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EMERGING MARKETS & CHINA STRATEGY

August 8, 2023

Inside China:
A Month Of Travel And Conversations With Locals

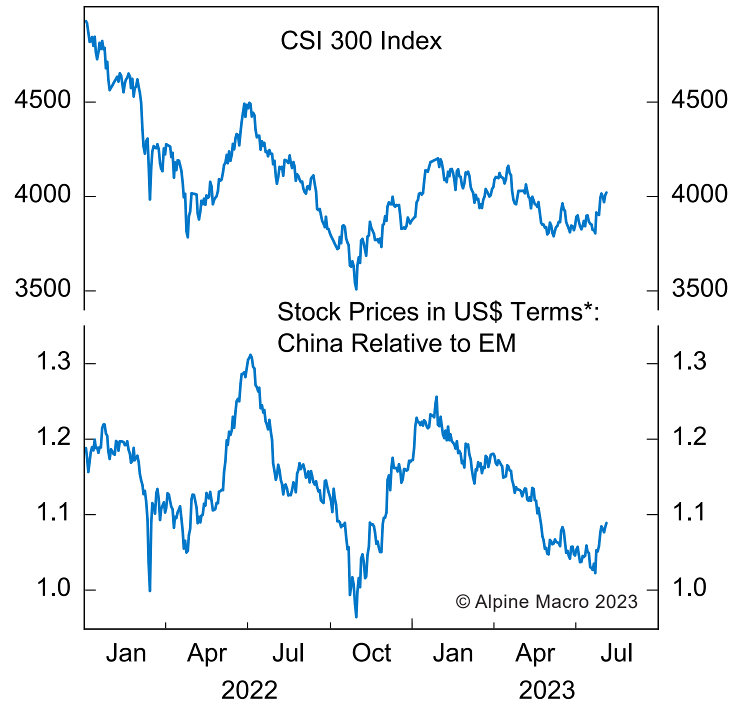
In This Report

I have just returned from another extended China field trip, a combination of work and leisure that I've been doing regularly over the past two decades.[1] The purpose of these trips is to supplement my "20,000-foot" view of China. As a strategist, I am supposed to focus on the forest, not the trees, but on-the-ground observations are also critical to formulating more nuanced views and perspectives.

Following my latest trip, I've become more concerned about China's growth outlook. At the grassroots level, the economy still feels very robust with diligence, productivity and competitiveness rarely seen in any other countries. But there appears to be widespread worries and discontent about government policies among both the business elite and civil servants. I was in Beijing when the government was ramping up an increasingly vocal campaign to support private businesses and boost growth, but the response on the ground was decisively muted, reflecting a collective lack of confidence in leadership and policies.

From an investor's perspective, the bearish sentiment is likely already reflected in Chinese stock prices, as domestic A shares have stabilized and overseas-listed "investable" stocks have begun to outperform the EM benchmark amid the latest disappointing macro numbers (Chart 1). But the longer-term trajectory is murky, and I struggle to see how Beijing can rebuild credibility and revive business confidence with piecemeal changes.

Chart 1 Chinese Stocks Have Stabilized Amid Continued Growth Disappointment



*Source: MSCI

The country may need a watershed moment for a directional shift, similar to the boiling economic and social pressure at the end of last year that forced Beijing to suddenly abandon its zero-Covid policy. Conditions for such drastic policy changes do not appear present.

1 Alpine Macro *EM & China Strategy* "China Ups The Ante, And EM Scorecard" (June 27, 2023).

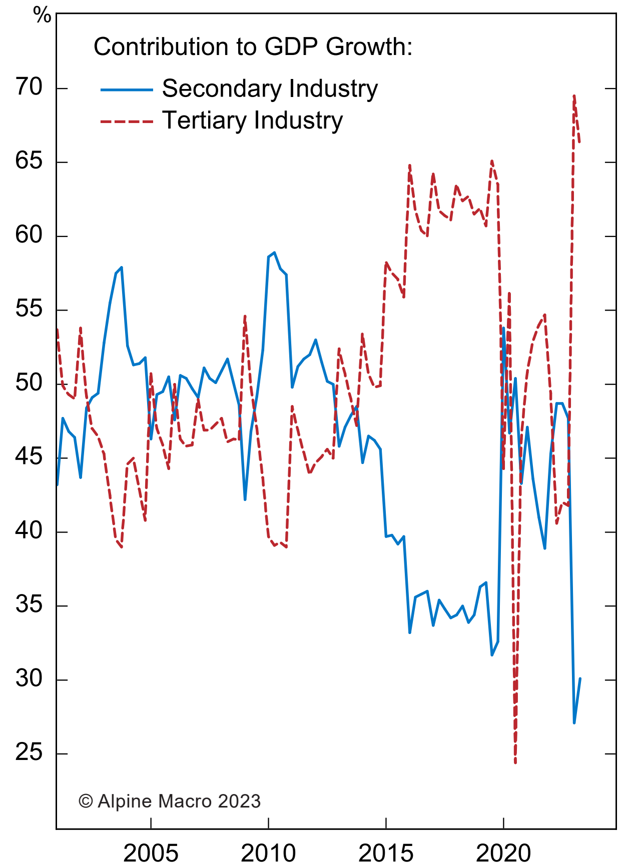
A Two-Speed Economy

To a visitor, the Chinese economy always feels buoyant, probably due to its population density and lack of restrictions on street food or other "curbside" businesses. This latest trip felt particularly so, due to massive post-Covid "revenge" travelling. Popular restaurants saw huge lineups, tourist spots were as packed as ever, and train and airline tickets were harder to come by. The catering business has been in full-fledge recovery mode and is clearly booming (**Chart 2**).

Beneath the surface, however, scars of the pandemic were plenty. I had numerous encounters with Uber/Didi-type taxi drivers, who were new to the business with similar stories: Some of them have other regular jobs but have been imposed significant salary reductions and forced to supplement their income in their spare time. Others were small business owners whose operations closed down during the pandemic. Many still want to go back to their previous businesses, but that would require substantial initial investment, which they either no longer have funds for, or have become a lot more risk-averse to starting new ventures.

My conversations with private entrepreneurs revealed a similar pattern, where the common theme was to contain costs rather than make money – to survive rather than expand. This is in stark contrast to my previous experiences when sentiment was a lot more confident, if not hubristic. The darkened mood is due both to the cyclical difficulties in the economy and the structural challenges arising from political and geopolitical factors. Some manufacturers pointed to an increase in pressure from foreign buyers to

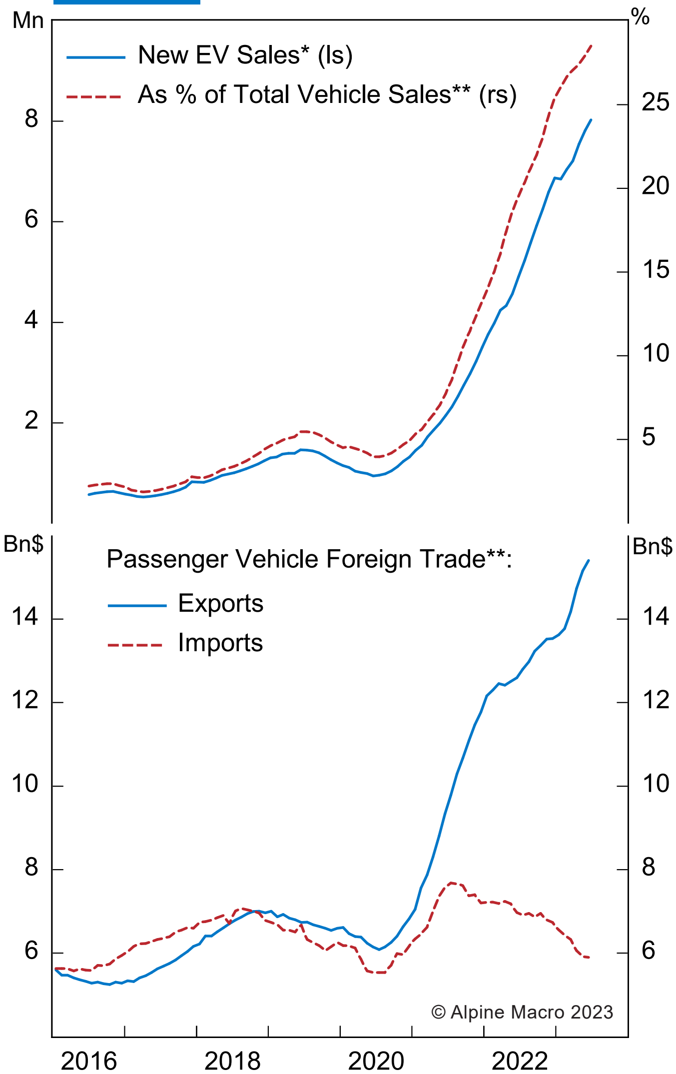
Chart 2 A Two-Speed Recovery



diversify supply chains, and had to relocate some capacities to other countries. This likely explains why China's post-Covid growth performance has been underwhelming, and why Beijing's numerous growth-boosting measures have so far been barely effective.

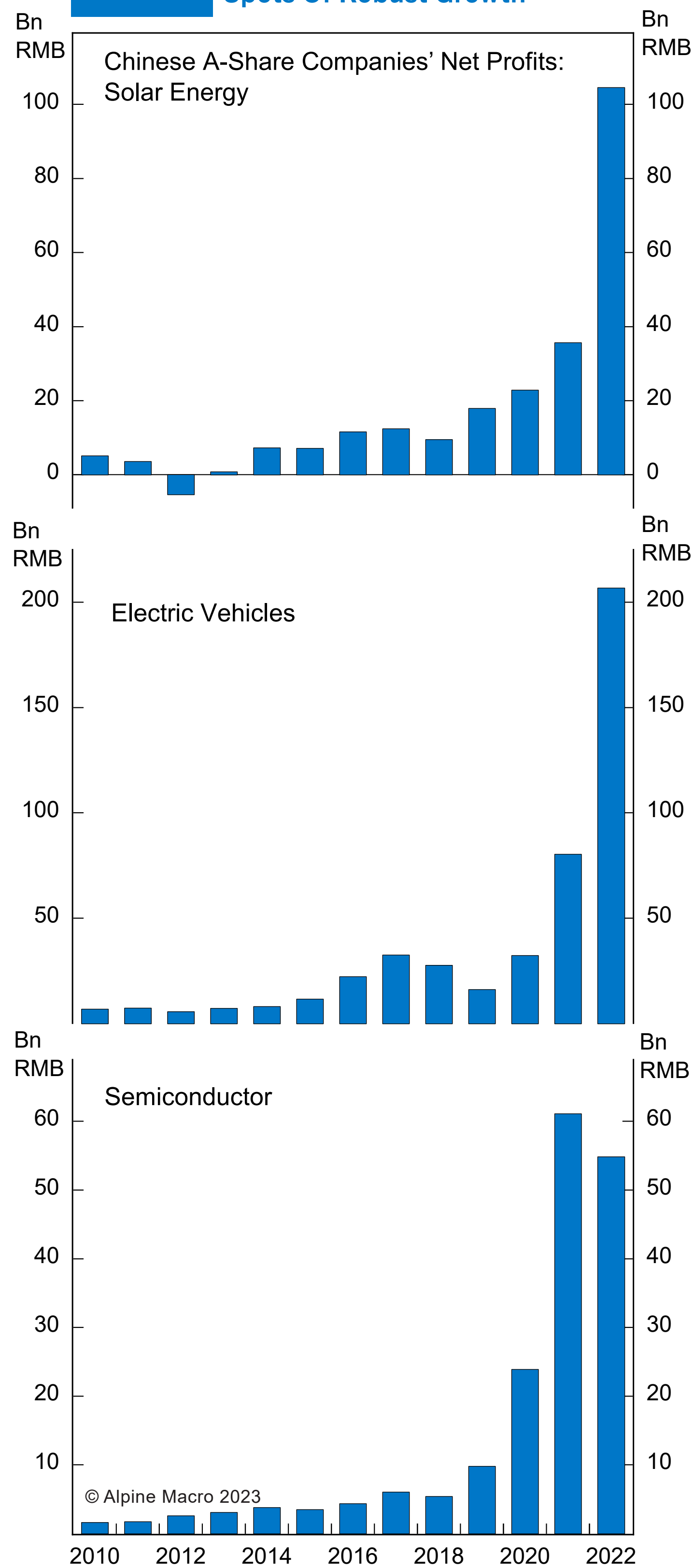
Amid the lukewarm macro backdrop, it is also easy to spot pockets of strong confidence and robust growth. The most visible change on this trip was the sudden emergence of electric vehicles on roads across the country, something not even as noticeable as during my six-month stay in China in 2021. EV sales have increased by seven-fold since Covid, currently accounting for nearly 30% of China's auto sales, compared to about 5% two years ago (**Chart 3**).

Chart 3 The Booming EV Sector



*Shown as annualised
**Shown as 12-month moving average

Chart 4 Spots Of Robust Growth



Source: Choice

Meanwhile, Chinese domestic brands absolutely dominate EV sales, among all foreign brands only Tesla making it to the top sellers list. Other global brands appear to be hopelessly lagging behind with no appealing offerings and have lost their allure as premium and superior products in the Chinese domestic market. The explosive increase in vehicle exports in recent years is a clear testimony of Chinese automakers' dramatic improvement in competitiveness.

There are similar bursts of growth in many other industries, such as alternative energy, automation, and some high-tech hardware sectors (**Chart 4**). I saw plenty of sprawling wind farms and solar power plants when I was travelling along highways and railways. In private conversations, many tech sector executives were excited about favorable policies and growth opportunities but preferred to stay out of the limelight to avoid potential backlash from the public.

Travelling throughout China, it is difficult not to be impressed by the extremely hard-working people with excessively long hours. I had numerous late-night dinners with friends who were called back to the office for overtime, and it was common to see store staff attending to customers while holding lunch boxes. I hired a driver for a planned 10-hour day trip, which eventually finished almost 17 hours later with no extra charges. I was supposed to return some rented equipment to a store, which was scheduled to close at 9 PM. I got there at 11 PM, and called the manager, who showed up promptly, something that would probably never happen outside of China. Overall, the labor force is extremely motivated to work hard.

The highly industrious and pro-business environment is a critical factor for being positive on the Chinese economy. Globally, this has created formidable competitiveness, even as the country's income level has been rising. Domestically, however, this also has led to cutthroat competition and strong downward pressure on prices. The sluggish post-Covid growth situation has further amplified these problems.

Deep Concerns About Politics And Policy

Various public surveys typically show a higher level of trust in government among the Chinese people than most other countries, which I would agree with based on my own observations from all my previous China trips. This time around, however, I felt widespread discontent, from the general public to business elites to government officials. The general public is primarily concerned about growth conditions, particularly the poor labor market, which will likely recover once the economy improves. The discontent among businesspeople and civil servants will be more difficult to change.

- It appears that Beijing's crackdown on private enterprises in recent years has severely damaged business confidence. Some of my contacts in the business community have decided to take a long pause in their careers – even retire at quite a young age. Beijing's recent repeated pledges to support the private sector have done little to ease the anxiety.

- Government officials, especially at local levels, complain about much greater restrictions from top leadership. They quibble privately that they are spending too much time studying political ideologies and Party disciplines rather than focusing on social and economic issues. The harsh years-long anti-corruption campaign has also led to indolence among some officials amid fears of getting entangled in corruption charges.

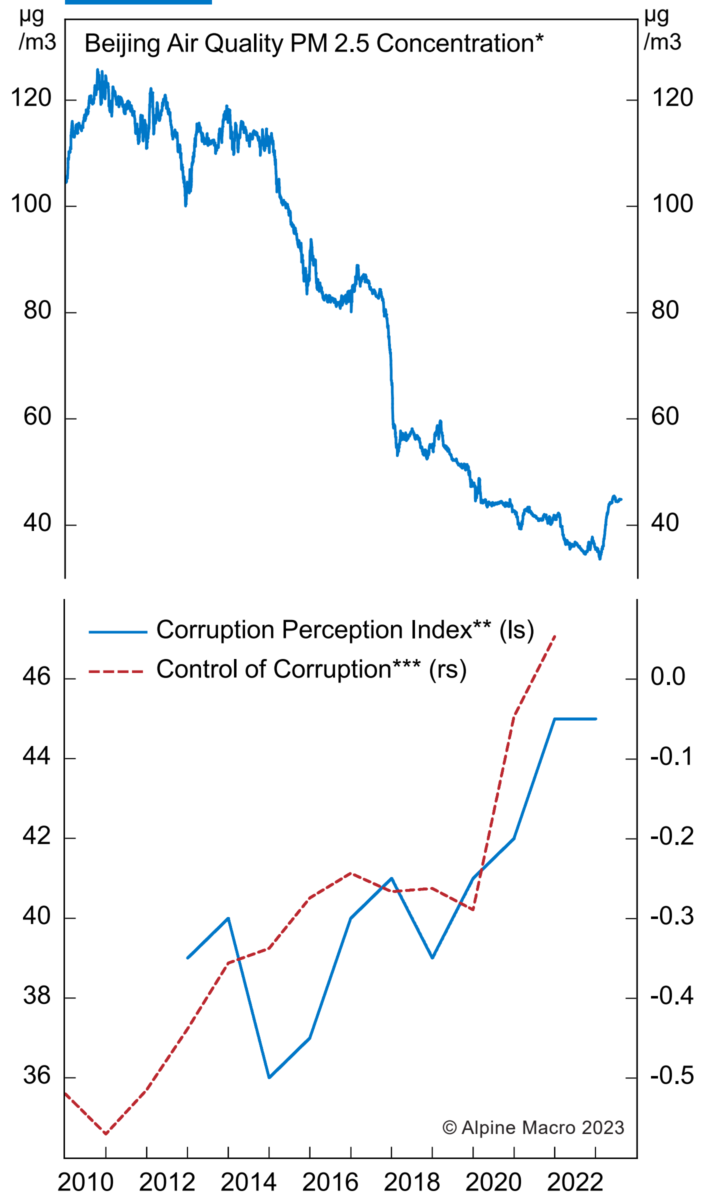
Fundamentally, there have been two main self-reinforcing drivers behind China's economic miracle, namely, the rapid expansion of private enterprises and fierce regional competition among local governments. The peer pressure to outperform among local governments has played a key role in fostering a more business-friendly environment, which in turn has further facilitated private enterprises to flourish.

This unique growth model, however, has also created some deeply rooted social ills during decades of economic boom, such as relentless corruption at all levels, rapid environmental degradation, extreme unaffordability of housing and a glaring wealth gap between the haves and have-nots. All these issues are sources of immense social tensions and have long been considered fundamentally detrimental to China's long-term sustainability. Yet, previous administrations had not been able to change these problems.

Beijing's strong handed approach in the past several years has made tremendous progress in correcting some of these social ills (**Chart 5**). My more recent China trips have witnessed the environment becoming visibly cleaner due to tougher emission regulations, while government officials have been put under much stricter discipline, and the level of corruption and rent-seeking – at least in people's daily lives – has become noticeably lower. In some ways China feels more "normal" from a Western perspective. However, the harsh crackdown, and sometimes abusive state power, have also dampened the animal spirit of both private enterprises and local government officials.

My sense is that Beijing will have to find ways to re-incentivize these sectors and reinvigorate the economy without reigniting these old social ills.

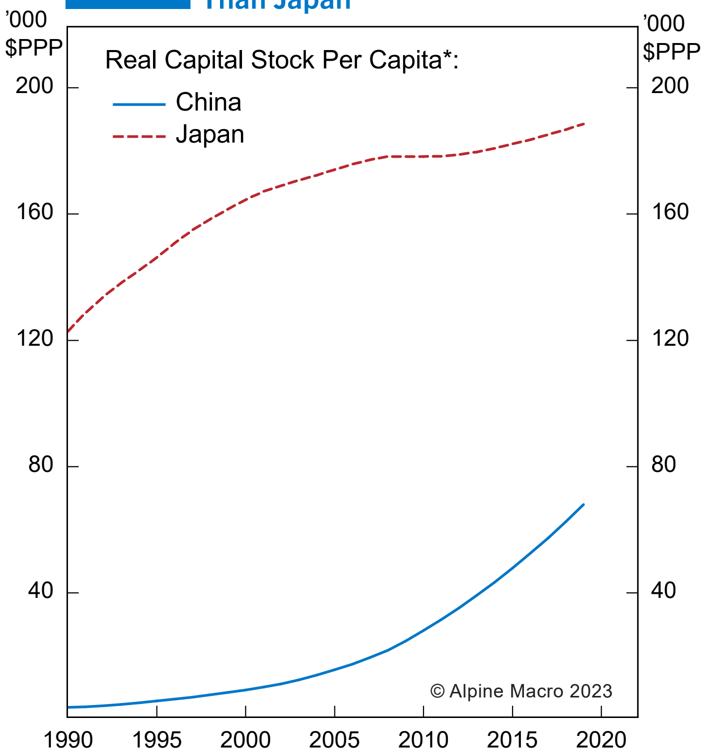
Chart 5 Some Social Ills Are Easing



*Source: U.S. Embassy Beijing Air Quality Monitor; shown as 1-year moving average
**Source: Transparency International
***Source: World Bank

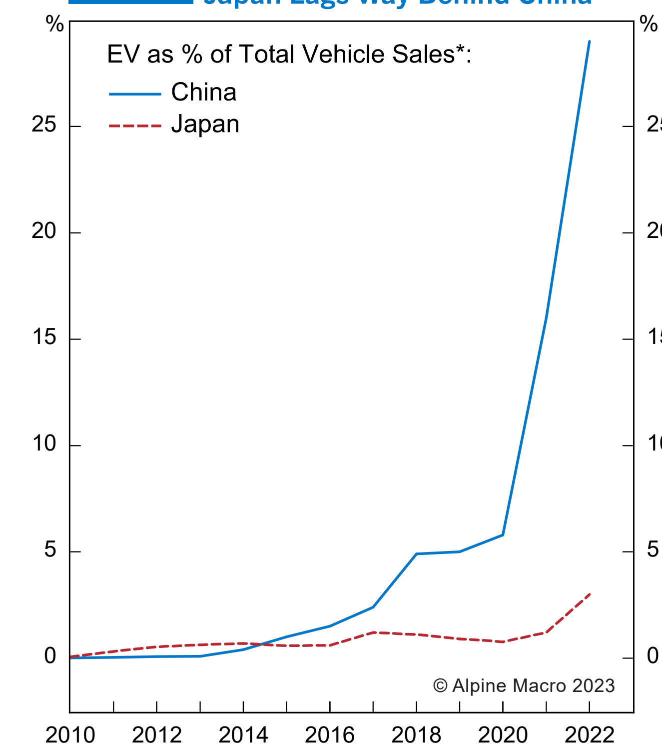
This is a tough balancing act, and also likely a key reason behind Beijing's sometimes confusing and even contradictory priorities in many of its latest policies. For me as an "armchair expert," it is easy to see the problems, but much harder to find solutions.

Chart 6 China Is Still A Far Poorer Country Than Japan



*Shown in real PPP terms; source: Penn World Table

Chart 7 EV Penetration: Japan Lags Way Behind China



*Source: IEA

Is China Turning Into Japan?

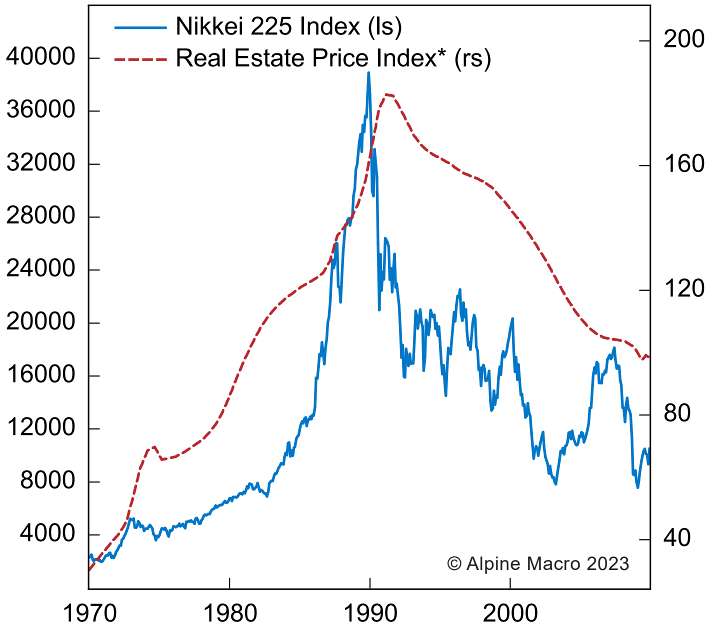
The last leg of my China trip brought me to Japan because most direct flights between China and North America are still suspended, a legacy of Covid restrictions. I stayed in Japan for over a week, which also gave me an opportunity to observe its economy and society closely. China's macro situation shares some disconcerting similarities with that of Japan some 30 years ago, and there is a strong case for the Chinese government to step in to absorb excess domestic savings,[2] but there are also some important differences.

First, China is far less developed. Compared with Japan, where almost all public spaces are perfectly manicured, bus shelters are equipped with cooling misting sprays, and public toilets are furnished with automatic bidets, China is much less asset-rich, even in its stunning first-tier cities. This reflects China's capital stock per capita being only a fraction of Japan's level, underscoring tremendous potential to catch up (**Chart 6**). The accumulation of capital stock in of itself is a key driver for productivity gains, and the view that China has already massively "overinvested" is wrong. Meanwhile, as a poorer country, the desire to get rich among the Chinese population is also a lot stronger than its Japanese counterpart. All of this should put China on a much higher potential growth trajectory.

Second, as a society, Japan feels orderly but rigid, while China is chaotic yet flexible. Japan's rigidity may have something to do with cultural reasons, but more importantly, as a highly developed country,

2 Alpine Macro *EM* & *China Strategy* "'A Closer Look At China's Fiscal Profile" (August 1, 2023).

Chart 8 Japan's Bust Of "Dual Bubbles" Led To "Balance Sheet Recession" . . .



*Source: BIS

Chart 9 . . . Not In China

*Shanghai Stock Exchange Composite Index
**Shown as 12-month moving average; source: NBS

Japan's system is "perfected" with well established norms and legacy players. This likely explains the country's much slower adoption of "newer" technologies, such as mobile payments and EVs – I barely saw any EVs on Japanese streets (**Chart 7**). Many shops even in the most touristy spots still only accept cash, which I have rarely experienced in any other country that I've visited in recent years.

China, on the contrary, is transitional, and therefore very open to change. It is interesting to me how restaurants in Japan typically emphasize their long tradition and history, while those in China often boast about new flavors and new recipes. In addition, while Japan typically follows strict rules of conduct, China is more results-oriented – whatever it takes. This attitude may be a key factor behind China's aggressive experiment in new technologies and processes, enabling it to achieve faster productivity gains, and thus higher economic growth.

Meanwhile, the Japanese economy has suffered a massive "balance sheet recession" following the bust of the country's spectacular late-1980s dual-bubbles in housing and stocks (**Chart 8**). Asset value evaporated but liabilities stayed constant, and it has taken decades for Japan to try to get out of it. China's economic situation is still mostly an "income statement recession," where poor economic performance during the pandemic has caused severe profit contraction and income losses, but asset prices have mostly stayed stable (**Chart 9**).

China's corporate sector is facing a "confidence crisis," which is preventing the economy from expanding and responding to government stimulus. This is a difficult challenge, but unlike Japan, there is no compelling reason for Chinese households and the corporate sector to permanently stay defensive to fix their balance sheets.

Finally, from an investor's perspective, a key difference between China and Japan is asset valuation. Japan was for a long time touted as the model economy, with sky high asset prices. Even in the mid-1990s, long after the burst of the bubble, the Japanese equity forward P/E ratio was still over 70 times and had been among the highest in the world until more recent years (**Chart 10**).

China's economic ascendence, on the other hand, has long been questioned, and Chinese equities have never claimed such a hefty premium. On the contrary, Chinese equities are currently among the cheapest worldwide and are trading at 35% discount to the global benchmark.

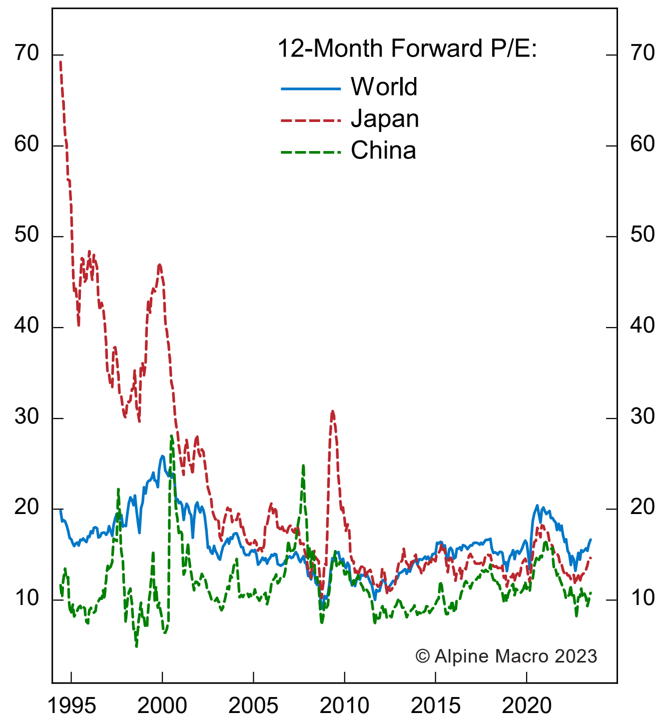
As such, I am still comfortable holding Chinese A shares, as the market likely has already reflected the widespread pessimism among investors and the business community, so any "less bad" news could be good enough to push the market higher. But the deeper concerns I gathered on my trip mean that Chinese stocks may not be a long-term hold, but trading vehicles. For global investors it is impossible to completely shy away from Chinese stocks,[3] but they will have to be opportunistic and demand a high risk premium.

Housekeeping

Our long positions in Colombian bonds and the Colombian peso (COP) versus the Chilean peso were stopped out last week, with a profit of 42% and 27% respectively. We are closing these positions and stand on the sidelines for now. We still expect Colombian bond yields to trend lower, but the rally in the COP in the past several months has been very strong, and will likely take a pause, especially as the Colombian central bank will likely ease going forward. We will follow up on this as well as other currencies and bonds in Latin American countries in an upcoming report.

3 Alpine Macro *EM & China Strategy* "Part I: Will China Become Uninvestable?" (May 2, 2023).

Chart 10 Equity Valuation: Mind The Gap



Source: MSCI

Yan Wang, CFA

Chief Emerging Markets & China Strategist

Investment Recommendations

Strategic Positions (6-12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long MSCI Emerging Markets	11/29/2022		12.1%	Long MSCI EM; rolling stop point -5%, or 2% from current level
Long MSCI Vietnam	11/29/2022		22.5%	Long MSCI Vietnam; rolling stop point -5%, or 5% from current level
Long MSCI Greece	06/19/2023		4.8%	Long MSCI Greece; rolling stop point -5%, or 3% from current level

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long MSCI South Korea	12/06/2022		13.0%	Long MSCI South Korea; rolling stop point -5%, or 1% from current level
Long Brazilian 10-year Govt Bond, Currency Unhedged	12/06/2022		28.0%	Long Brazilian 10-year local currency government bonds; rolling stop point -5%, or 3% from current level
Long Colombian 10-year Govt Bond, Currency Unhedged	12/06/2022		42.2%	Long Colombian 10-year local currency government bonds; take profit
Long COP/USD	03/13/2023		21.5%	Long Colombian Peso; rolling stop point -5%, or 1% from current level
Long COP/CLP	03/13/2023		27.2%	Long Colombian Peso, Short Chilean Peso; take profit
Long CSI 300, Currency Unhedged	05/08/2023		-4.6%	Long CSI 300; stop point at -10%
Long Mexican 10-year Govt Bond, Currency Unhedged	05/08/2023		4.9%	Long Mexican 10-year local currency government bonds; rolling stop point -5%, or 2% from current level
Long KRW/USD	05/08/2023		0.7%	Long Korean Won; stop point at -5%
Short TWD/JPY	06/05/2023		1.4%	Short Taiwanese Dollar versus Japanese Yen; stop point at -5%
Short CZK/PLN	06/05/2023		4.0%	Short Czech Koruna versus Polish Zloty; stop point at -5%
Short CZK/HUF	06/05/2023		-1.0%	Short Czech Koruna versus Hungarian Forint; stop point at -5%

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

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

EM Local-Currency Government Bond Allocation		
Overweight	**Neutral**	**Underweight**
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Our Leadership

Chen Zhao, Chief Global Strategist From 2015 to 2016, Chen was Co-Director of Macro Research at Brandywine Global Investment Management. Prior to Brandywine Global, Chen spent 23 years at BCA Research. As a Partner, Managing Editor and Chief Global Strategist, Chen created and wrote BCA's China and Emerging Markets publications in the 1990s, and was the author of BCA's flagship publication, Global Investment Strategy, from 2005 to 2015.

J. Anthony Boeckh, PhD, Executive Chairman & Editor-In-Chief Tony was previously Founder, Chairman, Chief Executive and Editor-In-Chief of Montreal-based BCA Research for 34 years. He authored The Great Reflation (Wiley) in 2010 and was publisher of, among others, the Bank Credit Analyst, a monthly big-picture analysis of the U.S. and global economies and financial markets.

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.

Yan Wang, Chief Emerging Markets & China Strategist Prior to Alpine Macro, Yan spent 15 years at BCA Research, as Managing Editor and Chief Strategist for BCA's China Investment Strategy service, and played a major role in formulating BCA's view on the Greater China region and emerging Asia. Prior to BCA, he spent six years as an equity analyst in China and Hong Kong.

Harvinder Kalirai, Chief Fixed Income & Currency Strategist Before joining Alpine Macro, Harvinder spent a decade with BCA Research, where he headed the firm's Foreign Exchange Strategy and Daily Insights services. Previously, Harvinder was Head of Currency Management at CIBC GAM. He also held various positions at State Street and he began his career at the Bank of Canada.

Mark McClellan, Chief U.S. Bond Strategist Prior to joining Alpine Macro, Mark was a Senior VP and held numerous key positions during his 23-year career at BCA Research, including Chief Global Fixed Income Strategist. He was instrumental in developing several fixed income publications, including the BCA Global Fixed Income Strategy and the U.S. Bond Strategy services.

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, the Caisse de dépôt et placement du Québec, J.P. Morgan, and GMO where she began her career in 1992.

Dan Alamariu, Chief Geopolitical Strategist Prior to joining Alpine Macro, Dan spent eight years with UBS, as an Executive Director, responsible for country sovereign risk analysis for the Americas. Prior to UBS, Dan was a Director at Eurasia Group in various roles, including in global comparative analysis, and ran product development. Dan has also worked at the Bank of Tokyo-Mitsubishi UFJ, and at Deloitte Consulting.

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