SYNCICAP ASSET MANAGEMENT

MARKET INSIGHTS

24 JANUARY 2024

Chinese equities: too cheap to ignore now?

Jean-Marie MERCADAL
CEO
SYNCICAP AM

Xinghang LI
Managing Director
SYNCICAP AM

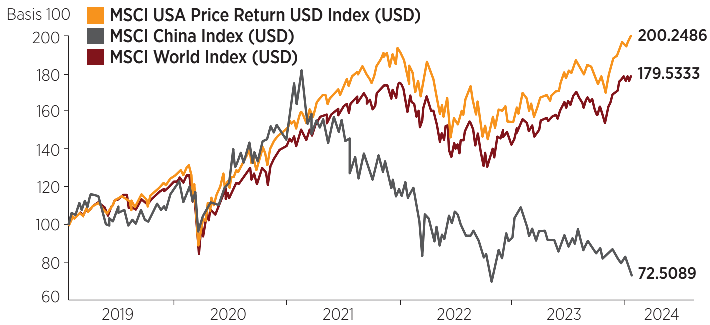
The start of the year has once again been very disappointing for Chinese equities with a drop of almost 12% in the MSCI China index (in USD) in less than a month. Admittedly, Chinese equities appear to be very undervalued in absolute terms and relative to other markets, but this infinite decline raises some key questions.

EMERGING MARKET (EM) EQUITIES WERE NOT AMONG THE BIG WINNERS LAST YEAR. ARE EM EQUITIES, AND ESPECIALLY CHINESE EQUITIES, NOW UNDERVALUED?

That is not entirely accurate. In fact, the subpar performance of the emerging markets equity indices is simply due to China's significant weight in these indices (around 30 to 35%). However, if you exclude China, the MSCI Emerging Markets **ex China** index has risen by 20% in 2023, and the MSCI EM Asia **ex China** index by 21% (in USD).

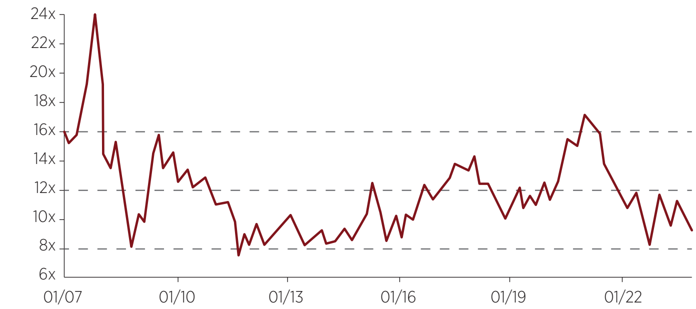
In 2023, the MSCI China index dropped by 11%, and is now down by almost 70% from its 2021 highs! And this trend is so far extending to 2024. Thus, Chinese equities look very discounted now with a 2024 P/E ratio of just above 9, with earnings expected to increase by 14% this year. This level of absolute and relative discount to other international markets is starting to attract interest. Historically, Chinese equities have repeatedly shown very powerful rebound capacities, often in the order of 30% in a few weeks. Recently, we have seen some major US asset managers advising to return to this market. In addition, in recent weeks, volumes on Chinese stock options have been on the rise...

5-year evolution: Chinese equities have become disconnected from global market developments since the 2021 "regulatory crackdown"



Source: Bloomberg as of 23/01/24

Forward P/E valuation of MSCI China index



Sources: Bloomberg, MSCI

WILL 2024 BE A COMEBACK STORY?

Despite today's very bad momentum, Chinese equities have the potential to surprise us in 2024. Macro appears to be stabilizing, so the downward revisions of corporate earnings that have marked 2023 may fade. In addition, valuations are low, and the positioning of international investors is weak. This could prompt some investors to try to capture rebounds, at least tactically. In addition, the government seems willing to be doing more to support the economy this year. In his New Year's speech, President Xi Jinping acknowledged that 2023 was not a satisfactory year and he wants to promote entrepreneurship again, which was seriously affected by the 2021 regulatory crackdown. A bigger budget deficit could appear in 2024. Further monetary easing (lower rates and a decline in banks' ratio requirements) is very likely. In a nutshell, a lot of parameters are in place that could trigger a market rebound, but there is still no clear catalyst for it. But let's keep in mind that when a catalyst eventually appears, it may be too late to invest…

WHAT POLICY MEASURES ARE NEEDED TO ACHIEVE THIS GOAL?

The new political roadmap given by president Xi Jinping in 2021, called "Common Prosperity" is a long-term social project that has been developed with the objective of aiming for an unprecedented 3rd term and probably a presidency for life. Implementation of this project has created a lot of short-term disruptions: deflation of the real estate bubble, collapse of internet stocks, loss of confidence of entrepreneurs, etc. Initially, the government does not seem to have taken the measure of the negative consequences that have been generated, which are now creating discontent among the population and weighing heavily on confidence, which naturally slows down consumption and investment. So, there is a need to correct the situation. In the short term, 3 types of political measures can create the conditions for recovery:
1 - Completing any undelivered apartments;
2 - Stopping the defaults of major real estate developers;
3 - Increasing household incomes.

The government seems to have become aware of this situation and started to organize a form of support for the real estate sector: a 1-trillionyuan package funded by the PBOC to support public housing has been set. It is equivalent to 8% of total real estate investment in 2023 and can reduce the decline of real estate investment in 2024 from 8/10% to 2/4%. This policy initiative can also serve a second purpose: it can accelerate the inventory correction in the housing market. Fiscal policy is also expected to be more expansionary this year with an estimated deficit of around 3.8% of GDP.

SHOULD CHINA NOT BE WRITTEN OFF?

After a multi-year bear market in Chinese stocks with no end in sight, some foreign asset managers have opted to underweigh or avoid Chinese stocks entirely. Some are probably exiting the market now, that could be one of the reasons for the fast decline in the current market. But the main explanation why some investors avoid China is of a political nature: China's undemocratic regime and its equivocal attitude towards Russia and Taiwan are the main causes. Let's also add the context of the trade war with the United States, which weighs on and maintains a climate of tensions. But it's a pity. China is the 2nd largest economy in the world and its stock market is vast with more than 3000 listed stocks and its market capitalization (including Hong Kong) represents 15% of the world's capitalization. Moreover, if the world becomes more polarized, the Chinese market will be increasingly uncorrelated from other financial centers, which is interesting from the point of view of portfolio diversification. Finally, China benefits from a gigantic domestic consumer market, which gives a critical mass to the companies that operate there. In other words, China is too big to ignore.

GIVEN THE TRADE WAR WITH THE US AND THE DISPUTES WITH TAIWAN, SHOULD INVESTORS REALLY INVEST?

The outcome of the presidential elections in Taiwan does not seem likely to cause further tensions in the short term. Admittedly, the candidate of the "pro-independence" party DPP won, which gives an unprecedented 3rd consecutive victory to this party. But unlike previous times, he won with less than 50% of the vote and did not have a majority in Parliament. China therefore considers this to be a weak adhesion and the United States has reacted with a rather moderate statement. We know China's long-term goals, but in the short term, therefore, there should not be any major changes before the next U.S. presidential election. In terms of trade tensions, the US ban on strategic exports, particularly in high-tech industries such as semiconductors, is holding back China's development. But on the other hand, it forces it to accelerate the construction of its own capabilities, which will make it more self-sufficient in the long run. As a result, and given the size of the Chinese market, there is room for high-quality companies to develop.

THE CHINESE MIDDLE CLASS HAS ALWAYS BEEN SEEN AS ONE OF THE ENGINES OF GROWTH. IS THIS STILL THE CASE DESPITE THE PROBLEMS IN CHINA?

Over the next few years, the government would like to refocus the country's growth more on domestic consumption than on exports and investment in infrastructure or real estate. China's household savings rate at more than 40% is very high by international standards, which suggests enormous potential. But it's a trend that will pay off in the long run. In the short term, household confidence is affected by the decline in the value of real estate, the main component of wealth. In addition, the government will need to put in place broader social protections and pension financing systems in the medium term to stimulate consumption in the long term. On this last point, the establishment of pension funds would be very positive for the financial markets.

WHICH SECTORS LOOK ATTRACTIVE?

We currently like state-owned enterprises in the field of utilities, such as electricity distribution, or telecoms. They currently have several attributes: they pay high dividends of around 6% to 8% depending on the case, which is very attractive, and these dividends seem to be sustainable because the government needs these returns to finance its programs to support the economy. In addition, they seem to be immune to potential new regulatory waves and offer good visibility. We also like the consumer sector, the healthcare sector and some internet stocks that are now very discounted. There are still very profitable Chinese companies in sectors ranging from technology to tourism that are trading at a "huge discount" relative to global stocks.

WHAT NEEDS TO BE CONSIDERED DESPITE THE OPPORTUNITIES?

There are two main factors to be considered when it comes to investing in China:

1 - **The RMB.** The Chinese currency has all the attributes to become a major international currency capable of competing with the US dollar. As we have seen with Russia and the freezing of Russian foreign exchange reserves, there is a risk in holding all your foreign exchange reserves in dollars. Countries in Africa or the Middle East which are in the process of forging strategic economic partnerships with China would do well to diversify their holdings and keep a significant part of their foreign exchange reserves in RMB, a currency backed by a large economy that is the 2nd largest in the world and has a deep bond market. The problem is that for the time being, the Chinese currency is not freely convertible due to capital controls. This keeps selling pressure on the RMB in the short term as many Chinese would like to invest internationally. However, we do not anticipate any strong swings in the RMB this year, as the government seems to be attached to some form of currency stability for the time being.

2 - **The weight of politics.** The recent wave of new regulations has shown this. The risk for long-term investments is the governance of the country. If the central government interferes too much in the business world and if the goal of getting rich is frowned upon, then the entrepreneurial spirit that has allowed China to experience unprecedented and spectacular growth during the last 40 years will collapse.

After such a decline, it now seems too late to sell Chinese equities at such low valuation levels. But the visibility still remains low. Although the government has already taken many monetary and budgetary support measures, we have the feeling that it has not yet fully taken the measure of the real estate challenges and the growing discontent of the population (or it is accommodating itself by aiming for a very long-term logic). As a result, there is no clear catalyst in the short term for a reversal of the current trend. However, it should be kept in mind that things can change very quickly in China... At this level, Chinese equities are a kind of option, with no time value... and that requires a lot of patience.

SYNCICAP ASSET MANAGEMENT

Syncicap AM is a joint-venture between Ofi Invest group (66%) and Degroof Petercam Asset Management (34%). It was licensed on 4 October 2021 by the Hong Kong Securities and Futures Commission.
Syncicap AM specializes in emerging markets and offers a beachhead into Asia from Hong Kong. It also manages a range of emerging markets funds offered to European investors by Ofi Invest Asset Management.

The figures cited deal with past years. Past performances are not a reliable indicator of future performances.
Investing in financial markets involves risks, including risk of capital loss. Source of indexes cited: www.bloomberg.com

www.syncicap.com
2801-02, 28/F, Man Yee Building, 68 Des Voeux Road Central, Central, Hong Kong • Tel.: +852 3842 8204