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Are Chinese Equities a Buy?

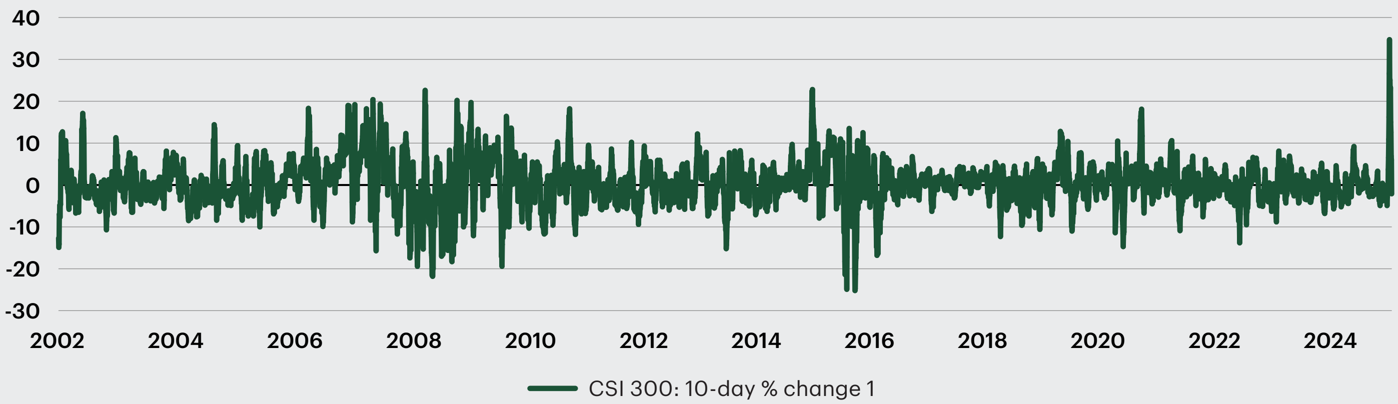
China's economy and stock market have faltered for several years now. However, many commentators believe Beijing's recent policy announcements mark a decisive inflection point, with the market set to mean revert and enter a prolonged period of outperformance. We agree the newest batch of policies are undoubtedly important, most notably for curtailing downside risks. However, this paper argues the recent move won't have legs and investors should fully fade the bounce.

For a start, the stimulus package does not represent a "big bazooka." This expression was used to describe the massive policy response unveiled by U.S. Treasury Secretary Hank Paulson in September 2008. Two months later, China announced an enormous stimulus plan, representing an eye-popping 15% of GDP, largely focused on infrastructure investment. European Central Bank (ECB) Governor Mario Draghi produced a similar effect a few years later when he promised to do "whatever it takes" to end the financial crisis threatening the euro. The key takeaway from these three experiences is the credible commitment of a "big bazooka" can be effective in rescinding prolonged downturns.

However, and in sharp contrast, last month's package amounts to small beer. To illustrate, it prompted Goldman Sachs to increase their GDP forecast for 2024 by an inconsequential 20 bps (to 4.9%) and for 2025 by a picayune 40 bps (to 4.7%). The near-term goal wasn't to massively stimulate demand, rather it was to fend off a brewing financial crisis. In particular, to bail out indebted Chinese municipalities that were approaching the brink of collapse. And from this relatively narrow perspective, ensuring stability and order, the policies have been an undeniable success. But there's been no bazooka.

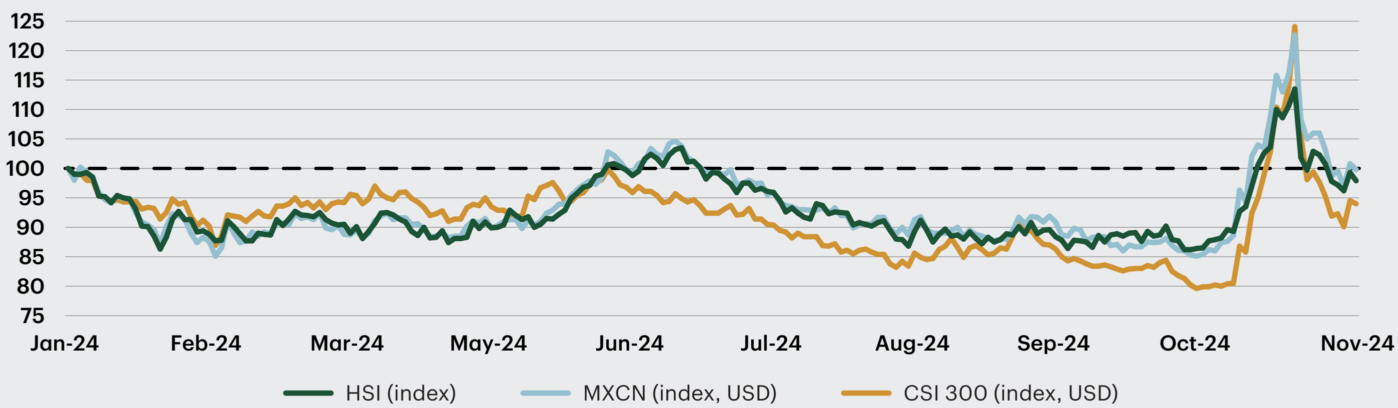
How have investors responded over the last few weeks? Initially, Chinese stock indices rallied hugely, with the Shanghai-Shenzhen CSI 300 Index experiencing the strongest 10-day move in its history (**Figure 1**). Much of this reflected positioning as the vast majority of investors were caught offside, being underweight at the time. And even though additional follow-on announcements are expected, it appears that many investors have chosen to fade the bounce (**Figure 2**).

Figure 1: Chinese stock markets enjoyed an enormous, albeit temporary, rally following Beijing's stimulus announcement on September 23.



Source: Bloomberg Finance, L.P.

Figure 2: Chinese indices lagged the SPX for most of 2024 but surged ahead in late September. However, this rally proved to be short-lived.

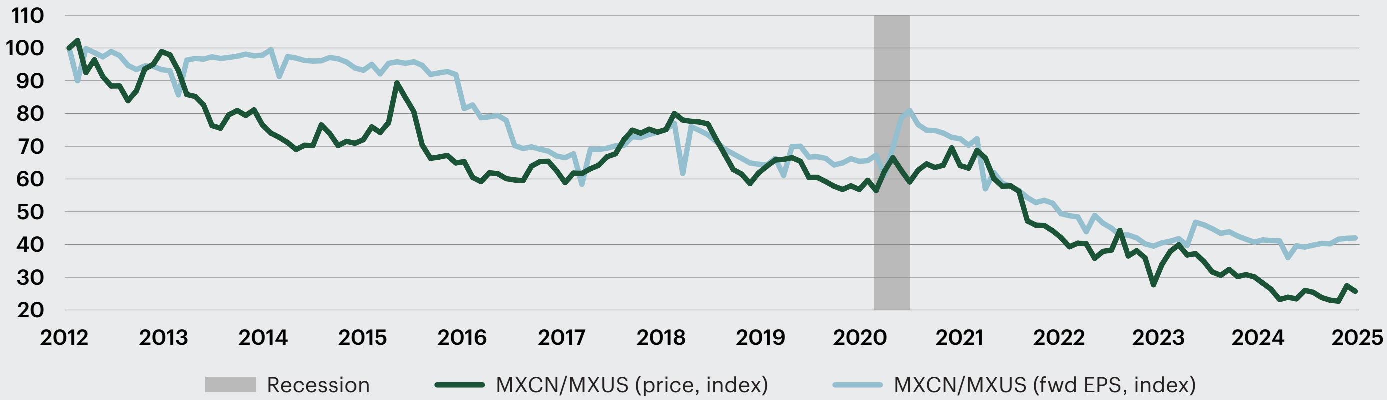


Source: Bloomberg Finance, L.P.

The longer-term view: Chinese equities have dramatically underperformed.

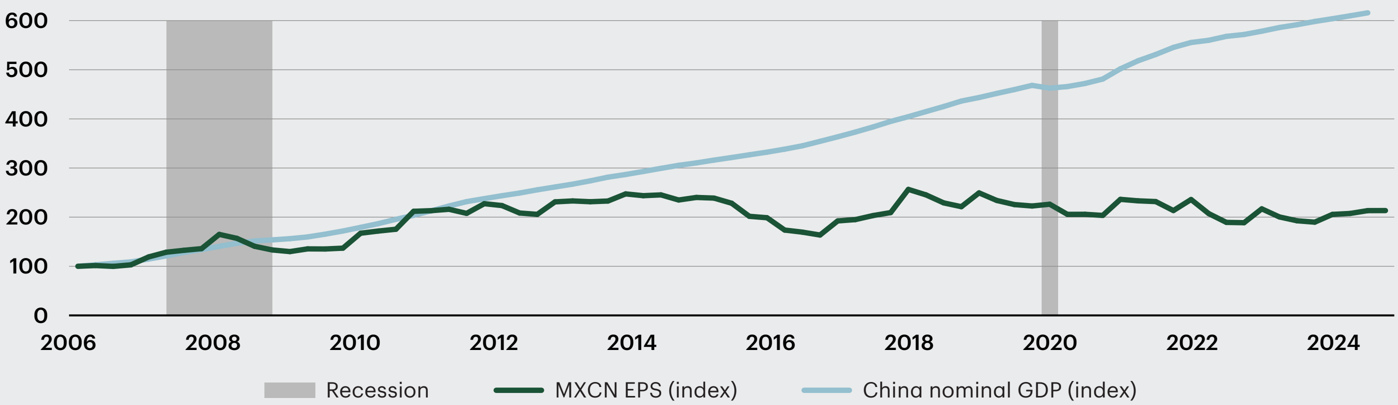
To understand both recent market action and what lies ahead, it is critical to move beyond a focus on the short-term. In particular, we emphasize that Chinese equities have underperformed for well over a decade now, with the bulk of that decline driven by disappointing EPS (**Figure 3**). Moreover, EPS hasn't lagged due to a lack of GDP growth, as the two series parted ways twelve years ago (**Figure 4**). It is widely underappreciated that China has exhibited the worst passthrough from GDP to equity earnings among major markets.

Figure 3: Since 2012, MSCI China has underperformed its U.S. counterpart by a stupefying 70%, largely due to weak earnings.



Source: Bloomberg Finance, L.P.

Figure 4: What explains the great divergence? Nominal GDP and EPS were 90% correlated prior to 2012, but since then the tight linkage has been shattered and earnings have flat-lined.

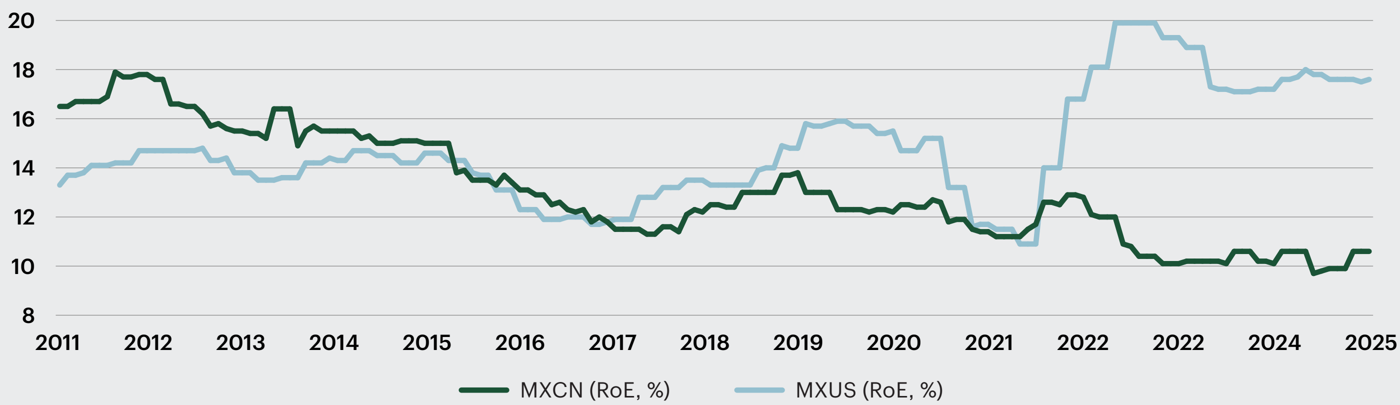


Source: Bloomberg Finance, L.P.

Why have earnings gone ex-growth? The main reason is ineffective capital allocation.

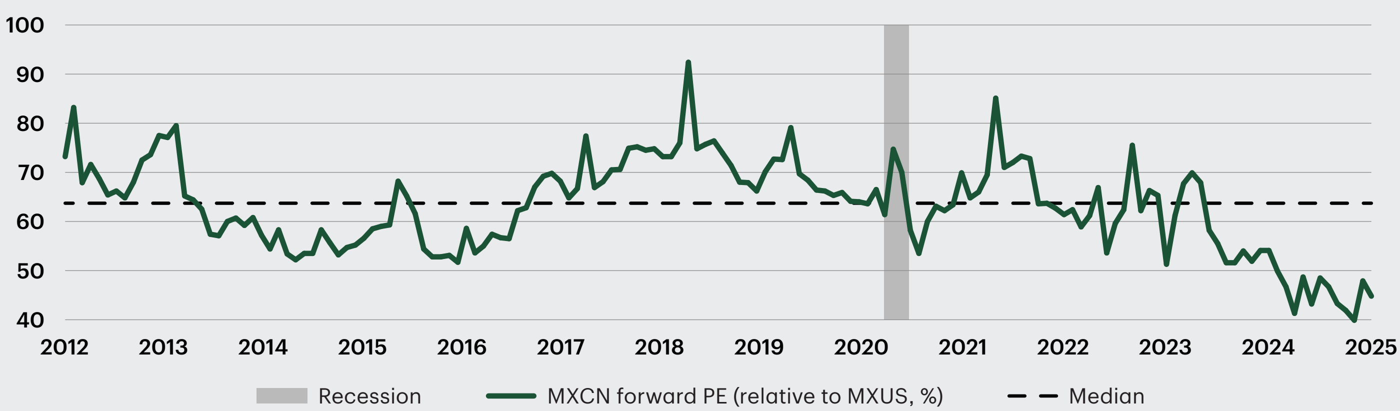
Rather than a problem with top-line growth, Chinese firms have, on average, become much less effective at capital allocation. This can be illustrated by return on equity (ROE), which is arrived at by dividing net income by shareholder equity. A decade ago, MSCI China exhibited an ROE that was an impressive 2 ppts above that for the U.S. However, since then, China's has deteriorated, from 17% to 11%, while America's ROE has increased from 14% to 18% (**Figure 5**). Less profitable markets should trade on lower multiples, and that is exactly what has transpired over the last decade (**Figure 6**).[1]

Figure 5: Trading places — over the last decade China's RoE has deteriorated by 6 ppts, while America's rose by 4 ppts.



Source: Bloomberg Finance, L.P.

Figure 6: MSCI China is currently trading on a forward PE of only 11x, which is 46% of the U.S. multiple. It is tempting, but misguided, to view Chinese equities as a bargain.



Source: Bloomberg Finance, L.P.

[1] Please see "The PE ratio: A user's manual," by S. Bleiberg et al, originally published 2019, republished 2023, Epoch Investment Partners, Inc.

Why has China's RoE deteriorated so dramatically?

Three factors account for the collapse in China's profitability. First, "reinventing globalization," which has been one of our key investment themes since 2016. China was the biggest beneficiary of the hyper-globalization period from 1990–2008. Unfortunately, it has also been the biggest loser as we play the movie backwards. Since 2012 exports to the U.S. and EU, expressed as a percentage of China's GDP, have declined by over 40%. There is every reason to believe this downward trend continues.

China's over-reliance on exports is especially problematic given escalating geopolitical tensions and rising populism in many western countries. In the U.S. this has created bipartisan support for targeted import tariffs, industrial policies to protect vulnerable supply chains and possibly even terminating "Permanent Normal Trade Relations" with China. We are skeptical that China's pivot, relying on export growth to the "global south" rather than the G7, will successfully counterbalance these secular trends.

Second, the state has become much more involved in capital allocation since 2012 when President Xi ascended to power. Reversing the "Deng reforms" and elevating Beijing's priorities has done much to reduce the vibrancy and efficiency of listed Chinese companies. State-directed capitalism necessarily leads to a less vibrant, innovative, and productive corporate sector, with correspondingly weaker returns on invested capital.

The third factor, and the one that receives the most attention, is the ongoing balance sheet recession. This malady is a direct result of China's economic model, which features an overemphasis on investment — a staggering 42% of GDP vs. 18% in the U.S. The FT's Martin Wolf recently asked, "Why does an economy growing at 5% need to invest 42% of GDP?" Good question, especially given that this dominance comes at the cost of consumption (only 39% of GDP vs. 67% in America) and chronically weak domestic demand. Efforts to fill this hole resulted in a massive, decade-long credit boom and real estate bubble.

This bubble began to burst three years ago and the process of working out imbalances will take the good part of a decade. This creates a powerful structural headwind for the real estate and financial sectors, to which many households and businesses are acutely enmeshed. Unsold homes are an essential feature of the balance sheet recession, with residential property sales down 24% yoy and property investment off 10% yoy. Prices of new properties have been declining since September of 2021 but remain above market-clearing levels. Regardless of Beijing's intentions, this is a slow-moving train wreck.

Local governments are also an integral part of the problem as they have become saddled with staggering debt burdens. To illustrate their vulnerability, 75% of Chinese government debt is held by local governments which, unfortunately, possess few sources of revenue to meet their obligations.[2] Further, many domestic financial institutions are under significant stress, especially if property loans were accurately valued and marked-to-market. Unfortunately, there is no quick fix to these structural, balance sheet headwinds.

Comparisons with Japan in the 1990s: History doesn't repeat but it does rhyme.

The lack of an easy solution to balance sheet recessions is best demonstrated by examining Japan's lost decade. The root of its problems lied in the economic model Japan embraced in the 1980s. Similar to China, it featured spectacular credit growth which drove an unsustainable investment boom as well as a real estate bubble. Japan's equity market peaked on the last day of 1989, but it took more than a decade after that for policymakers to summon up the courage to admit and confront the depth of the problem.

There are three lessons from the Japanese experience. First, denial and forbearance (or "extend and pretend") not only postpone the inevitable adjustments but increase the total costs that must be borne by society. Second, monetary policy is relatively ineffective (you can't force a horse to drink). Moreover, unorthodox policies like quantitative easing place a heavy burden on the central bank's balance sheet. Fiscal policy holds much more potential, but involves negotiating a labyrinth of political interests and, as a result, is often mistargeted and wasteful, and subject to numerous delays. And it places a heavy burden on the government's balance sheet.

The third lesson is that the resulting collapse in productivity and ensuing disinflation makes balance sheet recessions especially painful and persistent. Chinese core inflation, currently 0.1% yoy, risks slipping into negative territory which is problematic as it implies rising real debt levels. Asset price deflation is even more enduring and pernicious, which is a major headache for Beijing given that home prices are plummeting and the CSI 300 Index is down 20% from its 10-year mean in real terms.

[2] Local governments became overly dependent on the volatile real estate sector for revenues. In 2021 such income accounted for 50% of their total revenues. Land revenue more than tripled in the decade to 2021 (to a staggering 8.7 tn yuan) but has since fallen by half and is likely to shrink even further as the property downturn drags on. Source: Peterson Institute for International Economics.

Although there are many similarities between China's situation today and Japan's decades ago, investors we have met with stress two differences. First, outside the coastal cities, China is currently less wealthy than Japan was in 1990, suggesting a lot more potential to benefit from catch-up growth. Second, China has had the opportunity to study and learn from Japan's painful experience, which hopefully implies a more effective policy response.

Although both of these are good points, we still think the similarities vastly outweigh the differences. Moreover, it remains critical that policymakers address the balance sheet problems with a comprehensive, well-targeted bazooka. Unfortunately, that is not a fair description of Beijing's efforts to date, which makes us worry that history is about to rhyme.

During the 1990s, the TOPIX plummeted an astonishing 85% relative to the SPX. However, during that period, policy actions triggered three sizeable equity rallies (with the TOPIX rising over 40% trough to peak), even though the stimulus ultimately proved insufficient and counterproductive. We believe the current bounce in Chinese equities is similar and should be faded.

The Chinese equity market is investable

Given the above analysis, we believe investors may benefit from selling into strength and maintaining an underweight position in Chinese equities. However, that doesn't mean the market is uninvestable and should be avoided entirely. We are finding a diverse range of Chinese companies that are promising to be well positioned regardless of the secular challenges facing China.

Conclusion: The current bounce in Chinese equities should be faded.

Beijing's recent policy announcements are undoubtedly important, most notably for curtailing downside risks. However, we don't believe the recent stimulus amounts to the necessary bazooka. Further, we expect the ongoing balance sheet recession to pose a persistent headwind for the real estate and financial sectors, as well as local governments. For these reasons, investors should fade any strength in Chinese equities until Beijing implements a credible bazooka.

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