EMERGING MARKETS & CHINA STRATEGY

January 12, 2022

China: Three Pressing Concerns

- Beijing realizes the downside of its zero-tolerance Covid policy. There are rising odds of relaxation after the Winter Olympics, especially if the Omicron variant proves to be less deadly.

- The best entry point for stocks is when growth is weak, stocks are cheap, investors are bearish, and policymakers are turning stimulative. All these boxes are checked for the Chinese equity market.

- China's regulatory risk has peaked and it is not the start of a wholesale nationalization. U.S. punitive measures targeting Chinese companies complicate their growth outlook and stock performance, but collectively the damage is not dramatic.

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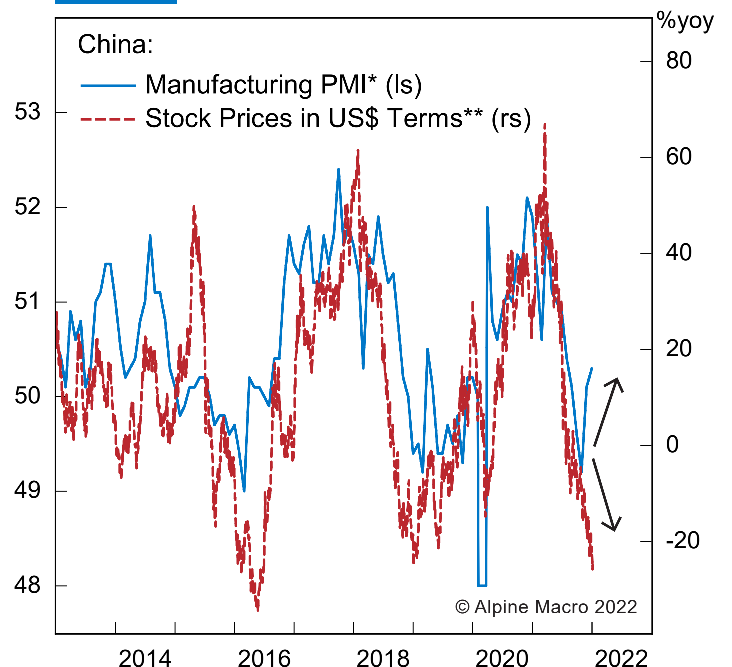
Chinese stocks have stumbled into the new year, with both domestic A shares and the offshore market tumbling, despite improvement in the latest PMIs and policymakers' pledges to continue to support growth (**Chart 1**). Markets are troubled by some pressing issues that could significantly impact China's growth outlook and financial asset performance. Our base case remains that China's policy reflation efforts will continue to gain momentum, boosting the country's growth outlook and stock prices, and that the ongoing market volatility is probably what is needed to shake off some complacency before the market regains their uptrend. Nonetheless, these pressing concerns deserve scrutiny and should be continuously assessed going forward.

Chart 1 Chinese Equities: Mind The Gap



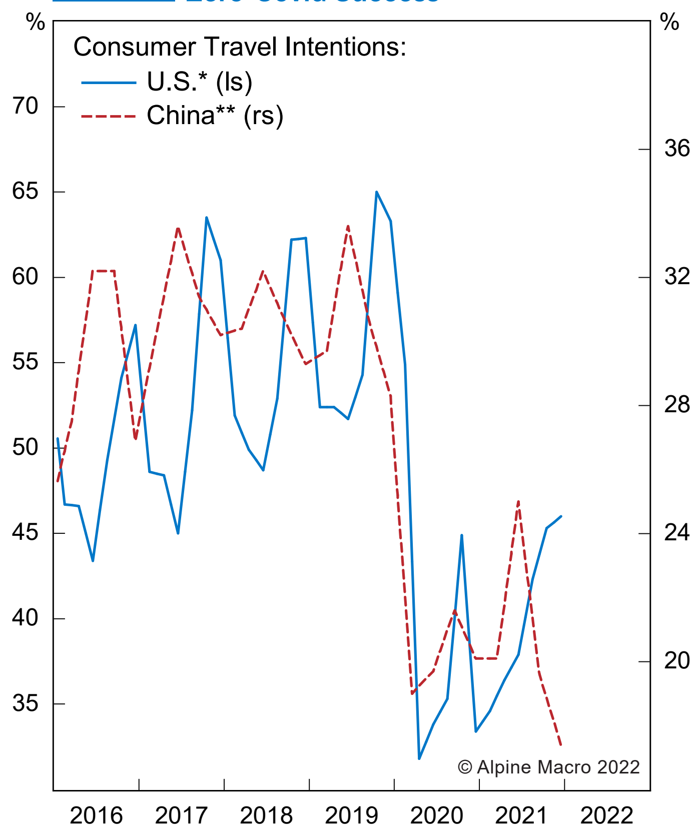
*Truncated at 48; source: NBS
**Source: MSCI

Can Zero-Tolerance Survive Omicron?

China is now trying to contain its first domestic outbreak of the Omicron variant. Tianjin, one of the largest metropolitan areas that borders Beijing with over 14 million people, is conducting multiple rounds of Covid screenings for its entire population, and non-essential businesses and activities have effectively come to a standstill. So far, the new infections have been primarily confined to one district and have not spread to other districts or beyond the city. However, given the highly contagious nature of the Omicron variant, how the situation evolves in the coming days is utterly unpredictable. What's more certain is that stringent control measures will likely remain in place ahead of the Beijing Winter Olympics scheduled to kick off on February 4. This could cause mini interruptions in global supply chains, but the impact should not be meaningful, because the bottleneck stress is primarily due to labor shortages and logistics disruptions in other major economies.

Needless to say, China's zero-tolerance Covid policy has succeeded in saving lives and maintaining normalcy for the majority of the population amid a global pandemic. Its sustainability, however, has become increasingly questionable. The containment strategy has acted as a constant drag on consumption. It is remarkable that Chinese consumers' travel intentions have plunged to an all time low, while consumer confidence in most other countries has improved markedly despite numerous waves of Covid infections (**Chart 2**). Moreover, most other countries have effectively given up containment measures against the Omicron variant, hoping to build herd immunity

Chart 2 The Side Effects Of China's Zero-Covid Success



*Vacations intended within 6 months; source: Conference Board
**Travel consumption intentions in the next quarter; source: PBoC

and get through the pandemic. For China, the key risk is that other countries re-open their borders and move on, while China remains isolated in its own bubble.

Some commentators have listed China's Covid policy as one of the key risks for the world in 2022, but we believe this risk is overrated. It is important to note that Beijing's zero-tolerance policy was designed to buy time to build population immunity through vaccinations and to develop therapies, and it was never intended to be sustained indefinitely. A collection of articles published in The BMJ (British Medical Journal) in December written by senior Chinese public health officials and top

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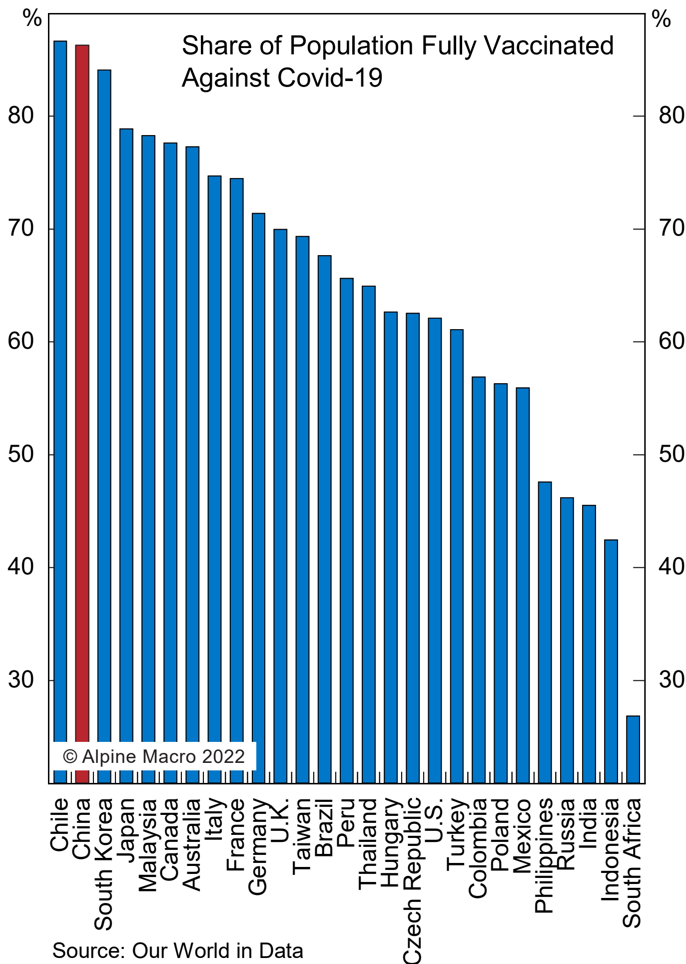
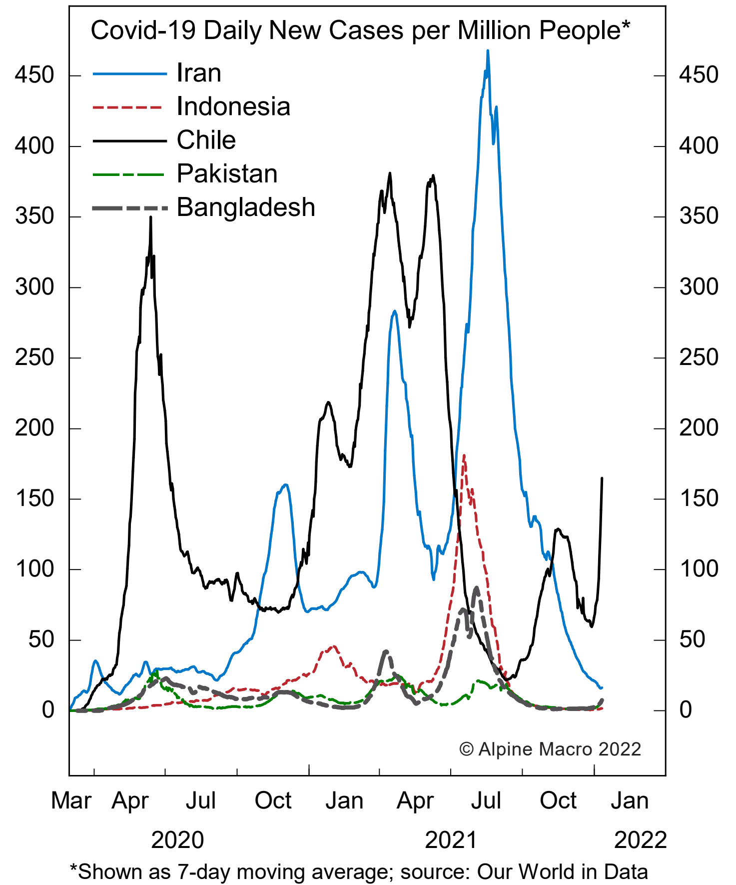
Chart 3 **China: Herd Immunity Is In Sight**



Source: Our World in Data

Chart 4 **Efficiencies Of Chinese Vaccines: Users' Experiences**



*Shown as 7-day moving average; source: Our World in Data

epidemiologists[1] articulated that "the *goal of building population immunity is to create an epidemiological environment in which it is safe to relax or retire some non-pharmaceutical interventions–especially international border quarantine.*" With over 85% of the population having been fully inoculated and 23% having received a booster shot, the country should have already reached herd immunity (**Chart 3**). This is also confirmed in a speech last week by Zhong Nanshan, a top Chinese epidemiologist and a leading advisor to the government on managing the pandemic.

It is generally believed that Chinese vaccines are not as effective as the mRNA vaccines used in the West, which may be one of the reasons behind the authorities' hesitation to end their zero-tolerance strategy. However, studies show Chinese vaccines are equally effective in preventing hospitalizations and fatalities. Other countries that have primarily used Chinese vaccines such as Chile, Indonesia, Iran, Pakistan and Bangladesh have not seen an explosive increase in Omicron cases lately, a positive sign of the vaccines' effectiveness (**Chart 4**).

1 https://www.bmj.com/how-china-responded-to-covid-19

Moreover, there are more than 20 vaccines in clinical trials by Chinese companies, 14 of which are in phase 3, including an mRNA candidate. Meanwhile, the Chinese distributor of Pfizer's BNT162b2 vaccine is also in the final stage of getting regulatory approvals for domestic adoption. In addition, Chinese regulators approved the first Covid treatment for emergency use last month, and several other candidates are in final-stage trials. All of this means that the country is medically much better prepared for the pandemic than in the past two years.

In other words, preconditions for a "lift off" are gradually falling into place, and the Chinese authorities may begin preparing for an exit strategy after the Winter Olympics, especially if the Omicron variant proves to be more contagious but less deadly in other countries. We expect the government will soon conduct serological surveys to determine the population's level of protection against the Covid virus. The numerous domestic mini outbreaks are also helpful in estimating the Rt and the consequences of spread to help policymakers safely retire social distancing restrictions.

The bottom line is that the pandemic remains a challenge for the Chinese economy this year, and the government's Covid policy further complicates the growth outlook, but it is a great exaggeration to claim that Beijing has backed itself into a corner with no way out. There are high odds that the zero-tolerance strategy will be dropped this year, without much disruption in social and business activities. It is worth noting that the U.S. and China established a Fast-Track Travel Channel program last week to allow American businesspeople and their families to travel to and from China more easily. Similar programs are likely to be expanded with other countries going forward.

More importantly, China's economic woes in the second half of last year were not due to its stringent Covid policies, but its overly tight macro policies. In this vein, the shift in China's macro policy is a lot more important in terms of driving China's growth outlook and financial market performance.

Will Chinese Reflation Underwhelm?

In our recent discussions with clients, we detected a clear consensus that investors are expecting a Chinese policy easing cycle, but barely enough to stabilize the economy, which is probably why Chinese stocks have remained sluggish of late. Looking forward, China's policy stance should of course be closely monitored, but we expect the unfolding policy reflation to be aggressive enough to boost growth and push up stock prices.

First, it has become increasingly clear that the Chinese authorities have become deeply concerned about growth conditions and have been stepping up the rhetoric on policy stimulus since late last year, as evidenced from the Politburo meeting, the Central Economic Work Conference and numerous speeches by senior officials.[2] More recently, Han Wenxiu, the deputy chief of General Office of the Central Financial And Economic Affairs Commission, China's top economic policy decision-making body, stated in an article last week that maintaining macro stability is not just

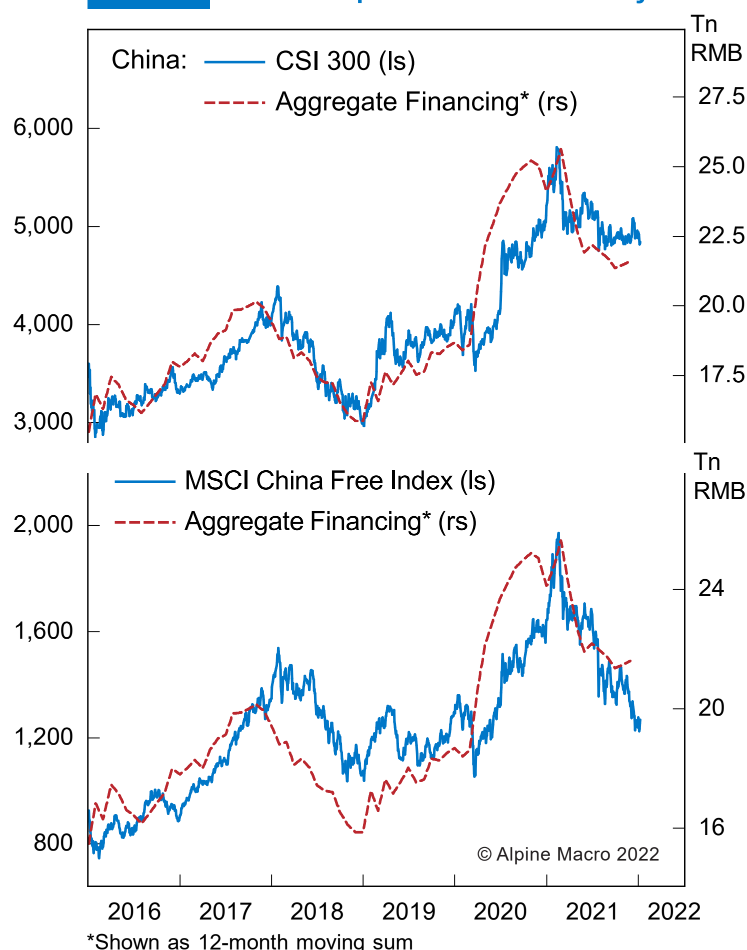
2 Alpine Macro *EM & China Strategy Webcast* "Inflection Point: China And EM Outlook" (December 23, 2021) and "A Year-End Q&A" (December 15, 2021) .

an economic issue, but more importantly a political priority. Early this week in a State Council meeting, Premier Li Keqiang demanded an even higher emphasis on "maintaining macro stability," and required local governments to front-load construction projects earmarked in the 14th five-year plan. This suggests that Beijing is pressuring local authorities to revive economic growth as the upmost task for 2022. In the Xi Jinping era, where Beijing commands absolute loyalty from local officials, such pressure from Beijing is likely to trigger strong policy responses from local governments.

Second, many investors are skeptical that Beijing will allow a massive rebound in credit to jeopardize their long-held deleveraging strategy. This is a legitimate concern, but it is noteworthy that the Chinese economy crumbled last year not just because of credit tightening. Rather, policies were tightened all around, including on the fiscal, monetary, housing, environmental and regulatory fronts, which amplified one another and led to a major growth downturn. Currently all these restrictive measures are being reversed. As Beijing reprioritizes economic growth, all other considerations have become secondary. Even without a massive rebound in credit creation, the removal of previous policy restrictions in and of itself is a major boost to business activity.

Finally, the risk-return tradeoff of Chinese equities remains positive, even if policy reflation is not as aggressive as we anticipate. The ebbs and flows of Chinese stocks, both onshore and offshore, have been closely driven by credit cycles (Chart 5). In this vein, the downside in stock prices should have become limited as policymakers are determined to put a bottom under credit and economic growth,

Chart 5 Chinese Equities Versus Credit Cycle



*Shown as 12-month moving sum

while the upside in stock prices is significant if policy reflation turns out to be more aggressive than the market currently anticipates. Moreover, Chart 6 shows that stock prices have already priced in a substantial earnings contraction and may be poised for upside surprises if the economy and earnings growth improve.

The bottom line is that the best entry point for stocks from a macro perspective is when growth is weak, stocks are cheap, investors are bearish, and policymakers are turning stimulative. All these boxes are checked for the Chinese equity market at the moment. This makes a compelling case for holding Chinese stocks.

Chart 6 Chinese Stocks Have Priced In A Sharp Earnings Contraction

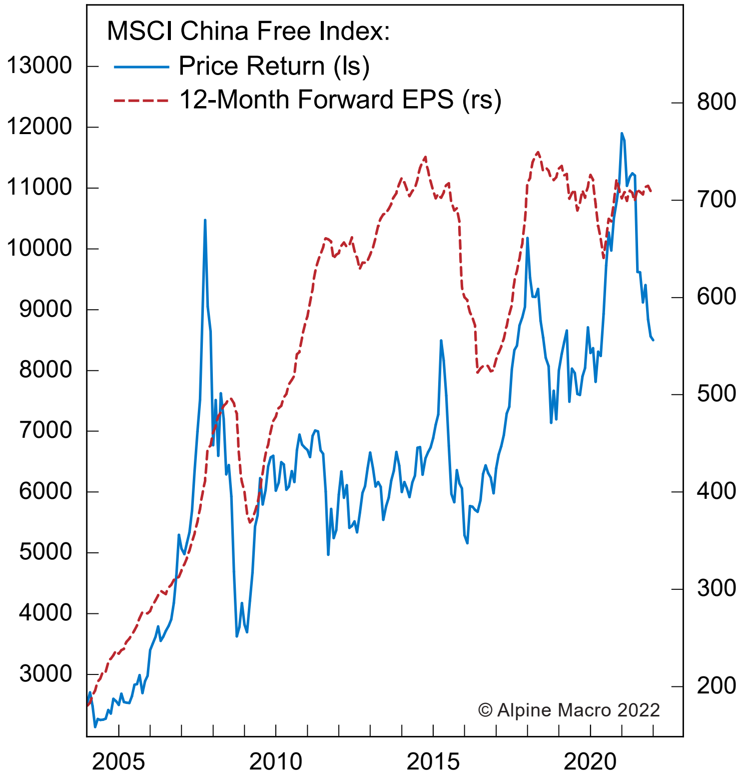
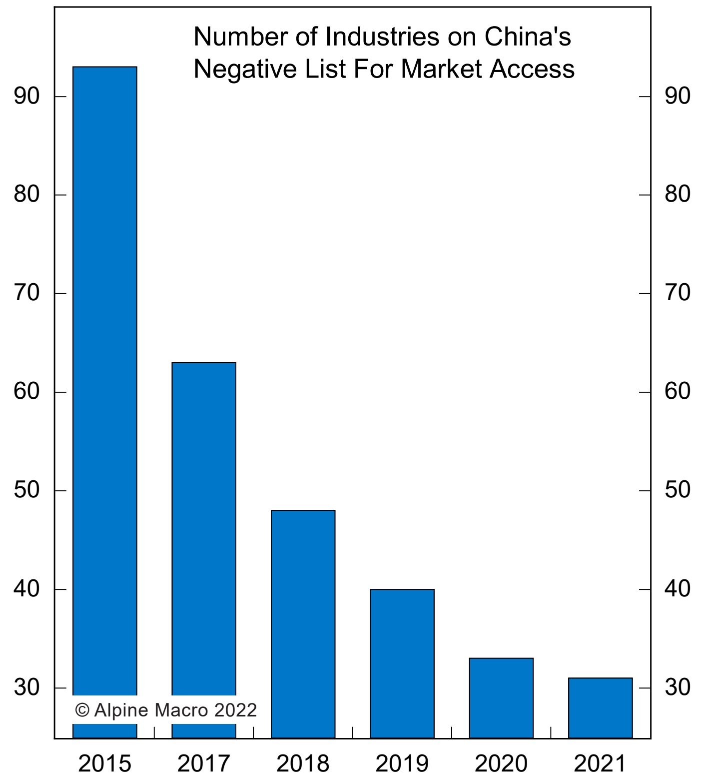


Chart 7 Chinese Market Access Continues To Improve



Are Chinese Equities Investable?

Another key question that has weighed heavily on investors' minds is whether Chinese equities are at all investable after last year's disasterous performance. This question reflects two concerns. First, some investors view China's regulatory changes as having made the country's business environment unpredictable, especially for private tech firms. Second, Chinese tech champions have been increasingly targeted by the U.S. authorities in the geopolitical rivalry between the two countries, which further dampens these companies' growth outlooks.

On the first concern, we believe China's regulatory risk has peaked. This is not only because the government now prioritizes growth, but also because the regulatory crackdowns were meant to correct some "wild-West" practices in select industries that also are not tolerated in Western economies.[3] The Chinese government has emphasized on fostering domestic demand to boost growth in its "dual circulation" strategy, but there are no signs that it is taking a decisive inward shift. On the contrary, Beijing has continued to open more industries to foreign businesses that were previously reserved specifically for domestic companies. In its latest revision last December, Beijing further cut the number of industries on the "negative list for market access," liberalizing some manufacturing and service sectors (**Chart 7**).

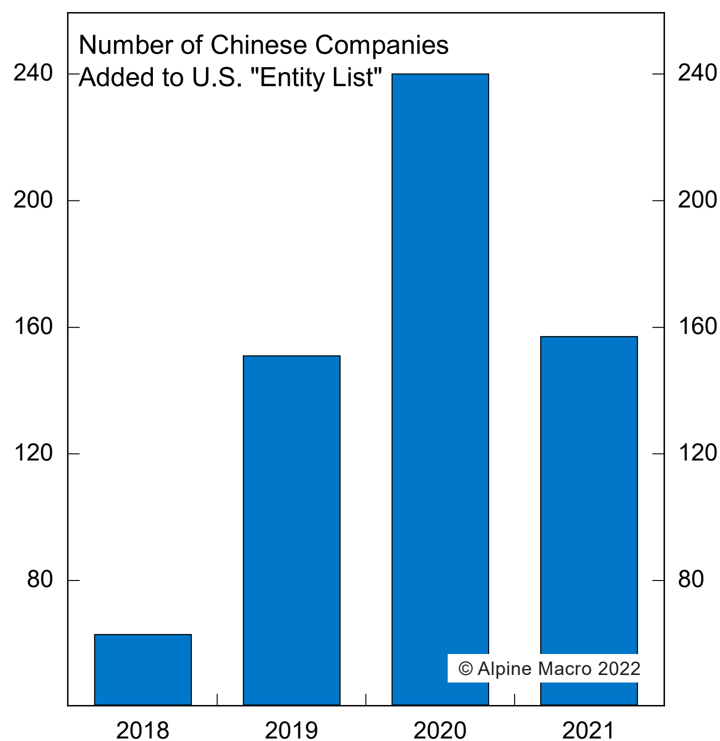
3 Alpine Macro *EM & China Strategy* "The Didi Fiasco And China-U.S. Financial Decoupling: What Are The Long-Term Implications?" (July 21, 2021).

Meanwhile, the Regional Comprehensive Economic Partnership (RCEP) that encompasses China and 14 other major economies in the Asia Pacific has officially been in effect since the beginning of the year. Furthermore, China is actively negotiating free-trade deals with other economies, seeking to join the Digital Economy Partnership Agreement (DEPA), and even planning to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Joining these free-trade blocs will move Chinese regulations closer to global norms and restrict the role of the government and state-owned enterprises. China surpassed the U.S. as the largest recipient of foreign direct investment in 2020 and continued to lead the U.S. in the first half of 2021, according to OECD data. This means that the global business community is a lot less concerned about China's business and regulatory environment than financial market investors.

The second concern is less predictable and may continue to escalate going forward. There are three ways that U.S. sanctions could impact Chinese companies' growth outlook and stock prices.

- First, with America's Holding Foreign Companies Accountable Act (AHFCA), some Chinese companies listed in the U.S. may be forced to delist if they cannot meet the regulatory requirements, and retreat to Hong Kong or Chinese domestic bourses. This may cause some execution glitches for some investors, but the impact on the performance of these companies should not be significant, as the change of stock exchange should not have any impact on future cash flows of these firms. Meanwhile, stock prices of these ADRs have already slumped massively since last year's peak, meaning a hefty risk premium has already been built in, which should further limit their downside risks.

Chart 8 The Expanding "Entity List"



Source: U.S. Bureau of Industry and Security (BIS)

- Second, the U.S. administration has been targeting some Chinese companies that allegedly present national security and human rights concerns to the U.S. By putting them on the Non-SDN Chinese Military-Industrial Complex Companies (NS-CMIC) List, regulators are prohibiting American investors from investing in securities of these companies. A total of 68 entities are currently listed.

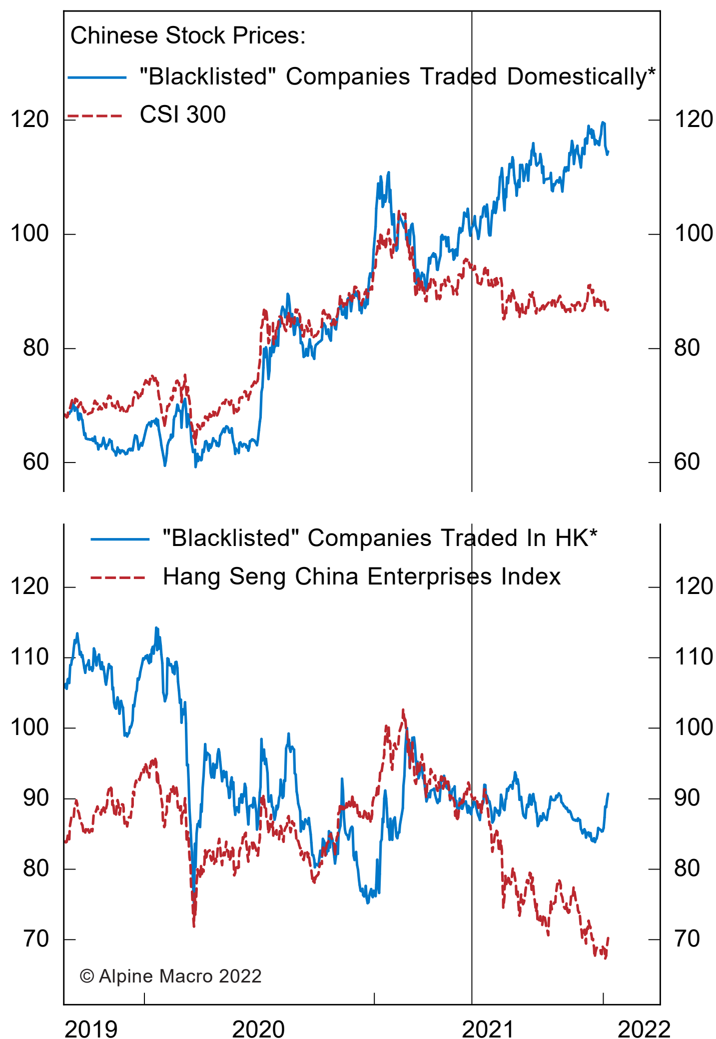
- The third way to punish Chinese companies is to put them on the U.S. Department of Commerce's "entity list." The Trump administration significantly increased the number of Chinese

companies on the list, and the number has continued to expand under the Biden administration (**Chart 8**). Over 600 Chinese entities have been added to the list since 2018, but many of them are government agencies, state-owned research institutes, universities and individuals. In addition, some of these entities belong to the same parent groups.

In general, Chinese companies on the NS-CMIC list and the "entity list" are in strategically important frontier technologies such as biotech, AI, micro-processing, advanced computers, data processing and robotics. The impact of the NS-CMIC list does not appear to be meaningful, as most of these companies are not dependent on American investors for financing. On the other hand, Chinese companies on the "entity list" are severely restricted from doing businesses with U.S. residents, and some have faced even harsher punishments, such as Huawei. However, many of them are not listed on stock exchanges, and therefore their financial information and equity valuations are not publicly available.

Being blacklisted by the U.S. government can have a significant impact on individual Chinese companies, but collectively the damage does not appear to be dramatic. In fact, the market cap-weighted index of "blacklisted" Chinese companies traded on Chinese domestic exchanges has outperformed the benchmark, according to our calculation (**Chart 9**). Their counterparts listed in Hong Kong have performed relatively poorly, but it is likely due to sectoral bias, as these companies are primarily state-owned conglomerates that have long been out of investors' favor.

Chart 9 **U.S. Sanctions Are Not A "Death Sentence"**



*Alpine Macro calculation based on the U.S. NS-CMIC List
Note: Verticle line represents the announcement of U.S. investment sanction (NS-CMIC List) on Chinese companies; series are rebased to Feb 2021=100; source: Bloomberg

The bottom line is that the ongoing U.S.-China rivalry has certainly complicated the investment case of Chinese companies. Many investors need to be mindful of regulatory and compliance obligations and will also need to identify potential "landmines" through bottom-up due diligence. However, being targeted by American sanctions does not amount to a "death sentence" for these

Chinese companies. Some of them may get nationalist sympathy from Chinese consumers and assistance from the Chinese government hoping them to become emerging champions. In this vein, being blacklisted by the American authorities may turn out to be a blessing.

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Investment Recommendations

Strategic Positions (6-12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long MSCI China	09/01/2021		-12.4%	Buy MSCI China Index; accumulate on weakness
Long Chinese A Shares	12/08/2021		-2.6%	Buy CSI 300 Index; currency unhedged

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long 5-year Chilean CDS	06/16/2021		11.3 bps	Buy 5-year Chilean Credit Default Swap; includes carry *(as a hedge against long EM positions)*
Long EM VIX	06/16/2021		11.0%	Long CBOE EM Volatility Index (VXEEM) *(as a hedge against long EM positions)*
Long Gold/Copper	06/16/2021		-0.3%	Long gold and short copper *(as a hedge against long EM positions)*; stop point at -10%
Long CZK, HUF, and PLN vs EUR	09/08/2021		1.4%	Long equal-weighted basket of CZK, HUF and PLN versus EUR; includes carry
Long RUB/INR	10/13/2021		-4.6%	Long RUB, short INR; includes carry; stop point at -5%

EM Equity Country Allocation				
Strong Overweight	**Overweight**	**Neutral**	**Underweight**	**Strong Underweight**
	Russia	Czech Republic	Brazil	
	China	South Africa	India	
	Hungary	Mexico	Peru	
	Poland	Colombia	Philippines	
	Indonesia	South Korea	Turkey	
	Malaysia	Thailand	Taiwan	
	Chile			

EM Equity Sector Allocation	
Strong Overweight	**Overweight**
	Energy
	Utilities
	Consumer Staples
	Financials
	Consumer Discretionary
Neutral	
Information Technology	
Strong Underweight	**Underweight**
	Industrials
	Materials
	Health Care
	Communication Services

EM Local-Currency Government Bond Allocation		
Overweight	**Neutral**	**Underweight**
China	Brazil	Philippines
Russia	South Africa	Thailand
Indonesia	India	Malaysia
Mexico	South Korea	Taiwan
Colombia		Chile
		Poland
		Czech Republic
		Hungary
		Turkey

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David Abramson, Chief U.S. Strategist & Director of Research Prior to joining Alpine Macro, David was a Macro Strategist holding a variety of senior roles at BCA Research. Most recently, he was Chief U.S. Strategist and also Director of Research for the firm. During his 28 years at BCA Research, David launched the European Strategy and Commodity & Energy Strategy services.

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Caroline Miller, Chief Asset Allocation Strategist Previously, Caroline spent 8 years at BCA Research as a global strategist and the chief advocate for the firm's research worldwide. Before that, Caroline spent 20 years in various global fixed income portfolio management roles, including positions at UBS, La Caisse de dépôt et placement du Québec, J.P. Morgan, and GMO where she began her career in 1992.

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