October 25th, 2022

Is China investable or uninvestable?

We make the case for China

We might be in front of a generational buying opportunity for Chinese equities.

Howard Marks coined the terms ''first level thinking'' and ''second level thinking''. According to Marks, "*first level thinking is simplistic and superficial, and just about everyone can do it* (a bad sign for anything involving an attempt at superiority). *Second level thinking is deep, complex and convoluted*."

As an example, first level thinking might say that China is largely uninvestable because it is ruled by the communist party which is not pro-business. They cite examples of what the party did to Alibaba's Jack Ma, to Didi, to the education sector, to Ant Group and so on to make the point that China is not investable. They would also cite lack of transparency and regulations as reasons for not to invest. This is what on the face of it, a casual observer would conclude.

Analysing things further and digging deeper, one would sight the following as second level thinking to make the case that China is indeed investable:

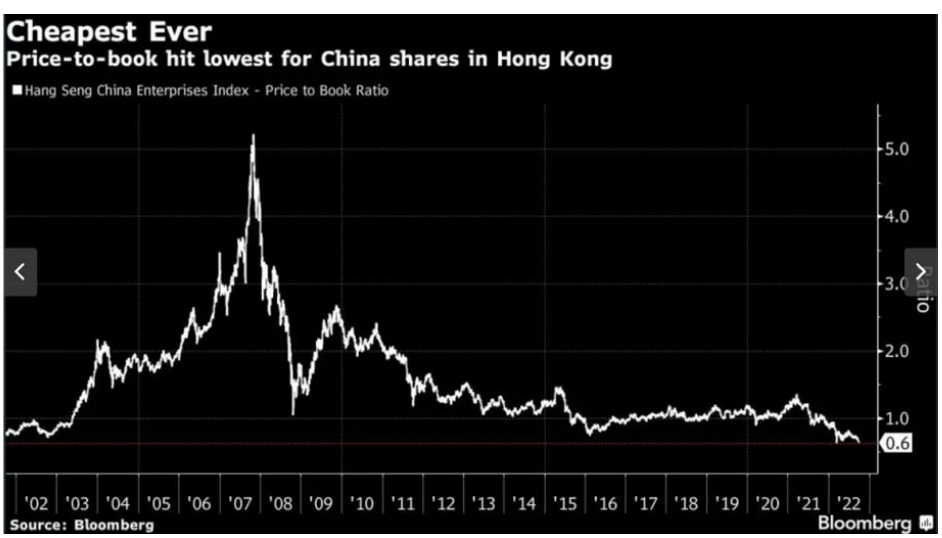
- During Berkshire Hathaway's annual shareholder meeting in 2021, Buffett put a chart of the top 20 companies around the world by market capitalization. 3 out of the 20 were Chinese; Alibaba, Tencent and Kweichou Moutai. 20 years earlier China had no company in the top 20. The Chinese and the Americans are strategic competitors and these three companies are national champions. The Chinese are smart and strategic and are legendary in taking a long-term view. In the century up to 1949, China had been humiliated. It no longer accepts to be humiliated, it wants to be proud. These national champions make it proud. It makes no sense to interfere with them to the extent of decapitating their growth.

- Chinese president Xi Jinping's address to the communist party this weekend emphasized that economic development remains the party's "top priority" despite some analysts thinking that national security will be that. In fact, the party reiterated that China aims to raise its GDP per capita to a middle-developed-country level by 2035, implying an average annual growth of 4.7% between 2021-2035. This would be an unheard-of achievement for an economy the size of China. This doesn't sound like a socialist or a communist goal at all. Furthermore, their goal to lead in technology and work tirelessly to get their own chip manufacturing technology doesn't sound communist to us. And why would they not? Why is it that Europe has Infineon and ASML and the Chinese would not be allowed to have their own technology? They work harder, are as well educated as any, and have the resources.

- According to professor Kishore Mahbubani, the era of the last 200 years where the west has been ruling the world is coming to an end. We are going back to a different world order where China and India from the beginning of history in year 1 to the year 1820 were the 2 most dominant economies in the world. The Chinese know that you don't dominate the world militarily but more importantly economically. According to professor Mahbubani, the Chinese middle class of 120m is the largest in the world. He says 100m people travel a year and all of them come back to China. Beijing now has more billionaires than New York. In fact, president Xi's daughter studied at Harvard and there are over 300,000 Chinese students studying at colleges and universities in the US, including Ivy League universities. Furthermore, China is now a leader in 5G, AI, robotics, etc... Again, all this doesn’t feel like socialism or a market-unfriendly regime.

- Stating the obvious, China is the second largest economy in the world and well on its way to become the largest. In fact, by some measures, China is already the largest in the world. In PPP terms, China surpassed the U.S. in 2014.
- Charlie Munger is a great admirer of the Chinese and has brought the BYD idea to Buffett who invested in it and made a ton of money on it. He owns Alibaba for his company the Daily Journal. Munger says, ''*China has its own system and it works for them and we have our own system and it works for us.*'' Charlie’s point is you can't argue with success. He says there is no example in the history of civilizations of a country that has lifted more than 700m out of poverty in such a short period of time.
- In the last 30 years, the average income of the bottom 50% in China has risen dramatically, while the average income of the bottom 50% in the US has declined. In 1990 there were more than 750m ppl living below the international poverty line (about 2/3 of the population). By 2012, that had fallen to fewer than 90m and by 2016 it had fallen to just 7.2m ppl or 0.5% of the total population.
- China’s economic growth has slowed because it is shifting from one model of economic growth to another model of economic growth, namely from an export-led economy to a consumption-led economy. This takes quite a long time and it has a profound positive implication on China.
- The China Conference has concluded this weekend with the appointment of the 7-member strong politburo all allies of President Xi Jinping. Most analysts are worried that this concentrates power in his own hands and fail to see the other major message: “We will firmly deepen reform and opening up, firmly push forward high-quality development.”

We conclude from the above that one cannot ignore China as a major investment opportunity. We think conventional wisdom is long on convention and short on wisdom. The conventional wisdom is that China is not investable. In our opinion, China is not only investable but also represents a major buying opportunity. First, the valuation of the market is compelling. Chinese-listed equities in Hong Kong trade at 0.6x book:



If you take the valuation of Alibaba and Tencent for instance and compare them to their U.S. counterparts, even accounting for regulatory risk and taking a huge China discount they are still compelling. **Michael Burry who predicted and profited from the 2008-2009 sub-prime crisis and who was immortalized by the movie "The Big Short" thinks investing in China today is like investing in the U.S in 2009 after the crisis. What he is effectively saying is that this is a generational buying opportunity, and we agree. Furthermore, sentiment is even worse than the 2008 global financial crisis. "The market situation currently might be the worst I've even seen in my career.''** said Harris Wan, vice president at iFAST Global Markets.

To state the obvious, the size of the Chinese economy dwarfs almost all others, be it developed or developing. In 2021, their economy surpassed all 27 countries of the European Union which stood at $15.7 trillion. One advantage that China has is the size of its internet population of close to one billion which is more than the US and Europe combined. About 800 million people use mobile payments on a daily basis, that is eight times more than the US, leading the world in fintech. China's tech ambitions are no longer limited to the domestic market either. For example, TikTok, which is owned by the Chinese company ByteDance, now has one billion monthly users, even though the platform is not available in China itself.

As the case of TikTok shows, trends that began in China are beginning to influence trends worldwide. Consequently, it is becoming more important to learn from the Chinese market to inform business models and strategies for global audiences.

Beyond opening an enormous market, investing in China positions international companies to gain experience with innovative products that can make them more innovative and competitive in their home countries. China's spending on research and development is around 2.5% of GDP. This is much higher than other countries at similar development. This spending has contributed to innovative business models in fintech, AI, e-commerce that are world-leading.

Additionally, the real conflict between the U.S and China is that it is the only country in the world that is a real strategic competitor to the U.S. and poses a threat to their world dominance both economically and militarily. The U.S. is really trying to stop or delay the advancement of the Chinese, which is coming, and is only a matter of time. We see this as a co-dependant relationship where both the China and the U.S need each other and will have to learn how to peacefully co-exist together as this is no question mutually beneficial for both. The Chinese market is by far the largest international market for U.S multinationals such as Apple and Nike.

It is also important to note, in the last 40 years China has not attacked anyone and is not really interested in waging wars on nations as some of the conventional wisdom suggests. They are interested in their economic development only. In the end from an investment perspective, once the restrictions on Covid lift permanently, and they will (it is only a matter of time), and as stimulus starts to kick in (China is the only major country in the world stimulating its economy both on the fiscal and monetary side), we believe Chinese stocks will rally and will revalue from their dirt cheap levels.