Lotos Asset Management

Quarterly Investment View

Lotos
Asset Management

China: Tradable but not investable?

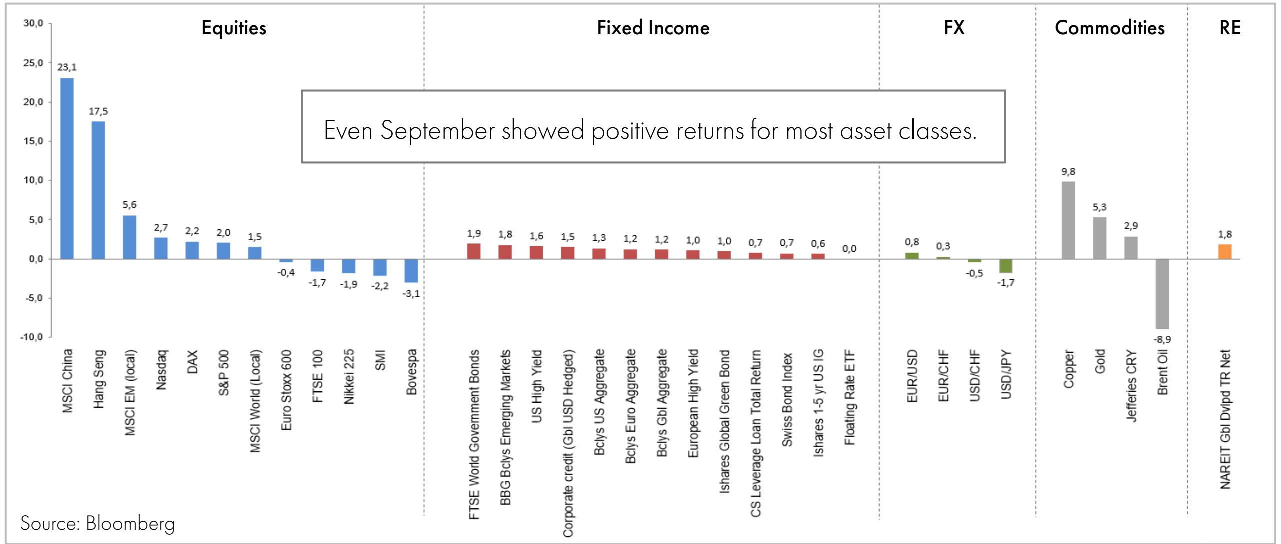
The third quarter continued to show strong performance. Even the historically difficult September generated positive returns for most assets (see graph to the top right). The sharp jump in Chinese equities in September clearly stands out - even more so as it was the clear laggard for close to two years.

This brings us to the question if China – after so many false starts during the last three years – has finally become investable, or is this just a trading opportunity?

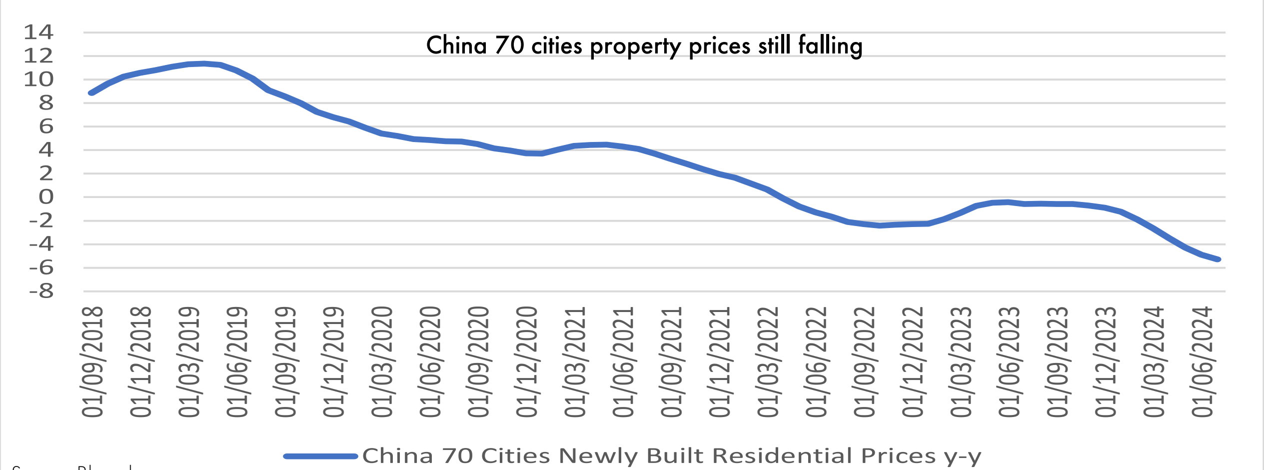
As we have invested right on the day that China's central bank unveiled a broad package of monetary stimulus measures, it is no rhetorical question for us. Most critical at this juncture is if and to what extent further actions will follow. Are these already priced in the market?

In order for China to become an investment, it has to address several issues - first and foremost the deep real estate crisis. Some data to illustrate to what extent this crunch has not been solved even after several years: According to Bloomberg Intelligence, at least 48 million homes sold in China before completion remain unfinished. It is estimated that up to Yuan 5 trillion ($712 billion) would be needed to buy unsold homes from developers and convert them into affordable homes. Officials asked local governments across the country to buy unsold homes from beleaguered developers. In the announcement on September 24, it announced that it would cover 100% of loans for local governments buying unsold homes with cheap funding. The central bank cut mortgage rates and announced easing rules for second-home purchases. Given the troubled situation some of these local governments are in, it remains questionable if these measures can induce a property recovery. In the meantime, new home prices continue to fall.

The property crisis, the slowdown in economic growth and the long-lasting selloff in Chinese stocks weighed on consumer and business confidence and spending, spurring a deflationary feedback loop within the economy (see graph on next page). A rapidly aging society also represents a headwinds to the country's flagging economy.



Source: Bloomberg



Source: Bloomberg

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Until the end of September, policy makers tried to revive the economy by:

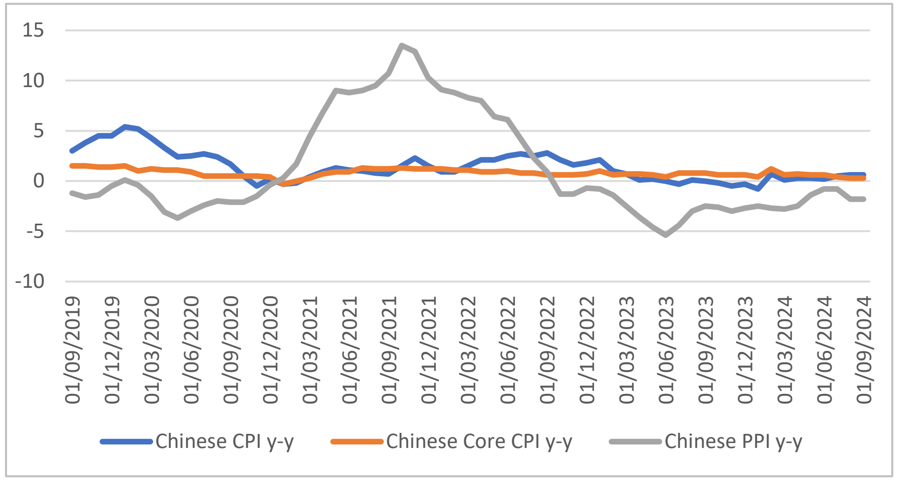
- Telling state- owned companies to buy shares onshore through the Hong Kong exchange link by using offshore money to minimize impact on an already weakening yuan
- Ordering local funds to invest in onshore shares through specific brokers
- Installing a tenfold fee increase on high-frequency traders
- Tightening its grip on the financial industry (after they had already done so on the technology industry and others) by establishing a pay cap and bonus drawbacks
- Asking some brokers to recall stock loans to clients for shorting purposes
- Banning some quantitative hedge funds from cutting equity positions in their leverage market neutral funds
- Ordering state funds to buy Chinese stocks
- Telling analysts not to publish negative reports on Chinese companies
- No longer making available economic reports when the trend became quite negative. This aggravated an already questionable quality of statistics as also company figures are not really reliable.
- Letting CEOs of the most reputable Chinese companies unexpectedly disappear.
- Cutting interest rates modestly

It goes without saying that this approach is questionable and not credible. The unpredictability and opacity of governance and data represented to us an enormous hurdle to invest in China.

End of September, however, the People's Bank of China's attitude changed given the deteriorating situation. It announced a barrage of measures, each of them on its own of significance, which is highly unusual. It included among others cuts to interest rates, lower reserve requirements thereby making more central bank funding available, raising liquidity in order for investors to purchase stocks. In four major cities, restrictions on the purchase of residential property were eased and the central bank lowered mortgage rates.

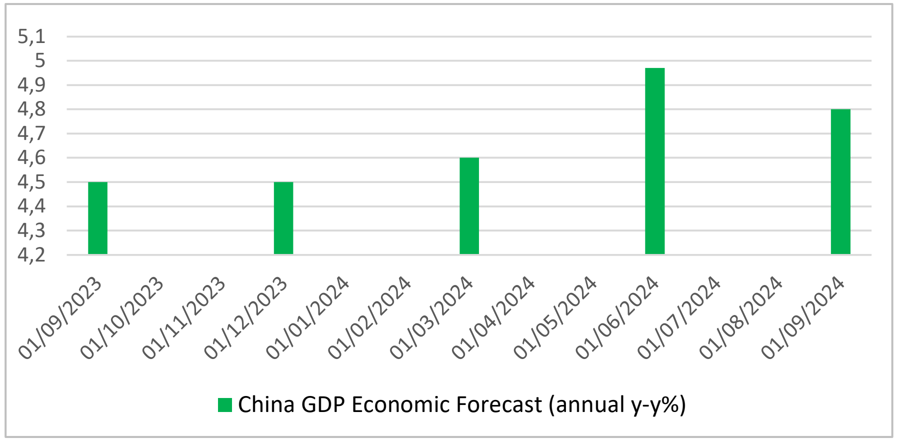
These true measures and not just orders and words incited us to buy Chinese stocks.

Deflation fears in China



Source:Bloomberg

Economists are skeptical China will reach goal of 5% GDP growth



Source:Bloomberg

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After the fast and furious reaction to the announced measures (see chart top right), the question is to what extent this rally is sustainable. China would need to be successful in managing the size and pace of fiscal stimulus in order to stabilize demand and maintain local governments' basic operations. But even more importantly, it should quickly and drastically increase its efforts to fixing the enormous problems in the property sector. Expectations particularly regarding fiscal support have increased quite significantly in recent days. There are even scenarios of a $ 1.4 trillion fiscal package, by issuing special debts. This should lift confidence. Jobs will be created, incomes for citizens will raise and unlock consumption potential.

While this sound theoretically feasible, the practical side is much more complicated. In our point of view, the wealth decline from property will be very difficult to be relieved by other measures. Unless there is a solution in that respect we doubt that confidence and hence household spending will pick up.

Conclusion:

- **Only a credible strategy for the troubled property market will make China investable again.**
- **As this will take time and enormous investments, we consider the current jump in equity prices as non-lasting.**
- **The sentiment versus Chinese equities was very negative and the underweight significant. Now speculation and fear of having missed out seems to reign market action.**
- **While China still seems attractively valued (see Price/Earnings Multiples chart to the right), earnings growth may decelerate in 2025 versus acceleration in most other world regions.**
- **Economic growth is also endangered by possible new tariffs.**
- **We consider China a trade rather than an investment.**
- **By the time you are reading this we might have already cut or sold our position.**

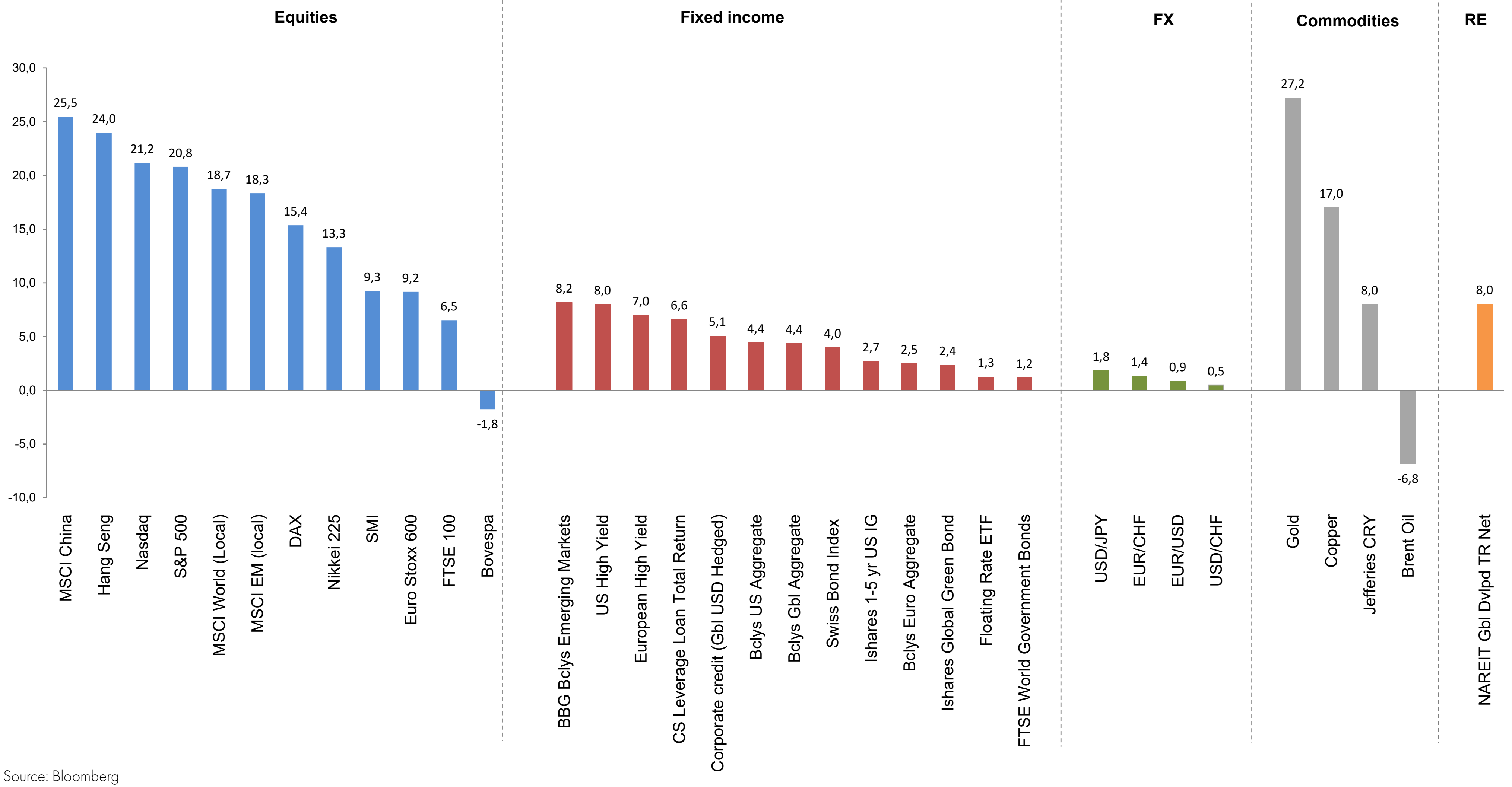
For other asset classes, please refer to the section ***How are we invested and why***.

MSCI China A Equity incredible recovery

Source: iShares

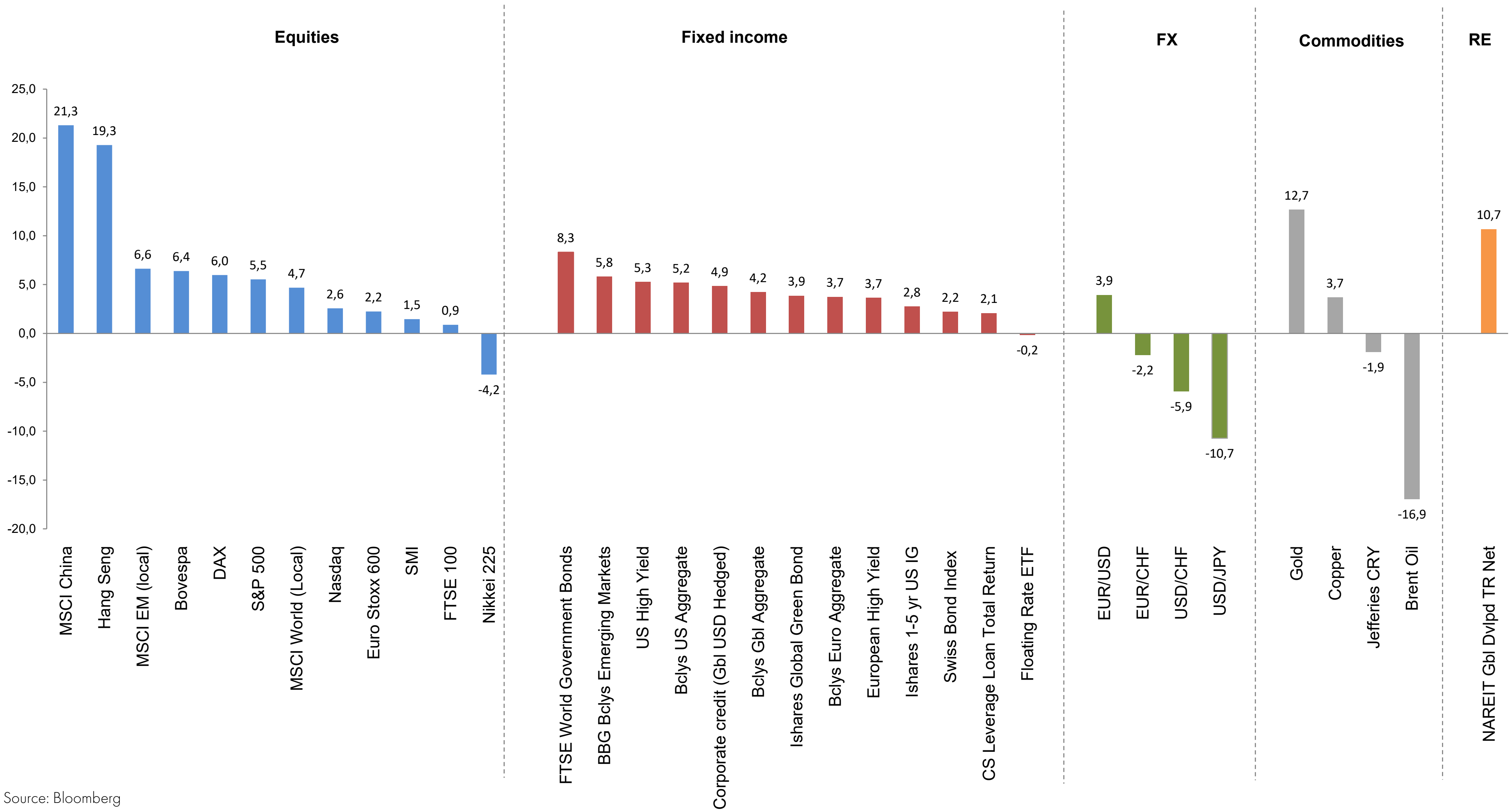
Source: MSCI

Performance major asset classes 2024 (September 30) in local currencies



Source: Bloomberg

Performance major asset classes Q3 2024 in local currencies



Source: Bloomberg

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