INTUITION
13 JANUARY 2023

CHINA - Lifting the virtual Great Wall

"All things change, and we change with them" (Chinese proverb). Since the first headline broke of a virus emanating from Wuhan, China, the world as we knew it, changed. Despite China having escaped relatively unscathed in 2020, last year's self-imposed zero-tolerance Covid lockdowns created a virtual "Great Wall" that suffocated the world's 2nd largest economy. As global inflation soared last year, supply chains reliant on China choked and consequently global GDP has been steadily revised down. Amidst all of this, the world watched on as President Xi paved the way for an unprecedented 3rd term. His intentions were made clear over the past few years as he imposed strict regulations across any sector that was not seen to be toeing the Communist Party line. Tech giants such as Tencent & Alibaba bore the brunt followed by the property and consumer sectors. However, since late October 2022, the Chinese Yuan has jumped c7% versus the US Dollar and the tech sector by 80%. This article will look at what transpired and why it was a lesson, once again, in holding one's nerve, especially as one watched the Chinese tech sector and JSE-listed Napsers/Prosus plummet from record highs.

Nick Rogers

The first signs of what was to come appeared in the Fintech space. Having transitioned from an agricultural/rural economy into the world's largest manufacturer of goods, China then pivoted towards technology and e-Commerce. Exponential growth followed, especially within the financial system which had also transitioned from third world (i.e. cash-based) to one centred around Fintech 'super-apps'. To understand Tencent's WeChat Pay or Alibaba's Alipay, think Facebook, Google, Twitter, Instagram, Amazon & J.P. Morgan/Citibank all rolled into one app, used collectively by over 2.5 billion people. According to Ernst & Young, 87% of China's digitally active population use at least one fintech service, namely mobile payments, online banking, insurance, borrowing, etc. daily. Despite the massive convenience and economic advantage that these apps facilitated versus traditional banks, they also provided immense power to their newly created billionaire owners. CEO Jack Ma's stake in Alibaba had made the former English teacher China's richest man and Tencent CEO, Pony Ma, the 2nd wealthiest. This had not gone unnoticed by power-hungry President Xi, especially juxtaposed against his 'common prosperity' election campaign. Besides income inequality, common prosperity seeks to address perceived social ills stemming from capitalism and unchecked growth.

SPEED READ

- **In 2020, the Chinese Tech sector hit record highs only to plummet over 70% over the ensuing 22 months.**
- **In early 2023, Tencent crept back into the #10 spot of the world's most valuable companies after surging 80% in 3 months (It is now worth $442 billion versus a peak valuation of $949 billion in January 2021).**
- **China Evergrande Group, once the country's biggest property developer, defaulted in December 2021, with liabilities totalling c2% of China's annual GDP.**
- **An astonishing 70% of Chinese household wealth is now tied up in real estate.**
- **Chinese consumers have the equivalent savings in the bank as the entire German GDP. This bodes well for consumption as hard lockdowns are eased.**

In October 2020, Ant Group (the fintech subsidiary of Alibaba) was primed for the world's biggest-ever IPO, valuing the company at $37 billion. Ma addressed an assembly of high-profile figures with a controversial speech

TENCENT V ALIBABA

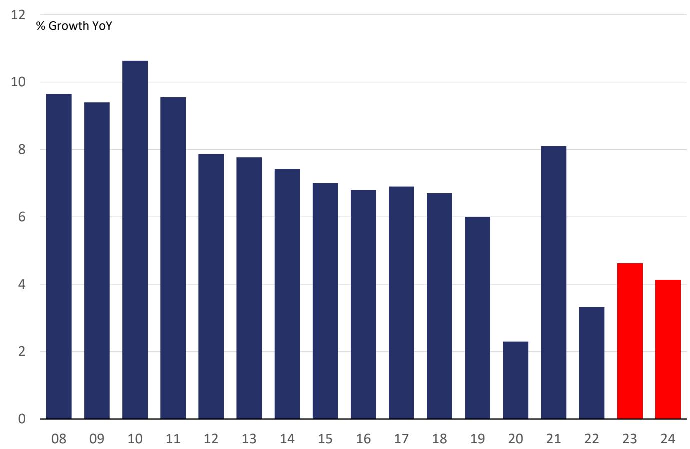
Chinese Tech giants, Tencent & Alibaba, having faced the wrath of President Xi's new policy, are showing early signs of a recovery.

that criticised the country's financial rules for stifling innovation. Immediately, the Communist Party tightened financial regulation, scuppering the Ant Group IPO in November and Jack Ma was not seen again in public until January 2021. The days of relaxed government oversight and minimal capital requirements in the financial system were over. Having hit a record high on the 28th of October 2020, Alibaba plummeted c80% by late 2022.

Gaming was next in the crosshairs. JSE-listed Naspers' and Prosus' largest investment, Tencent, had become #1 in the video game industry by revenue, with 2021 game-related revenue of $32 billion, well ahead of Sony ($18,2 billion) & Apple ($15.3 billion). Like Walt Disney, content is king but revenue growth is tied to new releases. Unlike in the US, the state controls the approval of new gaming licenses in China. In late 2020, new licenses dried up and stringent new regulations governing the amount of time minors could spend gaming came into force, hitting profits. Online educational courses, a big money-spinner for tech companies, were deemed not-for-profit overnight too. This may have been great news for poorer families who could not afford tuition previously but bad news for companies that had invested heavily into this industry. Tencent's share price suffered a similar fate to Alibaba's. Thus, over the past two years, Xi's government has squeezed the tech giants it once celebrated which in turn has resulted in global investors running for the exit.

According to research by Harvard University, real estate and related industries accounted for almost 30% of China's GDP in 2016, about twice the equivalent share in the US. Global miners, including those listed on the JSE, rely heavily on China's demand which is tied to the property sector. In 2017, President Xi Jinping's stated that "houses are for living in, not for speculation." This was in response to a housing boom which has seen house prices rise sixfold over the last 15 years. In late 2020, the Communist Party rolled out a "three red lines" policy aimed at carefully deflating a huge housing bubble that had been decades in the making. The policy had two goals, namely, lessening the economy's over-reliance on property and clamping down on speculation that had put house prices out of reach for many middle-class Chinese. For instance, new industrial cities like Shenzhen were becoming less affordable than London. The "three red lines" had an immediate effect on the operations of highly indebted developers. China Evergrande Group, once the country's biggest developer, was declared to be in default in late 2021. Its liabilities amounted to nearly 2% of China's annual GDP! Currently, about 2 million off-plan homes remain unfinished across China, according to a rough estimate by S&P. Consequently, the likes of BHP Group Ltd and Anglo American have seen demand for building-related commodities like iron ore (used to produce steel) fall.

CHINA GDP GROWTH



The OECD's outlook for China's GDP growth highlights a struggling economy just emerging from 3 years of stringent Covid-19 lockdown regulations.

Last October, President Xi tightened his grip on power when he secured a third consecutive 5-year term as leader of the Communist Party. He proceeded to elevate political allies with defense backgrounds to key posts, causing much concern in the West. In March, the new Communist Party's economic policy will be announced which will provide further clarity on Xi's intentions. Despite the uncertainty, the following positive moves have seen the first green shoots, in over 2 years, emerge:

- Chinese Tech: last week, Ant Group received the green light from Chinese regulators to raise $1.5 billion for its consumer unit, opening the door for a possible IPO, just as CEO Ma relinquished full control. Furthermore, Tencent has received approval for new gaming licenses. Both events signal a growing co-operation between China's e-commerce giants and the state, as regular supervision and support is given to help them play a bigger role in job creation and fuel global competitiveness. Chinese regulators have also allowed US auditors full access to specific financial records, removing the threat that companies dual-listed on America's Nasdaq exchange would be delisted.

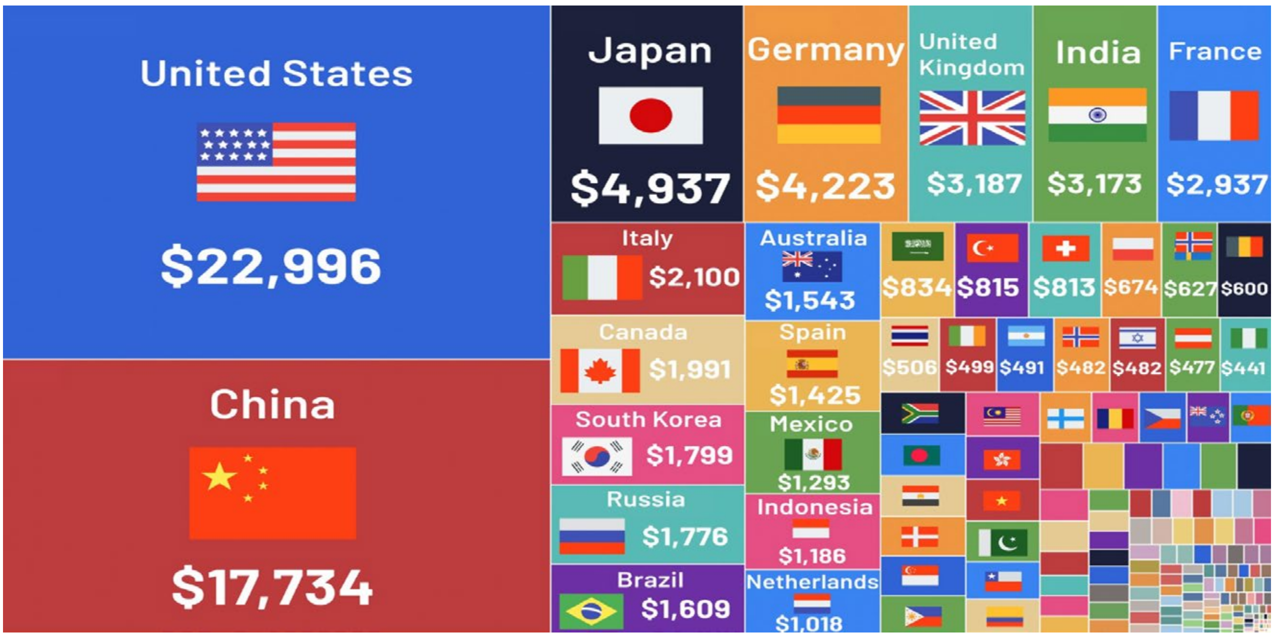
- Property: the government is planning to relax restrictions on developer borrowing, dialing back the stringent "three red lines" policy that exacerbated the real estate meltdown. With an astonishing 70% of household wealth tied up in property, this bodes well for sentiment. Global miners have reacted strongly off the back of this move to restore market confidence in the embattled sector.
- Covid-19 Lockdowns: having been locked in their homes due to the zero-tolerance lockdown rules, Chinese consumers are currently operating 20% below the average historical retail sales levels. There is thus potential that pent-up demand could provide a tailwind in the medium term. China has just reopened its borders to travelers from abroad for the first time in nearly 3 years. JSE luxury goods company, CF Richemont, a big beneficiary of the Chinese consumer, has moved up over 30% in recent months.

But as is always the case with China, it's not all plain sailing. Risks remain, and include:

- Taiwan: hostilities between China and the US over Taiwan have seen the island become a geo-political hotspot. Taiwan is the world's largest supplier of high-tech semiconductors, which amongst other uses, enable advanced weapons and Artificial Intelligence systems to operate. The US has forbidden foreign companies that use embedded American technologies from exporting cutting-edge semiconductors and equipment to China in a direct blow to Xi's tech ambitions.
- COVID infections: re-opening has led to a surge in infections which will create a drag on economic activity. JP Morgan has revised down growth for Q1 2023 however, it also implies an earlier peak in infection cases to reach herd immunity and hence earlier normalization in economic activity which is positive.

In conclusion, President Xi Jinping has proved more than willing to sacrifice economic growth and other priorities in exchange for control. Going forward, the state and private sectors will run in parallel. China's dual circulation strategy involves tapping into its huge domestic market of 1.4 billion consumers to stimulate economic growth from within and become more self-sufficient to mitigate external risks. As a result, the past 2 years have not been easy at all for investors with direct exposure to Chinese equities. What is plain to see is that as much as the world relies on China, China is still very much reliant on global demand for its goods and services as well. The softening of policy from Beijing has bought some much-needed relief to the markets yet there is still a long way to go in understanding the implications of President Xi's 3rd term. However, the speed at which global markets have reacted to the recent news flow proves once again the importance of remaining level-headed and invested through the tough times.

China's Share of Global GDP



This pictogram illustrates perfectly China's increasing contribution to the global economy. It is now 2nd only to the US

The details of our next Insight seminar will be published shortly.

Harvard House is on Facebook

Harvard House is on YouTube

Topic: TBC

Natal Midlands	
Date:	TBC
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	TBC
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za