Fidelity Connects

Post-Congress: China's Economy in Focus

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Voiceover: Podcast Intro – Catherine Yeung (Oct. 24):

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

President Xi Jinping has officially secured a third term and will lead the Communist Party for another five years. But just one day into President Xi's new term of leadership, Asian markets fell sharply, as investors reacted to the increasing risk of consolidated power.

Today we welcome Investment Director Catherine Yeung to the show. Catherine is based out of Hong Kong and helps break down the significance of this precedent-breaking new term for Xi. She explains what we can expect under Xi's leadership and how investors should position themselves for what's to come.

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Pamela Ritchie: So, I think I'll begin, if you don't mind, with the market reaction because that seems like the most recent piece of what's been going on. I'd love to get your take. We've seen selling.

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Catherine Yeung: Yes, heavy selling, in fact. At lunchtime yesterday, 80% of the flows we were seeing when we look at the northbound stock connect trading -that's the trading going on in mainland China- it really came primarily from European as well as U.S.-based investors. Taking a step backward though, Pamela, even before the Congress there was a lot of uncertainty, so treading water, and investors were sort of hoping for certain things to come out of the Congress, even though expectations going into the Congress were quite low in terms of new policies announced to underpin economic growth. Over the weekend, when the new Standing Committee, so seven members still were announced and, as you highlighted, the perception is that the new leadership team is perceived to be less market orientated.

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The markets opened up yesterday and had some extreme movements on the downside even though, interestingly, we had some data releases. Total social financing was on the positive side in terms of medium- to longer-term lending. In terms of GDP, beat expectations. Exports. even, were relatively good in terms of versus consensus and guidance. But that wasn't enough to really see or overcome a lot of the question marks from the Congress itself, so you saw some heavy selling in those very well-loved names such as Alibaba.

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Pamela Ritchie: You spoke about the northbound, are you seeing some buying? There is a bit of a bid coming in from the other direction, from Chinese investors picking up certain equities. Tell us what you see there.

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Catherine Yeung: Yeah, exactly. As we've spoken about in the past, that sort of rise of the domestic investor base is becoming very important. The southbound Stock Connect trading -so that's local domestic Chinese investors buying stocks in Hong Kong- but actually at the same period, lunchtime yesterday, was in net inflows. Just to give you a sense of the dynamic between the extreme outflows from foreign investors versus the local flows coming into the market, there were a lot of expectations yesterday as well that should we see further or significant downward movements at the national team, that consortium of companies in China could step in and support the market but they would tend to buy the A-shares, the mainland stocks. But there's no suggestion of that at this precise moment in time. What's interesting is that throughout this past year the national team hasn't really been present. They don't notify the market when they're buying, but you can kind of gauge in terms of the trading desks, do tend to see movements when this happens.

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Pamela Ritchie: I want to get your opinion, dig further into really the politics of what we've seen. There are, I think, also economic releases to come. There are going to be updates on the economic story and, actually, areas for further stimulus, as I understand it. Is that sort of how investors should also kind of be waiting for some of those pieces to fall into place?

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Catherine Yeung: I think people were just banking so much on this big Congress meeting and it was almost like the goalposts have now shifted, so there's continuation of treading water. The Congress itself is a political event. Later this year, towards December, we have the Working Committee, which is where further economic policy is going to be articulated. We also have the Politburo meeting and then in March -around about March next year- we have the two-party meetings. These predominantly will focus on the economic story of China. This is why the market just feels there's a bit of this opaqueness because there is no clear-cut economic policy.

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Having said that, the markets also tended to ignore -or commentators have ignored- the emphasis that Xi Jinping, from his first day speech to towards the end of the Congress, the focus on China continuing to open up; not just continuing to open up but the areas of growth. Whether it's, again, a focus on high-end manufacturing, on areas like aerospace, on infrastructure or targeted infrastructure, on environmental, on health care, and not too much emphasis on property, although property still remains something we need to be cognizant of and focus on. It's almost like the market has just completely ignored all that and capitulated and that's why those very well-loved names or almost proxies for the China market were significantly sold off yesterday.

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Pamela Ritchie: It's fascinating. You brought in opening up, and I see how you mean in particular sectors, but I do want to ask about the COVID-zero policy. I think of more recent sort of updates, it did seem that COVID-zero policy was not going to just go away right after the Congress, although months ago there was sort of a thought around that. What did you take from the overall discussion?

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Catherine Yeung: Again, I think this was an area of disappointment because the zero-COVID policy has taken a toll on both economic *[data?]* or economic recovery. The economic recovery is probably going to be a lot more gradual, so, that W-shape we spoke about previously, but also that there was no roadmap out. Now, what's happening on the ground in terms of the dynamic zero-COVID policy is that we're seeing the removal of city-wide lockdowns. It's now more community-wide lockdowns. The infrastructure around PCR testing is quite amazing what they've done. You still need these regular PCR tests to really go anywhere in the Chinese cities. There are expectations that, and [indecipherable]

China PMs do think that by March next year we'll see an improvement. You could see a tweak to policy if the WHO were to change their definition or define the pandemic or endemic differently. In terms of just that moving to 180-degrees and opening up, it's quite unlikely to occur.

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Pamela Ritchie: Throughout the Chinese COVID-zero policy, it's obviously an overall policy but it's certainly taken a working together approach at very local levels. When you look at sort of who was appointed to the various positions, were those that did the COVID policy well in local situations rewarded? Was there a sense of sort of that type of discussion coming into who is now running China for Xi Jinping?

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Catherine Yeung: Some commentators are saying that and again, saying that loyalty is very, very important in this regard. When I look at the COVID situation, though, and Hong Kong versus where we were last time we chatted, I flew in the other day, and it was just almost like Hong Kong was back to total efficiency. It took me less time to get in and out of the airport or out of the airport home than, let's say, other airports around Europe and the U.K. What happens in Hong Kong is that you fly in, you don't have to have all those PCR tests before getting on the airplane. The airplanes aren't banned if they have more than X amount of people on the flight. You're allowed to do medical surveillance at home, and you get regular PCR tests, and you submit your RATs every day -your rapid antigen tests. For those three days medical surveillance you're not really allowed to go to restaurants or bars or anywhere where you effectively have to take your mask off.

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So, there are a lot of expectations that this kind of policy could be rolled over into Guangdong, or the province, and if it's successful, rolled further afield into the various provinces in China. That's one area of potential, quite meaningful changes to the COVID policy. It's interesting, I was talking to one of our portfolio managers who covers a key sector for us, which has been impacted by the zero-COVID policy and he said his parents are actually quite fine with the policy because they need to go to their local hospital on a regular basis for certain treatments. Now, if that hospital was to become overwhelmed, they couldn't get those treatments. So, it is a little bit of a different mindset when you're on the ground in China in terms of whether … I'm not saying that everyone thinks like that, but it's interesting hearing the viewpoints on the ground in support of zero-COVID policy.

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Pamela Ritchie: Absolutely. Speaking of the portfolio managers, the fund management team has a little bit of an update. Do you want to share with us what has changed and, actually, what's the same, but what's going on there?

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Catherine Yeung: From the 1st of October, we've got a new lead portfolio manager. Jing, who was previously managing the strategy, has, in fact, relocated to Shanghai and she's been promoted to head of equities. Because of regulation, you can't manage international assets or money from China. What was really key for us was to maintain this value style bias because, quite frankly, there are hardly any, if any, genuine value contrarian investors when it comes to China. We did look externally, but we really found that our other very value-orientated portfolio manager who is great colleagues with Jing -they actually asked her to help the team, or I should say join the team- so, Alice, who is already part of the management team or portfolio manager team with Jing, remains and she's a co-portfolio manager. We've asked Karen to become an assistant portfolio manager and she retains her research coverage in terms of property and then Nitin Bajaj is now the lead portfolio manager.

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Nitin is a very established value regional portfolio manager, but he tends to focus -in terms of his other strategies which currently still runs- on the small-cap part of the market. So, while he's been investing in China for over a decade, it's been mostly small, mid-cap. So, he's really ramped up -since we were talking about Jing moving back to China- in terms of the top names, all those names he was less familiar with. He's really done a deep dive into the industries. Karen and Alice, obviously fully on top of China, given their expertise, and so now we have this team of three. I still speak to Jing all the time, but Jing does not have any portfolio management responsibilities across any of the strategies. She's there in China to share her insights. As I said, she's always been so interesting in terms of those insights in different markets, and we'll be able to work closely with the team in terms of those insights.

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Pamela Ritchie: The discussion of a truly value contrarian side of things, is it fair to say that defensively-positioned is still sort of the way to go at this point, or is there anything to add to that? Is there a new way of looking at things at this point in terms of positioning?

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Catherine Yeung: I still think, that despite the dispersion between value and growth narrowing, and not being as wide as it was -let's say earlier this year or last year- those companies with defensive earnings, that dividend-yield, which acts as a cushion, makes a lot of sense in this kind of market. In terms of the portfolio itself it's going to be very, very similar. Even if you say, "Well, why have you hired a small, mid-cap fund manager to be the lead?" Even before, let's say, if the portfolio had 10% small, mid-caps, incrementally it would go up to maybe 13-15, nothing that would set the models off saying this is now a small-cap [indecipherable], so it's going to remain a large-cap value contrarian-style biased portfolio.

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The way the managers think is very, very similar. Value, again, in China isn't about just owning utilities or low-beta strategies. We think that we can continue to find value opportunities across a number of industries, no matter where you are in the cycle. At this point in the cycle -as you highlighted- having that sort of defensiveness means a lot. Although yesterday companies that have got attractive free cash flows are paying an incredibly attractive dividend yield, no debt, they also got caught up in the massive sell-off, even though fundamentals remained really sound. It just felt like a bit of a capitulation yesterday and panic selling, so it'll be interesting to see what happens this week and further afield.

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Pamela Ritchie: Ultimately, if certain opportunities perhaps open up on that front. Is there ... going back to the Congress itself, how much, I guess, was a surprise? There were some things that were expected, I think, probably by some of the portfolio managers that you're working with on the team, but how different is the policy outlined and, therefore, how closely do you need to stay to certain types of policy that are in place probably going forward? Just give us a sense of sort of how you know how to stick with the policy side of things for opportunities.

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Catherine Yeung: I've always said that policy is important when it comes to China, whether it's broad, overarching policy or industry policy. That hasn't changed. I guess what investors are trying to grapple with is how much of potential policy could change, which then has a knock-on effect to the economy. If you think about it, if China really wants to continue to be a superpower, they need to have a very, very healthy private sector. They need to see the continued development of the capital markets, especially with, for example, property no longer being a backbone of the economy, so what's going to replace that? I think that often, when you see these extreme market movements either on the upside or the downside, they're often driven by high emotions.

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It will be interesting to see -and history has showed us that- it will be interesting to see what happens this week and subsequent weeks as we, perhaps, get further clarity on that economic policy. I think the market was just disappointed that we're still treading water. Everything technically looks in China's favour in terms of... it's still at a different stage. The most developed economies in terms of it has the ability to support the economy, to loosen monetary and fiscal policy. It just feels like it's another hurdle before we see that delta coming through.

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Pamela Ritchie: It's interesting how economies are at very different stages. Obviously, the story of central banks around the world in recent weeks has been extraordinary as well. There's lots of extraordinary news going on. Coming back to the sectors that you mentioned focusing on... can you just give a little bit more colour on sort of where aerospace is at this point, where it's going and, I suppose, how there could be opportunities to capitalize when more reopening actually happens, when more flying happens.

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Catherine Yeung: It's aerospace in terms of the high-end, like going into space and those kinds of areas. They're in the newer part of the cycle. It's just like the semi-cycle, we've come from a very low base in China, but the development's been so quick but versus, let's say, some of the semiconductor manufacturers in Taiwan and Korea, it's still quite wide in terms of the end product. In terms of the areas that the portfolio is looking at, it's still industrials; it's still the Chinese banks, it's still some plays on recovery. For example, there's an advertising company in there, which is doing incredibly well, even though we've had this sort of downturn in terms of consumer and the retail.

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Interesting, Pamela, as well, when you look at the household savings rate it's over 30%. It's not that Chinese households don't have the cash, it's just that sentiment coming through. In fact, when you look at household assets it's worth something like 618% of GDP or over 100 trillion USD. It's not that households have the same situation as many households globally in terms of debt, it's just that sentiment. Again, maybe this is why the market's disappointed; there was no change in the COVID policy so when is that pent-up demand recovery going to come through?

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Pamela Ritchie: But you say it sounds like it will be sort of phased in or tweaks. All of the reopenings were that way, but is that sort of perhaps how investors should be thinking about this?

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Catherine Yeung: It feels that way. As I said, it'll be interesting to see how... if the model that we're seeing in Hong Kong is rolled out into the Mainland [indecipherable].

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Pamela Ritchie: You told us about a couple of interesting consumer brands. This would be a few months ago now, but I know that sort of the cultural consumption, everything to do with sports. Also, you've mentioned health care, but go into sort of the cultural consumption side of things and also the sports industry.

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Catherine Yeung: The sporting names are actually looking quite expensive valuation-wise. Jing actually sold out of the main sport names or sports paranames when we saw a lot of the re-ratings come through. In terms of consumer staples, they're likely to be somewhat of an inflationary beneficiary. Now, China's inflation is benign versus, again, let's say, global economies. It's hovering around 2-2.5%. You're still going to see that knock-on global impact coming through into China. Some of the consumer staples names are in the portfolio. In terms of health care it's not those well-known health care names, so that is sort of skewed towards or beneficiaries of biotech development and R&D. It's most of pharmaceutical retail names which have niche positions demographically or geographically in China.

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Again, it's a very contrarian approach when we look at those big overarching themes, whether it's consumption and health care and, obviously, we can't ignore property; it's still part of that common prosperity angle. In terms of property, those large-cap, state-owned enterprises, such as China Overseas Land, continue to be in the portfolio. We've discussed the path, the consolidation, the flight to quality and all these companies are actually benefiting. That's what we saw in the coal industry five years ago, could play out in the property industry in terms of a more consolidated market, the kind of winner takes all.

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Pamela Ritchie: I was going to ask for a bit more detail on the energy story. The rest of the world has struggled for the year, most of the year, with higher energy prices and lots of frailties have been shown globally because of that. What is the story ... you've mentioned sort of the investment side of things on, perhaps, green technology moving forward, but what is the energy story? What sort of security is there for China at this point?

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Catherine Yeung: China, again, is in a different situation versus parts of Europe when it comes to the energy situation and supply demand. Certainly, as we go into winter or power shortages, etc., you could see a slight increase in coal production. It's been very obvious that carbon-neutral aim by 2060 is in place and many energy-related companies are, in fact, spending their capex or doing their R&D on renewables. It is definitely a key area of opportunity. Again, though, when you look at some of these energy or green energy-related names, it comes down to valuation again as well as the fundamentals of the company.

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Pamela Ritchie: Investors, ultimately, on ... let's just go back to sort of the capital opening up and side of things. People should still see that that is going to be an important part for domestic investors, capital markets. There's a narrative that things are sort of, maybe, through the Congress come to a halt. Can you just sort of clarify what's changed, what hasn't changed, ultimately, on the importance of equities within the Chinese development plans.

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Catherine Yeung: Again, I think that if China is to achieve this continued growth trajectory, they need a healthy domestic environment or economy. Whether it's state-owned enterprises or, indeed, the private enterprises are needed, whether it's listed companies or indeed the unlisted names. Especially when you look at, for example, the youth unemployment rate, it's something that needs to be focused on and providing jobs for university graduates. You can sit here and go "Why would you try and destroy these iconic Chinese brands now that are becoming globally recognized? Why would you halt economic growth?" Again, I think that's where the perception has been that there's been so much emphasis on social policy at the expense of economic policy and is this now the new norm. Until we get clarity in terms of economic policy, despite the... in May the 33 supportive measures and the additional 19 announced in August; it just feels that it's not enough to turn the cycle.

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It's very interesting looking at the earnings chart. Earnings expectations have historically been, no surprise, actually higher in terms... or I should, say versus actual earnings. But more recently, earnings expectations have gone completely south and actual earnings; so basically there's been an inverse relationship of the chart. It feels like most people have kind of just given up on China. That's how it feels. Yesterday's market movement probably further highlights that. But, as I said, the fundamentals of the companies remain intact and there has been too much of a skew to focus on the perceived negatives from the Congress versus the positives that were spoken about or came out of the Congress. We could talk about valuations, but valuations are still attractive... or looking cheap versus global peers and versus history. At the end of the day, I can also appreciate if people just feel that it's still very, very opaque what's going on.

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Pamela Ritchie: I'm sure we'll check back in with you in the times where some of these economic meetings take place. It's been such a pleasure to speak with you and to get some of your thoughts on what you've been watching, what markets are watching and what we need to know going forward. Catherine Yeung, thank you for joining us.

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Catherine Yeung: Thanks, Pamela.

Ending: [00:25:54]

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