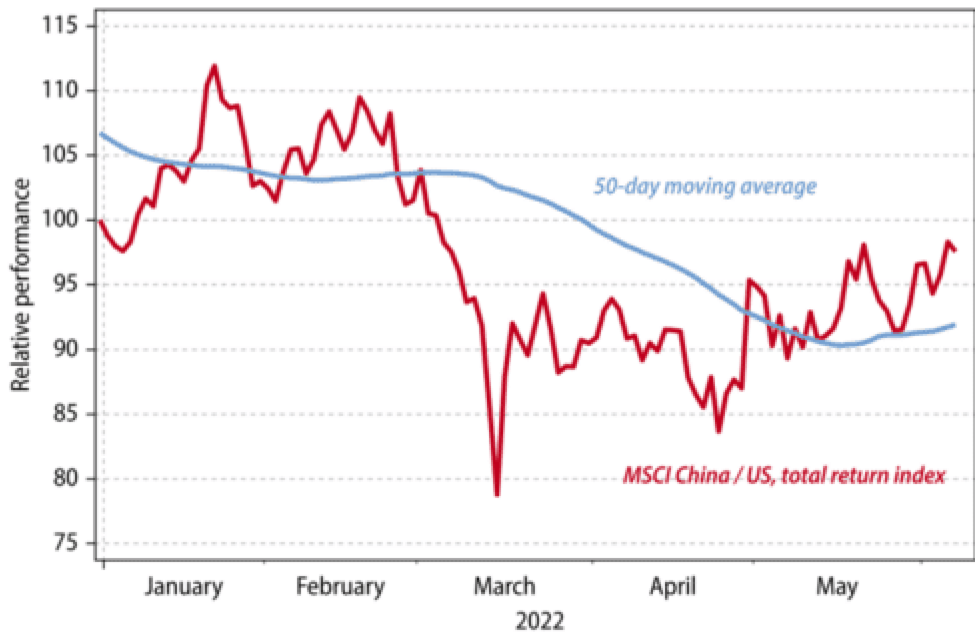
Looking For Silver Linings

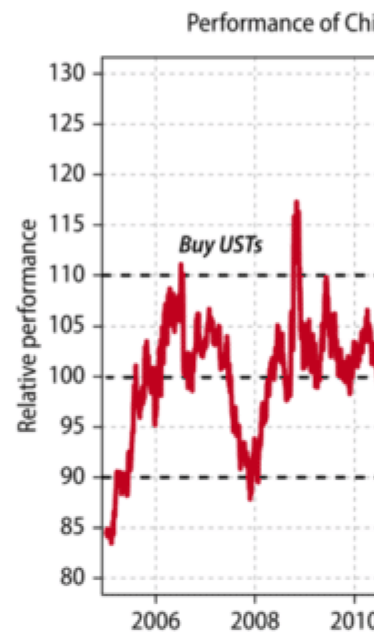
By Louis-Vincent Gave

As the Cambridge economist Arthur Cecil Pigou once noted, “the era of optimism dies in the crisis, but in dying it gives birth to an era of pessimism.” This could describe most investors’ pivot on China over the past few years. The prevalent view for a decade was that China was set to take over the world, guided by infallible policymakers. Today, many investors are taking the opposite view. Between China’s tech crackdown, President Xi Jinping’s focus on “common prosperity”, interminable Covid lockdowns and heightened tensions over Taiwan, the general perception has shifted to a widespread
belief that China is now “uninvestable.”

Interestingly however, Chinese equities have managed to claw back some losses over the past two months despite these negative headlines, while the Chinese government bond market has remained a bright spot in an otherwise grim global landscape (see charts overleaf). If China is about to invade Taiwan, it seems that the CGB market did not get the memo. Rather than be uninvestible, could China, in fact, lead the way out of today’s bearish global environment? And if so, what could serve as a catalyst for such a rally?

- **Catalyst #1: China winds down its Covid lockdown strategy.** In a recent piece, my colleagues Ernan Cui and Andrew Batson argued that supply chain disruptions should ease significantly as Shanghai emerges from lockdown. Arguably, policymakers may choose to go further with reopening measures. First, Covid tends to be less transmissiblein the summer. Second, the economic damage caused by lockdowns has seen an unusual airing of separate views, with Xi and premier Li Keqiang reportedly disagreeing over the issue of lockdowns. Third, the Communist Party will be hosting its 20th Party Congressthis fall, a major event in which Xi is expected to be given an unprecedented third term.The tonal dissonance between such pageantry and ongoing lockdowns would drawunflattering comparisons between Xi and embattled UK prime minister Boris Johnson.
- **Catalyst #2: China moves on from "common prosperity."** Over the past year, Xi's common prosperity slogan seems to have been dropped from his speeches. Typically, a new campaign is accompanied by a raft of policies; for example, former top leader Hu Jintao's "Go West" campaign to spur development in China's western provinces produced major infrastructure plans and tax breaks for companies who moved out west. Common prosperity, however, seems to have been a buzzword with relatively few accompanying measures—aside from the obvious shakedown of China's tech barons. Which brings us to the third potential catalyst.
- **Catalyst #3: China attempts to support equities.** The recent announcement by Alibaba that it would proceed with the biggest share-buyback in Chinese corporate history is perhaps a sign that China has finished shaking down its tech barons—at least for now—and wants to put a floor under equity prices. Top-level rhetoric seems to besoftening on internet companies, a boon for the embattled sector and Chinese equities ingeneral.
- **Catalyst #4: Chinese easing kicks into higher gear.** Policymakers are clearly trying to get the Chinese economy back on its feet. The current easing measures could be the government combating a greater-than-expected economic slowdown, or it could be trying to kick-start a "feel-good" atmosphere before the Party congress. Either way, China's fiscal and monetary policies are likely to be a tailwind for markets.





All the above illustrates the extent to which Chinese markets remain dependent on policy choices—and, by extension, how important the upcoming Party Congress will prove to be for the long-term health of Chinese capital markets, particularly equities. This can be frustrating, as outside the Vatican there are few bureaucracies as obscure as the Chinese politburo. Still, one can likely envisage two opposite outcomes at the 20th Party Congress. The first is that Xi consolidates his long-term authority over China, with no clear successor in view. The market would likely be non-plussed by such an outcome: after all, a further concentration of political power would increase China's political risks, both domestic and international. The second scenario is that Xi is given his third term but must also contend with a clearly designated successor. The market would likely cheer this outcome, as it would be portrayed as the victory of the Party's internal checks and balances over Xi's one-man rule.

There is no clarity as to which scenario might unfold. However, should the coming months see China turning its back on lockdowns, one-man rule and tech crackdowns, choosing instead to stimulate its domestic economy while also benefiting from increased commodity trade with Russia, then a lot of a conditions would have come together to push Chinese equity markets—and optimism on the broader emerging market space—much higher.

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