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China Market Strategy

What does "Common Prosperity" Mean for China's Stock Market?

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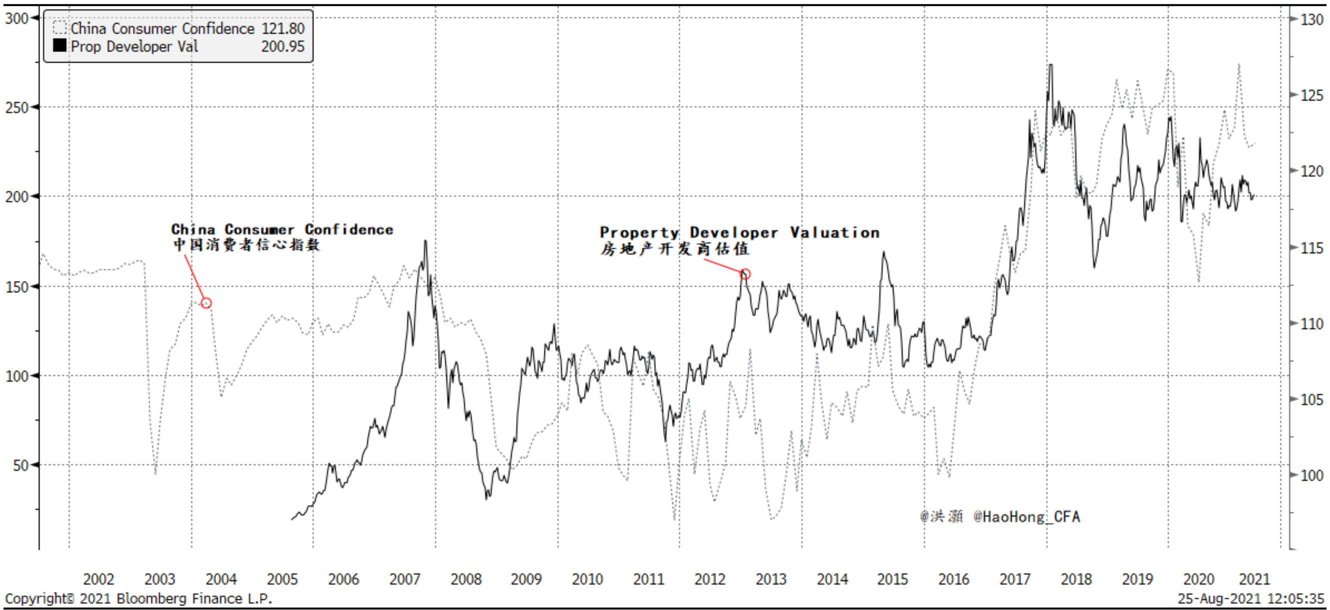
During the early days of China's "Reform and Open", Mr. Deng Xiaoping repeatedly emphasized the term "common prosperity". In December 1990, he was conversing with the comrades working along his side at a meeting. Mr. Deng said: "We have been discussing 'common prosperity' since the inception of 'Reform and Open'. One day in the future it will become a focal topic. Socialism is not about a few people getting rich while the majority stays poor. The foremost advantage of socialism is common prosperity, and it is one of the essences of socialism." (p.207, second volume, *The Governance of China*)

At a recent central meeting, common prosperity was discussed in further details. Transfer payments, tax and charity were all discussed during the meeting. Amid the tightening oversight of the internet platform unicorns, many companies chose to expand their donations to help achieve the goal of common prosperity in the remote and less developed areas. Yet, market gyrations engulfing many of China's biggest tech firms into epic volatility have caused much confusion among investors, leaving some foreign investors heading toward the exit. But we are far less pessimistic, and are confident that the prospects beyond the immediate term have indeed been improving.

As early as in November 2016 and again in November 2017, we had written two in-depth thought pieces about income and wealth inequity, and how the disparity in income and wealth distribution has contributed to insufficient demand and deflation, as well as other social issues that will likely become more glaring in the future (Please refer to "A Price Revolution" on 2016.11.14 and "Decoding Disinflation" on 2017.11.14). Note that 2017 is the year when the "principal social contradiction" was redefined. Since then, the ratio between the top and bottom incomes in China has stabilized, after rising for over a decade. That is, income inequity has indeed stopped worsening since then.

Another way to look at this is to examine the change in China's social confidence, proxied here by consumer confidence, and then compare it with the valuation of property owners and developers (Figure 1).

Figure 1: Social confidence has been rising to an elevated plateau since 2017



Source: Bloomberg, BOCOM Int'l

As we can show, social confidence started to rise in 2017, after a dip in 2016, and remain elevated ever since then. Meanwhile, property owners and developers' valuation, a closely correlated measure, has risen in tandem. Now, both measures are sitting at an elevated level that is visually incomparable to the period prior to 2017. That is, common prosperity promotes social confidence, as seen in data. And since 2017 when the principal social contradiction was redefined, China has started to work toward this goal, not today. It is a progress that has been ongoing for some years, and can be clearly seen in data. The concurrent rise in property owners and developers' valuation can also be viewed as a measure that indicates improving social confidence from working toward "common prosperity".

If so, why is the market suddenly so concerned about "common prosperity"?

We would argue that this term has been misconstrued by foreign investors. As there is more than one "China market" as represented by the US-listed Chinese companies, HK-listed and A-share-listed companies, we can gauge who has gotten the wrong message by simply contrasting the index performance of these different groups of companies.

Figure 2: Diverging performance of different "China market" tech indices

Source: Bloomberg, BOCOM Int'l

In Figure 2, we compare US-listed Chinese internet companies (KWEB US), MSCI China Tech Top 100 Index, MSCI China Index, ChiNext (China's NASDAQ) and NASDAQ Top 100 (NDX). We can see significant divergence in performance between them – the ChiNext and the NASDAQ 100 are at the top and continue to make new highs, while the US-listed ones and MSCI China are underperforming. As the ChiNext is mostly traded by domestic investors, while the US-listed Chinese tech firms are held by many foreign investors, such divergence in their performance suggests that the latest developments in China that augurs well for the country in the long term are somewhat misconstrued by foreign investors. Some even were hasty to declare China "un-investable". Respectfully, we disagree.

We were among the first to point out that tech valuation in February was a bubble, and warned of an impending burst ("Value Strikes Back", 2020.11.20). Now, depending on which index you use, China's tech firms have corrected 50% to well over 60%, and their valuation has become more agreeable. Common prosperity is not to redistribute the existing accumulated wealth involuntarily. It is more about devising a fairer process in which the fruits of economic development can be shared by more Chinese people who have contributed greatly to the revival of China's economic and cultural prominence. And there are many ways to achieve this goal, such as capital gain tax and some other forms of redistribution/transfer payment in the future. The interpretation of foreign investors versus domestic ones, as seen in the diverging performance between the indices held by different groups of investors, corresponds to the different beneficiaries of the changes toward "common prosperity", with domestic investors being the clear winners going forward. No wonder the A-share indices have remained mostly unfazed amid the turmoil in the offshore Chinese stocks.

We believe the Hang Seng has reached an important low after last week's selloff, as seen in Figure 3. While a second, higher low is possible, long-term investors should start thinking about the long term, and deploy capital accordingly.

Figure 3: The Hang Seng has reached an important low after last week's selloff

Source: Bloomberg, BOCOM Int'l

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