Investing for a world of change

China: Recovery or relapse

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Once touted as the next big thing in global markets, China's equity performance over the past three years has disappointed investors, leading to a flight from Chinese equities. Yet with the unveiling of the biggest stimulus package in years, improving shareholder returns and the sheer scale of the Chinese market, the question is: should investors be looking at China differently?

The drivers of underperformance

Until the dramatic September 2024 market rally, which saw markets rebound by c.30%, China's stock markets reflected the country's slowing economic growth, underperforming global financial markets - including other emerging markets - for about three-and-a-half years. From the end of August 2021 to August 2024, the cumulative total return for the MSCI China index was -35.5%, in stark contrast to the MSCI ACWI's 18.4% gain and the MSCI Emerging Markets index's 8.9% decline[1]. The two key causes of the savage de-rating of Chinese stocks were the initiation of policies designed to deflate a property bubble and address escalating geopolitical tensions with the US and its allies. Policy missteps also unsettled investors, particularly Beijing's crackdown on formerly dynamic private sectors such as the internet platforms and private education. The Chinese Communist Party's draconian approach to the COVID crisis also contributed by shaking the consumer's confidence in the government.

1. World Bank, April 2024.

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Understanding the nuances in stimulus measures

Over the past three years the Chinese government has announced a series of primarily monetary measures to boost growth which failed to inspire confidence among consumers or entrepreneurs. Government bond yields fell to 2%, reflecting strong deflationary pressures resulting from property sector deleveraging on the broader economy. In the second half of 2024, a more robust response began to emerge as the Chinese government introduced a mix of monetary and fiscal measures to support the economy and the stock market.

Among the key actions, the People's Bank of China (PBoC) reduced the required reserve ratio for major banks from 10% to 9.5%, freeing up additional capital to stimulate economic growth. The PBoC also cut short-term interest rates and reduced rates on existing mortgages, potentially easing some of the strain on China's struggling property sector – once a major driver of China's rapid growth. In addition, a US$114 billion lending pool was established to support capital markets, facilitating share buybacks by companies and allowing non-bank financial institutions, such as insurers, to borrow at low cost to invest in local equities.

Further fiscal stimulus packages targeted the ongoing issue of heavily indebted local authorities, which had previously hindered efforts to stabilise property markets. These packages included subsidies for low-income consumers and measures to bolster the capital of major state-owned commercial banks, improving their ability to withstand risks and provide credit to the real economy.

Shortly after the US election results were announced on 6 November, the government unveiled an additional Rmb10 trillion ($1.4 trillion) fiscal package to bail out local governments, and bolster the economy further.

While stimulus measures were anticipated, their initial scale surprised many, as reflected in the strength of the September rally, and indicated that economic weakness has become a dominant concern for the government. The MSCI China Index rallied from a decade-low 10x P/E to a more reasonable 12.3x in September, bringing valuations closer to the broader MSCI Emerging Markets Index at 15.5x, but still lower than the MSCI World Index at 21.5x[2]. However, subsequent announcements fell short of investor expectations for stronger support to boost household consumption.

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2. Bloomberg, as at September 2024.

The key question now is whether these dramatic market moves represent a temporary adjustment in positioning or signal a turning point in China's fundamental economic prospects. While only time will tell, the evidence suggests that Chinese equity valuations have likely established a base. Much will depend on the extent and effectiveness of the measures introduced and whether they are sufficient to turn around consumer and entrepreneurial sentiment. Should households begin drawing on the elevated savings they have accumulated, rather than leaving them in low-interest bank accounts, this could lay the foundation for a strong and sustained economic, and capital market, upswing.

More importantly, these actions signal support for risk assets and should help stabilise growth while mitigating deflation risks. Key indicators of a confirmation of a reflationary trend include core inflation data and forward corporate earnings expectations. For long-term investors, reassurance will require more than just a stimulus-driven market rally reminiscent of the 'stop go cycles' of the post GFC period. In this context it's important to understand China's structural challenges and the government's broader intentions.

For example, while the reserve ratio has been lowered to free up additional capital, this move is not intended to stimulate consumption by increasing consumer debt, a strategy more common in the West and one the Chinese government has consistently avoided. While specific policies are being rolled out to increase consumer demand, this is qualitatively different and reflects a cautious, long-term approach.

Moreover, the property stimulus measures may have been misinterpreted by some investors. These initiatives are designed to provide liquidity to clear excess supply at lower prices, rather than to artificially stimulate demand to support the profitability of property developers. This distinction is subtle, but significant.

China's approach focuses on creating a stable financial environment that supports sustainable, long-term growth, rather than inflating asset prices for temporary wealth effects. This emphasis on structural stability over short-term gains underlines the government's commitment to fostering a durable economic foundation rather than merely stimulating consumer sentiment or spending. It also explains why China's actions often diverge from the expectations of Western investors, who are more accustomed to policies that prioritise immediate market gains. With that in mind, let's unpack some of the structural changes underway.

The structural transformation of China's economy

The emergence of China's 'New Economy' has been overshadowed by an investor narrative focused exclusively on the legacy of its rapid growth, marked by an overall debt-to-GDP ratio of over 300%, inflated property prices and capital misallocation together with its ageing population and inadequate investment in health and social welfare. True, China faces formidable challenges, but the economy has been undergoing a fundamental shift from an investment-driven model towards a 'dual circulation model', where the government prioritises domestic production and consumption to reduce reliance on foreign markets while remaining open to international trade and investment. Recognising that the traditional drivers of high GDP growth - property, infrastructure investment, and low-value manufacturing exports - are unsustainable, government policy is now focusing on moving rapidly 'up the value chain' through the development of technological self-sufficiency and advanced manufacturing. By combining its scale with technological prowess, especially in automation, China is emerging as an even more formidable manufacturing powerhouse. Its rise from being an also-ran in auto exports to being the largest auto exporter in just four years is just one example demonstrating its speed of adaptation.

A risk to this outlook is whether consumption, and its twin, consumer confidence, can recover its prior rate of growth. Rising incomes and urbanisation suggest that consumption can still emerge as a key driver of GDP over the next decade. However, government-led initiatives in healthcare, education, and social security will be essential to encourage domestic spending. Currently China's gross savings rate stands at 44.3%, far exceeding the EU's 25.7% or the US's 17.8%[3]. For sustainable growth, people need greater economic and social security, which would reduce the need for such high levels of saving. When this shift occurs, it should better set the stage for slower, but more balanced and resilient long-term growth.

3. CEIC data 2023.

Understanding geopolitical realities

China's evolving relationship with the US is important to understanding the current political and economic tensions that lie at the heart of global trade dynamics. Since joining the WTO in 2001, China's economy has grown from 12.7% to 64.1% of the size of the US economy by 2023[4], shifting its role from a participant in the global economy to a very real contender for leadership.

This transformation accelerated with the launch of China's 'Made in China 2025' strategy, which aims to establish the country as a global leader in industries critical to shaping the future of the world economy. The strategy's ultimate objective was articulated by Wang Huning, a prominent author, philosopher and economic advisor to Xi Jinping. In his seminal book *America against America*, Huning writes: "If you want to overwhelm the Americans, you must do one thing: surpass them in science and technology[5]". These ambitions have intensified the adversarial relationship with the US. This rivalry is poised to enter a new era of uncertainty with the election of Donald Trump to the US presidency. Trump campaigned on a platform of higher tariffs — 60% on Chinese goods — after a first term in which he launched a trade war that is still raging.

Combined, these dynamics fuel geostrategic competition as the global power structure shifts from unipolarity to multipolarity, driven by China's rise, Russia's belligerence, and India's growing influence.

However, China's economic ambitions must be weighed against its geopolitical actions. There is a growing tension between China's desire to be part of the global order and its perceived territorial assertiveness. This increases the risk of geopolitical instability, which could lead to significant losses for investors.

De-risking operations from geopolitics

In response to these geopolitical tensions, companies around the world are reconfiguring their supply chains, whether by bringing their manufacturing home (onshoring), relocating closer to home (nearshoring), or shifting to strategically neutral countries (friendshoring).

Despite initial fears that China would be a net loser from these shifts, it has continued to record an increase in its trade surplus and expand its share in complex value chains since the first COVID-related supply chain disruptions. Chinese manufacturers are adapting by investing in and expanding capacities within countries that offer strategic access to key markets, such as Southeast Asia for the US and Turkey for Europe[6]. In the medium term, China's role in global supply chains is expected to grow, even as it navigates the complexities of global trade relationships.

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4. IMF World Economic Outlook.
5. How a Book About America's History Foretold China'a Future I The New Yorker.
6 The Fed - Global trafe patterns in the wake of the 2018 - 2019 US - China tariff hikes.

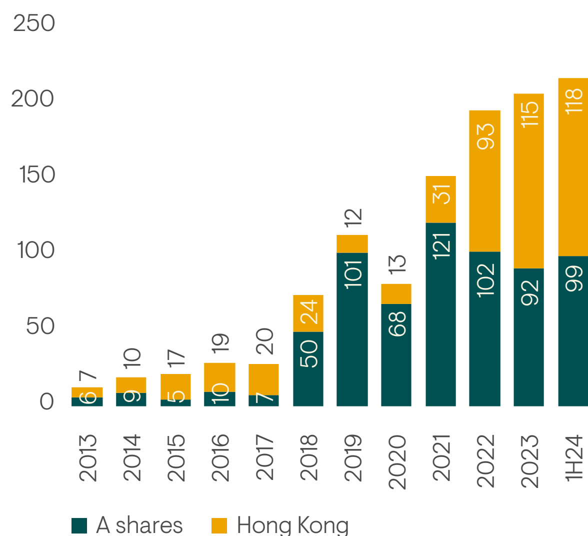
Investment outlook: a governance transformation

While geopolitics surrounding China may sow fear in some investors and GDP numbers may not spark enthusiasm, the changes taking place at a company level should not be overlooked. Chinese companies are transitioning from a growth-at-all-costs phase to a more sophisticated and stable one where the focus is shifting toward profitability, capital discipline and delivering shareholder returns.

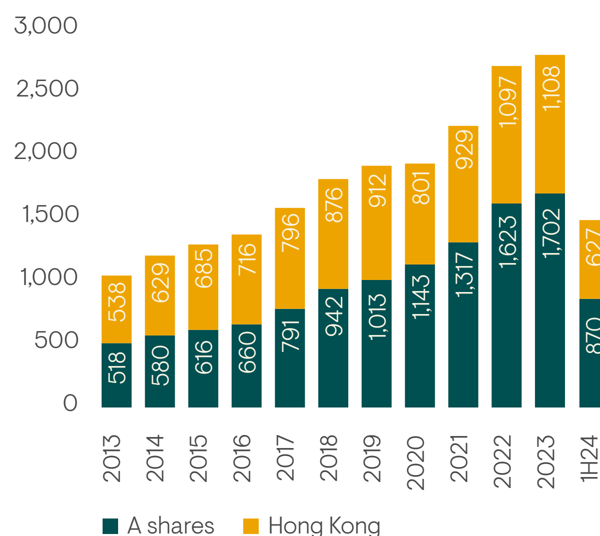
This shift is supported by a more favourable policy environment. The China Securities Regulatory Commission (CSRC) has taken a proactive approach to reforming and strengthening capital markets, while the agency overseeing state-owned enterprises (SOEs) has introduced key metrics, including return on equity and dividend payouts, to evaluate performance. This reflects a growing focus on profitability and shareholder returns among large SOEs, which paid out between 84% and 116% of last year's earnings as dividends. Listed private enterprises are also increasingly returning capital to shareholders through dividends, buybacks, and spin-offs[7]. As a result, total share buybacks of China A-shares in 2022 and 2023 surpassed the combined total of the previous decade, with dividend payouts nearly tripling over the same period[8].

Record level of share buyback and dividends
Chinese companies are increasing shareholder returns

Chinese companies annual buybacks (Rmb bn)



Chinese companies dividend payout (Rmb bn)



Source: Ninety One, June 2024.

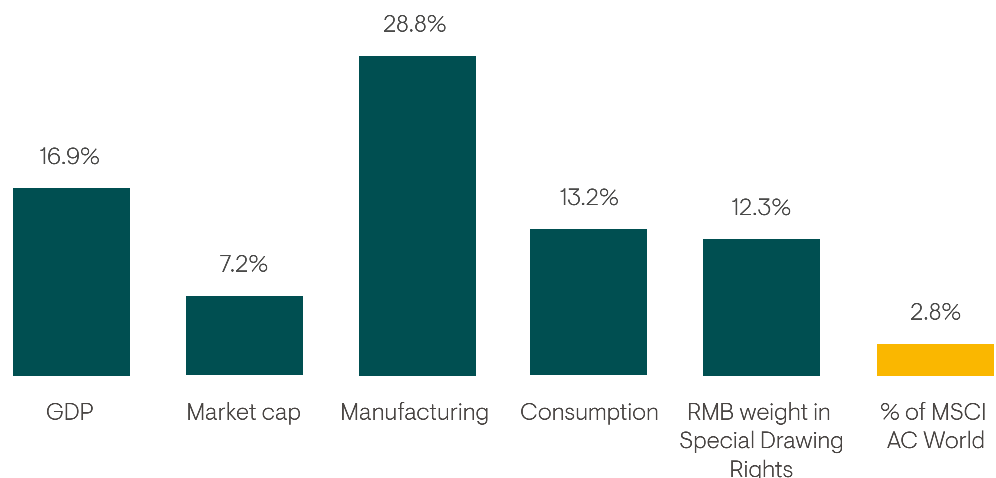
7. Riscura.
8. Ninety One research: China A shares are back.

Notable share buyback examples include Alibaba, which repurchased US$9.5 billion worth of stock during 2023 and approved an additional US$25 billion share buyback in early 2024. Tencent plans to more than double its share buyback programme to at least US$12.8 billion in 2024, while Meituan initiated its first-ever share repurchase programme in January 2024. Beyond share buybacks, cash flow return on investment (CFROI) also has improved over the years, reflecting a focus on cashflow generation and more conservative capital expenditure. Higher CFROI translates into better returns for shareholders.

Chinese markets: to big an opportunity set to be ignored?

With over 5,000 companies listed on domestic Chinese exchanges and more than 2,000 in Hong Kong, the breadth of opportunity is substantial. While the macro picture may raise some concerns, at the micro level the case for selective, bottom-up stock picking is compelling.

China is under-represented in global equities



Source: World Bank, IMF. Data as at June 2024.

Sector-specific opportunities

While sectors such as consumer and the global tech supply chain are already achieving global recognition, China's focus on high-end manufacturing is fostering the rise of what China dubs 'little giants', namely small, specialised companies excelling in advanced manufacturing sectors like aerospace and telecoms.

One area of significant structural opportunities is decarbonisation. China itself is the world's largest emitter of greenhouse gases, accounting for c.26% of the global total. In the renewable energy sector, firms are advancing solar power, battery production, and electric vehicles, leveraging scale and market leadership to drive decarbonisation. Moreover, China's auto sector is already on track to become a global success story, with significant investments in electric and hybrid vehicles that further support the transition to a sustainable future. In addition, construction, responsible for about 20% of China's greenhouse gas emissions, is also part of the opportunity set. While the sector remains inefficient and carbon intensive, and lacks digitisation, greater adoption of building information modelling (BIM) solutions could drive efficiency and reduce carbon intensity, creating a clear market opportunity for providers in this space.

Healthcare is another structural beneficiary, with a material mismatch between available resources and rising demand. China's elderly population is growing rapidly, with 28% of the population expected to be over 60 by 2040, driven by longer life expectancies and declining fertility rates. Yet, healthcare spending in China remains far below that of developed nations, accounting for just 6% of GDP in 2020 compared to 11% in Japan and the EU, and 19% in the US. As household incomes rise, consumers are increasingly willing to spend on healthcare services and products. Greater health awareness has fueled demand for quality healthcare, expanded insurance coverage, preventive services, and wellness products.

China's consumer market is also undergoing a shift toward more thoughtful consumption, with consumers prioritising quality and experiences over brand prestige. Spending on experiences like travel and entertainment is rising, driving growth in sectors such as online travel agencies and food services. The retail landscape is also evolving rapidly with the integration of technology. Innovations like live streaming and instant retail have become mainstream, reshaping how consumers shop and engage with brands. This digital transformation, accelerated by the pandemic, has increased online shopping penetration and introduced new retail formats.

Conclusion: China's day in the sun may still be coming

China's stock markets are showing signs of momentum, though it remains to be seen whether this can be sustained. The September 2024 rally, in our view, was largely driven by a 'bear squeeze' as short positions were unwound, likely helping to set a floor under the market – a 'Beijing put' as it were – signalling the start of a base building process.

For investors, China offers access to a large and diverse set of companies, many of which are underrepresented in global indices. The growing prominence of the industrial, technology and consumer sectors provides valuable diversification opportunities that were less accessible a decade ago.

However, it is important to recognise that China's government manages its economy differently from what Western investors may expect. A nuanced understanding of these dynamics is critical. Under Xi Jinping, the Chinese Communist Party has taken more direct control of government, but reliance on market forces to set prices and the role of private enterprise – essentially 'capitalism with Chinese characteristics' – remains crucial if China is to overcome its structural challenges. On the other hand, if the government wishes to build a robust equity market as an alternative to property investment and to improve capital allocation, domestic investors will need stronger incentives to own equities.

Considering these factors, a bottom-up investment approach can help identify shares with solid fundamentals, potentially leading to better risk-adjusted returns. In such environments, active management plays an essential role. With the support of extensive research and market experience, investors can better navigate market complexities and uncover opportunities that passive strategies might miss.

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Specific risks. Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems.

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CS_725 11/2024 - MACS18184