ARA Asset Management

Research Paper

Invest in China
live with the noise, act on the fundamental

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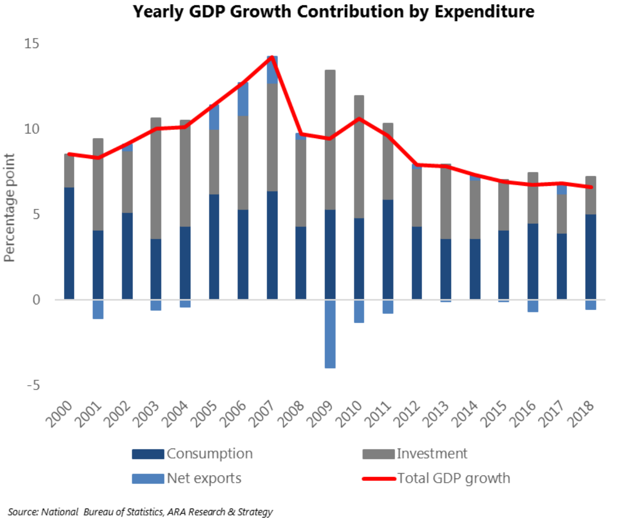
Executive Summary

- Amidst the US-China trade disputes lies a concern of the impact a slower domestic growth has on the “Invest in China” strategy.
- Given China’s centralised state power and President Xi Jinping’s (“Xi”, thereafter) unlimited presidential terms, the central government’s policy plays a predominant role in steering China’s economic development.
- A raft of growth policies has been announced and implemented at several high-level political meetings since 2H2018, aiming to defy domestic weakness and support growth momentum.
- In our view, these growth policies would boost China’s economic growth in the short-to-medium term and could impact China’s real estate markets positively.

Slower domestic growth poses a bigger risk

- The US-China trade disputes have caused tremendous economic woes and financial market turmoil since March 2018, dampening market sentiment and business investment.
- Aside from some progress made in the trade dialog[1] between US and China, differences remain over structural issues particularly the former's concern over forced technology transfer and protection of intellectual property rights. Arguably this US-China dispute is set to continue in other areas such as technology and diplomacy[2].
- As a deal to end the year-long US-China trade tensions seems probable[3], investors are increasingly adopting a business-as-usual stance, looking beyond the external uncertainties, focusing instead on China's long-term domestic growth potential – the essence of any Invest-in-China strategy.
- According to a survey of fund managers by Bank of America Merrill Lynch conducted in March 2019[4] , about one-third of investors ranked slower domestic growth in China as their biggest worry for the first time in almost two years, replacing concerns over a trade war and corporate credit crunch. Indeed, China's GDP growth slowed to the 28-year low of 6.6% in 2018 amid economic rebalancing, whereas domestic consumption has overtaken export and investment as the most significant GDP growth contributor.

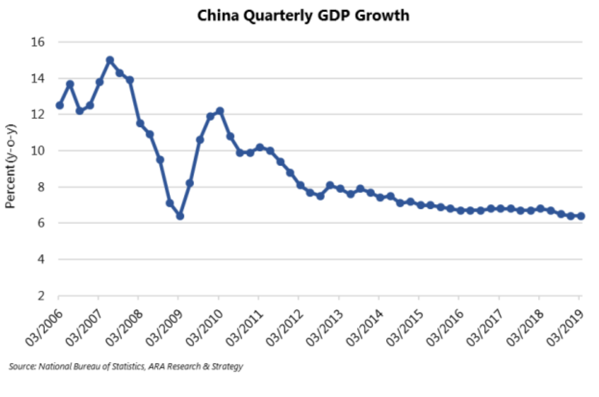


Source: National Bureau of Statistics, ARA Research & Strategy

[1]Mainly on China's promise to buy more American products.
[2]For example, 5G technology, the Belt and Road initiative.
[3]Reportedly, the trade talks may have reached a tipping point: if compromises on some structural issues are made, a (partial) deal remains visible as both countries are keen for a soft landing, with Xi battling China's domestic slowdown and President Donald Trump underway to run for the 2020 US presidential election.
[4] Bob Pisani. "This survey of global investors is useful because it often pays to do the opposite of the crowd." *CNBC, Trader Talk,* 19 March 2019, https://www.cnbc.com/2019/03/19/merrills-survey-of-global-investors-is-useful-because-it-often-pays-to-do-the-opposite.html

Slower domestic growth poses a bigger risk

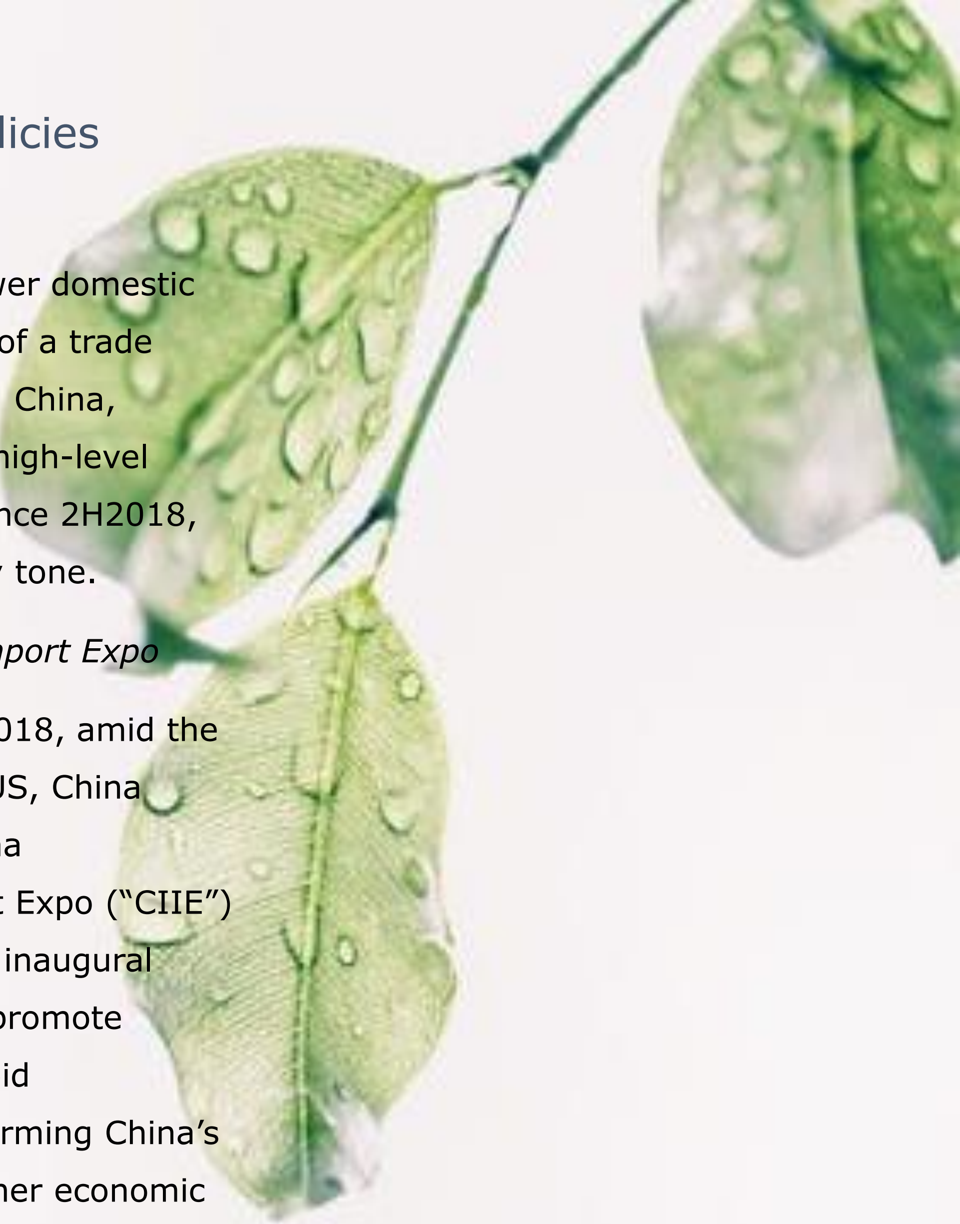
- To weather economic headwinds and stabilise domestic growth momentum, China has rolled out a raft of pro-growth policies since 2H2018, with a significant focus on fiscal easing and further opening-up of the economy.
- Reportedly, the Chinese economy has held steady in recent months, expanding 6.4% y-o-y during 1Q2019, similar to that in the previous quarter. In March 2019, the Caixin Composite Purchasing Manager Index hit a nine-month high of 52.9, suggesting a broad-based improvement in business conditions. Exports also showed signs of recovery rising 14.2% y-o-y, in contrast with the 20.7% y-o-y slump in February.
- In the April 2019 release of the World Economic Outlook, the International Monetary Fund upgraded the 2019 GDP growth outlook for China to 6.3%, up 0.1 percentage point from the January's projection, citing the combined effects of positive progress with the US-China trade talks and support from China's fiscal policy.
- Nonetheless, China is forecast to expand at 6.1% in 2020, down marginally from January's estimate of 6.2%, as the structural reform towards a consumption and services-based economy battles the lingering external challenges.



Slower domestic growth poses a bigger risk

- A socialist market economy with uniquely Chinese characteristics, the central government in China has long been playing a predominant role in steering the country's national policies, including economic development[5].
- What's more, Xi's unlimited presidency enshrined in the country's constitution during the 19th Communist Party Congress has not only tightened his grip on the domestic economy and politics but also strengthened the enforcement of the central government's policy.
- Against this backdrop, the pro-growth policies implemented over the last six months should support China's domestic growth momentum.

[5]In the wake of the 2008 Global Financial Crisis triggered by the sub-prime loan defaults in the US banking system, the Chinese government has decisively rolled out an unprecedented stimulus package, which not only strike for a speedy domestic recovery but also benefit other economies with strong export dependence on China such as Australia.



Major Growth Policies

- In a bid to curb slower domestic growth in the wake of a trade dispute with the US, China, throughout several high-level political meetings since 2H2018, has eased the policy tone.

China International Import Expo

- On 5th November 2018, amid the trade war with the US, China hosted the first China International Import Expo ("CIIE") in Shanghai. At this inaugural event, Xi vowed to promote cooperation and avoid protectionism, reaffirming China's commitment to further economic liberalisation. Separately, at the Central Economic Work Conference ("CEWC") held on 21st December 2018, Chinese policymakers who had gathered to chart the economy for 2019, committed to large-scale fiscal easing and further liberalisation as ways to arrest the domestic slowdown.

Major Growth Policies

Two Sessions - Lianghui

- The annual sessions of the National People's Congress ("NPC", the legislature) and the Chinese People's Political Consultative Conference (an advisory body), jointly known as the "Two Sessions" or "Lianghui" (两会), took place in Beijing between 3rd-15th March 2019. After a challenging 2018, the 2019 Lianghui was held amidst expectations of a stronger pro-growth policy stimulus and a possible US-China trade agreement. In the Government Work Report ("GWR") released by Premier Li Keqiang ("Li" thereafter), the overall policy tone has further loosened, with counter-cyclical easing set to move into full swing to stabilise domestic economic growth. Nonetheless, China's 2019 GDP growth target was softened from last year's "around 6.5%" to "between 6% and 6.5%", reflecting the policymakers' bid to manage the double drag - the slowing external growth, and the domestic need for higher-quality development (i.e. lower growth).
- More importantly, the 2019 GWR was geared towards manufacturing sectors and private small- and medium-sized enterprises. Constrained by China's massive debt burdens[6] and to contain potential financial risks, monetary easing was quite modest. Li has also suggested that growth in total social financing[7] shouldn't exceed the growth rate of nominal GDP. The GWR further highlighted the need for adequate liquidity as well to mitigate corporate financing pressures[8].

[6]Orange Wang. "China's central bank suggest it will stem flood of money into economy." *South China Morning Post*, 17 April 2019, https://www.scmp.com/economy/china-economy/article/3006404/chinas-central-bank-suggests-it-will-stem-flood-money-economy?utm_source=ExactTarget&utm_medium=Email&utm_term=5228851&utm_content=7240240&utm_campaign=Savills%20China%20Daily%20News%20Highlights%20%2817%20April,%202019%29

[7]It is a widely-used gauge of aggregate financing in China

[8]The mitigation is likely to be in the form of a cut in bank reserve requirement or a longer-term credit provision.

Major Growth Policies

- In contrast, this year's GWR is primarily focused on expansionary fiscal easing and further economic liberalisation to support domestic growth momentum. On the fiscal front, the central government has reportedly increased the official fiscal deficit to 2.8% of GDP, up by 0.2 percentage points in 2018, as it introduced a CNY2.0 trillion worth of fiscal stimulus package featuring lower value-add corporate tax rate and social pension contribution ratio by the employer:
    - Value-Add Tax ("VAT") rate cut: effective from 1st Apr, China has cut the VAT rate from 16% to 13% for manufacturing and from 10% to 9% for transportation and construction and other sectors, as well as kept the VAT rate for services unchanged at 6%, translating into a CNY 700-800 billion tax cut.
- Lower social pension contribution ratio for employers: effective from 1st May, the ratio will be reduced to 16% across the country (versus 18-20% currently in major cities), with no change in existing social pension collection[9].

[9]It is estimated the actual corporate contribution ratio to social insurance (including pensions and insurance for medical, unemployment, injury and fertility) is merely 20%, significantly lower than the mandatory ratio of 30%.

Major Growth Policies

Foreign Investment Law

- As far as economic liberalisation is concerned, the Foreign Investment Law ("the Law" thereafter)[10] that was passed at the 2019 NPC markedly echoed Li's pledge of the further opening-up to foreign investment. Foreign investment has substantially contributed to China's growth miracle over the last three decades. It is reported that the number of foreign-invested companies reached 950,000, equivalent to more than USD2.1 trillion worth of registered capital as of Oct 2018[11].
- With effect from 1st January 2020, the Law will be dedicated to tackling long-standing issues in the foreign business environment, accelerating China's economic reforms, and addressing structural problems central to US-China trade talks. Under the Law, not only will foreign companies registered in China be treated equally as Chinese counterparts, but also the Chinese government is prohibited from using administrative power to force technology transfer and hinder the repatriation of investment returns by foreign companies.
- Following the opening of 2019 Boao Forum of Asia on 28th March, Li reaffirmed that the Chinese government would establish supporting regulations and revise or cancel rules inconsistent with the Law. China would expand market access for foreign investors in banking, securities, and insurance industries, as well as other service sectors such as medical care and education. Besides, Li also promised to continue to shorten the "negative list" for foreign investment access by the end of June 2019 and to revise the Patent Law to improve intellectual property protection.

[10]The prime minister also said that the Shanghai Free Trade Zone, where market reforms were often piloted, would be further expanded in 2019, with details to be provided alongside the year.
[11]Deborah Healey and Lu Wang. "China's proposed law on foreign investment." *Asia & the Pacific Policy Society*, 4 March 2019, https://www.policyforum.net/chinas-proposed-law-on-foreign-investment/

Real Estate Markets: Implications of Growth Policies

- Overall, we think these growth policies, mainly fiscal easing and further economic liberalisation, will likely impact China real estate markets positively.
- Firstly, the reduced VAT rate and social pension contribution ratio by employers would lighten corporate financial burdens and boost business activity, in turn bolstering corporate profit and stabilising labour markets.
- For export-oriented manufacturing firms weighed by external weakness, tax concessions should not only lift business sentiment but also encourage capital expenditure. As such, should manufacturing firms raise production capacity and output as the external environment improves, demand for factory and warehousing space should rise accordingly.
- Additionally, manufacturing firms may also increase their footprint in business parks and/or decentralised offices as they expand their business operation.

Real Estate Markets: Implications of Growth Policies

- Secondly, the foreign investment law will level the playing field for international companies and support the further development of the economy.
- With the phased relaxation of rules limiting foreign investors' ownership of Chinese financial institutions, the China Securities Regulatory Commission has granted approvals for the set-up of majority-owned foreign brokerage joint ventures[12].
- Demand for CBD office spaces should strengthen as more foreign financial institutions, drawn by China's enlarged market, move into more established financial centres such as Shanghai or Beijing.
- Key hub cities within the Greater Bay Area such as Shenzhen and Guangzhou should benefit too, as these cities have been at the forefront of China's reform and "opening-up" campaign. They are equally well positioned to capitalise on this increasingly conducive foreign investment environment.

[12]For example, J.P.Morgan, Nomura, and UBS. Credit Suisse are reportedly in the process of applying for regulatory approval.

Real Estate Markets: Implications of Growth Policies

- Lastly, other select pro-growth policy measures announced at recent high-level political meetings should shed some light on the long-term prospect of alternative property investment as well:
  - China's call on the private sector to run senior and childcare institutions during the 2019 NPC has laid a favourable foundation to invest in hospitals, senior housing, and child/infant-care centre leveraging on secular demographic trends in China.
  - China's persistent ambition to crown global 5G telecom networks reaffirmed during the 2019 NPC, coupled with its improved digital infrastructure and cybersecurity, has favoured data centre as a promising asset class.
  - As the domestic credit crunch continues amid a restrained monetary easing, private real estate debt is likely to gain accelerated traction particularly among offshore investors who used to underbid their Chinese peers for direct property investments.
- To achieve an environment-friendly economic development put forward at the 13th five-year plan, China has further lifted its pollution reduction target during the 2019 NPC[13]. The elevated environmental regulations[14] are likely to fuel occupier and investor demand for green buildings in select city clusters, e.g., the Beijing-Tianjin-Hebei and the Yangtze River Delta under closer regulatory scrutiny and stricter policy enforcement.

[13]China plans to reduce sulphur dioxide and nitrogen oxide emissions by 3% in 2019, while making a continuous effort to decrease the density of PM 2.5, a major particulate pollutant
[14]The built environment is reported to account for a huge amount of CO2 emission and energy consumption globally, thus being a fundamental force to address the urban pollution issue.

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