

China Journal, musings from a small cap investor

12/12/19 | Nick Guidera, Analyst at Eley Griffiths Group

A trip to China can yield many outcomes for an investor. The sheer land mass and multitude of micro economies can make it difficult to ascertain whether a Hebei steel mill's bullish outlook lines up with the local property developer in Chongqing. Having travelled to China for the best part of a decade it can be easy to construct a trip to reaffirm biases - positive or negative. Any conclusions drawn need to be viewed in the context of the sample size, however the more regular you visit, it becomes easier to monitor the rate of change.

The team at EGG make a point of visiting China every 6 months or so. The stimulus cycles of the late 2000s and in recent years have shortened, challenging the ability to pick inflection points in certain sectors and hastening the need to monitor data more closely. Despite our investment universe being limited to Australian & New Zealand small caps at this juncture, we find ignoring the China macro (Policy, Liquidity, Commodities, FX) and micro (Infant Formula, EVs, Steel demand, etc) can lead to missed investment opportunities.

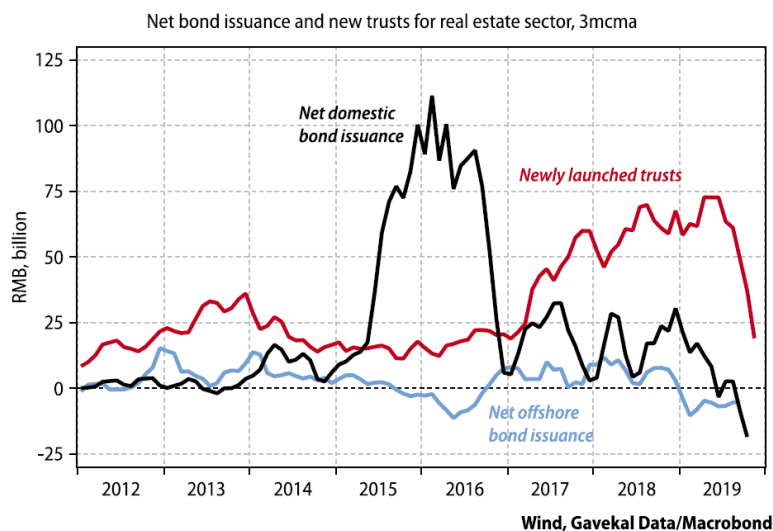
Touring Inner Mongolia in late 2012 and seeing the set up for met coal's rise to \$US250/t or meeting Alibaba in Hangzhou in Jan 2016 to learn about the very bright future of A2 Milk are just a few of the examples of where attempting to understand the China market can be very lucrative. Going beyond the annual report ensures our assumptions that we build into our investment process, are well researched and ultimately lead to better investment decisions.

China is set to get worse before it gets better

The rhetoric for the past two years has been deleveraging and a focus on the environment. This impetus appears to have waned as the economic outlook has deteriorated. Going forward financial stability and full employment appear to be the key objectives. For the China bears this will create cause for concern in the medium term.

Our most recent trip to China in early November came at a particularly crucial time. China's economic data had begun to slow meaningfully, albeit much of it had been orchestrated on the back of reduced liquidity, a significant reduction in shadow financing and the curbing of property speculation.

The crackdown on bond sales and shadow finance is aggressive



Credit growth, EV sales and property sales have all disappointed in recent months. The motivation for a deal between the US & China on trade seemed necessary at the time with both parties apparently 'needing' a deal for different reasons - Trump's 2020 re-election campaign and China's deteriorating economic outlook.

What surprised me was the clarity of message from those we met with, most were convinced China is set to get worse before it gets better particularly over the next 3 months.

2020 should be a lot better

There are several reasons why 2020 should be a lot better with Fiscal policy set to take the lead ahead of further monetary measures.

The Chinese Government in some-ways has created a rod for its own back for itself in 2020 with several targets set in the 13th 5yr plan meant to be achieved by the end of 2020 (the last year of the 5yr plan). In addition, the Government has also set a target to double the size of the economy by 2020. For that to happen GDP needs to run at ~6-6.1% through 2020. Based on the current economic trajectory the only way this can happen is through enhanced liquidity measures. Special Purpose Government Bonds – look to be one of the liquidity tools in focus and should provide necessary funds to drive growth in infrastructure. There is talk of further support for the property market if conditions deteriorate and sales volumes were to trend significantly negative (~-5%) in 2020, but there is also reluctance given the affordability crisis created by the last loosening efforts in 2016.

A trade deal consensus - cause for concern?

Coupled with plans to loosen liquidity, a 'Phase 1' trade deal was consensus, to the point it was somewhat uncomfortable. At the time the messaging from the US administration was also that of confidence, and here we are 5 weeks later and the December 15 tariffs are quickly approaching, and doubt has re-emerged as to whether a deal can be done. Should these be invoked they will ultimately hurt the consumer on both sides of the Pacific. There was little consensus in China that any tariffs would be rolled back, and as yet we have no concession from the US.

Therefore a 'Phase 1' deal maybe symbolic and drive some confidence, but further work may be required to ensure tariffs are paused and ultimately rolled back – potentially 'Phase 2'. Ultimately ongoing trade disputes look increasingly likely to be a feature well beyond the 2020 US election, as enforcement of any deal will be a stumbling block.

Stimulus + a trade deal = good news for markets

For Australian small cap investors, the minutiae of what a trade deal looks like is unlikely to drive individual stock performance, however should we get Stimulus + a Trade deal, it could well be very positive for markets, confidence and investment over the next 6mnths. The cycling of the shadow financing withdrawal will ensure a key drag from credit growth begins to fade. In addition, further beneficiaries include:

1. Autos - as consumption rebounds and the base is cycled
2. Manufacturing - certainty on trade should drive investment for the first time since 2012 (PMI ticked +ve on Dec 1st, for the first time since April 2019)
3. Infrastructure related construction (local governments look to stimulate).

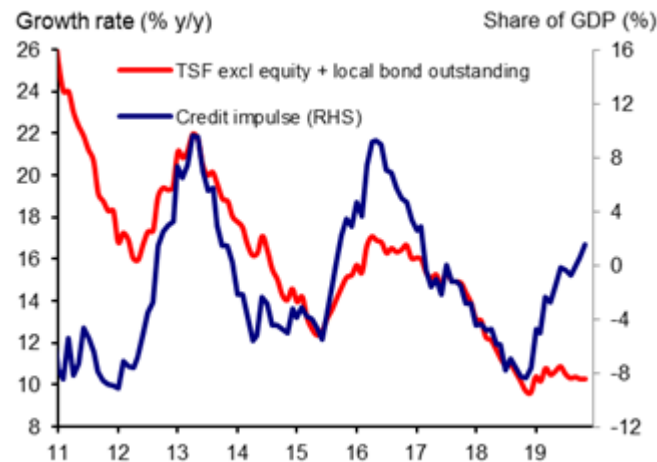
The read through for Australian Investors

A multitude of Australian & New Zealand small cap stocks from resources, energy, consumer and industrials have end market exposure to China. **Champion Iron, Galaxy Resources, Blackmores, Synlait, Graincorp** to name a few. Should the outlook for the Chinese economy improve in 2020 as tipped by those economists, policy and credit experts and end market consumers, many of these names are well placed to do well.

Liquidity is Challenging but improving

Stimulus cannot be achieved without improving liquidity and the key takeaway being it has begun. SME's have struggled to lend from banks as the shadow financing system was a victim of the most recent deleveraging campaign. The government has new tools in its wheelhouse including the recent reforms of the loan prime rate - designed to increase liquidity without cutting official interest rates, and 3 trillion RMB of Special Purpose Government Bonds to fund infrastructure spending.

Overall credit growth likely stabilized in Nov



Source: CEIC, UBS estimates. Aug 2019 data are UBS forecast.

For Australian investors, improving liquidity should drive confidence for a renewed investment cycle in China. Whether it's Chinese steel mills restocking iron ore or Chinese consumers feeling more confident about their hip pocket driving consumption of Australian goods, Australian companies with export demand from China should benefit.

Property slowing down but starts still +ve

The real estate agencies and consultants we met with were surprised at the resilience to August, since then less liquidity to land-owners, has slowed land purchases, and sales volumes have also slowed. Pricing has been relatively stable, and inventory is yet to build, so there is little motivation to change policy settings as yet. Over our trip we had heard that some easing had begun, and should things get too bad, easing programs will re-emerge, as the property sector is the back-bone of the economy.

Property sales in 30 major cities slowed to -6% y/y in Nov



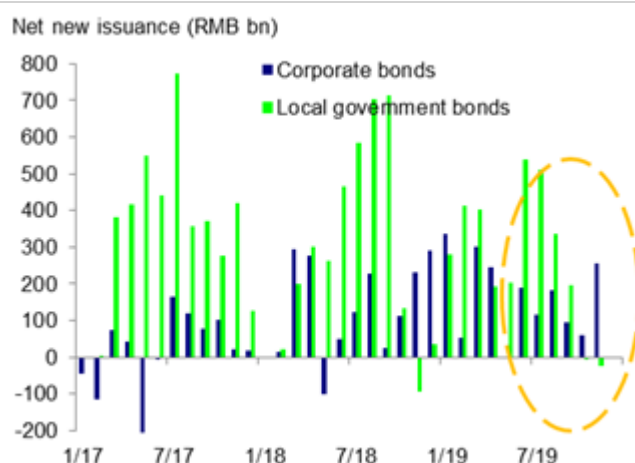
Source: CEIC, Wind, UBS estimates

For Australia the outlook for China Property is one of the key drivers for steel demand and consumption. Official Chinese figures say we have seen 8% growth in steel demand this year, largely driven by property starts. While there is some conjecture over whether the incremental production is actually being consumed, there is confidence we will see positive steel demand growth in 2020 albeit not at the same rate of 2019 which should see Iron Ore pricing supported.

Infrastructure the great white hope

Despite the Chinese governments best efforts to stimulate the economy through infrastructure projects in 2019, the local governments have been reluctant to spend. Whether it was bottlenecks, lack of backable projects or fear of further indebtedness the message was clear that 2020 needs to be a better outcome.

Net new issuance of corporate bonds jumped and no issuance of new LG bonds in Nov



Source: CEIC, Wind, UBS estimates.

As noted above liquidity instruments should alleviate the financial burden to construct and the beneficiaries of new toll roads, subways and specialist projects are likely to be Australia's commodity exports. Steel demand is a clear beneficiary - therefore iron ore and coking coal are clear standouts.

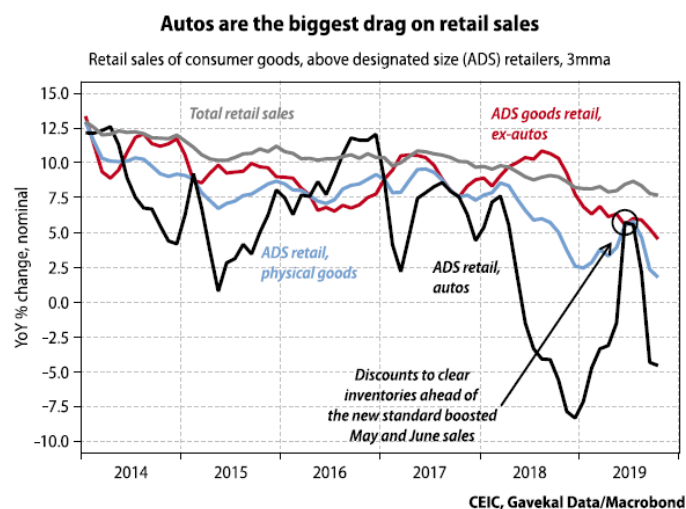
Copper while not a direct beneficiary of new infrastructure should benefit from improving liquidity and increased investment in manufacturing capacity as well as a key benefactor of the sentiment trade.

Downstream consolidation required to drive improvement in EV

Much has been written on weakness in China's auto demand, with EVs finally feeling the brunt as comp growth went negative in September as the full effect of reduced subsidies was felt by dealers. Research house Gavekal estimates the deep downturn in auto sales accounts for about half of the slowdown in GDP

growth since 2018. While it's too early to call a recovery our meetings in China pointed to declines in sales moderating and the growth drag coming towards an end.

The market for EVs looks incredibly tough near term with limited incentives for manufacturers to chase longer range vehicles and consumers yet to stomach the price differential between ICE and EVs although Hybrids are getting very close. While quotas on ICE to EV production will keep the market stable, the lofty growth is unlikely to return without renewed subsidies or cost competitiveness. With too many brands there is a need to see significant rationalization before support for the industry returns.



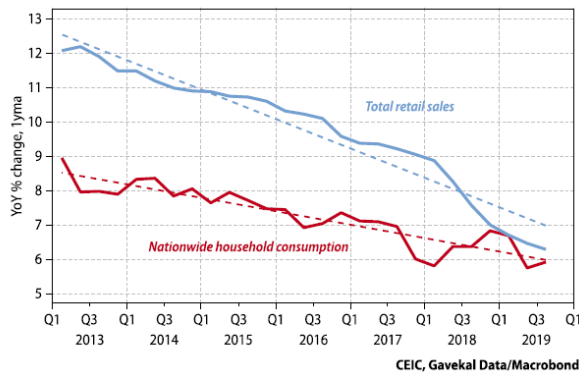
For battery materials it's tough going, however close to peak bearishness. With downside risk to Lithium Carbonate & Hydroxide pricing and 12mnths worth of inventory to be consumed, its not easy. We would be looking for consolidation further downstream as a sign that raw material prices are due to begin a recovery.

Fiscal austerity creeping into the consumer

Consumer demand has slowed on lack of confidence in employment, and higher indebtedness. Larger scale capital purchases have been halted (hence autos), but if you sell what the China consumer wants you will be in luck. For now the Chinese consumer appears to be more discerning, have a greater trust in domestic brands than they once did and are changing the way they consume.

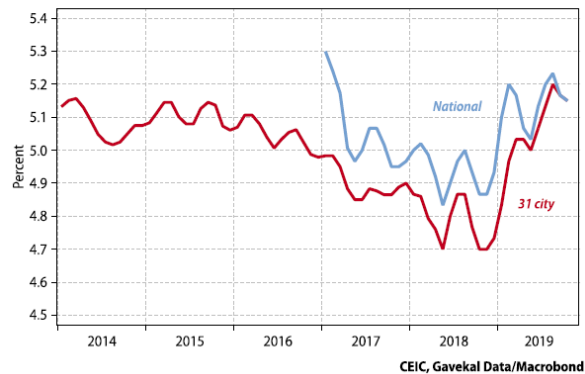
Consumer spending is still on a steadily slowing trend

Real growth in the two main measures of consumer spending, with linear trend



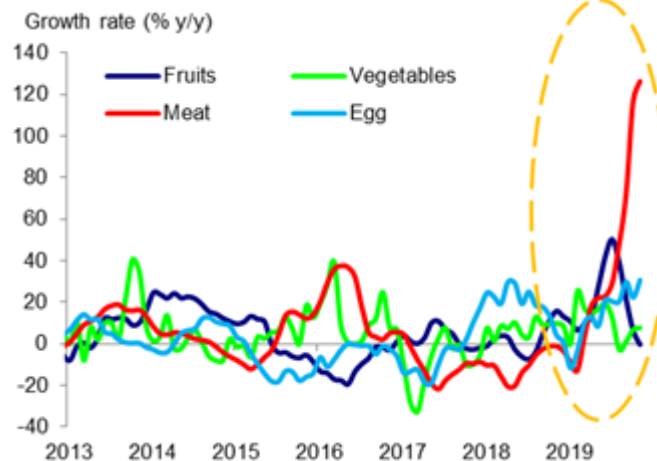
China's official jobless rate has picked up in 2019

Survey-based unemployment rates, 3m cma



The African swine flu has wiped out a significant proportion of the Chinese Pig population, and has been the key driver behind rampant food inflation. This has limited the ability of the government to use typical monetary policy methods to drive improving liquidity.

Pork price rose by another 5%/m (130%/y), in Nov



Source: CEIC, Wind, UBS estimates

As for the Australian read through, NZ & Australia made baby nutrition, supplements and food continue to resonate with consumers. The growth rates of the middle of this decade may have faded but are still credible. As the likes of A2 Milk have pointed out, it costs more and takes longer to grow distribution the traditional way in China, and should other Australian brands reach the share and recognition which they have, they could expect a similar challenge. Niche products such as goat infant formula and ambient yoghurt appear to be the next hero's, but time will tell how long the fad will last.

Monitor the data closely

With any China tour, the takeaways are endless. In summary a better China outlook in 2020 albeit artificially supported coupled with a cease fire in global trade disputes could create a reasonably positive set up for markets, cyclically exposed sectors and pending the supply demand dynamic, specific commodities. Making a great rotation at this point appears premature but we believe a close monitoring of data points over next few months will prove prudent for future portfolio construction.

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