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China Musings

10 key debates on, and reasons to buy, China in 2022

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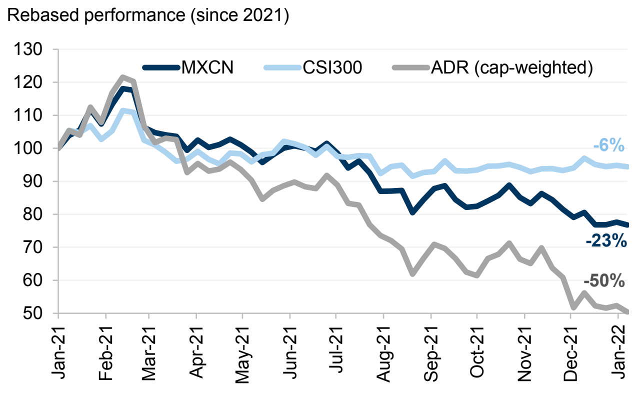
We have held extensive client conversations in the past 6 weeks to discuss the outlook for Chinese stocks in 2022. We summarize the key debates, recent market developments, and our refreshed views to kick-off the new year:

1. **Is China investable?** We'd say Yes, especially for investors whose investable universe goes beyond the ADR market where forced delisting remains a risk.
2. **Slowing GDP growth equals bad returns?** No. Our economists look for 4.8% GDP growth for 2022, the lowest on record outside of crisis years. But empirically, decelerating GDP growth has low correlation with stock returns.
3. **Can equities perform well on subdued profit growth?** Yes, particularly after a "Major" correction and when the equity cycle morphs from "Despair" to "Hope". Our EPSg estimate (7%) is below consensus (13%) for 2022.
4. **What could re-rate equities?** Policy (easing), politics (transition), and regulation (moderation). China is likely to be an outlier globally to loosen policy in 2022, thereby helping compress the high risk premia embedded in valuations.
5. **Is the worst of regulation tightening behind us?** We think Yes, in terms of its intensity, and the risks seem well priced per our indicators. Policy clarity is also improving, notably on issues such as VIE and overseas listing.
6. **Are valuations really attractive?** Yes. Index valuations (12x) are at recent-year lows and at significant discounts to global equities. Forward returns tend to be strong at current PE levels, inline with the results from our macro PE model.
7. **Will the property credit turmoil spoil the party?** Unlikely. Property activities look set to slow significantly but a contagion scenario could be avoided on GS's base case, inline with the latest pricing in asset markets.
8. **Will the zero-Covid policy be relaxed?** Not until late 2022, implying a bumpy recovery path for consumer equities, but trading opportunities elsewhere.
9. **China A or H?** We like both: China A is a big, liquid, growthy but underowned asset class, and we think China H offers compelling tactical upside optionality.
10. **Buy laggards (Internet) or winners (policy beneficiaries)?** Not a binary decision, but Growth and "Common Prosperity" are the key overlays.

1. Is China investable?

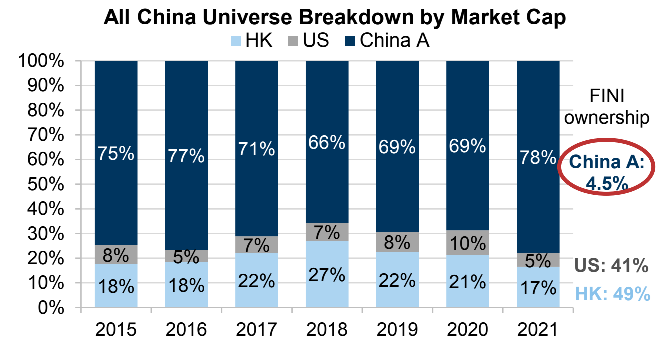
- Unprecedented regulatory tightening targeting the private economy (see our regulation series here) and lingering risks about forced delisting of Chinese ADRs from US exchanges have resulted in the worst ever correction (-50%) in China Internet/Tech stocks last year, with US1.5tn of market cap lost, a significant reduction in positioning across mutual fund (450bps underweight) and hedge fund investors, existential concerns about the ADR market, and questions about the **investability of Chinese assets**.
- While we recognize the difficult investment landscape for Chinese ADRs, we'd be hard pressed to label China as "uninvestable" because:
    a. **ADRs represent only 5% of the US$18tn aggregate market value of Chinese equities,** with close to 80% of the remaining market cap residing in domestic A shares where foreign ownership is merely at 4.5%;
    b. regulatory shifts may have structurally changed the investment logic and the profitability profile for certain sectors (e.g. After School Tutoring), but there are plenty of **listed companies that could benefit from structural policy tailwinds;**
    c. **the regulation cycle may start to improve** in terms of intensity and clarity (see Section 5);
    d. the ADR delisting clock has started ticking after the SEC announced the final rule implementation for HFCAA on Dec 2 but the 3-year transition window should allow more than **70 ADRs to relist in HK** where most US institutional investors can continue to trade these companies if they wish; and
    e. market opening up/reform momentum has remained strong in the domestic A-share market, notably the launch of MSCI China A50 Connect Index futures in HK and the creation of Beijing Stock Exchange late in 2021, arguably making it **more investable/accessible to international investors**, partly reflected by record-high Northbound inflows in 2021 and an overweight allocation in A shares by global mutual funds.
- For 2022, we stay **Overweight Chinese A shares** (upgraded in Feb 2020) and **raised China Offshore to Overweight** (in Nov 2021) from Marketweight**,** forecasting 13% and 30% price returns respectively. See Section 9 for details.

Exhibit 1: Significant divergence among Chinese equity markets in 2021, with A shares staying resilient but ADRs halving in market value



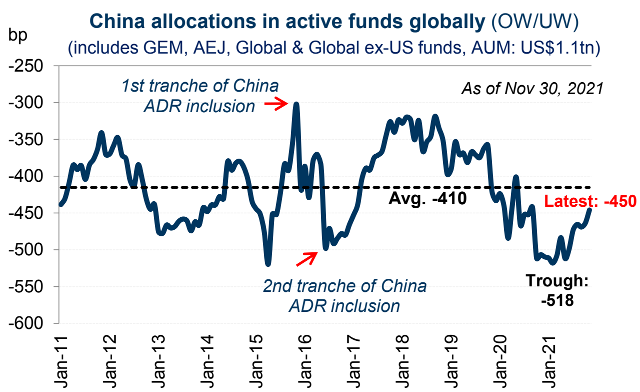
Source: FactSet, MSCI, Wind, Goldman Sachs Global Investment Research

Exhibit 2: ADRs represent only 5% of aggregate Chinese equity market cap



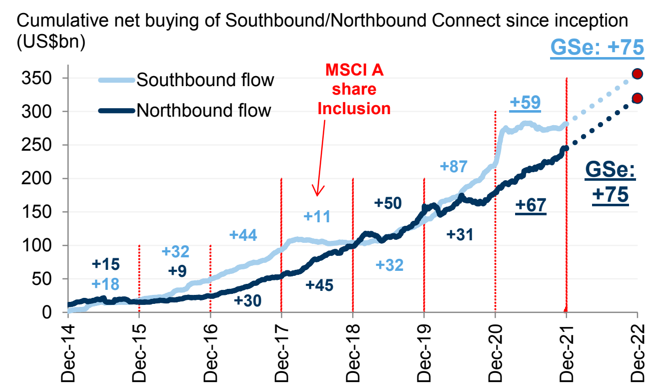
Source: FactSet, Wind, Bloomberg, Goldman Sachs Global Investment Research

Exhibit 3: Regulatory and macro concerns have resulted in significant underweight allocations by investors in Chinese stocks, notably China Offshore



Source: EPFR, MSCI, Goldman Sachs Global Investment Research

Exhibit 4: Northbound net buying reached an all-time high in 2021, reflecting continued interest from international investors in A shares



Source: Wind, Goldman Sachs Global Investment Research

2. Slowing GDP growth equals bad returns?

- **GS economics team calls for 4.8% real GDP growth for 2022**, below Bloomberg Consensus of 5.2% and trend growth for China at 5-5.7% per PBOC's estimate. Their forecast implies a noticeable growth deceleration from 7.8% in 2021 (albeit due to Covid disruptions), and would be the lowest yoy growth on record outside of crisis years over the past 4 decades.
- **The economic headwinds are multi-faceted but well-telegraphed**: a prolonged property market deleveraging, China's zero Covid policy and its drags on consumption (see Section 8), partially normalizing export growth as the world re-opens, elevated upstream inflation that could weigh on corporate profitability, and other structural issues, notably an aging population and high system-wide leverage.
- Despite a challenging macro backdrop, we don't think it there is a valid argument to write off Chinese equities for 2022. In fact, we note **a very weak/inconclusive**

relationship between annual GDP growth (real and nominal) **and equity market returns** on a concurrent basis, suggesting that other macro (e.g. policy, see next section) and micro factors are also influential in framing the risk/reward and driving the performance for Chinese stocks.

Exhibit 5: Our economists expect China to grow 4.8% in 2022, with recovering consumption being the key growth contributor

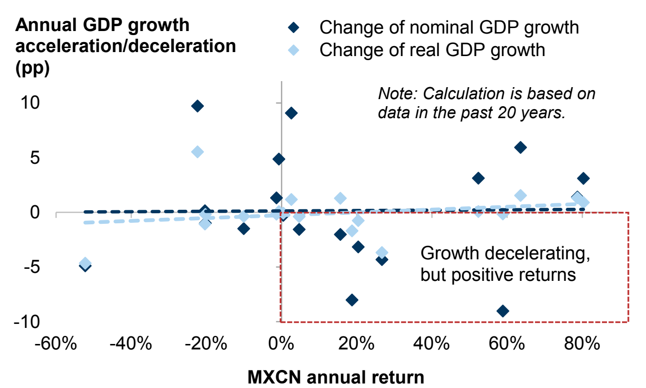
		2019	2020	2021F	2022F
GDP	**% yoy**	**6.0**	**2.3**	**7.8**	**4.8**
Domestic Demand	pp	5.2	1.7	6.8	4.9
Consumption	% yoy	6.2	-0.9	8.3	6.7
Household Consumption	% yoy	6.4	-1.7	11.0	7.0
Gross Capital Formation	% yoy	4.0	5.3	5.3	2.8
Net Exports	pp	0.7	0.7	1.1	-0.1
Exports of Goods (nominal USD)	% yoy	0.5	3.6	28	12
Imports of Goods (nominal USD)	% yoy	-2.7	-0.6	32	14
Inflation					
CPI	% yoy	2.9	2.5	0.9	2.7
Core CPI	% yoy	1.7	0.7	0.9	1.8
PPI	% yoy	-0.5	-1.8	8.2	4.5
Other					
Current Account	% GDP	0.7	1.9	1.7	1.6
USDCNY (eop)	level	6.96	6.53	6.35	6.20
OMO 7-Day Repo Rate	%	2.50	2.20	2.20	2.20
TSF Stock Growth (eop)	%	10.7	13.3	10.5	10.5
Augmented Fiscal Deficit	% GDP	11.8	16.5	11.0	12.0

Source: Goldman Sachs Global Investment Research

Exhibit 6: Market expectation on GDP growth has been trending down

Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 7: Very weak concurrent relationships between annual GDP growth and stock returns



Source: Bloomberg, Goldman Sachs Global Investment Research

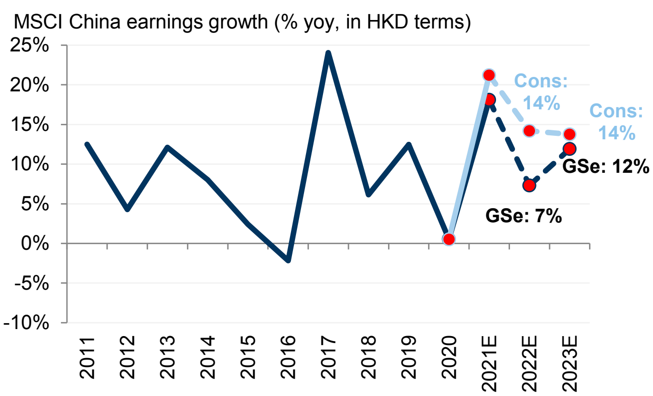
3. Can equities perform well on subdued profit growth?

- **Indeed, we forecast 7% EPS growth for MSCI China in 2022, meaningfully below consensus expectation of 13%.**
- Our 2022 EPS forecast can be broken down into 9% top-line revenue growth, which is broadly in-line with nominal GDP growth, and a net margin assumption of 9.5%, the lowest in the past 2 decades. Our cautious earnings outlook for next year is

attributable to: a) our economists' below-consensus GDP growth forecast % for 2022; b) the **growth drags from a slowing property market** which is linked to about 15% of aggregate market earnings, and the potential downward revisions there; and, c) wide PPI-CPI gaps, at least in 1H, which could pressure profit margins in select downstream sectors.

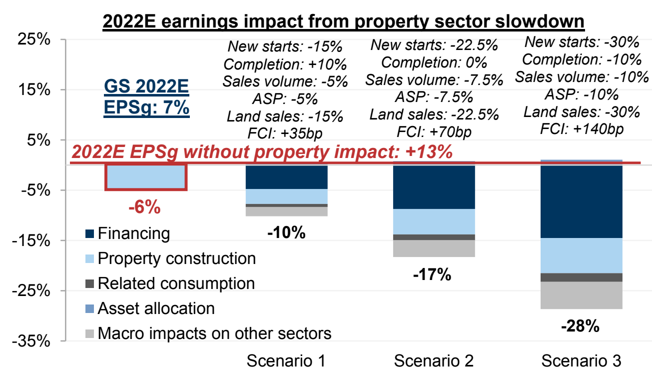
- We however see several technical and cyclical offsets to the profit growth deceleration headwind: a) MSCI China has tended to trade well (+30% in 12 months on average) after reaching the troughs in a **"Major" correction** per our classification; b) MSCI China has **never suffered 2 consecutive years of negative annual returns** since 2002 if we exclude 2016 when the index returned -1.6% after a 10% correction in 2015; and, c) the Chinese equity cycle is likely **transitioning into a "Hope" phase** (from "Despair") where PE expansion normally trumps weak fundamental growth and drives strong equity gains.

Exhibit 8: Our EPS growth forecast is below consensus for 2022, reflecting the growth drags from a slowing property market



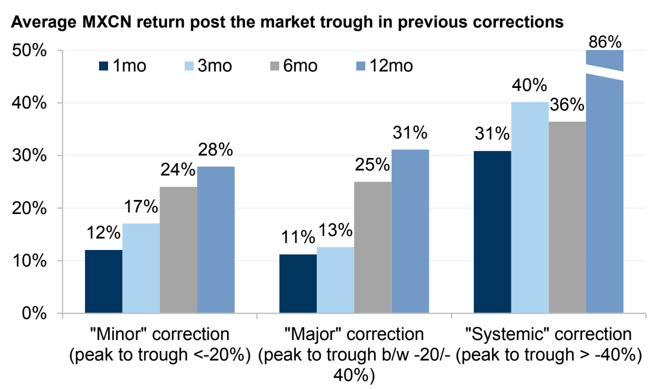
Source: FactSet, I/B/E/S, MSCI, Goldman Sachs Global Investment Research

Exhibit 9: The severity of the property market slowdown is a principal risk factor to our earnings forecast



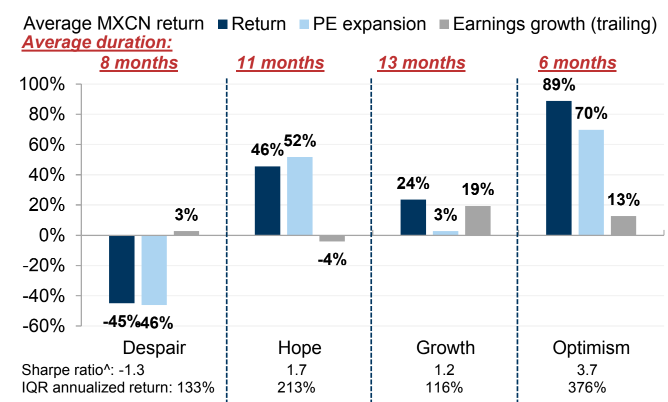
Source: FactSet, CEIC, Goldman Sachs Global Investment Research

Exhibit 10: The recent 33% peak-to-through market correction is reminiscent of a Major correction, which tends to precede a strong subsequent market recovery



Source: MSCI, FactSet, Goldman Sachs Global Investment Research

Exhibit 11: The Chinese equity cycle may morph into the Hope phase as 2022 progresses



^ is calculated as the average return/volatility, ignoring the risk-free rate.

Source: MSCI, FactSet, Goldman Sachs Global Investment Research

4. What could re-rate equities?

Given our subdued profit growth outlook, **our constructive equity story is predicated on meaningful PE expansion upside**. In a nutshell, we see 3 potential catalysts for re-rating:

1. **Policy easing:** Since we published our 2022 Outlook on November 11, we note that the market narrative about China policy has changed from **"Will China ease and when?"** to **"How much more will China loosen?"** given the somewhat unexpected 50bps RRR cut on Dec 6, the rather symbolic 5bps cut in 1Y LPR on Dec 20, and the pro-growth rhetoric from official policy statements in the past month. For 2022, our economists expect **another 50bps cut in RRR in 1Q**, policy rates to stay low/potentially drift lower, fiscal policy to be front-loaded and turn more expansionary via higher augmented budget deficits and more (new) infra investments, TSF growth to remain broadly stable vs. 2021, and targeted/specific policy relaxation in local property markets where supply/demand pressures are the strongest.
2. **Politics:** The Chinese Communist Party will host its 20th National Party Congress in November 2022, where changes at the 7-member Politburo Standing Committee, China's top decision-making body, are expected. While datapoints are limited, growth momentum has usually been robust on easy policy leading up to the once-every-five-years political event, and the **equity market has tended to perform well on PE expansion, generating roughly 30% 12m returns on average ahead of the transition**, with an 80% ex-post probability of positive returns.
3. **Regulation**: As we detail in the next section, we believe **the regulation cycle will improve** in 2022 in terms of its tightening intensity and clarity to investors, boding well for partial valuation recovery for the Internet sector.

In aggregate, these potential policy changes suggest that **China could very well be the only major economy globally that will ease incrementally in 2022**, reversing its policy divergence vis-a-vis the world since mid-2020 when policy normalization began. This would help curtail the left-tail risk in growth expectations, and compress the high risk premia currently embedded in equity valuations (Section 6).

Exhibit 12: Likely stable monetary and credit, but easier fiscal policy in 2022

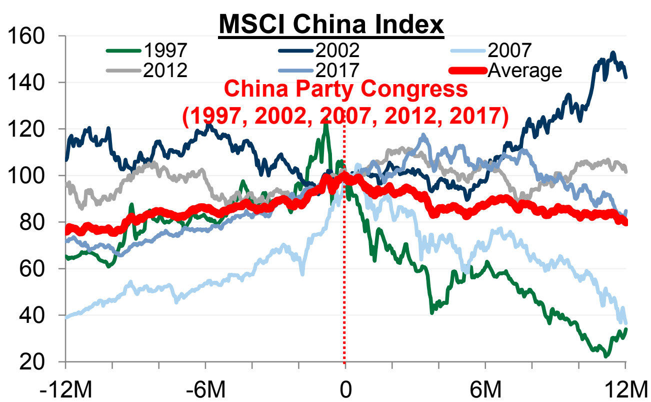
Type	Instrument	2021	GS 2022F
Monetary	RRR	Large bank avg: 11.5% Small/med bank avg: 8.5%	Large bank avg: 11% Small/med bank avg: 8%
	DR007	average 2.25%	average 2.25%
	7-Day OMO	average 2.20%	2.2%
	MLF (1-year)	average 2.95%	2.95%
	LPR (1-year)	average 3.80%	-
Fiscal	Effective on-budget deficit	4.0% of GDP	5.0% of GDP
	Augmented fiscal deficit	11.0% of GDP	12.0% of GDP
Credit	TSF stock	10.5% (eop yoy)	10.5% (eop yoy)
Housing	Housing policy	significant tightening in H2	moderate easing
FX	USDCNY	6.35 (eop)	6.20 (12m)

Source: Goldman Sachs Global Investment Research

Exhibit 13: Policy has begun to turn more growth supportive in recent months

Source: Wind, Haver Analytics, CEIC, Goldman Sachs Global Investment Research

Exhibit 14: Equities tend to trade well during political transition years



Source: FactSet, MSCI, Goldman Sachs Global Investment Research

Exhibit 15: While most markets will likely be tightening policy, China could ease at the margin in 2022

Monetary policy outlook for US, EU and APAC markets

Markets	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4
US	+25 bps	+25 bps	+25 bps		+25 bps	+25 bps	+25 bps	
Euro area		*Tapering*						
China								
HK			+25 bps	+25 bps		+25 bps		+25 bps
India		+25 bps	+25 bps	+25 bps		+25 bps	+25 bps	+25 bps
Indonesia			+25 bps	+50 bps	+50 bps	+25 bps	+25 bps	+25 bps
Malaysia		+25 bps	+25 bps	+25 bps	+25 bps	+25 bps		
Philippines				+25 bps	+25 bps	+25 bps	+25 bps	+25 bps
Singapore*		+100 bps						
Korea		+25 bps		+25 bps		+25 bps		+25 bps
Taiwan	+12.5 bps	+12.5 bps		+12.5 bps		+12.5 bps		+12.5 bps
Thailand				+25 bps	+25 bps	+25 bps	+25 bps	+25 bps
Australia	*Tapering*							+15 bps

Note: Values refer to the GS expected increase of the MAS S$NEER slope.

Source: Goldman Sachs Global Investment Research

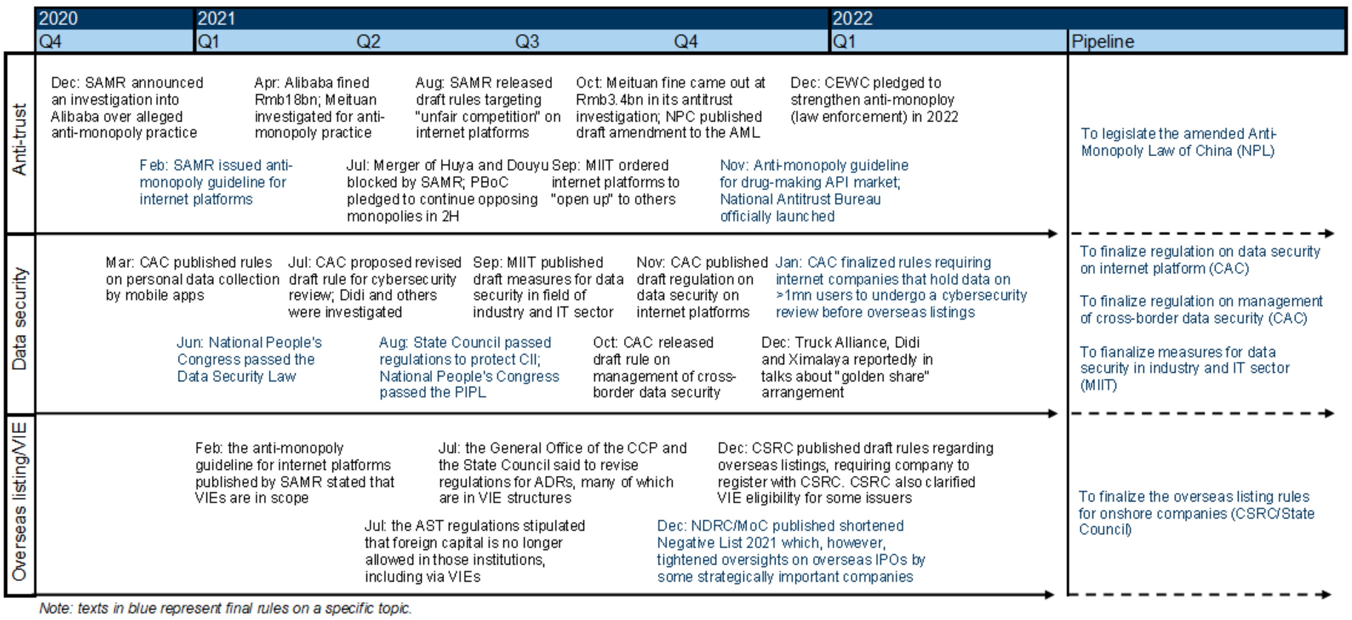
5. Is the worst of regulation tightening behind us?

- Industry regulation has been front and center for (Offshore) Chinese stocks in the past year. We have been arguing that the **ongoing regulatory tightening cycle has been unprecedented** along 4 dimensions—duration, severity, scope, and velocity of new policy announcements—implying that investors are probably facing a new regulatory/governance regime.
- Feedback from our client conversations suggests that while more regulations could be unveiled in 2022 as the regulatory framework takes shape, most believe **the worst is likely behind us in terms of the regulation intensity** and the corresponding shocks to the market. This view could be explained by their expectation that the regulation cycle may be transitioning from an announcement phase into an implementation stage where improved policy transparency may help

investors better price the regulatory impacts on earnings and equity risk premium, consistent with the falling readings (tightening intensity) from our **POE Regulation Proxy** over the past few months, and official policy **announcements/clarifications of late on issues such as the VIE structures, overseas listing, and data/national security compliance**.

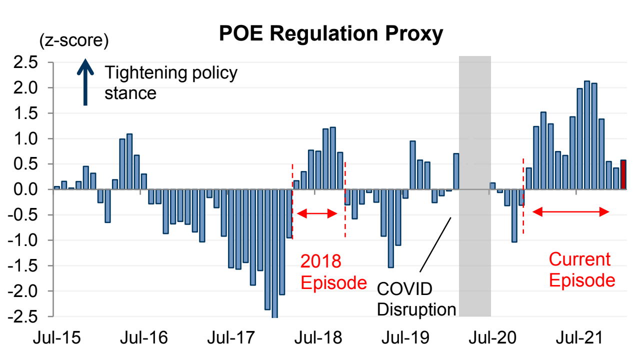
- While the regulation cycle seems to be turning more market-friendly, our Regulation Barometer (GSSRCNRG), which aggregates 18 equity portfolio pairs across 4 main policy cohorts—Antitrust, Financial Markets, Data Security, and Social Sector—to estimate market-implied concerns on announced regulations, currently stands at 87 (in a scale of 0 to 100, roughly at 2 s.d.), implying that **a great deal of regulation uncertainty is already in the price**.

Exhibit 16: We believe the regulation cycle is transitioning from an announcement phase to an implemenation stage



Source: SAMR, CAC, CSRC, NDRC, MoC, State Council, Data compiled by Goldman Sachs Global Investment Research

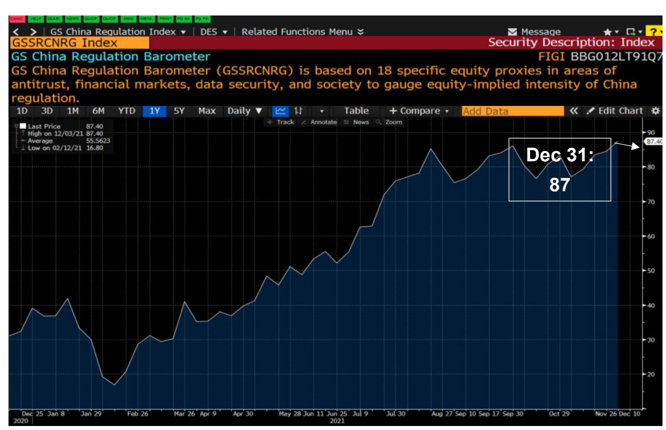
Exhibit 17: Our POE regulation proxy suggests that regulatory tightening intensity has meaningfully eased in recent months



Note: POE Regulation Proxy reflects the text-mining results of news among POE-heavy sectors. Data points during Mar-Jun 2020 have been removed due to COVID disruptions.

Source: Factiva, MSCI, FactSet, Goldman Sachs Global Investment Research

Exhibit 18: GSSRCNRG remains elevated at 87, implying that a great deal of regulation risks could already be in the price



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 19: The announced regulations so far in this cycle can be broadly grouped under four main categories, in our view

	Anti-trust	Financial Markets	Data Security	Social Sector
Nov-21	**SAMR** issued guidelines (Nov 18) on strengthening Chinese companies' **anti-monopoly management overseas**, mainly applying to importers, exporters, and those conducting overseas business operations including overseas investments, mergers, intellectual property transfers	**SASAC** (Nov 19) published a notice to **strictly limit the target and scale of financing guarantees** for **central SOEs**	**CAC** issued a notice on Nov 14, soliciting public opinions on the draft regulation on the **management of online data security**. Based on the draft, China will establish a hierarchical data classification of data into **"general", "important" and "core"** categories. Prospective **IPOs in Hong Kong** will need approval if authorities decide there's potential impact to **national security**.	**8 ministries** including **SAMR** jointly issued a notice on Nov 9 reiterating **crackdown on the advertisement of off-campus tutoring**
	SAMR (Nov 18) issued **anti-monopoly guidelines** for **drug-making API** market	CBIRC (Nov 24) said in a notice to keep promoting the campaign of **"strengthening internal controls and compliance policies"** for financial institutions		**MIIT** said on Nov 23 its cyberspace administration and police had summoned the **cloud units of Alibaba and Baidu** urging them to better prevent **telecom network fraud**
	National Anti-monopoly Bureau, the former anti-monopoly department under SAMR, was officially launched on Nov 18. The bureau will create a **fair, transparent and predictable competitive landscape** for over **150 million** Chinese market participants, said Xinhua News Agency	According to **Shanghai Securities News** (Nov 25), Chinese regulators launched an investigation into **illegal usage of insurance funds** beyond the approved investment scope		**MIIT** required **Tencent** to submit **new apps and updates** for inspection before they can be uploaded after a total of **9** apps were found to have **infringed users' rights and interests** by the regulator previously
	SAMR (Nov 20) imposed fines of **RMB500k** each on **43** past merger & acquisitions cases, including **Alibaba, Baidu and JD.com** for failing to declare market concentration risks to the authority for review	**CBIRC** (Nov 30) issued revised regulations requiring **insurance groups** to have a clear **equity structure** and a reasonable level of **equity ownership** in subsidiaries, **focusing on their core insurance business**		**SAMR** (Nov 26) published **draft Measures for the Administration of Internet Advertisements** that are open to public review until Dec 25
Dec-21	China policymakers would **"strengthen anti-monopoly and be against unfair competition"** in 2022, according to the statement issued after the annual **Central Economic Work Conference**	According to FT (Dec 8), China is reportedly drafting a **blacklist** that is expected to restrict tech start-ups from using **VIE structures** to raise international capital and listing overseas	**China Financial Standards Technical Committee (CFSTC)** issued a draft document on Dec 3 on **standards of financial data security** and evaluation method	**Ministry of Culture and Tourism** issued guidelines on strengthening the **protection of minors in online culture and content market**
	SAMR announced **13** past merger & acquisition deals failed to report market concentration risks, and imposed a fine of **RMB500k for** each deal	According to Reuters (Dec 17), citing unidentified persons, Chinese regulators are planning to ban online brokers such as **Futu and UP Fintech** from offering offshore trading services to mainland clients. The potential ban is driven by concerns over **data security and capital outflow**, as Reuters reported	**MIIT** (Dec 9) ordered **106 apps** to be removed from app stores following the campaign launched on Nov 3 targeting data violations such as unnecessary collection of **users' personal information**	**The State Tobacco Monopoly Administration** (Dec 2) issued draft rules governing **e-cigarettes**
		China's e-commerce livestreaming KOL Viya was fined **RMB 1.34bn** for **tax evasion**, according to an announcement published by **State Taxation Administration** on its website on Dec 20	Reuters reported (Dec 15), citing people with knowledge of the matter, the Chinese government has been expanding the practice of taking minority stakes in private companies - known as **"golden share"** arrangements. According to Reuters, golden shares have been taken in **Truck Alliance**	**CAC** said on Dec 2 that it had summoned and fined social media company **Douban RMB1.5mn** over **"unlawful release of information"**. According to CAC, Douban has been punished 20 times since Jan
		Local taxation bureau in Beijing, Shanghai, Zhejiang, Jiangsu and Guangdong separately issued announcements (Dec 22), asking celebrities and online streamers to **"self-check" tax declarations** and **report business irregularity** to local authorities by end of 2021, otherwise they will face more severe actions from the authorities	According to **Southern Finance** (Dec 22), a state-backed media, **MIIT** suspended a cooperative partnership with **Alibaba Cloud** for **6mo** on alleged cybersecurity threats. MIIT earlier said that Alibaba Cloud failed to immediately report a **security loophole** related to Apache Log4j2, a Java-based tool widely used in enterprise systems	**Ministry of Education** said on Dec 13 that it was suspending new filing of **online tutoring apps** and withdrawing existing authorisations, including for apps that encourage **bad learning habits** by simply providing answers to exercises
		CSRC (Dec 24) put forward updates on rules regarding **overseas listings**, requiring companies to **register with CSRC before overseas offerings**. CSRC clarified that companies with **VIE structures** are eligible for overseas listing if they meet compliance requirements, but didn't provide further details	4 ministries including **CAC, MIIT, MPS and SAMR** jointly issued regulations targeting the use of **algorithm recommendation technology**, which will take effect on Mar 1, 2022. The finalized rules were approved by CAC in Nov 2021 after the public consultation ended in Sept 2021	**CAC (Dec 14)** imposed **RMB3mn** fine on **Weibo** for repeatedly **publishing illegal information**, which was said to have violated cybersecurity law and minor-protection law. CAC said its Beijing bureau had imposed **44 penalties** on Weibo **totalling 14.3mn yuan** for the year to Nov
		NDRC and the Ministry of Commerce (Dec 27) published the 2021 **"Negative List"** for foreign investments that will take effect on Jan 1, 2022. The updated list was shortened to **31** items compared with **33** items in 2020. Companies that operate in **industries where foreign investment is prohibited** would need to **apply for regulatory approval before overseas listings**. Similar to domestic listing companies, **foreign ownership** in these companies is capped at 30% in aggregate and 10% for a single investor	**CAC and 12 other ministries** published rules on **cybersecurity review** which will become effective on Feb 15, 2022. Platform companies with data on **more than 1mn users** are required to go through a cybersecurity review before they can list abroad. The finalized rules were approved by CAC in Nov 2021	**CAC's Beijing bureau** said on Dec 20 that CAC had summoned Zhihu for **"unlawful release of information"** and demanded **"immediate rectification"** from the company. Some functions would be suspended during the rectification period, as Zhihu announced
				China Netcasting Services Association published updated rules on Dec 15 regulating **online short video content**
				CAC announced a **2-month campaign** on Dec 23 targeting **deceptive behaviors** on online platforms, such as faking fans and reviews, boosting engagement statistics, etc.

Source: SAMR, CBIRC, CSRC, MoC, NDRC, MIIT, CAC, MoE, State Council, CPCCC, Goldman Sachs Global Investment Research

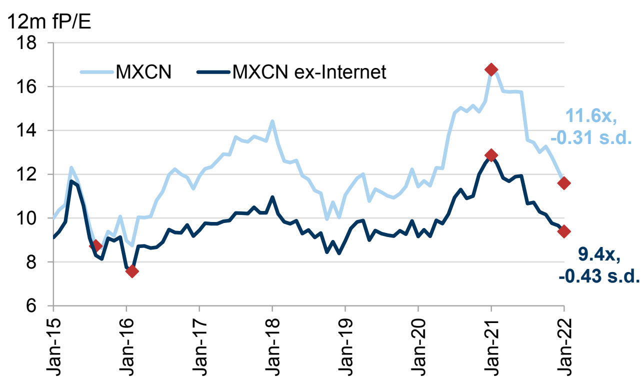
6. Are valuations really attractive?

MSCI China and CSI300 (post rebalancing on Dec 10) currently trade on 12m fP/E multiples of 11.6x and 14.3x, at -1.4 and +0.3 s.d, and in the 5%ile and 67%ile relative to their respective 5-year history. This compares to 18.6x and 17.1x when the markets reached their respective peaks 11 months ago. MSCI China is also being priced at **significant discounts to global equities** (33% to MSCI ACWI), with Offshore China Tech (Internet) trading 27% cheaper than US Tech, the widest gap in recent years.

While low absolute valuations may not be a convincing reason to buy equities, especially in an environment where profit growth is decelerating and regulatory concern is still elevated, we believe the valuation setup looks compelling to us, because:

- Empirically, **prospective index returns have tended to be strong at current valuation levels** (average 17% in 12 months);
- Our top-down macro PE model, which helps quantify how valuations based on our economists' forecasts on key macro variables, points to 14.5x fair fP/E for MXCN, **implying 25% valuation gains from here**;
- China Internet is trading on 21.8x fP/E, 0.7x fPEG, and 9.4% IERP, close to the trough levels in their respective 5Y ranges. Our sensitivity analysis suggests that the expectations of structural ROE impairment and/or sustained risk premia uplift are still prominently featured in its fair value distribution, implying that the **removal of left-tail regulation risks from its DCF-based valuation should drive +20% re-rating for the sector;**
- **Equity duration years for China Offshore have shortened** amid the de-rating and **domestic bond yields have fallen** in recent months, both lending valuation support to Chinese stocks at a time when the US is normalizing policy.

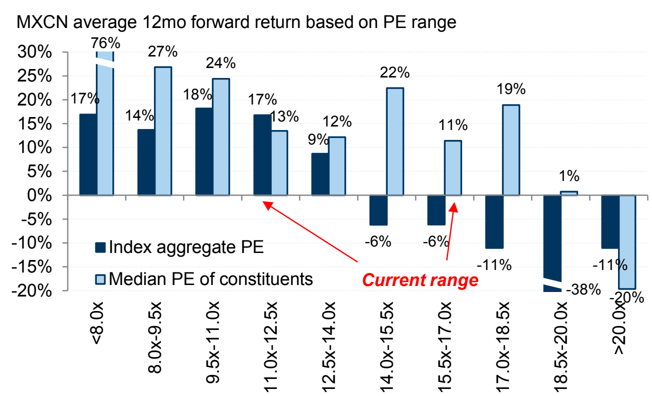
Exhibit 20: Chinese equities are being priced at the low-end of their recent-year valuation ranges



s.d. calculated based on valuations since Jan 2015

Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 21: Empirically, forward returns tend to be strong at prevailing valuation levels



Source: MSCI, FactSet, Goldman Sachs Global Investment Research

Exhibit 22: Some bearish growth assumptions appear well discounted in Internet stocks' valuations

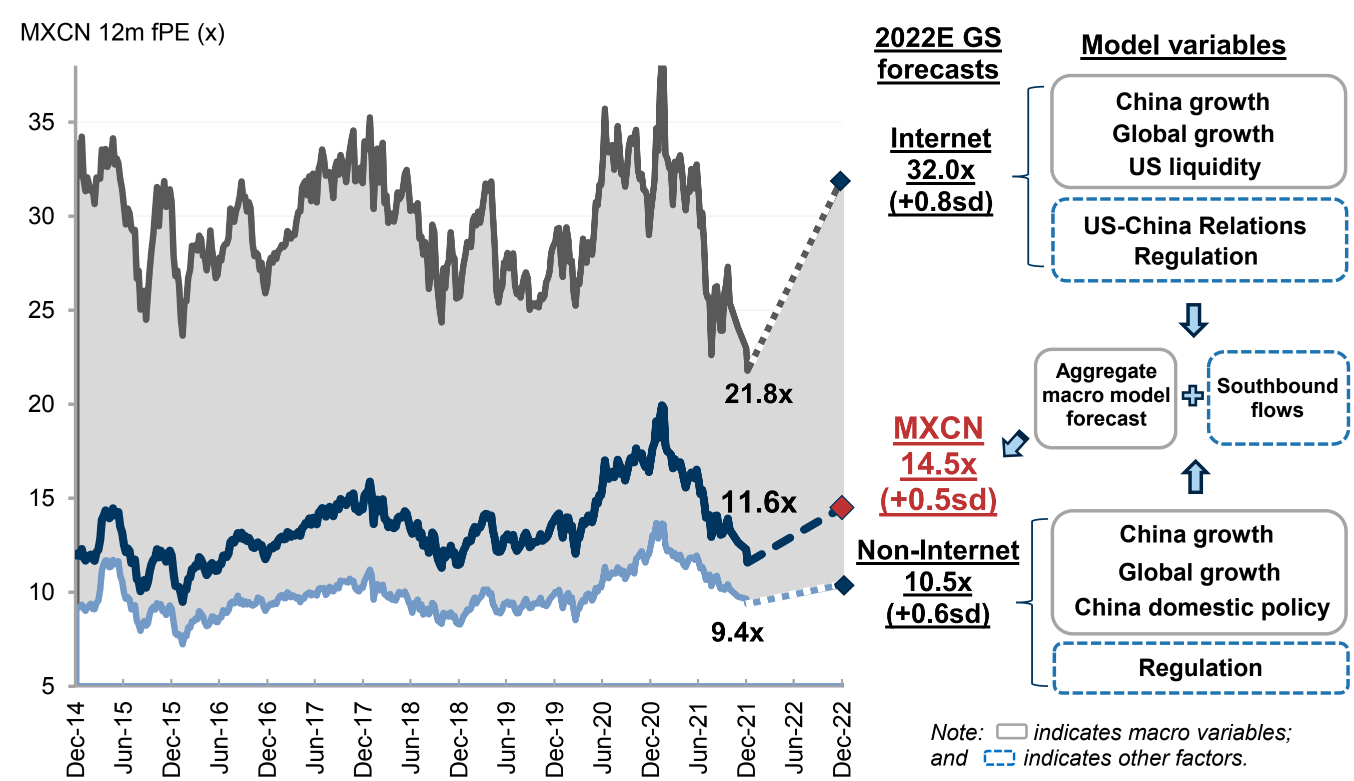
Potential 12M Upside for China Internet under different ERP & Earnings/ROE assumptions in a DCF model
(Base Case: 30% Internet EPS Growth in 2022)

(China Internet Equity Risk Premium Scenario)	Equity Risk Premium (ERP) Assumptions	Internet's ROE assumptions in the medium-term (Year 3-8 Average) under a DCF Model: 18.0%	Consensus / GS Model: 17.0% medium-term ROE	Moderate Scenario: 16%	Bearish Scenario: 15%	Extreme Scenario: 14.0%
Current Comparable SOE IERP Level	9.7%	42%	19%	0%	-17%	-37%
Current IERP Level (+1.7 s.d. above 5yr mean)	9.4%	55%	30%	9%	-9%	-31%
Mid-Point b/w Current vs. GS Assumptions	8.7%	93%	62%	36%	13%	-15%
Past 5-year Avg IERP	7.9%	146%	106%	72%	43%	7%
2021 Trough (Mid-Feb)	7.6%	170%	126%	89%	57%	17%

(Current Market Priced / Implied Assumptions) *(More bearish scenarios/ assumptions if markets expect negative returns in 12M)*

Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 23: We see the potential for valuations to expand/recover in 2022 as policy eases and regulation visibility improves



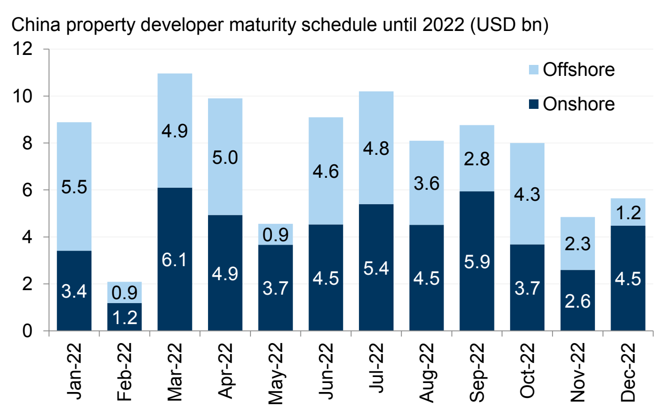
Source: MSCI, FactSet, Goldman Sachs Global Investment Research

7. Will the property credit turmoil spoil the party?

- The property-centric risks and concerns have been well documented, but the significant size of the property market (US$60tn of notional value including inventory), and its intricate linkages to the economy (~15-20% of GDP, two-thirds of household asset allocation) and the equity market earnings (15% of aggregate profits) make it the **most consequential risk factor and a major client pushback to our constructive market view.**

- GS Equity Research team's base case remains that whilst the liquidity issues at Evergrande (and other highly geared developers) may continue, the **negative macro spillovers to the broader economy and financial markets should be largely contained** as policymakers have begun shifting to a more supportive stance on the housing market in recent months via monetary, credit/mortgage, and various administrative measures (e.g. encouraging M&A, Hukou incentives).
- The coast is far from clear, given our property team's forecast that nationwide housing sales may fall 20% yoy in 2022, the most severe downturn in history, and the heavy principle repayment schedule in the high-yield credit market where more than US$10bn of developer bonds will come due in 1Q22. For now, both the credit and equity markets seem to be pricing in a **"muddle-through" scenario** with property HY bonds trading at distressed levels but property IG credits being priced at very tight spreads, SOE developers substantially outperforming their POE peers in recent months, and cross-asset correlations (w.r.t property HY) implying limited macro contagion risks,
- On the brighter side, we believe **asset reallocation flows** from the US$60tn property market to equities (US$13tn for A shares) could accelerate in 2022 as the property market slowdown deepens and Chinese households' entrenched perception of ever-rising property prices comes into question. We estimate that Chinese households will generate Rmb11tn of net investable capital in 2022, of which Rmb3tn could be deployed in the equity market.

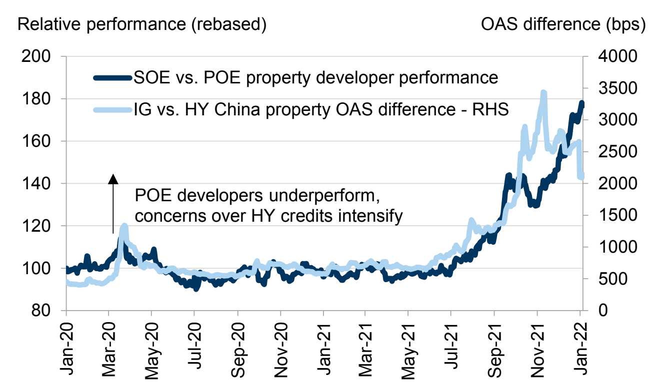
Exhibit 24: A heavy maturity schedule for China property developers over the next 12 months



Onshore: China property RMB bonds. Offshore: China USD HY property developer. Defaulted companies are excluded. USDCNY as of Nov 5 spot.

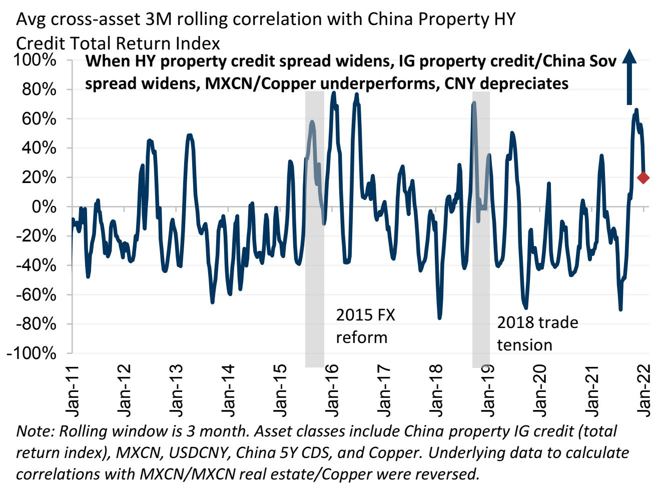
Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 25: The credit and equity markets are pricing in significant differentiation between risky and less risky property-related securities



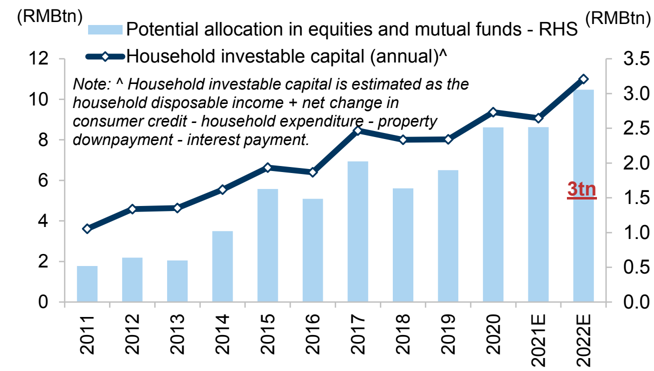
Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 26: Cross-asset correlations with property HY credits had increased in 2H21, but less significant than previous macro stress points



Source: FactSet, MSCI, Bloomberg, Goldman Sachs Global Investment Research

Exhibit 27: Asset reallocation flows from property to equities could be more visible in 2022 as the property market slows



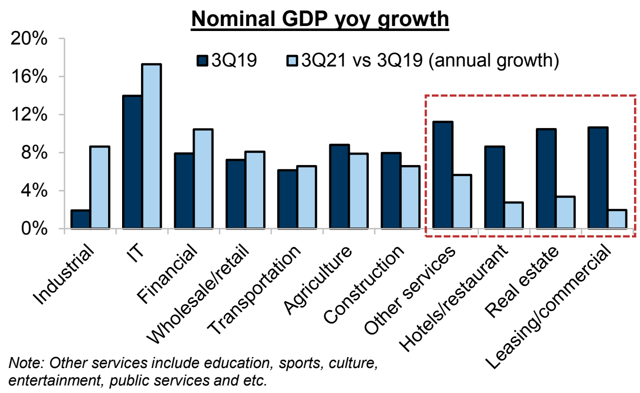
Source: CEIC, Bloomberg, Goldman Sachs Global Investment Research

8. Will the zero-Covid policy be relaxed?

- **China has seen rising Covid cases** starting late December alongside the latest wave of pandemic outbreaks linked to Omicron, with Shaanxi province being the new epicenter and its provincial capital Xi'an (13mn population) enforcing comprehensive lockdown.
- While the reported cases in China are just a fraction of the infections in other major economies, our economists believe **China will maintain its zero-(tolerance) Covid policy (ZCP) through at least late 2022** on political (social stability ahead of the 20th National Party Congress which will be held in Oct/Nov 2022) and economic (costs of "live with Covid" may outweigh the benefits of opening up) considerations. Specifically, they estimate the impact of recurring but small local Covid-19 outbreaks to be -0.9pp on China's 2022 GDP growth, which has already been reflected in their current growth forecast, although the growth hit could be exponentially higher in a nationwide lockdown scenario.
- The strict Covid policy also suggests that the **demand normalization path for Chinese consumers will stay bumpy**, with the service economy, particularly discretionary items such as tourism, catering, and offline entertainment still operating below their respective trend growth rates in the pre-pandemic era.
- Some sectors should benefit from restrained consumption and travel curbs but other than typical Stay-at-home proxies, such as online gaming and E-commerce platforms, which are also exposed to regulatory risk, we screen for industries that performed well during previous domestic Covid outbreaks and are sensitive to our economists' Effective Lockdown index. We note that **Pharma, Food & Staples Retailing, Durables, Communication Equipment, and Logistics could present sensible investment opportunities** for investors who take a more cautious view

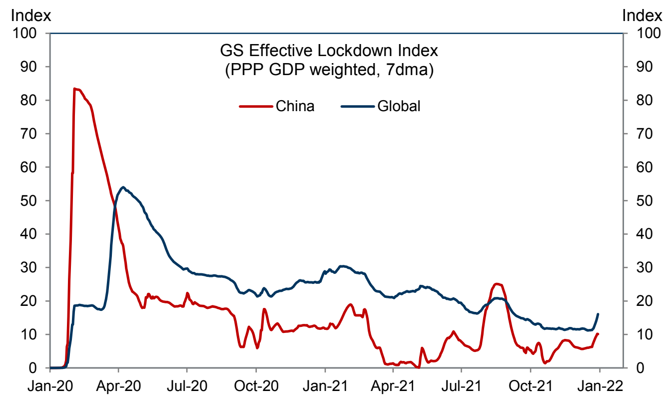
on the Covid development in China.

Exhibit 28: Service-related sectors are yet to recover to their trend growth level



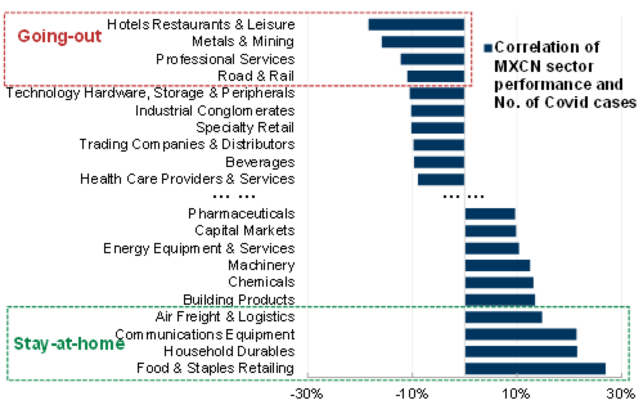
Source: Wind, Goldman Sachs Global Investment Research

Exhibit 29: China has imposed more restrictive measures to contain the pandemic since late December



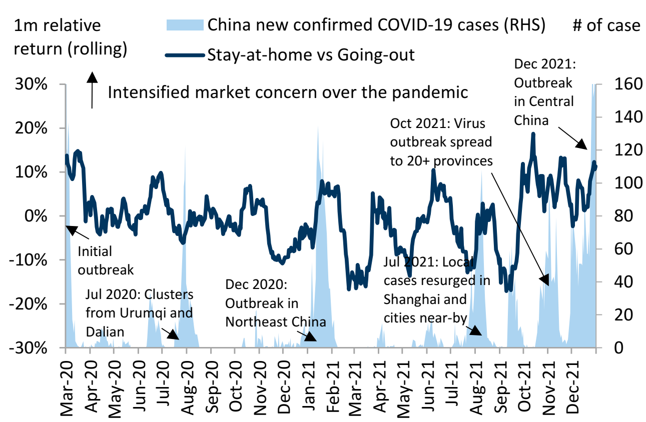
Source: Goldman Sachs Global Investment Research, University of Oxford (covidtracker.bsg.ox.ac.uk), Google LLC "Google COVID-19 Community Mobility Reports"; accessed: Jan 04 2022; Wind

Exhibit 30: Tourism and catering usually trade negatively as Covid cases rise whereas Staples and Logistics could outperform



Source: FactSet, NHC, Goldman Sachs Global Investment Research

Exhibit 31: Stay-at-home proxies have started to outperform in recent weeks



Source: FactSet, NHC, Goldman Sachs Global Investment Research

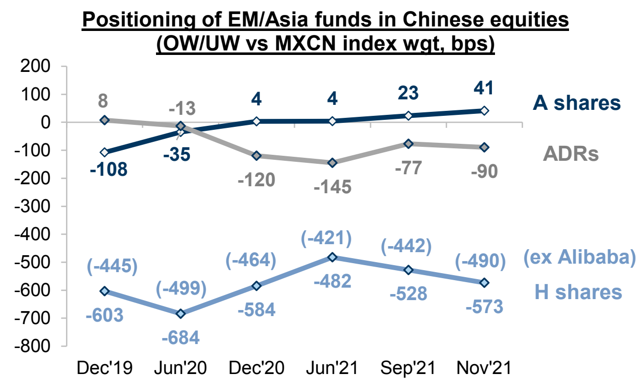
9. China A or Offshore?

- **We are Overweight both China A and China Offshore** in our regional allocation framework, although they present **different value propositions** to investors in our view.
- We think China A's investment continues to rest on its significant size and depth, under-representation in global benchmarks and low FINI ownership, continued market opening-up momentum, relatively strong economic and earnings growth potential in a global context, and other market appeals revolving around diversification benefits, abundant alpha opportunities, and potential inefficiency gains. Importantly, the A-share market also appears more insulated from further

regulation tightening risk, more favorably sensitive to potential macro policy easing, and better placed for long-term growth initiatives. In sum, we see **China A as a strategic asset class that is too important to ignore for global equity investors**.

- Our optimism towards **China Offshore is nevertheless more tactical in nature**, given last year's drawdown in the Internet sector which accounts for 40% of MSCI China index weight. The fundamental outlook remains uncertain, but depressed headline valuations and light positioning suggest that the risk/reward is compelling if our expectation of policy easing and a moderating regulation cycle materializes.

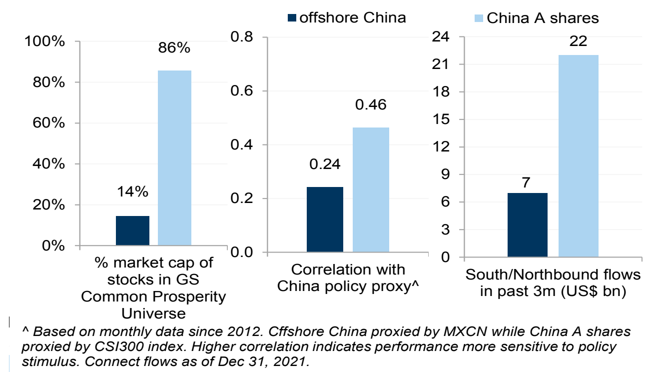
Exhibit 32: Investor positioning is particularly light in the HK market



Alibaba is counted under H shares (9988.HK) while other secondary-listing names are under ADRs.

Source: FactSet, MSCI, Goldman Sachs Global Investment Research

Exhibit 33: Chinese A shares look better positioned from a top-down macro and regulation perspective



Source: Bloomberg, Wind, FactSet, Goldman Sachs Global Investment Research

10. Buy laggards (Internet) or winners (policy beneficiaries)?

- Statistically, our framework for analyzing the ex-post probability of leadership rotation between last-year winners (top-quartile performing index constituents) and laggards (bottom-quartile) in the ensuing year suggests **a 50/50 chance for performance reversal** for the two groups in 2022.
- Top-down, we believe **the more important alpha-generating factor for 2022 is Growth**, especially when GDP growth will likely operate below trend but liquidity conditions should be largely supportive domestically, a combination which tends to bode well for Growth premium expansion.
- Along the Growth axis, sectorally, we like the valuation recovery case for **Internet Retailing and Media** post their significant de-rating and their potential to return to a strong organic growth trajectory in 2022 and 2023 after the 40% regulation-provoked earnings downgrades last year. We are also **Overweight on Autos, Consumer Durables (e.g. Sportswear) and Semis** given their favorable policy exposures to the "Common Prosperity" theme. To fund the overweights, we would avoid the property-related cohorts, notably Real Estate (prefer SOE developers over POE players), Materials (especially steel and cement), and Banks where profitability will likely come under pressure as the property market slows and

local rates likely drift lower.

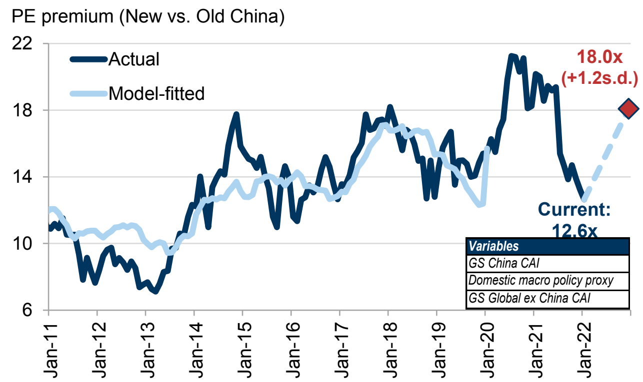
- Thematically, we'd continue to focus on our **"Common Prosperity" portfolio** to gain diversified exposures to long-term policy directions. The portfolio has lost 2% since its inception on Oct 25, outpacing MSCI China by 12pp.

Exhibit 34: Our analysis shows a balanced risk for leadership rotation between last-year winners and laggards

	Since 2010			
	Price Return (Median Stocks)		Excess Return (vs. MXCN)	
	Leaders	Laggards	Leaders	Laggards
Average (Annual)	11%	3%	7%	-1%
Median (Annual)	4%	1%	4%	3%
Probability of outperformance	50%	50%		

Source: FactSet, MSCI, Goldman Sachs Global Investment Research

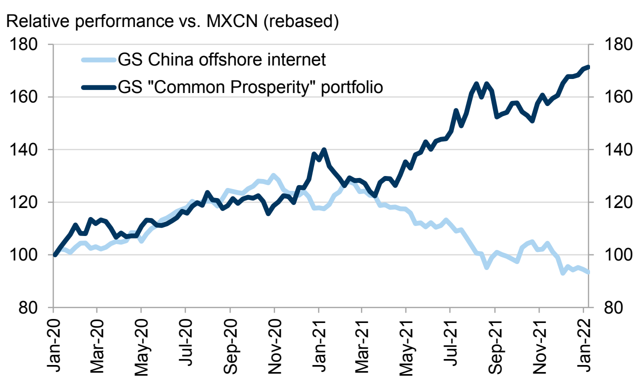
Exhibit 35: Our enivsaged macro backdrop of slowing growth but easier policy should bode well for Growth premium expansion



Based on current MXCN constituents. Valuation gaps: New China less Old China.

Source: MSCI, FactSet, Goldman Sachs Global Investment Research

Exhibit 36: Buying Structural Policy Growth, and out of-favor Internet Growth in 2022



Source: FactSet, Bloomberg, MSCI, Goldman Sachs Global Investment Research

Exhibit 37: Recovering growth and policy-driven growth are the key themes that run through our sector recommendations

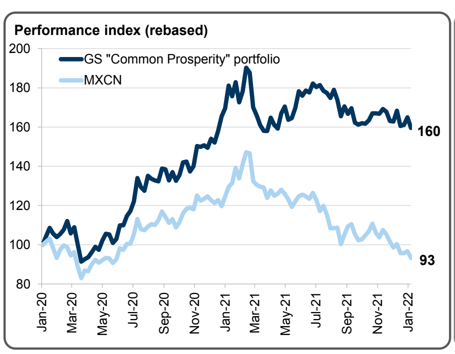
Allocation	MXCN industry groups	21-23E EPS CAGR	22E P/E (X)	22E P/B (X)	22E PEG
Overweight	Autos	39%	31.7	3.0	1.0
	Consumer Durables	22%	24.8	5.6	1.4
	Media	21%	24.2	3.0	1.0
	Retailing	25%	21.0	2.6	0.7
	Semis	24%	31.6	5.2	1.2
Marketweight	Capital Goods	12%	9.3	1.1	0.9
	Consumer Svcs	48%	23.8	1.6	0.6
	Div Financials	11%	8.3	0.9	0.8
	Energy	-5%	6.0	0.6	-
	Food Bev	24%	26.8	5.7	1.2
	HC Equip & Svcs	20%	20.8	2.2	1.0
	Insurance	15%	5.2	0.7	0.5
	Pharma Biotech	38%	56.6	5.3	1.4
	Tech Hardware	15%	15.7	2.9	1.2
	Transportation	-12%	10.3	1.2	-
	Utilities	12%	12.6	1.4	1.1
Underweight	Banks	7%	4.2	0.5	0.6
	Materials	10%	8.7	1.5	1.4
	Real Estate	9%	5.0	0.6	0.6
	Telecom	15%	14.0	0.7	1.1

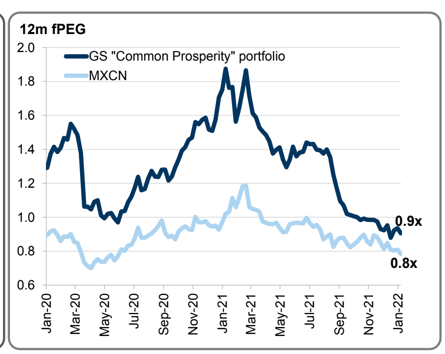
Source: FactSet, Goldman Sachs Global Investment Research

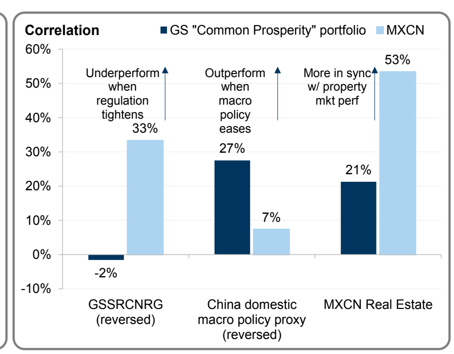
Exhibit 38: Our "Common Prosperity" portfolio has outperformed the aggregate market, with low sensitivity to regulation risk and limited exposures to the property market

				Top 50 based on avg ranking							B*/B/N
Ticker	Name	GICS Sub-Industry	Basket weight	R&D intensity	Revenue CAGR (2020-22E)	ROE	Listed Mkt Cap (US$bn)	6M ADVT (US$mn)	22E PEG (x)	2021-23E EPS CAGR (%)	GS Ratings
Common Prosperity Portfolio											
1810 HK	Xiaomi	Hardware Storage & Peripherals	5.0%	4%	29%	16%	48.5	275	1.1	14	B
601012 CG	LONGi Green Energy	Semiconductors	5.0%	4%	41%	22%	72.1	1,097	1.4	28	B*
601888 CG	China Tourism Group Duty Free	Specialty Stores	5.0%	0%	45%	22%	65.6	406	0.8	36	B*
002475 CS	Luxshare Precision	Electronic Comp.	5.0%	7%	32%	23%	56.4	393	1.2	36	B
2331 HK	Li Ning	Apparel Accessories & Luxury	5.0%	2%	31%	20%	26.5	181	1.7	23	B*
000651 CS	Gree	Household Appliances	5.0%	3%	14%	25%	34.9	342	0.6	14	B
300274 CS	Sungrow Power Supply	Electrical Comp. & Equip.	5.0%	5%	29%	14%	30.9	601	1.5	41	B*
600276 CG	Hengrui Pharma	Pharmaceuticals	5.0%	17%	22%	23%	50.6	384	2.1	17	B
TCOM UW	Trip.com	Hotels Resorts & Cruise Lines	4.6%	34%	40%	4%	16.4	150	0.3	188	B
2020 HK	ANTA Sports	Footwear	4.4%	2%	31%	27%	39.1	159	1.2	25	B
002714 CS	Muyuan Foods	Packaged Foods & Meats	3.7%	1%	46%	29%	47.7	375	0.2	54	B
603501 CG	Will Semiconductor	Semiconductors	3.3%	8%	32%	16%	42.6	301	1.8	27	B
002812 CS	Yunnan Energy New Material	Paper Packaging	3.1%	4%	58%	17%	35.6	323	1.3	55	B
603986 CG	Giga Device Semiconductor	Semiconductors	2.6%	11%	47%	17%	18.4	436	2.2	18	B
300450 CS	Wuxi Lead	Electronic Manuf. Svcs	2.5%	9%	56%	20%	17.5	184	1.5	45	B
300124 CS	Inovance Technology	Industrial Machinery	2.5%	11%	32%	17%	28.9	268	1.6	29	B
1093 HK	CSPC Pharma	Pharmaceuticals	2.2%	9%	16%	23%	13.3	40	1.3	12	B
600703 CG	Sanan Optoelectronics	Semiconductors	2.2%	8%	38%	8%	26.3	510	1.6	45	B
968 HK	Xinyi Solar	Semiconductor Equip.	2.0%	2%	27%	20%	14.7	70	0.8	18	B
600745 CG	Wingtech Technology	Electronic Manuf. Svcs	1.8%	5%	30%	7%	25.4	256	1.0	42	B
600196 CG	Fosun Pharma	Pharmaceuticals	1.7%	10%	19%	9%	15.2	340	1.1	21	N
002050 CS	Sanhua Intelligent Controls	Industrial Machinery	1.5%	4%	22%	15%	14.5	88	1.8	27	B*
300782 CS	Maxscend Microelectronics	Electronic Comp.	1.4%	8%	62%	40%	17.2	237	1.3	32	B
601877 CG	Chint Electrics	Electrical Comp. & Equip.	1.4%	3%	20%	19%	16.8	280	1.3	19	N
600754 CG	Jin Jiang Int'l Hotels	Hotels Resorts & Cruise Lines	1.3%	0%	31%	5%	8.6	41	1.1	172	B
603659 CG	Putailai New Energy	Specialty Chemicals	1.2%	5%	54%	7%	17.2	186	1.2	43	N
002008 CS	Han's Laser Technology	Industrial Machinery	1.1%	10%	18%	13%	8.7	161	1.4	20	B
354 HK	Chinasoft Int'l	IT Consulting & Other Svcs	1.1%	7%	26%	13%	3.8	34	0.7	25	B*
300496 CS	Thunder Software Tech	Application Software	1.1%	18%	43%	13%	9.0	110	1.7	42	B
300568 CS	Senior Technology Material	Commodity Chemicals	1.0%	6%	62%	9%	4.3	159	0.6	83	N
300003 CS	Lepu Medical Technology	Health Care Equip.	1.0%	8%	18%	20%	6.6	68	0.7	16	B
1347 HK	Hua Hong Semiconductor	Semiconductors	0.9%	41%	34%	6%	6.8	53	1.3	22	B*
6186 HK	Feihe	Packaged Foods & Meats	0.9%	1%	26%	39%	12.1	35	0.5	18	B
002007 CS	Biological Engineering	Biotechnology	0.8%	4%	19%	21%	8.4	77	1.4	19	N
603486 CG	Ecovacs Robotics	Household Appliances	0.8%	5%	53%	21%	13.3	92	1.1	33	N
688169 CG	Roborock Technology	Household Appliances	0.7%	5%	37%	19%	8.0	74	0.9	31	B
603517 CG	Juewei Food	Packaged Foods & Meats	0.7%	0%	23%	20%	6.7	57	1.4	16	B
603816 CG	Jason Furniture	Home Furnishings	0.6%	2%	24%	18%	7.6	37	1.1	23	N
601865 CG	Flat Glass	Semiconductors	0.5%	4%	50%	23%	13.9	135	1.2	31	N
3692 HK	Hansoh Pharma	Pharmaceuticals	0.5%	14%	24%	14%	14.3	11	1.5	17	B
300144 CS	Songcheng Performance	Leisure Facilities	0.5%	3%	99%	14%	6.2	59	0.7	86	B
780 HK	Tongcheng-Elong	Hotels Resorts & Cruise Lines	0.5%	21%	36%	2%	4.0	11	0.5	29	N
603160 CG	Goodix Technology	Semiconductors	0.5%	22%	7%	29%	7.7	53	1.2	40	N
300558 CS	Betta Pharma	Pharmaceuticals	0.5%	37%	30%	12%	5.2	38	1.7	34	N
300146 CS	By-health	Personal Products	0.5%	2%	25%	20%	7.4	56	1.1	20	B
002916 CS	Shennan Circuit	Electronic Comp.	0.5%	5%	17%	19%	9.4	59	1.5	23	N
688188 CG	Friendess Electronics Tech	Electronic Equip. & Instr.	0.5%	13%	42%	15%	5.9	36	1.5	32	B
002508 CS	Robam	Household Appliances	0.5%	4%	17%	24%	5.5	57	1.1	15	B
603338 CG	Dingli Machinery	Industrial Machinery	0.5%	3%	36%	21%	6.2	62	1.5	27	B
002032 CS	Zhejiang Supor	Household Appliances	0.5%	2%	15%	29%	7.8	25	1.7	13	N
Average				8%	34%	18%	20	190	1.2	36	-
Aggregate							990	9,484	61.3	1,797	

*Notes: Prices as of Jan 4, 2022; Valuation items are I/B/E/S consensus. GS Ratings: B=Buy, N=Neutral, and * indicates the Asia Pacific Conviction List. ^Data is only available for China A shares. China A shares with foreign ownership reaching 30% limit are excluded. Companies under US investment restrictions are excluded. Basket weights of individual stocks are restricted to be within [0.5%, 5%].*







Source: FactSet, IBES, Goldman Sachs Global Investment Research

Disclosure Appendix

Reg AC

We, Kinger Lau, CFA, Timothy Moe, CFA, Si Fu, Ph.D. and Kevin Wang, CFA, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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