LIONTRUST

GLOBAL EQUITY

The Chinese New Year – a return to growth?

Ewan Thompson, Manager of the Liontrust Emerging Markets Fund

This time last year, China entered into the Year of the Tiger hoping to see the return of confidence and competitiveness after a torrid period of poor economic and stock market performance. Instead, 2022 only compounded a number of structural and cyclical issues facing the Chinese economy, as well as extending the stock market's underperforming trend since late 2020. As we head towards the Year of the Water Rabbit – associated with quiet and calm – there are again hopes for China's emergence from its long winter. However, if the first few weeks of the year are anything to go by, 2023 may prove less quiet and calm than hoped for.

Looking back to 2020, the Chinese market enjoyed a notably strong year, returning an impressive 27.3% in US dollars, despite the ravages of the global pandemic. The "first in, first out" assessment with respect to China's covid policy at that time – given China's early zero-tolerance lockdowns were much earlier and more stringent than elsewhere globally – has subsequently been proved incorrect in the most extreme manner possible. The persistence of rolling lockdowns across China throughout 2021 and 2022 severely curtailed economic growth and served to ratchet up social division and unrest, leading to the market nearly halving in dollar terms by the end of October. Although there was a degree of easing in terms of monetary conditions, the absence of a major policy response from the government – coupled with the loss of investor confidence over the perceived anti-business "common prosperity" – exacerbated the sense that policy making would continue to prioritise ideology and nationalism at the expense of economic growth. With many global investors finally throwing in the towel, labelling China as "uninvestible", the turning point came in the final weeks of the year with a series of policy shifts, most notably an apparent volte face on the previously unshakeable zero-covid policy.

The prevailing consensus had been for a gradual loosening of restrictions into the spring, but the rapidity of normalisation – including dropping quarantine restrictions on travel and downgrading covid from Class A to Class B under the law for protection of infectious diseases – has taken markets by surprise. Infection rates have rapidly risen towards 70% of the population – up to 90% in key urban areas – with predictions of peak infections already being in the rear-view mirror, suggesting that there is little will or even ability to walk back these changes. Moreover, plenty has been done in the background to shore up the economy, which has laboured under the pressures of draconian restrictions. Indeed, M2 money supply has been accelerating since as early as the second half of 2021. Ordinarily this would create very attractive liquidity conditions, but these have been obscured by zero-covid policies.

With the abrupt policy shifts of recent weeks, the favourable macro-economic backdrop has been foregrounded in investors' minds. Furthermore, concerns over the property market, specifically the liquidity and solvency of developers, have been addressed with direct injections of equity into key entities. The 20th National Congress, held in October, begun the economic reset towards economic recovery, further reinforced by the China Economic Work Conference (CEWC) in November. The CEWC recognised the economy's shrinking demand profile and the harm done by the ongoing lockdowns and highlighted the importance of getting the economy back on track, supported by a proactive fiscal policy and prudent monetary policy.

The result of this abrupt policy shift has been a rapid recovery in markets, reflecting the renewed optimism surrounding China's great reopening. Since the end of October, the MSCI China index has rallied over 50% (in US dollars), against a 7% return for MSCI World and 22% for Emerging Markets. At the market bottom MSCI China was trading at nearly 9x forward earnings, against a 5-year average of 13.5x, setting the stage for a strong re-rating. The key areas of improvement in the economy are likely to be centred on services and consumption rather than investment, so we are unlikely to see a major stimulus program. There has been a dramatic build up in savings due to the pandemic and uncertainty around the property market, leading to more than 5% of nominal GDP being held in excess savings, providing significant ammunition for a recovery in consumption both this year and next. China will see overall GDP growth improve dramatically from a negative rate in the first quarter of this year to hit around 5% for the year as a whole. Given the recessionary fears stalking the developed economies this year, the global economy will receive a welcome support from China (its second-largest contributor), where growth will be rapidly accelerating at a time of considerably uncertainty elsewhere. Moreover, as by far the largest country by weight in emerging market indices, not to mention a key driver of both regional supply and demand, China's return to growth will be a significant boon to emerging markets as a wider asset class, where prospects for outperformance against developed markets now look as good as they have done in many years.

Key Risks:

Past performance is not a guide to future performance. Do remember that the value of an investment and the income generated from them can fall as well as rise and is not guaranteed, therefore, you may not get back the amount originally invested and potentially risk total loss of capital.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term. Investment in funds managed by the Global Equity (GE) team may involve investment in smaller companies - these stocks may be less liquid and the price swings greater than those in, for example, larger companies. Investment in funds managed by the GE team may involve foreign currencies and may be subject to fluctuations in value due to movements in exchange rates.

The team may invest in emerging markets/soft currencies or in financial derivative instruments, both of which may have the effect of increasing volatility. Some of the funds managed by the GE team hold a concentrated portfolio of stocks, meaning that if the price of one of these stocks should move significantly, this may have a notable effect on the value of that portfolio.