Fidelity Connects

China's Path Forward: What to Look for in the Second Half

Catherine Yeung, Investment Director

Pamela Ritchie, Host

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

Joining us on today's show is Catherine Yeung, Investment Director at Fidelity International, and based in Hong Kong.

We recently saw Shanghai lift its two-month lockdown, opening up the city to more than 25 million of its residents. But then just one day later, 2 million residents were placed under lockdown *again* after being deemed a "high-risk" neighbourhood for COVID by the government.

We'll hear from Catherine today how she feels that despite these persistent lockdowns, investors are bearish on China, and she says the consumer story is still the key driver for economic growth. Catherine also notes that the biggest risk in Asia right now is global inflation. She also explains to host Pamela Ritchie how China is currently taking reflationary measures that put them one cycle ahead of the rest of the central banks around the world.

Today's podcast was recorded on June 3, 2022.

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Pamela Ritchie: Catherine, hello. 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, thank you. Because we've all come to know each others' homes, I can tell you're not in your home, actually, because I know what it looks like.

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Catherine Yeung: Yes, I don't have all those paintings behind me, all the fish paintings. I'm actually in hotel quarantine, day six out of day seven. I just returned from actually a work trip, my first work trip since the pandemic over to Europe and also London just seeing clients, doing some events. It was fascinating. It was great seeing people face-to-face, so hopefully I'll get to see you face-to-face at some point and clients over in North America.

It was really interesting because I went over there with a lot of expectations that clients would be incredibly bearish about China given the headline news flow that we're seeing and just commentators' thoughts and views have turned incredibly negative. To be honest, I was actually pleasantly surprised. Both the places I was at in Europe as well as London, although the people that are bearish are extremely bearish.

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Pamela Ritchie: But there was quite a lot of interest in opportunities. We'll talk about those, too, there have been policy moves, regulatory, everything we've seen, and to many it's an interesting point to think about it. I'm quite curious what you make of the recent world macro story and ultimately Asia and particularly China's place in this right now. It's a very interesting time of change.

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Catherine Yeung: It's very complex what's going on globally when we look at both policy from a fiscal monetary perspective as well as the geopolitical background that we find ourselves in. I guess one of the biggest risks that we see sitting in Asia is that of global inflation. What we've seen since the pandemic is this transfer of cash almost from government balance sheets to family balance sheets and what happens when that cash is taken away from these households. What happens to spending? A global inflation – a statistic was given to me when I was in the UK that for that month alone, groceries had gone up 10%. Now we're starting to see … I mean, it's a lot in one month, so that's a risk. In Asia, predominantly China, we're at a different stage of the cycle. In fact, some could argue that China is technically in a bit of a recession. Other economies are in the late cycle. So, what we are now beginning to see are a lot of reflationary measures in China itself.

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Pamela Ritchie: There's actual easing going on in certain areas of the market but as you say, it's in a different stage in the cycle, perhaps. Tell us a little bit about the overall story of lockdowns. You're currently in quarantine, we know this, but you're in Hong Kong which can be a bit different. The overall story of where growth is in the moment of a lot of lockdowns at this point.

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Catherine Yeung: I would say that the lockdowns, again, especially in China, and where Asia is versus, let's say, Canada and Europe, it is the biggest risk for clients. Again, if I refer back to what clients were saying in Europe and in the UK, they were almost willing to give up that initial rally of the market if we were to see it, like a prolonged rally or a sustainable rally, because of their caution towards some of these cyclical headwinds. It's not just China and Hong Kong. We can focus on China and Hong Kong in a second, but if we look at Asia, yes, you're seeing a lot of the economies open up so borders, but there are still some restrictions. Singapore still has some restrictions even though it's made significant progress in terms of opening up borders. In Japan, for example, they're beginning to allow tourists in, business travellers were allowed in but you have to take PCR tests at Haneda Airport, as an example.

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So you're seeing this gradual reopening, definitely hasn't been the 180-degree policy shift that you have seen in the West. China and Hong Kong, let's focus first on Hong Kong, we are incrementally seeing changes to our restrictions especially when we look at the movement of people. Cases have significantly come down. I'm still in quarantine because Hong Kong is still deciphering what to do about the border reopenings both with China Mainland as well as international

borders. We have, since we last spoke, seen a new chief executive being announced, that's John Lee. He formally starts his role on the 1st of July. That's going to be very interesting in terms of his policies going forward.

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Pamela Ritchie: Give us a sense of what that might mean. New leadership in Hong Kong, what might that bring? A new era in what way?

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Catherine Yeung: Probably more aligned to Mainland China. He hasn't said too much yet but there's definitely a focus on really ensuring, let's say, for the housing situation in Hong Kong, the elimination of what we call caged homes. That's a subdivided flat almost. If someone has an apartment, they subdivide it and leases it out. That's big on his agenda. There will be an addressment of COVID policy and the borders at some point. It feels that things are beginning to normalize.

Over in China, Shanghai, our team in Shanghai were really pleased yesterday because we saw the opening up of Shanghai after several days of a very strict lockdown. China's policy ... it's interesting though, Pamela, we spoke to a medical expert last week and I guess what's difficult for investors to grapple with is why is China's policy like this when the rest of the world has simply moved on? That's how it feels most simplistically.

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China's measure of success is the mortality rate and the number of lives saved or the number of lives lost. That's what they're trying to protect. You could argue it's part of maybe their overarching policy, common prosperity. So that's what they're looking at. They're looking to develop their own mRNA vaccination. They're doing a lot of work into the nasal vaccination...

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Pamela Ritchie: Does that seem, Catherine, quite a long way out? I'm just trying to get a sense also from an investment perspective, is there any sort of sense of a horizon or timeline on that?

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Catherine Yeung: The vaccination? Probably 2023 but it's going to be a Chinese made vaccination, unlikely to be imported. For example, one of the multinationals and they estimate that if they were to open the borders completely or do this 180-degree policy turn, you could see between 1 to 2 million deaths. So they're just not willing to see that. So that's their policy. It's unlikely that we will see a shift from Zero-COVID policy. It doesn't mean that they're aiming for no COVID cases at all, but expect to see this continual testing and lockdowns should cases appear in the various provinces. Again, that is perceived to be a headwind but we need to look at it at how the Chinese authorities are looking at their overarching policy, not just when it comes to COVID but then, more broadly speaking, their domestic policy.

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Pamela Ritchie: It's so interesting. The domestic policy, I'd love you to sort of decipher for us because I hear certain pieces of news and I'm sure you could bring some more perspective to this. We saw, I think it was a 33-item agenda that was coming out, different types of subsidies basically to help stimulate the economy. That was one area it looked like there was, I think, more of a focus on jobs. What can you tell us about that or what it might tell us about the overarching, as you say, domestic policy?

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Catherine Yeung: I mentioned earlier that we are in a bit of a reflationary environment in China. China, as we've spoken about over the past couple of discussions, is probably one cycle ahead of the rest of the central banks around the world in general. The conundrum that the People's Bank of China, the PBOC, faces is that as the US Federal Reserve – I believe the Canadian Central Bank also raised rates recently, yesterday or two days ago – as we see the Reserve Bank of Australia tightening the rates, if the PBOC were to ease too much, you'd have this huge interest rate differential which would have a knock-on impact in terms of the currency. It's unlikely we'll see aggressive easing in terms of outright interest rates in China. You're seeing some supportive measures from a monetary perspective in terms of cuts to the RRR, the Reserve Requirement Ratio, focusing on the small and medium enterprise part of the economy.

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Therefore, if you're not seeing too much monetary-wise, the focus is on fiscal and the Chinese authorities have the balance sheet and a tool set to further add from a supportive perspective. But they also don't want to encounter the same situation that they did when they did implement a lot of liquidity stimulus into the market during the global financial crisis because that led to debt. We still need to see that deleverage that debt, so they're being very cautious. They have announced, as you rightly pointed out, what we call the 33-item program and it focuses on, for example, subsidies, a big focus on employment, especially with youth employment, so graduates, focuses on really improving the sentiment of the consumer because even though the consumer story is still so intact and still a driver of growth because of the lockdowns, yes, you've seen online spending but it hasn't been the same degree in terms of the spending patterns we have been seeing over the past several years in China.

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From an infrastructure perspective, the infrastructure projects are likely to be very targeted. The reason why infrastructure hasn't picked up is, again, this lack of movement because of the lockdowns we have seen across a number of provinces. It feels that the market's disappointed with the lack of measures being implemented because maybe we're so used to the supportive measures we've seen globally over the past couple of years. But again, I go back to the stability aim that the government has in place and really ensuring that the measures are there for long-term growth. They do make a lot of sense versus just trying to support the market or support investor sentiment.

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Pamela Ritchie: You've spoken for some time about, and others have, the steps taken for a maturing market, for maturing capital markets environment ultimately for investors domestically in China to have different ways to have investments for retirement and so on, apart from property. Give us a bit of an update on that. What else has been either focused on or what new steps have come to the fore in terms of, again, the capital markets maturation?

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Catherine Yeung: It appears that Liu He, who is very high up in the party, is really doing the messaging in terms of this area. I mean, the entire party is but he tends to be the focus point. He's the gentleman that made the speech in March, the kind of equivalent of whatever it takes the market to stage a very significant rally. It remains a key driver of the market often overlooked by foreign investors, I think.

Think of it as 12 years ago, 10 years ago, the rise of the Chinese consumer was becoming real. I think the rise of the domestic investor shouldn't go unnoticed. If we look at assets under management within the domestic capital markets, if we look at the number of funds available with public licences, you've seen enormous growth over the years.

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Pamela Ritchie: Wealth management, actually.

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Catherine Yeung: Definitely. Some of even the state-owned banks are really focusing on this area of growth from an overarching business perspective.

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Pamela Ritchie: I was just curious, you mentioned a focus domestically but also on small- and medium-size businesses. It seems to me that that fits somewhat with Jing's way of investing. I know that she always follows policy very, very closely. Can you give some examples of small, medium areas that really cater to a domestic economy?

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Catherine Yeung: The strategy looks interesting at the moment because we've seen a lot of the platform players or internet players. Their valuations have come off significantly since the downturn last year in the market. They've actually become your typical value names, so recovery names. So she's added to them. That typical growth area of the market where the strategy would either be underweight or have a very small exposure or lack of exposure, that has increased.

We are still seeing this value rotation away from growth. I think I might have mentioned last time that last year value outperformed growth because the growth names were derated. This year we expect value to outperform as the value names get rerated.

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When we look at the portfolio, there's still, when we look at the core names, that exposure to those three areas: recovery names or turnaround names, the best names in unloved sectors, so market consolidation, so you could argue property in this regard, materials and then that dividend-yield play and some names obviously cross into more than one of these categories.

So that dividend yield story, it's fascinating still seeing the dividend policy of companies in the commitment to yield. The strategy in general pays or has about a double dividend yield to that of MSCI China. That feeds back into the argument about the growth of the capital markets and domestic investors looking at equities as a long-term asset allocation decision not just short term and, again, the diversification away from property from an asset allocation perspective.

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Finally, as you highlighted, when we look at the SMEs, one of the last stages historically speaking of the value rotation to occur are small/mid-caps. So in fact, we have seen an increase in the position over the years to that part of the market cap.

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Pamela Ritchie: How important is ... I know it's incredibly important but just put it into context for us as timing within the year, possibly, for the investment calendar, the Congress in the fall. Do we know exactly when that is?

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Catherine Yeung: Not yet. It's scheduled for October, November. There are some commentators who are debating whether we'll see it being brought forward but at this stage it's still timed for that part of the year. It's key, it's the equivalent of a presidential election. They're the second tier of the government below Xi Jinping likely to see some changes in that regard. That's probably also why you're seeing the COVID policy being taken very seriously by the local governments in terms of ensuring that the lockdown ... Shenzhen had a very successful lockdown. It only lasted a week, so these lockdowns are sharp and short and prevent the cases from increasing in the various provinces and cities. So, yes, the Congress is important.

Historically, again, we've seen stimulus being implemented or announced before the Congress. This is probably likely to be the case this year. We do expect to see, on top of the 33-item agenda, the implementation of more fiscal stimulus in the second half. But as I said, it's going to be very targeted versus just an outright huge policy being announced.

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Pamela Ritchie: There is, without question, more and more competition between ... it doesn't entirely feel like two blocks of the world competing with one another but there is more of a move towards that. The so-called trade wars have been around for some time. Give us a sense of what's increasing, what isn't, where you see tension there one way or the other.

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Catherine Yeung: It's this continued competitiveness especially between the two largest economies in the world in terms of taking global market share from across a number of industries. That's likely to continue to be the case for years to come. In fact, if we look past the cyclical trends or the headwinds in China, there are some structural trends that investors, we think, should take into consideration. When the recovery does occur it's not going to be just driven, we don't think, by momentum and growth like we saw in 2020 and 2019. It's likely to be a more diversified rally, again, for the reasons I mentioned, looking for that total return strategy, not just concentrating in, let's say, one industry or a couple of sectors. So in terms of the direction of the market, the direction of policy, again, it goes back to that stability that we've been talking about.

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Pamela Ritchie: Fascinating. Demographics is a story that we've spoken about quite recently taking a look at the bond picture, taking a look at where fixed income belongs. We've had other conversations on Fidelity Connects about that and perhaps an increasing interest towards that. A big piece of that story, along with everywhere, is the demographic backdrop really for the globe but also China. China also has an ageing population. How does that fit into what investors are looking at, ultimately what is catered to within the economy?

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Catherine Yeung: Remember the consumption story or the beneficiaries of the consumer, that was where most people tended to be aligned when it came to their China exposure. The structural trends, a lot of them are still intact but we have to be cognizant of potentially some of these structural trends not being as meaningful in the future. Demographics is one. Demographics, as well as this decoupling, the decoupling potentially could see China export inflation.

When we look at demographics, the fertility rate is only 1.3% in China, so it's low. We've seen the government try and increase that fertility rate by various policies. If we look at the ageing population, it's predicted to go from 14% in 2020 to 26% by 2050, so that's [inaudible] people in China. It's a large jump, isn't it, that's above 65 years age. The working population peaked back in 2010. It's predicted or it has been predicted.

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So we are seeing an ageing demographic and it was always in the back of the investors' minds, it appeared, but I think it should be taken into consideration because as you see this ageing demographic, you will see a change structurally in terms of consumption patterns and what people consume. So just something to bear in mind.

I just think all those factors that saw a rush of inflows into the China story are still there. They're just there in a different manner. I don't think we should expect this almighty rally in Chinese equities on the back of these catalysts or drivers. I think it has to be a little bit more balanced going forward.

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Pamela Ritchie: A couple of words to sentiment. A lot of people have said over the last month or so that sentiment actually went a little too far. There's room for a more balanced story or at least taking a look at a more balanced story. Tell us a bit about sentiment. You alluded to it when we first started speaking about those that were very interested in China, who you spoke to in Europe, were very interested and those that had a more bearish tone, had a very bearish tone. Where does sentiment lie, would you say, at this point about Chinese equities?

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Catherine Yeung: I would say that in March it was so negative. China couldn't do anything right in terms of headline news flow. People are probably feeling a little bit better given that we're seeing, in particular Shanghai, the lockdowns easing or being removed to a degree. It feels slightly better but it's still incredibly negative, I would say. Probably the most negative since I've focused on Chinese equities and it's probably too negative.

I just feel that the valuations, I mean, we could talk about how valuations are really, really attractive, all the bad news is priced in or most of the bad news is priced in, we're probably going to see further earnings downgrades especially from the sell side. We, ourselves, have in the last earnings season downgraded across the sectors. Earnings visibility is key. Cash flow on balance sheets is key. Ensuring you have products and services that people want to buy is key. But I don't think that the earnings situation is different in China to a lot of other markets. I think we're globally going to see that focus on earnings and supply demand continue.

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Taking into consideration the valuations, taking into consideration, in theory, the policy direction is more favourable in China versus other economies and markets, taking into consideration that the policy isn't about big bang policies being announced but more meaningful policies coming through, I still think that China, long term, looks very, very attractive.

Interestingly, if I take, for example, one of our regional portfolio managers, he's value small-cap, so he works very closely with Jing in terms of that value style and he's, in his regional portfolio, the most overweight China he's ever been at 30%, him and his team, the team ... just to give you an indication of the opportunity set that is there.

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Pamela Ritchie: It's fascinating. Where, ultimately, do you think some of the stories ... there's a lot of discussions about where the US dollar goes and, ultimately, how the commodity story ties into all of this and then what that means for the rest of the world. I feel like to an extent we've talked about commodities to death but it's still very relevant to get your take on how this works for China. It's still something that's imported. It's still a story. How do high commodity prices, particularly oil, affect China in the near mid-term?

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Catherine Yeung: We had a conversation with an agricultural expert last week. The key area of, let's say, potential risk for Chinese imports or the commodities available from a household perspective, a manufacturing perspective, a business perspective, are soybeans. China imports a lot of soybeans from places like Brazil, etc. Ex-soybeans, wheat, rice, that's all very stable. State-owned enterprises and the government really do tend to monitor prices, so that actually works in China's favour.

Inflation is benign, so we're not seeing the same kind of inflation rates as, let's say, the US and China. That puts China at a different end of the spectrum versus the global inflation story. You could see some inflation creep in because of the global commodity cycle but in general, it's less of a risk inflationary pressures. Again, when we look at the argument about free money and consumer sentiment globally, what happens there with the tightening of rates? The Chinese household's never had that free money being given to them. The household savings rate is, in fact, still over 30%, so it's healthy. What we do need to see is that household savings being spent.

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Pamela Ritchie: Actually, saving and spending patterns have been changing, as you would think, over the last decade or so in China. When, as you say, the lockdowns do end and there is that ability for a bit of a rebound and maybe more to the services side of things, do you think spending will happen based on what you've seen over the last decade or so of changing saving patterns in China?

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Catherine Yeung: Yeah. When we look at the consumption story, the premiumization story still remains intact. The rise of the local brand story remains intact. An interesting one, actually, from a sub consumption theme is that … I don't know whether it's big in Canada but in China what we call consumer group buying. It's a trend that was originally in the … you'd see the [indecipherable] consumption story play out.

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Pamela Ritchie: It's like a co-op?

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Catherine Yeung: Yeah, exactly. You group-buy eggs or meat and then almost to a point where you'd have a shared storage facility and then you'd divvy it up. The reason being that that last mile was quite significant when it came to delivery, so getting the goods and services to that destination from a rural logistic perspective.

During the lockdowns it became very popular. In fact, Monica, who is our director of equities in Shanghai, we used to chat just because of the lockdown and we'd often talk about things non-work related. I was asking Monica how her mother was and she's like, oh, she's become like the key CGB in her apartment block and she's loving it.

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Pamela Ritchie: She's running the place and getting all the goods.

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Catherine Yeung: She's running the place, you get this, you get that. The argument about whether CGB will continue after the lockdowns and the CAGR actually looks really attractive over the years. That the argument, not the argument, it's not just what consumers buy, it's how they buy, still very, very important. In fact, part of this fiscal policy, the measures is a focus on encouraging the platforms or providing a very supportive base for the platform players especially given what happened last year from a regulatory perspective, because we do need the platform plays in terms of encouraging the spending in China.

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Pamela Ritchie: How amazing. I have lots of stories about the co-op, having grown up outside of the city. It has an interesting feel. It's like a community feeling.

What would be a final message to leave with investors about timing, about what this kind of opportunity means for this moment we're taking a look at Chinese equities.

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Catherine Yeung: Past evaluations argument in terms of Chinese equities looking very attractive at the moment, across most sectors, that is. I think what we've seen over the past couple of years, last year in particular year-to-date, is that understanding policy in China really does play a part or an input in terms of your investment or doing business in China. Last year was almost a wake-up call with all that regulatory news flow. This year, when we look at those regulations it's more about the underlying news coming through. What's very, very interesting is the regulations we've seen, the pace at which companies have adapted is unbelievable.

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Pamela Ritchie: That is amazing to think that there's been an obstruction of the policy changes because I guess we've all had to change an awful lot of late but it has actually happened.

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Catherine Yeung: It's been rapid and companies have become very adaptive and innovative in terms of the policy. For me, that really reflects how in China things happen at a quick pace when things need to change. Maybe you could apply that same argument to the easing of the lockdowns. The COVID policy's unlikely to change. You'll see some tweaks but it's unlikely to change. I think we have to be cognizant about the reasons why the policy is there.

The Government's probably looking at other countries ensuring there's no new severe variant before they make further changes. The underlying policy cycle in China is a positive but that policy ... As I think we've spoken about in the past, it's all about like almost driving a car, accelerating, braking, accelerating, braking. Maybe China just has a different speed versus the rest of the world but it's a speed that suits them. I think, therefore, the world is, when we look at inflation, we look at policy, monetary policy, to deal with inflation, again, China is at the other end of the spectrum in that regard and policy should in China positively underpin the market.

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Pamela Ritchie: It's fabulous to get your perspective. It sort of underpins everything else that we look at in terms of headlines and research analysis. Catherine Yeung, thank you very much for joining us.

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Catherine Yeung: Thanks, Pamela.

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