October 24th, 2022

The Downside to the Fear of Upside

- **Another equity bear market rally in the offing**
- **We prefer not to trade these highly risky rallies given the ongoing challenges**
- **Investors had hoped that Chinese asset markets only had upside risk however…**
- **…its time to ask again, is China becoming uninvestable?**
- **The lurch towards unbridled communist thought does not bode well for capital markets**
- **Those looking to redeploy their cash should probably start with bonds where valuations are much closer to reasonable but still somewhat short of excellent value**

Be wary of bear market rallies

Last week's smart rebound in the US equity market had investors fearing that they could be missing out on another sharp bear market rally. Remember that between mid-June and mid-August, the S&P500 witnessed a 17% rally.

We would counsel investors to focus on the medium-term risks and not try to trade the rallies. Ned Davis Research points out that bear market rallies average around 11.5% over 39 days. With the market already up 5% from its lows, there's still room for a further 6.5% upside – to around the 4000 level. But we are up against different realities now. Between June and August, the market thought the Fed was backing off from an aggressive tightening as inflation moderated somewhat. The US 10-year bond yield fell 100bps to 2.5%. We see little reason to believe that such a helpful bond market background will build in the coming months.

To be fair, a couple of other factors could help the market in the near term:

1. Technically, the market has been quite oversold, with market positioning being heavily negative. According to Bank of America surveys, institutional cash holdings are high, and the long-short managers have maxed out their bear positionings.
2. Aggregate US corporate profits to date have not disappointed. Indeed, according to Bloomberg, US corporate profit forecasts for the current year have risen marginally. Certainly, aggregate economic growth data has come ahead of expectations.

Understandably investors' concerns multiply when they are holding large negative bets on the market and the market rallies against those bets. Too often, what follows is analysts tuning their analysis to the direction of the markets rather than sticking to their conviction. We don't want to belittle the near-term arguments advocating some further upside, but there are reasons to be cautious, in our view.

- If US economic growth retreats further, it can only increase the pressure on the Fed to stick to its guns and tighten further. The US economy MUST build some slack to bring inflation under control.
- We have seen nothing of that sort yet. Monetary tightening has only happened recently—and reluctantly. It is in 2023 that there is a greater risk of disappointment with growth and downgrades to corporate profit forecasts.

China uninvestable?

For some months, global investors have been edgy about the prospects of Chinese equity markets rebounding from their recent malaise. The argument runs that China saved the global economy from the global financial crisis with a huge wave of fiscal easing. So why wouldn't that happen again? Secondly, typically after a Chinese Communist Party Congress, the equity market does well in the subsequent 12-month period as the Chinese authorities relax the purse strings.

China's precipitously weak relative performance has the capacity for a rebound, but this time could be different. On this occasion, we fear that investors in Chinese equities could be disappointed and that they should fear as much the risk of a market downside as much as they have been edgy about the upside.

Chart 1: MSCI China Total Return Relative to MSCI ACWI Index
Rebased to 31/12/1998 rebased =100

Source: Bloomberg

The National Congress of the Chinese Communist Party concluded on unambiguous terms. Chinese President Xi Jinping and his 'philosophy' is now unchallengeable. The very public physical removal of former Premier Hu Jintao from the closing ceremony of the Congress as the cameras were rolling was chilling. Only time will tell whether the removal was because the former premier had a “health problem”, or it was a very visible sign of the reinforcement of Xi's authority. The party, meanwhile, this past week referred to Xi as "core" in its constitution. That is a special term because it takes him ever closer to Mao's status as the "leader". In essence, the party appears to have returned to its dark roots of an omnipotent individual leading the party and the country.

We now struggle to hold onto the hopes that Xi was repositioning China as a hybrid model of restrained capitalism and a reform-minded communist philosophy. We believe the implied messages from the past week's events only reinforce the fear that Xi is taking the Chinese policy back to communism. To be sure, the president spoke of the need for China to be open to the rest of the world. However, his vision of openness does not quite align with that of the West. As the Financial Times commented on October 19th, *"Joe Biden this month launched a full-blown economic war on China – all but committing the US to stopping its rise," adding, "His (Biden's) escalation also marks a final break with decades of US foreign policy that assumed China's global integration would tame its rise as a great power".*

Even before this week's events, investors increasingly asked whether China was gradually becoming uninvestable. We think so. Investors have already been voting with their feet as capital outflows from China have accelerated.

Asia Financial (October 18th) adds context to the happenings. *"Officially, China's national financial accounts, which cover stock and bond markets and direct investment flows, show a net $101 billion was pulled out over the six months to June, putting 2022 on track to record the largest annual such outflows since 2016. Outbound investment under the cross-border Bond Connect, which links mainland China with Hong Kong and global markets, totalled 301.5 billion yuan ($42 billion) at the end of August, up 34% from a month earlier and up 19-fold since March".*

A longer-term thought here. The Ukraine crisis has seen the weaponisation of the dollar and dramatic restrictions on market access. With China almost pivoting back to communism and the sabre-rattling concerning Taiwan, investors need to factor in all likely scenarios that might unfold. One wonders whether MSCI will eventually be asked to look at how it treats Chinese equities in its indices. Similarly, what view will the bond index providers take on the weightage – or inclusion – of Chinese bonds into global indices? If China wants foreign capital, it will need to pander at least in some way to the demands of the western index providers, who, in turn, may come under political pressure to exclude/moderate the weight of Chinese assets in global indices.

Bonds are where you should start

We finish by reiterating our view that bonds will likely be the first asset class that we will add to our holdings as we become more comfortable with market levels in this profound sell-off period. Indeed, we see more bond strategists warming up to the asset class. Global high-yield bond index at a yield of 10.5% and the US high yield at close to 10% are a far cry from the 4-5% yield on offer within the past year. The Bloomberg US investment grade bond index yields 5.4%, sharply up from a one-year low of 1.6%. We worry less about the upside to the bond yields than the downside to the equity markets.

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