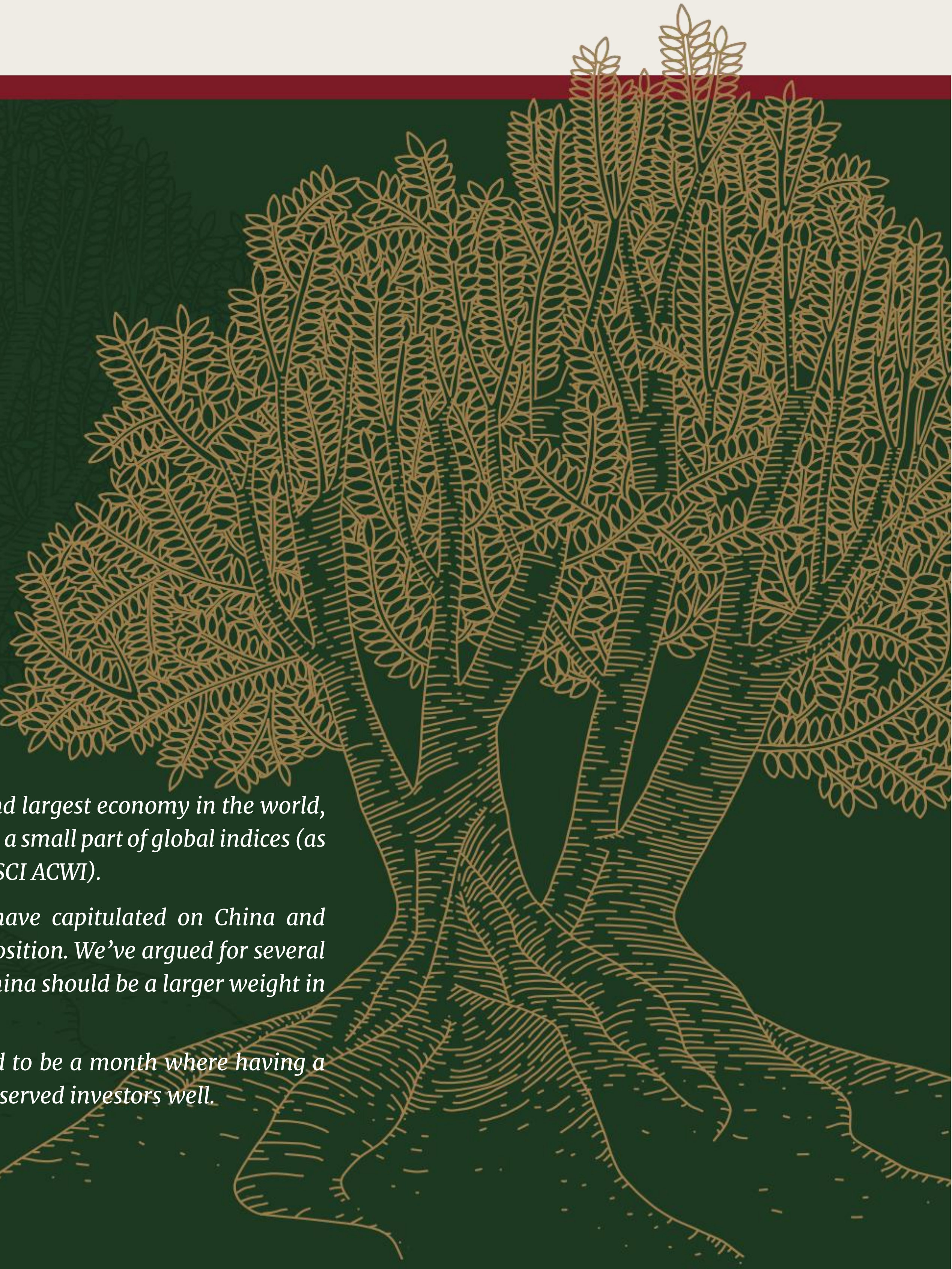
CHINA – ON THE REBOUND…?

A discussion of China's stock market rally

October 2024



China is the second largest economy in the world, yet makes up such a small part of global indices (as little as c3% in MSCI ACWI).

Many investors have capitulated on China and hold little to no position. We've argued for several years now that China should be a larger weight in portfolios.

September proved to be a month where having a position in China served investors well.

OVERVIEW

After several years of underperformance, China's stock market posted the best one-month performance in 9 years with the CSI300 and MSCI China up 21.1% and 23.9%, respectively.

Many factors have led to the underperformance of China's stock market in recent years: extended China lockdowns during the Covid pandemic, a weak property sector, geopolitical tensions with many Western countries and a capitulation from many global investors who no longer wanted exposure to China.

In this document we look back at this underperformance and discuss some of the recent events which have driven the strong rebound in China's stock market.

PAST PERFORMANCE

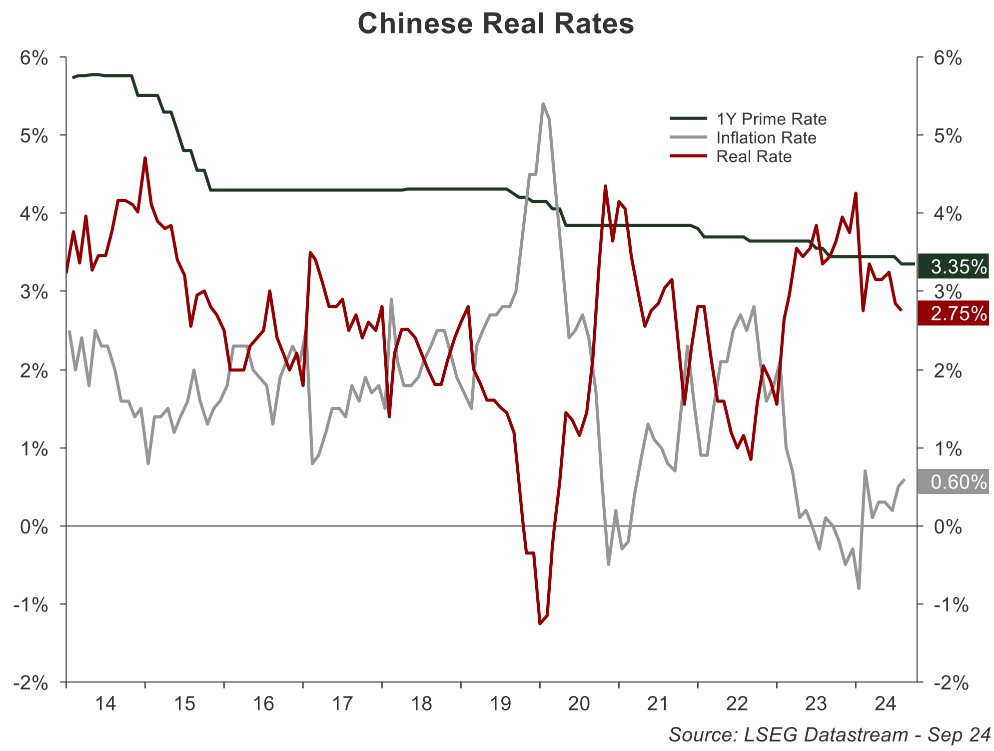
After a strong rally in 2019 and following the Covid-19 lockdowns, China's stock market has lagged developed markets and been a drag on Emerging Market indices. The month of September has seen a strong rebound.

Performance (USD)	2018	2019	2020	2021	2022	2023	YTD	September
CSI 300	-27.6%	37.2%	38.4%	-1.0%	-26.5%	-10.9%	21.6%	22.4%
FTSE China	-22.8%	21.1%	39.3%	-18.4%	-28.4%	-13.4%	39.2%	25.3%
KWEB	-33.9%	29.9%	58.2%	-48.9%	-17.2%	-9.0%	42.3%	32.4%
MSCI World	-8.2%	28.4%	16.5%	22.3%	-17.7%	24.4%	18.5%	1.9%
MSCI EM	-14.2%	18.9%	18.7%	-2.2%	-19.7%	10.3%	18.1%	6.7%

Source: Refinitiv - 05/10/2024

INFLATION AND INTEREST RATES

Although China has been cutting its prime lending rate over the last couple years, inflation has been very low. While this is good for exported inflation to buyers of Chinese goods, it has meant real interest rates in China are not that accommodative despite a declining headline lending rate. China will want to avoid a deflationary environment as consumers might hold back on purchases in anticipation of lower prices.



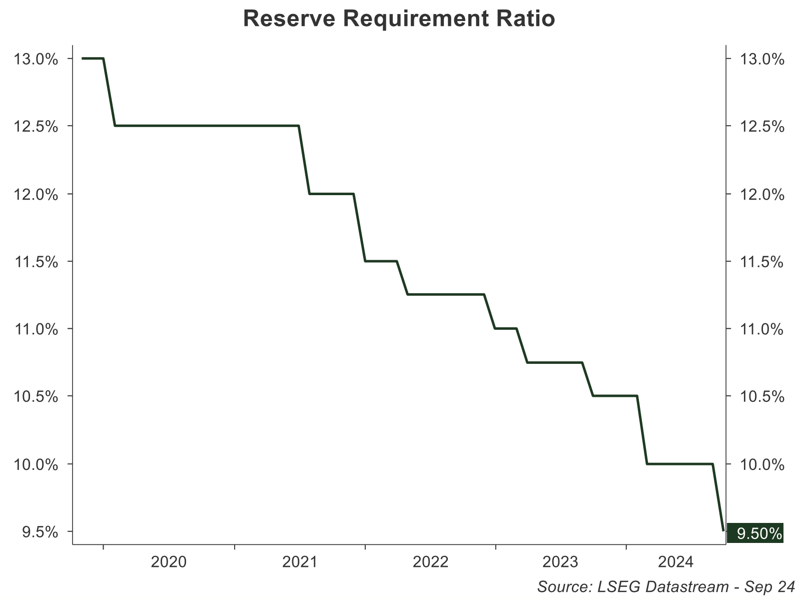
POLICY ANNOUNCEMENTS

Chinese policy makers have announced a coordinated series of policies. On the 24th of September 2024 the PBOC, together with the China Securities Regulatory Commission (CSRC) and NFRA, held a press conference announcing a host of new stimulus measures covering property, equity markets and monetary policy:

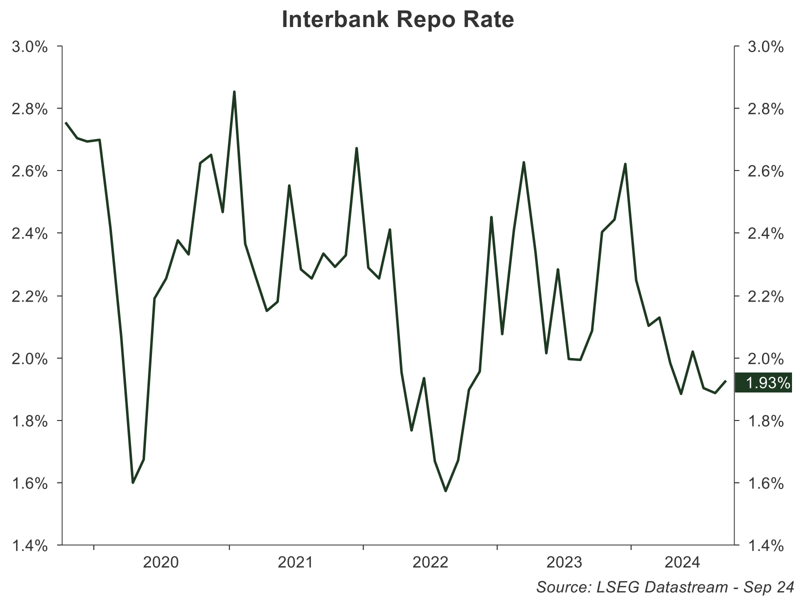
Property Market: Existing mortgagors will be allowed to refinance their home loans, which amounted to Rmb38tn as of 2Q24. This should be around 50bps on average cheaper for existing borrowers.

Authorities cut the minimum downpayment ratio for second homes from 25% to 15% across the country, the lowest on record.

Monetary Policy: They announced a reduction in the reserve requirement ratio (RRR) for banks by 50bps, the second reduction this year aimed at bolstering the economy. The change, which took effect, Sept. 27th, was signalled earlier in that week by Governor Pan Gongsheng, bringing the weighted average RRR to 6.6%.



Additionally, the PBOC trimmed the 7-day reverse repo rate by 20bps to 1.5%. This rate is used to determine the nation's key lending rates.



A Rmb300bn re-lending program for corporate buybacks: This is consistent with the policy objectives from the Nine Measure Document published in April 2024, which discussed strengthening supervision and preventing risks in capital markets and will help listed companies do share buybacks by obtaining the necessary funding.

They announced a **Rmb500bn asset swap facility** from the PBOC that could be topped up if needed for investing in equities demonstrating policymakers' commitment to instil stability in the domestic stock market. Qualified non-bank financial institutions with acceptable collateral, notably brokers and insurers, can buy equities at more competitive financing costs.

National Stabilization Fund: The PBOC confirmed that this is currently under consideration. Direct government sponsorship in equity markets could be effective in boosting returns in the short run.

Furthermore, on the 29th of September at the State Council meeting, policymakers focused on the implementation of incremental easing measures and reiterated the pledge to "**strive for the full-year growth targets**", echoing President Xi's call in the September Politburo meeting. Specifically, Premier Li Qiang pledged to "**accelerate the pace for rolling out and implementing policy easing measures**", requiring more forceful collaboration across different ministries and more synergy between various policy measures. He vowed to "**speed up the progress of 102 key investment projects under China's 14th Five Year Plan**". Meanwhile, PBOC and several large cities also unveiled some easing policies for the housing sector.

On Saturday 12th October, China pledged to "significantly increase" debt to revive its sputtering economy, but unfortunately left investors guessing on the overall size of the stimulus package.

Finance Minister Lan Foan told a press conference in Beijing they will help local governments tackle their debt problems, offer subsidies to people with low incomes, support the property market and replenish state banks' capital, among other measures. Local governments still have 2.3 trillion yuan ($325.3 billion) of unused bond quotas available for funding before the end of the year. The government will also allow local governments to use special bonds to purchase idle land from troubled developers. They also announced other measures including doubling the quota for college student subsidies and optimising tax policies with a study to take place on the abolition of VAT on ordinary residential buildings.

The key message from the 12th of October announcements is that the central bank has the capacity to issue more bonds and raise the fiscal deficit. This is a key shift in fiscal policy stance to boost domestic demand and mitigate deflationary pressures.

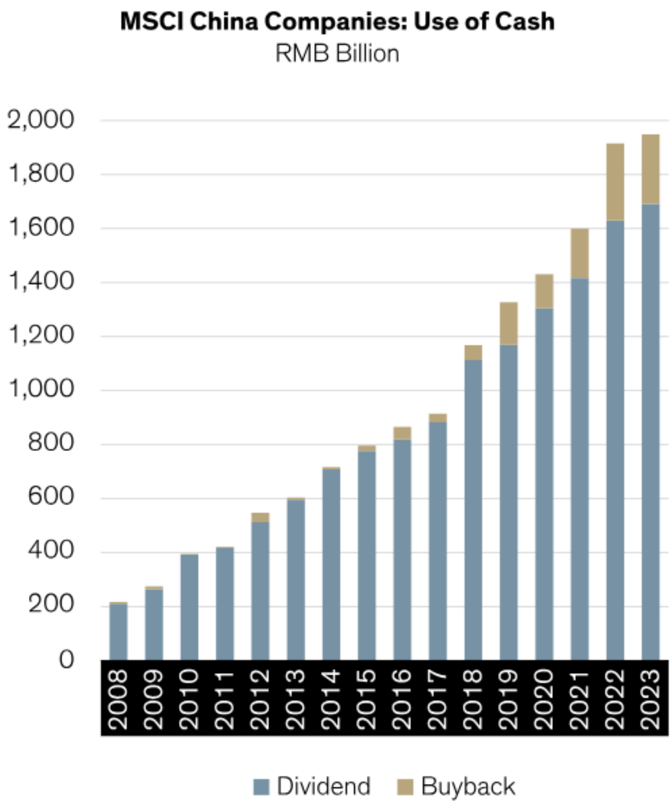
DIVIDENDS AND SHARE BUYBACKS

The dividends of listed companies in 2023 reached 2.2 trillion yuan (c.$315bn), a record high.

Share buybacks also reached a record high of CNY 130 billion (c.$18.5bn) during the first eight months of 2024.

As of June 2024, according to the Shanghai Stock Exchange, more than 1,500 listed companies in China's A share market announced share buybacks for 2024[1].

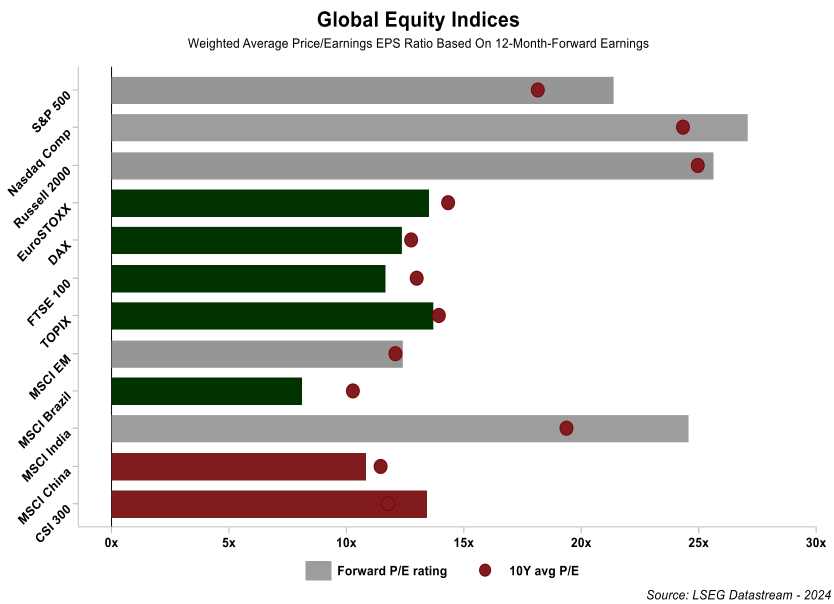
The below chart provided by Alliance Bernstein[2] shows the increase in dividends and share buy-backs from Chinese companies. As noted in their report, the outperformance of value stocks, which typically declare more dividends than growth stocks, has been notable since 2022. In our discussions with clients over the last few years, one of the key questions they ask is whether they will actually participate as a shareholder in the economic success of a company in China. Well, quite simply, stock buybacks and dividends are clearly a return to shareholders and have been increasing. So, in our view the answer is "yes".



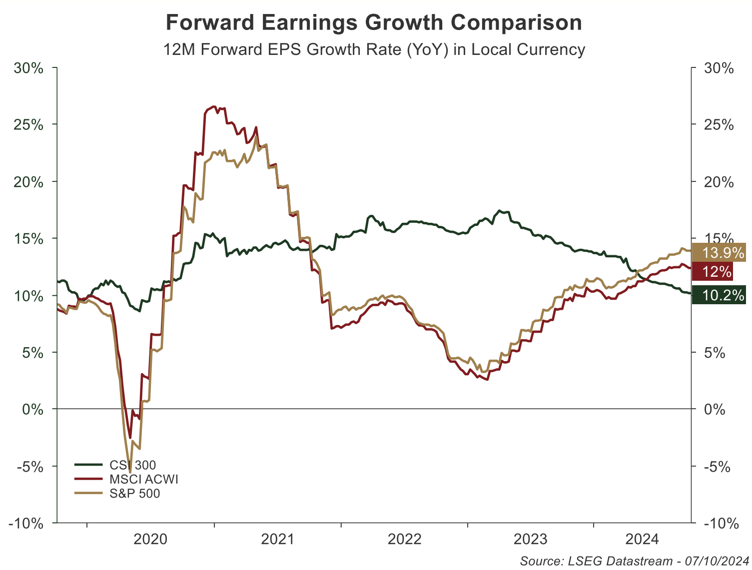
Source: As of December 31, 2023, Bloomberg, FactSet, Goldman Sachs Global Investment Research, MSCI and AB

VALUATIONS & EARNINGS

China's stock market valuation, as measured by P/E ratios, remains attractive, especially when compared to many other major stock markets. The bars below show various equity market current P/E ratios based on 12-month forward earnings. The red dots show the 10-year average P/E – bars extending to the right of the dot indicate a premium versus the average, while those to the left indicate a discount. You will notice some of the European indices such as the Dax40 and Eurostoxx600 also trade cheaper than their 10year average, but China's earnings growth ("E") is far superior to that of Europe (as of 3 Oct 2024)



In the chart below, one can see that the Earnings Per Share 1-year forward growth rates for the onshore CSI300 companies are currently comparable to that of the US, especially if one adjusts for inflation differentials.



China's leading internet companies trade at relatively low multiples despite high growth rates.

These Chinese companies are not only some of the biggest in the world, they are also household names in China used by hundreds of millions of customers. The green below indicates a more favourable metric.

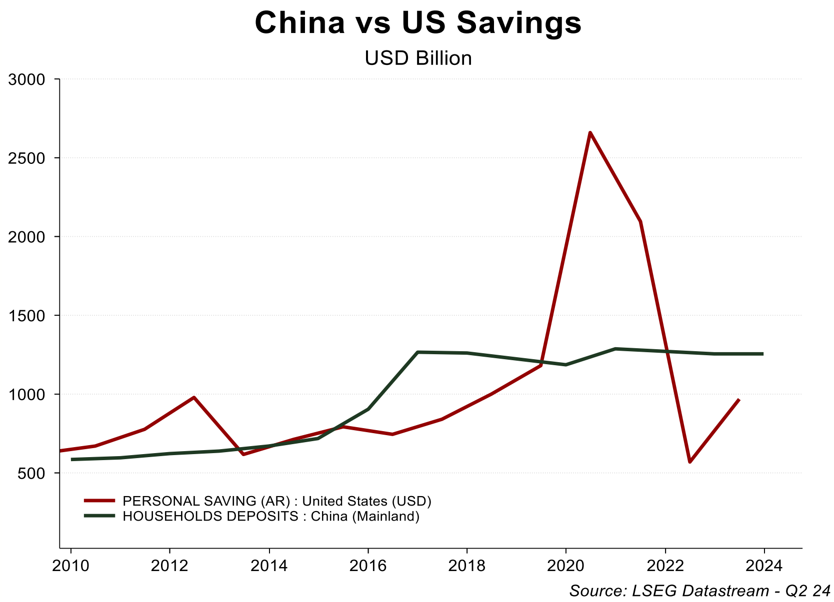
Instrument Name	Market Cap USD (bn)	Sector	Revenue Growth NTM	Fwd P/E	Comparable US Company	Revenue Growth NTM	Fwd P/E
Tencent Holdings Ltd	524.1	Social Media	8.9	17.6	Meta Platforms	15.4	27.2
Alibaba Group Holding Ltd	281.5	E-commerce	8.0	13.1	Amazon	10.6	37.9
Meituan	141.2	Food Delivery	16.7	24.2	JustEat	2.5	-
PDD Holdings Inc	212.6	E-commerce	33.9	12.5	Amazon	10.6	37.9
Baidu Inc	40.1	Search	4.3	9.9	Google	11.7	21.2
NetEase Inc	64.2	Gaming	7.6	14.0	Electronic Arts	4.7	19.0
JD Health International Inc	12.1	Healthcare	12.0	19.1	Walgreens	1.3	3.1
Trip.com Group Ltd	42.5	Travel	16.0	19.4	Booking.com	7.7	23.8
JD.Com Inc	66.7	E-commerce	5.1	11.8	Amazon	10.6	37.9

Source: Refinitiv as of 08/10/24

OTHER INTERESTING DEVELOPMENTS…

- On the 10th of September, **Alibaba** was added to Southbound Stock Connect, opening the company's shares up to investors located in Mainland China after making its Hong Kong share class a dual-primary listing alongside New York. Alibaba historically couldn't be owned by mainland Chinese investors. As this trend continues for many other Chinese companies listed in Hong Kong or New York, we expect flows to be price supportive. Furthermore, this should diversify the shareholder base to include more domestic Chinese investors who might prefer to be long term holders of the stock than many of the Western shareholders. For residents of mainland China, investing in Alibaba is analogous to an American investing in Amazon, Google, Facebook, or Uber; these are services and platforms that people use daily.
- Alibaba has added **Tencent's WeChat Pay** as a payment method within its Taobao and T-Mall E-Commerce platforms in China, which may help the platforms support more users and represents a welcome integration in China's vast digital payments ecosystem.
- **Baidu's** "Apollo Go" autonomous vehicle program switched to fully driverless operations in Wuhan, reducing costs by 50% year over year.
- According to China's National Bureau of Statistics (NBS), **online retail sales** increased +8.9% year-over-year (YoY) in August compared to an increase of only +2.1% for overall retail sales, showing the strong growth in Chinese internet companies. Despite this uptick in retail sales, savings rates have risen in China over the last few years, driven by extended Covid-19 lockdowns and a nervousness of consumers to spend, exacerbated by nervousness about the housing market and/or deflationary pressures. When compared to US households, the numbers look quite stark – the

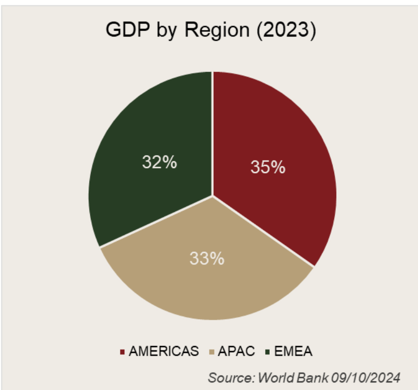
US consumer came out of lockdown and spent money, supporting growth. This has started to reverse in recent months.

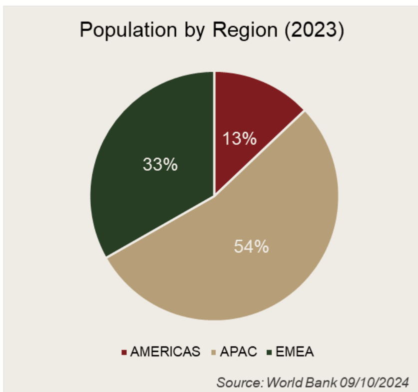


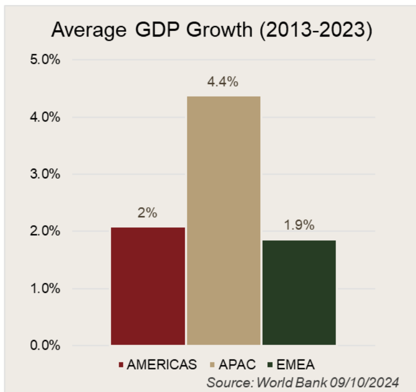
ECONOMIC PICTURE OF CHINA AND ASIA-PACIFIC

GLOBAL GDP SKEWED TO ASIA

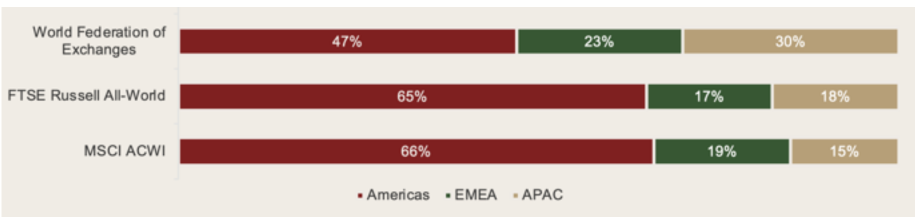
When one looks at the big economic picture (as summarized in charts below), it becomes clear that the Asia Pacific region is growing faster, has more people and the share of global GDP is not adequately represented by the major equity indices.







Market Capitalisation Per Region



Source: Omba, FTSE, MSCI (as of 31/1/24) and World Federation of Exchanges (as of 30/6/23)

WORLD TRADE

China is strongly integrated with the USA and EU in terms of trade and has many other strong trade links.

Merchandise imports – EU, Chinese Taipei, Republic of Korea, USA

Source: WTO.org

Merchandise Exports – USA, EU, Japan, Republic of Korea

Source: WTO.org

Hong Kong excluded due to exports being transitionary to the rest of the world via HK ports.

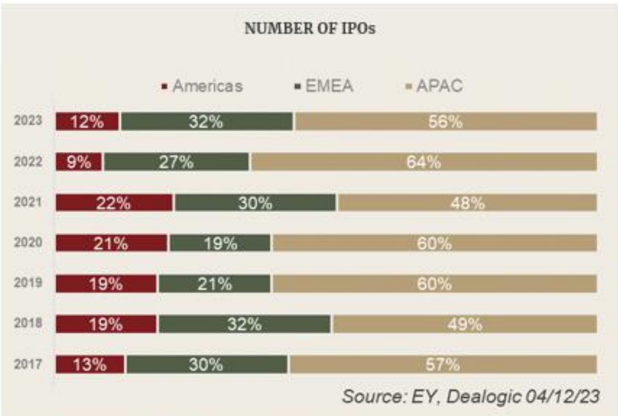
The PRC has **bilateral investment agreements with over 100 countries and economies**, including Austria, the Belgium-Luxembourg Economic Union, Canada, France, Germany, Italy, Japan, South Korea, Spain, Thailand, and the United Kingdom.

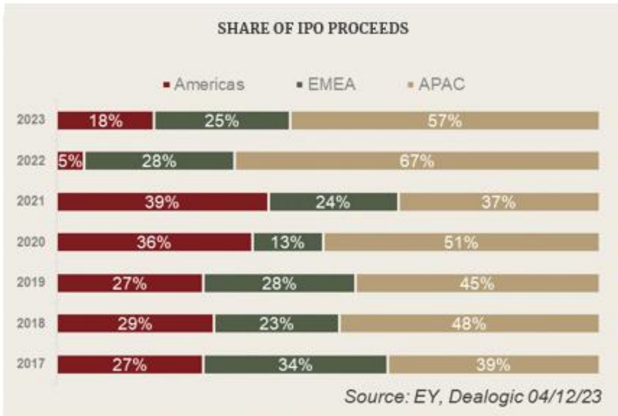
China **maintains 17 Free Trade Agreements (FTAs) with its trade and investment partners** and is negotiating or implementing an additional eight FTAs. China's FTA partners are ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam), Pakistan, New Zealand, Chile, Peru, Costa Rica, Iceland, Switzerland, Maldives, Mauritius, Georgia, South Korea, Australia, Cambodia, Hong Kong, and Macao.

In addition, in November 2020, **China and 14 other countries signed the Regional Comprehensive Economic Partnership (RCEP).** China announced the ratification of the agreement in early 2021[3]. The RECP is expected to eliminate 90% of the tariffs on imports between its signatories within 20 years of coming into force. The 15 member countries account for about 30% of the world's population and 30% of global GDP so despite tariffs being charged on Chinese imports into the EU and USA, China's trading relationship with the rest of the world remains strong and improving.

STRONG CAPITAL MARKET ACTIVITY

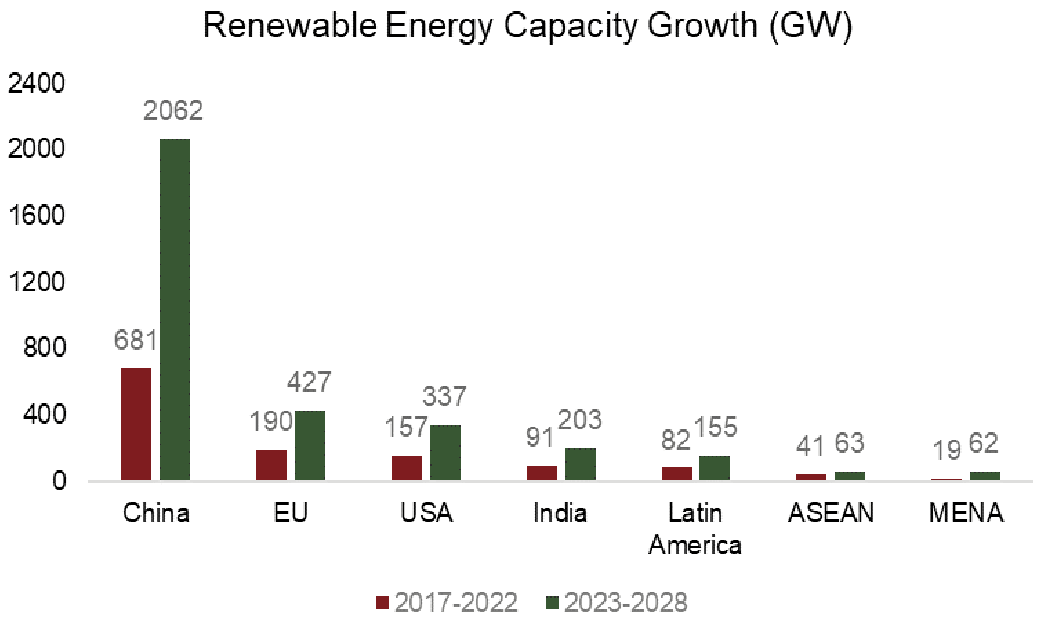
The Asia Pacific (APAC) region is home to more IPO's and a greater quantum of capital raising activity than the Americas or EMEA regions, and this is to a significant degree influenced by China. Improving and deepening capital markets leads to improved long term economic output through access to financial capital. This complements human capital, which is both increasing in number and improving in terms of knowledge and skills as APAC urbanises and provides access to education.





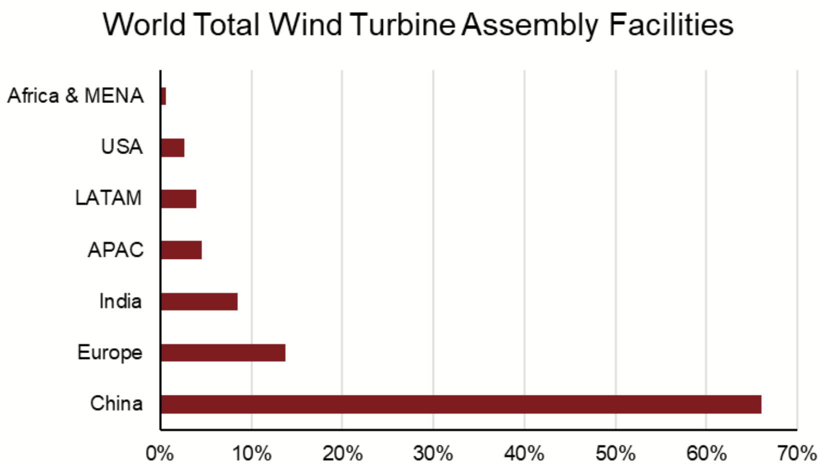
RENEWABLE ENERGY

China's commitment to further expand its role in renewables will play a major part in the energy mix of the country (and world). Over 2023-2028, China is expected to deploy 5x the EU capacity and 6x the US capacity. This is greater than the rest of the world combined.

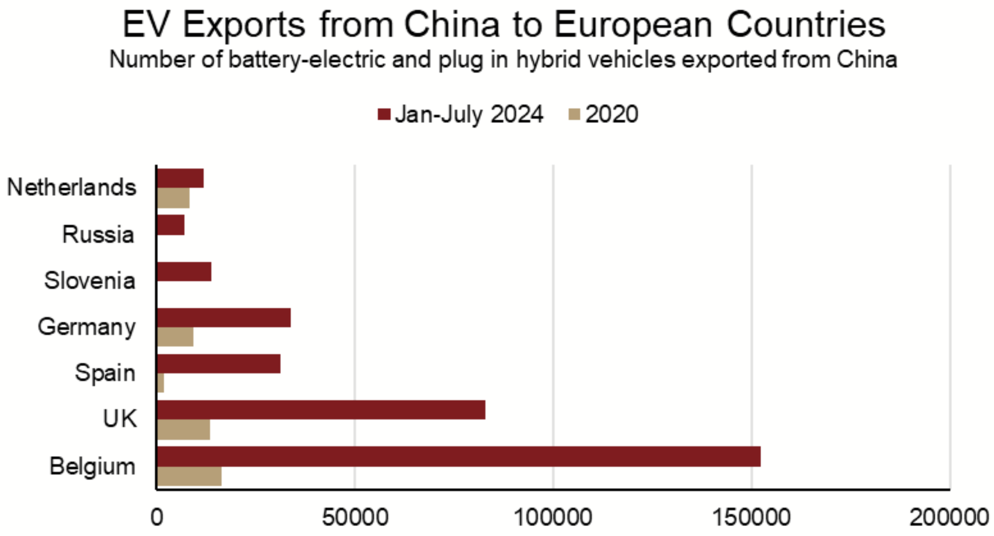


Source: IEA, January 2024

Europe might be the birthplace of the wind industry, but China is the world's manufacturing plant. The Asian country is also the largest production hub for key components and raw materials. Energy system reforms in Europe and the Inflation Reduction Act (IRA) in the USA should further boost demand for clean energy, and China is the dominant global player.



The chart below highlights why the EU want to impose tariffs on Chinese electric vehicle imports: the number of Chinese EV cars sold in Europe has ballooned over the last 4 years.



Source: China Passenger Car Association, Reuters - 3 Sept 24

RISKS

TARIFFS

Both the USA and EU have targeted China with tariffs, most recently on electric vehicles. Tariffs extend to batteries, battery components, semiconductors, steel and aluminium to name a few. The risk for China is that the potential re-election of Donald Trump may result in these tariffs extending to more exports from China, or an increase in the rate of these tariffs. Perversely, this would also hurt the American consumer as it would be inflationary, but it could offset some of the tax cuts proposed.

PROPERTY MARKET

China's housing market has been a drag on the consumer for several years, sparked by the 2021 default of Evergrande Group spreading in subsequent years to a number of others. This followed from the "three red lines" rule announced in August 2020 relating to the debt-to-cash/ equity/ assets ratios. Many property developers crossed all three lines and a correction in the property market ensued. "Property is to be lived in, not speculated upon" is the governing principle underlying this rule. In 2021, a number of reforms to legislation were implemented including mortgage limits, rent caps and cancellations of land auctions. In our view, these are quite sensible, especially if one draws parallels with the US Global Financial Crisis caused by the sub-prime lending crisis.

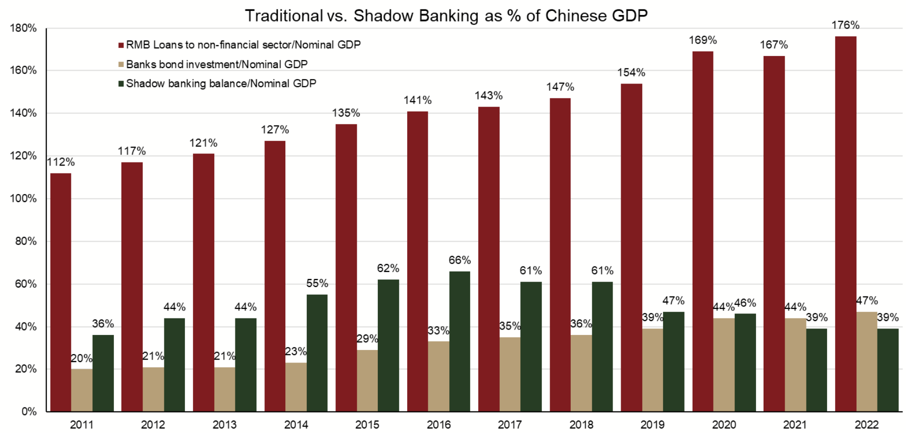
Chinese affluent investors typically invest their savings into a second home or multiple homes and many people in China value their wealth based on the number of properties they own, not based on the size of their share portfolio. Fortunately for the rest of the world, the property crisis in China was (is?) not systemic, but it has remained a drag on the Chinese consumer and - exacerbated by Covid19 lock downs - the stock market. There remains a drag from the property market in China but hopefully the recent announcements will put a floor on the correction we've seen.

SHADOW BANKING

Since the Global Financial Crisis (GFC), there has been a boom across the globe in non-traditional lending as banks shied away from doing riskier lending, either due to fear of higher defaults, or more likely due to stricter regulatory capital requirements forcing them to hold more capital against riskier loans. This phenomenon is not unique to China at all, in fact the private and non-traditional lending markets have ballooned across the Western world too. According to Pitchbook[4] private debt accounted for 16.6% of total Assets Under Management in private markets at 30 September 2023. Estimates are the size of the market has grown to $1.6 trillion with the US accounting for $1.1 trillion of that[5]. China's shadow banking is an iteration of private credit (i.e. lending outside traditional bank loans) where investors have bought "wealth management products" as a conduit for banks to fund off balance sheet loans. Peer-to-peer loans also ballooned since the GFC.

Estimates in 2018 indicate that the size of the shadow banking market in China was in the range of $7.8 to $14 trillion). Since 2017 the sales of these products and extent of peer-to-peer loans have fallen dramatically as China tightened regulations. The number of peer-to-peer lenders have more than halved since the peak. Banks have also been writing down loans since 2016 when the government focussed economic policy on reducing financial risk. This has been one of the many drags on the Chinese economy but the positive side of this has been an improved financial system.

When one thinks about booms and busts in banking, we cannot forget the Savings and Loans crisis in the US. In the mid-80's 32% of Savings and Loans associations failed. In 1989 Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 dramatically changing the savings and loan industry. Yet, despite regulatory reform back in the late 1980's the GFC still occurred due to other failures in regulating banks and financial services firms. The point we're making is that China has recognised an issue in shadow banking and since 2016 has been improving regulation to manage risk. In the week ending 24 June 2024, 40 Chinese banks vanished as they were absorbed into bigger ones[6]. China has been working on cleaning up its banking sector and supporters of these consolidations argue that it will be easier for authorities to regulate fewer bigger banks. Those critical argue that bad banks are just being consolidated creating bigger bad banks but in all these consolidations write downs are taking place. On 28 June 2024, the National People's Congress released the second draft of the PRC Financial Stability Law (FSL) – although not yet enacted it is intended to provide a financial stability guarantee fund as a back-up emergency fund with resources to resolve financial risks. The Draft FSL stipulates certain offences for financial institutions and their major shareholder(s) and actual controller(s). These are all positive developments in a maturing banking sector in China.



GEOPOLITICS – SEMI-CONDUCTORS, TAIWAN, SOUTH CHINA SEA

The geopolitical uncertainty relating to China is unlikely to abate any time soon. As China rises in strength and influence, Western governments are likely to remain cautious of how they interact with China.

China consumes a quarter of global smartphone and PC units and around 15%–20% of global memory supply. Restrictions on selling components and technology to Chinese companies has previously impacted US chip manufacturers as China is a major source of demand for their products. China has spoken about accelerating its plans to boost its domestic technology industry to eliminate dependence on the US suppliers. Tensions relating to Taiwan no doubt have some relation to Taiwan Semiconductor Manufacturing Company Limited (TSMC) which is the world's largest dedicated independent semiconductor foundry. Most 'fabless' semiconductor companies such as AMD, Apple, ARM, Broadcom, Marvell, MediaTek, Qualcomm and Nvidia, are customers of TSMC.

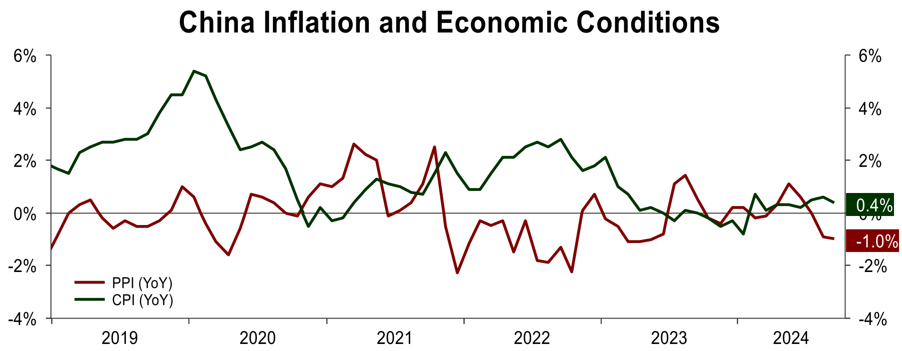
The South China Sea is an important trade route with nearly a quarter of the world's maritime shipping passing through the South China Sea. Several countries have made competing territorial claims over the South China Sea. These disputes have been considered as Asia's most potentially dangerous point of conflict. Fortunately, ASEAN have been keen to ensure disputes do not escalate, and joint development authorities have been set up in areas of overlapping claims.

INTERVENTION IN COMPANIES AND THE PRIVATE SECTOR

We often hear the argument that China is philosophically different to the West as pertains to capitalism - no surprises there perhaps! The argument made is that state intervention into large mega cap and more powerful and influential companies caps the upside one can gain from investing into China. This is a fair point, but we'd argue that Western governments, for example the US and the EU, often bring and have recently brought major anti-trust cases forward against some of the largest most successful companies in the world. The EU has greatly expanded both the scope and enforcement of its own antitrust laws over the last two decades, in a campaign waged largely against U.S.-based tech companies. This includes forceful new legislation such as the Digital Markets Act and the Digital Services Act[7].

How is this different from China clamping down on certain companies and sectors in the interests of their people?

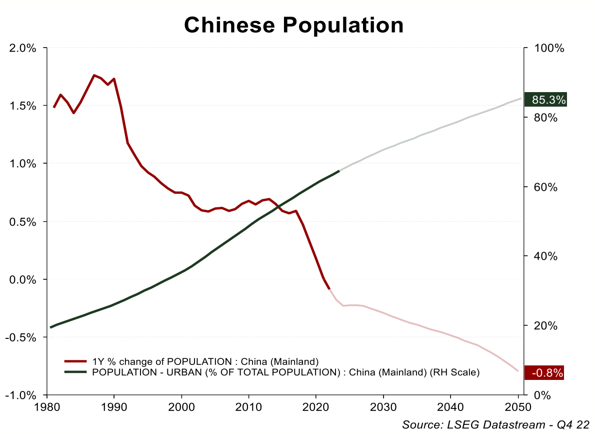
DEFLATION



Deflation is often cited as a risk for China. Decreased demand for products can manifest itself in the form of less personal spending, less investment spending, and less government spending as consumers and companies hold off on expenditures in the hope future prices will be lower. While deflation is often associated with an economic recession or depression, there are many nuances to this. Deflation is not automatically a problem in an economy, if it is only temporary, as consumers enjoy the short-term boost of lower prices and firms enjoy the higher quantity of sales despite the fall in prices. However, if sustained for a longer period, this introduces postponed consumption and this is where the margins and profits of firms start to become affected. Given governments and central banks want to avoid deflation, as we've seen from many Western countries cutting rates, implementing other monetary policy tools such as quantitative easing or fiscal stimulus, we believe China is doing and will continue to do the same. For now, the world arguably benefits from China exporting deflation, raising the real purchasing power of Western consumers.

AGEING DEMOGRAPHICS

Although China's one child policy ended on 1 January 2016 and all Chinese couples are now allowed to have two children, this policy, which restricted the majority of Chinese families to only one child for 35 years, will potentially pose demographic challenges in supporting GDP growth required for a society that is becoming richer, and more expensive, and has an improving social safety net and retirement system. Estimates are that China's population will drop below 1 Billion by 2080. These numbers are obviously rough, and tentative. Policy interventions, natural catastrophe, nuclear war, or other exogenous shocks could change outcomes from these projections.



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