China: Investing in an Era of Policy Uncertainty

2019 Asia Emerging Markets Outlook

FIERA CAPITAL

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The outlook on diplomatic dialogues between US and China has improved, but we remain cautious regarding the pace of progress. The US delegation spent three days in early January conducting trade negotiations in Beijing, China. Another high-powered delegation from China, led by the Chinese Vice-Premier Liu He, is slated to be in US end-January for further negotiations. Expectations are that these discussions will eventually result in agreements or roadmaps to resolve some of the trade differences. Some announcements seem likely ahead of or around the Chinese New Year in early February. Markets may react positively to the prospect of trade tension relief and we may see a continued improvement in Emerging Markets equity market sentiments, but we continue to remain cautious. Monitoring and implementation of any agreed roadmap on trade reforms milestones on China would be challenging. Just as it is debatable how much has the US achieved so far with the North Korea negotiations on Nuclear disarmament. Market uncertainties may resurface if there are doubts on the progress of such implementation. Moreover, several aspects of the US-China differences go beyond fair merchandise trade, market access and trade. Issues on Intellectual Property Rights, Privacy, Espionage etc. are unlikely to get resolved as the two nations have different political/social/economic ideologies and standards.

Besides the issues of US-China trade relations, there are several other reasons that may dent the market confidence in 2019. We highlight a couple of our broad concerns herein:

- **Global Slowdown**: A current economic slowdown across the board from China to India – which may be triggered by uncertainties on the trade front and will continue to impact business decisions
- **Geopolitics**: Tensions over the South China Sea between China & Taiwan, China & the Philippines, or the ever-present concerns over North Korea may resurface. Kim Jong-un visited China in early January, just as trade negotiations began, perhaps to pressure China to talk to the US about removing sanctions. Another meeting is scheduled between US and North Korea leaders in Hanoi next month.

But on the positive side, **valuations are compelling**, trading at around one standard deviation below the long-term mean across valuation metrics like Price/Equity Price/Sales and Price/Book. From purely a valuation perspective, in our view, such buying opportunities have rarely persisted in China and much of the EM Asia space for the better part of the past one decade.

Further, China has **reform and stimulus measures** in its arsenal, as well as its willingness and creativity in putting them to use. All of which provide further sources for optimism. On the monetary side, China's central bank cut their RRR (reserve requirement ratio) on January 4, 2019, increasing market liquidity. There are also fiscal measures they can take. For instance, China has openly referenced possible stimulus in the auto sector. However, the market perception is very negative at this point, given that the measures that China has taken so far have done little to alleviate the downturns in any industry. A common concern among analysts is that China lacks the legroom to appropriately stimulate their economy due to their current running deficit and large leverage of the economy, and as they are amid a policy-driven deleveraging phase. At this point, we anticipate that any positive move by China, even if the measures are not substantial but are well-targeted, can fuel market optimism.

Thus, we are evenly poised between the potential positive triggers for the market and the uncertainties, in our view. We remain cautiously optimistic on EM Asia Equities.

Meanwhile, most market observers would profess that a toppish US Market equities does not bode well for EM Equities, cheap valuations, notwithstanding the US market may continue to lose its upward momentum and sink into a fuller market correction, and while no one knows how emerging markets will react, history has taught us that if US markets correct, emerging markets do not generally do well, and often correct even more.

However, Emerging Market Equities have already corrected – discounting several of the expected uncertainties ahead. Emerging Market Equities are trading at a significant discount to the US market over a 5, 7 and 10 year horizon, having underperformed all the way! We would thus argue that history may not be the best teacher in this instance, and that EM may remain resilient even on the face of a US correction.

There may be interim pain for an unknown period of time (market volatility for a few months or quarters), but taking a long term (3-5 year) view we see this as an opportunity, as all these stocks have experienced material corrections. While investing in an era of policy uncertainty is certainly difficult, we do not act based on headline news and noise. We evaluate the long-term fundamentals of the companies we hold, through continuous detailed due diligence. We keep our process, philosophy and research steps intact. Our due diligence process remains the same. We are doing all that as we speak, to fine tune & update our proprietary financial models and rebalance our portfolio accordingly.

In 2018, China deepened structural reform across several industries and implemented new draconian measures to reach their long-term policy goals. While we believe that the reforms are positive for the economy in the long-run, these new measures have led to unexpected valuation de-rating and a potential short-term earnings shock. Below is a summary of a few major sectors impacted in 2018.

SUMMARY OF SELECT SECTORS IMPACTED IN 2018

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AUTO POLICY

- April 2018: China's National Development and Reform Commission announced that it would relax the 50% ceiling on foreign ownership of Chinese auto manufacturing joint ventures.
  - Previously, if a foreign carmaker, such as General Motors, wanted to sell cars in China, General Motors would have to establish a 50/50 joint venture with a local Chinese partner.
  - Under the new policy, foreign ownership limits on electric, commercial, and passenger vehicles would be relaxed in 2018, 2020, and 2022 respectively.[1]
- We believe that the market perceived this measure to be largely negative for all Chinese automakers.
  - Chinese automakers that are heavily reliant on their joint venture profits are expected to lose out on future earnings once the foreign owners raise ownership.
  - Domestic only car brands are also expected to lose to aggressive competition from foreign car makers; foreign brands have an added incentive to improve their product launches in China.

HEALTHCARE POLICY

- The Chinese government's long-term goal is to reduce the financial burden on its National Health Insurance system. In the past, the government had a system of reducing drug prices and issuing healthcare policy to reduce costs, such as:
  - Officials recommended that public doctors prescribe fewer antibiotics and traditional Chinese medicine injections.
  - Public hospitals' 15% mark-up on drugs cut to 0% in 2017.[2]
- Despite these measures, the government considered the cost savings to be mild and struggled to enact tougher measures, as healthcare policy had to be agreed between too many government departments (e.g. China Food and Drug Administration, Ministry of Finance, National Development Reform Commission, National Health and Family Planning Commission etc.).
- April 2018: a newly formed National Health Commission (NHC) was tasked with designing China's healthcare policy.
- September 2018: NHC announced pilot testing of a new Public Hospital Group Procurement bidding trial in 11 cities, whereby originator and generic drugs competed on price. The winning drug would be guaranteed 70% of the procurement volume.[3]
- December 2018: Initial bidding results indicated drug prices were cut by up to 90%.[4]
- We believe this policy will lead to near-term earnings shocks for many players. In the longer run, there may potentially be industry consolidation and specialization. Large pharmaceuticals with varied drugs portfolios are more likely to survive drastic price cuts in specific products. Pharmaceuticals may also choose to specialize in patented or generics rather than both, as the competitive requirements shift.

RENEWABLE ENERGY POLICY

- China's National Renewable Energy Fund subsidizes renewable energy, such as solar and wind farms, by paying a higher feed-in-tariff per kilowatt hour of electricity generated. Due to the rapid growth in China's renewable energy development, the Fund had been under a deficit for some time.
- May 2018: The Ministry of Finance, National Development and Reform Commission and National Energy Agency (NEA) suddenly announced that it will stop approving new solar farm installation and it will reduce the feed-in-tariff paid to subsidize new solar farms.
  - As most utility-scale solar farms are unprofitable, the lowered subsidy led to a sudden halt in solar farm construction and caused a major shock to the solar supply chain.
- November 2018: President Xi acknowledged that the May solar policy was announced too abruptly. NEA decided to loosen some of the initial measures announced in May and the State Administration of Taxation will study potential tax incentives for the solar sector.
- We believe that the solar policy U-turn is an example of the government's more trial-and-error policymaking. If new measures are deemed too harsh to build strategic industries, the government is willing to change quickly to support it.

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