this demand, but at the same time some of their balance sheets and management of their balance sheets have been quite questionable. Even as an investment team we are picking up on some of these areas in terms of mismanagement. So, whilst it seems a bit harsh, we're probably going to see consolidation in the market; we're likely to see default, albeit managed defaults, and essentially the bigger players are going to get bigger in terms of the well-managed property development companies.

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Pamela Ritchie: Very interesting. Is there an effort to land or maybe you could bring us up to date on the status of… in banks sort of holding some of the assets that are just not working. There are larger institutions where things have been, again, kind of ringfenced for the greater good, you might say, for the rest of the economy. Is there any update on sort of how that is working? To what extent that is working?

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Catherine Yeung: In terms of what we're seeing in the property sector itself, think of it as like a flight to safety. If we take, for example, 2021 pre-sales in terms of the land sales, state-owned enterprises or, what we call them is SOEs, accounted for about 26%. Last year this pre-sales land, that figure jumped up to … sorry, I should say this year, year-to-date in 2022, up to 75%. If you think about it, if you are a… even non-investment-wise, if you are a citizen in China and we're now seeing this in terms of the …I don't know whether it's been in your press or commentary has been shared over in Canada about people not paying their mortgages. It's not because they don't have the money to pay their mortgages, it's like a form of protest. So, you put a mortgage down on an apartment that hasn't yet been completed and you're still not getting this apartment. We have seen that, and this is really flagging the urgency towards the government in terms of trying to rectify the situation. Again, the state-owned enterprises are likely to benefit, but in the interim, going back to the common prosperity focus, we need to ensure -the government needs to ensure- that these citizens are indeed receiving the apartments that they have bought, and that also the pricing of these apartments doesn't go through the roof. Although, as I said, the property data has been significantly weaker of late.

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Pamela Ritchie: There's been a call to some regional banks, to other banks to sort of get involved, to help this overall sort of landing of this. Is that fair?

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Catherine Yeung: Yes, and I think also what we've seen since 2021, lot of people focusing on the regulatory environment last year, but we have seen a bit of an economic ... not even a bit, we have seen an economic slowdown in China. Sentiment wise, it was driven by these regulatory reforms we've seen, especially in the internet sector, the education sector; to a degree, the health care sector. Again, it's important to sort of differentiate the reforms that are beneficial for citizens versus how they impact the investment of these companies, all these industries. In general, China is very different to the rest of the world in terms of its easing bias, but it's almost like the market wants to see more.

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Pamela Ritchie: It's interesting, and you've mentioned it there, the other piece of common prosperity: education, but also health care. I'm curious about health care. It goes to the COVID-zero policy. It goes to ultimately the innovation within the sector, and the focus on it for policy and investors. What do you make of where health care is, where it's going, how good an investment it is, ultimately?

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Catherine Yeung: Again, it's very interesting because when you look... and I think we've spoken about in the past in terms of what citizens have access to and what they don't have access to. We were seeing incredibly rich gross margins by some of the pharmaceutical companies, staggering gross margins for just merely selling generics. So, there was a crackdown and we have seen pricing pressure for the companies. This has been going on for quite some time in terms of really focusing on the prices of different pharmaceuticals. That has also sort of put a bit of a ceiling on some of these health care names, but at the same time it's good for the citizens. The more innovative biotech companies are still doing well. In fact, a few of the companies that we've spoken to have just released their second quarter results. Again, if you have that market lead, that research and development capability, been managing your balance sheet well, there's still some very attractive names because they're still underpinned by government support in terms of innovation.

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Pamela Ritchie: Any mRNA, I'm sure there's trials going on. Is there anything coming to the fore?

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Catherine Yeung: There are lots, Pamela. But alongside property, the COVID policy and the zero-COVID policy remains a risk for China. We've seen some tweaks, admittedly, in both Hong Kong policy as well as China-related policy, but you will often see these short, sharp lockdowns or prolonged lockdowns. It's quite interesting how local governments have tweaked their policies. You're seeing a lot more mass testing really to try and contain the outbreak in a given city. There were like 2000 or so cases reported just today or yesterday. To give you an example, a city will say you can continue to manufacture and produce, but all forms of entertainment and leisure are closed. So, this is really putting a drag on sentiment and again, along with the property data we had today, we also had exports which was actually a relatively attractive number [indecipherable]. Across all levels, you saw numbers come in below estimates including consumer confidence. This sentiment gauge with consumption is something we really do need to focus on because there has been a sharp drop.

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Pamela Ritchie: There's so many things in that that I'd like to ask you. On the export front, the whole world is struggling right now, actually, apart from North America on some level and maybe, ultimately, North America's already in a recession. It's hard to know. What, ultimately, does that sort of forecast for the export story for China if Europe goes right into a recession. Are there any thoughts of how we look out to that a few months out?

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Catherine Yeung: Yeah, well, China is still such a big exporter, it's still such a big manufacturer. Even when the Shanghainese or Shanghai lifted its restriction per month production data, whether it was in [indecipherable] or other segments, really strongly rise. The issue is the capabilities. When you get a lack of movement of people nothing gets produced. That's why it's exciting to see these tweaks to policy where production is still occurring. It's really the domestic consumption side which needs to be monitored closely. Again, as the rest of the world picks up and there's more demand, China stands to benefit from an exporter's perspective.

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Pamela Ritchie: Perhaps the domestic story still needs some clarification. That's an area to look. Monetary policy is happening, there's a recognition that growth perhaps needs some help. We saw a small cut, in fact, interest rate cut, didn't seem to be very large. I wonder if you could put that in perspective. Is that a signal to something else or a willingness for more help, ultimately?

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Catherine Yeung: It was a little bit unexpected, the cut that we saw today. It was only 10 basis points. The conundrum that the PBOC, the central bank, finds itself in is that, as you see the Federal Reserve and other central banks aggressively tighten rates, they're in a position to ease, but if they ease too much then the interest rate differential will widen, which has a knock-on effect in terms of currency and capital flows. They're very cognizant of that. There's more of a focus, it appears, on the fiscal side of things. So, new bond issuance... there's a quota at bringing some of next year's quota to this year. Fixed asset investment spending, again, has a lot more room on the upside. We spoke about in the past, 5G networks, the building of more connecting cities, etc. So not just spending for the sake of spending, but really targeted. The problem with that, again, Pamela, is when you do see these lockdowns you haven't seen ... I mean, people are confined to their apartments or their homes, so even if you were trying to increase infrastructure spending, the work is not there to do the infrastructure spending. I think that's, again, this is why we're seeing a bit of a tweak to policy, but it's very unlikely that you'll see a 180 degree turn in terms of just opening up the borders, etc.

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Pamela Ritchie: If we go a bit further towards the Congress itself, what do you think investors need to know about this? It is going to be quite a moment. Ultimately, what are some of the strands that you look at as we get closer to this state?

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Catherine Yeung: We're seeing a reshuffle of the senior politicians or governments, Xi Jinping himself. It will be about the policy direction going forward, what their focus is. It's clear this common prosperity policy is here with us over a long-term environmental... but the issue is that, whilst the employment data, in fact, today was okay, there was a sharp increase in the unemployment rate to just shy of 20% with the 16 to 24-year-olds, the new graduates.

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Pamela Ritchie: That's the young generation. You've got to think how are they going to then spend on some level, the consumption story?

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Catherine Yeung: Exactly. This is an area that Premier Li Keqiang has actually been focusing on for quite some months. I think they know the problems are there, and they're in a position to add stimulus. Whether, again, it's more fiscally versus monetary given where the rest of the world is. But you just get the sense that people were expecting more; the market was expecting more. More hasn't come through, so will we just sort of plateau out for a while before the Congress itself occurs. To be honest with you, Pamela, I tend to be quite bullish on China, but it is a very complicated scenario that we do find ourselves in, combined with how the rest of the world looks as well. We could argue that a lot of it is priced in, and a lot of the negative news has been priced in. We could talk about the individual stocks which are still growing in terms of their earnings and their market share, but overall sentiment still remains relatively negative.

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Pamela Ritchie: Let's talk about either the individual stocks or even just the sectors. We know, ultimately, as you mentioned, some of the focus of policy on particular sectors last year, within tech but then ultimately education, health care. This is the worry of investors sometimes, right? That the policy will come in, and they'll be somewhat blindsided by how that comes through. Again, sort of just looking a little bit for tea leaves, but ultimately to the expertise of your team of how they see policy going forward. I guess, health care, obviously, we spoke about some of the issues within housing, but where to go now? Is it to go back to areas of the market that were really sold off and are looking therefore quite cheap?

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Catherine Yeung: Yes, but also there are those very well-loved names like the internet related names, e-commerce names. The issue is that there's so much competitive intensity. So it's great for consumers to have choice and different brands they can use, but it's very hard to now maintain that market share. The regulatory environment did teach us that it's not appropriate to be a monopoly or a duopoly in a given industry. That's a little bit tricky. There are opportunities across all industries, in fact. Even when you look at property, as I mentioned, the winners are going to become even bigger, or the big companies will get even bigger due to consolidation. It doesn't sound that appealing. You have a tanker that ships oil and gas, etc., versus, let's say, internet company but those kinds of names, where there's this demand-supply disconnect… Nobody's building ships anymore. The fleet is ageing but there's a Chinese company that has got a really, really good fleet, well managed, is benefiting because we're still seeing demand come through even though we are seeing a shift towards environmental ESG-related areas and usage.

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Again, it's very much a stock-pickers market. As we've spoken about over the last several months, that dividend yield and the focus on dividend yield and income does provide somewhat of a cushion in this period of volatility. I think, to me, very important towards the end of this month and early September, we are going to be seeing the second quarter numbers coming out. It will be very interesting to see because that was the period where we did see some fairly big lockdowns across the country and saw the impact of those lockdowns.

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Pamela Ritchie: It's kind of fascinating on how all of this sort of works its way through the system. When investors are looking at EM, emerging markets, Asia is a massive part, really. I mean, it's almost all of EM when you when you take a look at it across the region, generally speaking. And China, within that, obviously the biggest. How should investors look at sort of EM with those parameters we just mentioned, developed markets as well as China on its own in terms of investability? How do you think that's being looked at this point?

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Catherine Yeung: When I still look at China, if we look at just chip demand and supply and memory, China consumes about 56% of global demand. Then you take into consideration that, from a production perspective, a lot of that production at some point goes through China as well. You could argue "okay, it makes sense to play that Chinese demand but potentially through a non-Chinese listed company who has huge market share and pricing power". But that domestic demand story, whilst it's been bruised more recently, it's still there. The household savings rate is still over 30%. It's just that sentiment has taken ... it's just eroded a bit given the environment we find ourselves in. Again, from a policy perspective, because China does have the balance sheet to add stimulus while the rest of the world is going through a different part of the cycle, whilst free money is being taken away from households in a lot of economies around the world, China never had that. Or Chinese households never had that. They still have that savings rate.

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When you put this all together, China as a destination ... we still think that the growth of the capital markets, because property is going to be less of a significant driver for the reasons we spoke about, you're going to need this asset allocation choice for investors and households, and that really is about the capital markets. That's why whilst it's sort of the darkest at dawn or is it darkest before dawn? Kind of how it feels at the moment.

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Pamela Ritchie: But the commitment to the capital markets is there from your perspective. That is there.

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Catherine Yeung: Yes, that's for sure. Even the IPO market. We're still seeing companies come to market, the whole ADR issue, so companies de-listing in the U.S. and coming back to Hong Kong and China. The geopolitical issue I think we need to be cognizant of. But again, over the years we've spoken about this competitive nature between the U.S. and China. It's going to see periods of volatility and at times you're going to see further volatility, for example, of what we've recently seen. That has to also be on the radar, but it appears that China's really focusing on restoring that sentiment or consumer confidence as well as managing the property situation. The COVID strategy, they still maintain, the government maintains that their success is about fertility rates and very low fertility rates versus other countries.

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Pamela Ritchie: I wonder if you can just speak a little bit to the ... you get the sense sort of reading headlines and mostly commentary in perhaps newspapers or online here, that there's almost a willingness to not acknowledge the permanence of China. If you know what I mean. I think that's probably impossible, but I wonder how you sort of take that in or might guide investors in that way. China and its capital markets are here to stay. It is currently the second largest economy, but by most peoples' judgements it ultimately will be the largest economy. How do investors make sure that they keep that in mind?

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Catherine Yeung: I guess the argument is if you're ever to own China, why wouldn't you own it now because valuations are basically pricing in doomsday. I think, Pamela, from a foreign investors perspective we can't ignore the rise of the domestic investor base. The rise of the Chinese consumer has been a huge driver. We're going to see the rise of the Chinese investor base. Their part in terms of market dynamics and the makeup of the market is going to be really, really important. It just feels that there are lots and lots of headwinds. I remember speaking to you earlier this year, and it seemed that sentiment was at the lowest point. It just feels that we're not … we're probably maybe being a bit impatient.

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I think a lot is likely to rest in terms of the catalysts on what happens in the Congress and the news flow out of that. I think until then it's almost that we're probably treading water a bit. The interest rate cut today... It was a tweak, but it was unexpected. This continual focus on ensuring that the economy or economic growth or the trajectory is still in place. Again, it's a tough one given that, as I said, there are those risks, and it's not just one risk, but a couple of risks now that investors need to be mindful of.

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Pamela Ritchie: There's zero-COVID policy, there's also the Congress, as you've mentioned. Once we get past November, once we get past this [indecipherable], is there an argument for just being positioned for plain old reopening? We've been talking about reopening for several years now, it feels like it's almost a vanilla topic. But it's so important when you think about people being in their apartments and not being able to get out and consume and so on. Should investors think about that?

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Catherine Yeung: Yeah. The interesting topic about China more recently, I don't know whether you've heard of an area called Sanya, which is on Hainan Island. They call it China's Hawaii. I've been there and it's nice and all the beautiful hotels are there, it's very beach-like. They have some non-Chinese tourists go in as well, and that was in lockdown; started going into lockdown last week. So, you have these people on vacation who are locked in their hotel rooms, can't get home. So, if you've been locked up in Shanghai, let's say, for two months and you try and get away, it's almost like no matter where you go you could be at risk of a lockdown. I think that's what's hurting sentiment.

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So you're absolutely right. This pent-up demand is definitely a theme which is likely to eventuate once we get past some of these hurdles. But Pamela, nothing goes up in a straight line, nothing is linear. I think what's important is to really ensure that the companies that we own and our conviction in these companies is maintained. The team just did a trip to Indonesia to see companies, and that really engaging with companies, spending time with the management team, visiting their competition, visiting their vendors, visiting their R&D centres, their factories, it's so important: active management and conviction that we have in the various companies we invest in. Again, it's very difficult to get into China if you're not a Chinese national. We're really grateful that we have our amazing team in Shanghai still maintain a lot of those company meetings, and hopefully in the not-too-distant future we can all start going back in and resuming normal activities.

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Pamela Ritchie: Catherine, it's been so wonderful to sort of get your thoughts and get proper perspective and sort of conceptualize what some of the headlines mean. It's always helpful that you untangle some of these things for us. How has it come to bear sort of within the positioning of the group? I mean, how are they weighted, underweighted? How? Tell us a bit about the positioning.

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Catherine Yeung: Well in these kind of environments or markets, you know, it's the stock opportunities that present themselves. And so, even though it doesn't seem great from a macro perspective, the underlying stock opportunities are definitely there, especially from a valuations perspective. And, you know, a value contrarian portfolio manager that I do work with, he's never been so overweight China as he is right now.

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Pamela Ritchie: Oh, really?

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And it's fascinating. It's over 40% of his regional portfolio. And he was in Indonesia on that trip and found a lot of interesting Indonesian opportunities. But again, you're that China angle. And even using that example about the chips and the memory and the demand in China, I don't think we could ignore such a big economy in such an important market, especially when you are seeing a lot of the support of policies. Again, whether it's the growth of the capital markets that need to ensure domestic economic growth is there, though, you know, it's still long term. There are a number of opportunities.

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Pamela Ritchie: That's wonderful. So, sort of tied up with the actual positioning and how that works in reality. Catherine Yeung, thank you so much for your time and for joining us today.

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Catherine Yeung: Thanks, Pamela. Take care.

Ending [00:25:04]

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