China in the Spotlight – After Much Negativity in 2023, is 2024 Looking Better?

In mid-September, Hubbis hosted a very timely Digital Dialogue discussion amongst a panel of China experts to drill down into the opportunities on offer in China's capital markets. They discussed key challenges for international private client investors, and considered the best avenues for those that might want to build their exposures, assessing which might be the right target sectors, the right timing and the preferred avenues to achieve the optimal balance of opportunity, future liquidity and risk mitigation. Gary Dugan, Chief Executive Officer, The Global CIO Office, was one of the speakers, who, as usual, offered our virtual delegates some valuable perspectives and advice. He is cautiously optimistic about China, arguing that the remarkably low valuations of domestic equities present more upside than the more negative news would suggest. He argued that investors need to see through the fogs to focus clearly on China's many huge structural and sectoral strengths.

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GARY DUGAN
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Gary opened his comments by remarking on how most people had been surprised by the performance of the major developed markets in 2023, given all the many Western-economy financial and global geopolitical issues that remain largely unresolved.

"We are all still worried about inflation, about interest rates, and looking ahead, people are still absolutely in two minds, with one camp predicting a US recession and the other camp a soft landing," he observed. "Naturally, there are diametrically different approaches you would take to portfolio construction based on either of those outlooks. I think this is why we are seeing a lot of overreactions to news and often to single data points in the US. That is not a healthy situation."

He observed that in the emerging markets, India has been a standout performer, while in China, the end of the pandemic restrictions had not translated to the widely anticipated growth boost.

Sentiment towards China has not yet rebounded

"That has not played out as expected," he said, noting that official numbers from China are indicating that the country is currently unlikely to hit the 5% mark for GDP growth. Add to that the continued spats between China and some Asian countries, and particularly China and the United States, and he said it all means China has become rather difficult to navigate for investors.

Gary also reported that from the Western viewpoint, Asia might be considered rather homogenous, even today, but that is far from the case. "Many do not appreciate the cultural and other complexities and the geopolitical melting pot that is Asia in reality and find it incredibly difficult to look into China and understand what is going on there," he cautioned. "Often western analysts want to see a western like policy response to an Asian problem. Hence many analysts are not convinced that China recovers unless the policymakers deliver what is called a big bazooka like fiscal stimulus. But in truth China has learnt from the mistakes of the past that overcommitting to policies such as massive increases in government spending only to leave a legacy of imbalances in the economy that create even greater problems in the future"

Looking through a sharp lens

Gary said he had lived and worked in Singapore for many years and, from that viewpoint, is more in tune with the way Asia thinks about Asia and not so driven by the way that the West looks at Asia. "From here, we can see that the US economy faces huge structural changes, which are not being addressed, and the party parties on, whereas they should be addressing these issues structurally," he commented.

But that, he added, would naturally lead to slower growth and political challenges. However, he maintained that China sees and the leadership acknowledges their structural challenge. "They want to try to revive the economy but not reverse policies in terms of structural change," he observed. "In short, I think that is a realistic approach."

No blockbuster fix ahead

However, at the same time, Gary said that Western investors want

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more of the 'bazooka' approach. "And this is why they need to appreciate the overall direction of travel in China," he stated.

The idea is that would help them become more comfortable with the outlook, and then invest again more astutely and with a longer-term perspective, and not look at China just as a marginal portfolio play for a quick bounce and rapid capital gain.

"The bottom line for us in terms of our advice to clients is, China is cheap, you should not take it off your radar screen," he explained. "We're not sure where the big catalyst for performance will come from, but it could come from a number of small support measures and advances for the economy, as opposed to an overnight announcement of a massive spending plan."

Seeing things objectively

Gary also counselled people to take a more positive view of China's apparent problems, including the ongoing deflationary environment. "There are actually good reasons why we have seen deflation, and there are good reasons to believe inflation of some sort could return there."

"I accept that situation and take the positives from it at this time from an investment perspective because all the negatives are already fully priced into the low valuations in the market," he observed.

The implication is that while many in the West characterise China as having some huge structural problem around deflation, they are not being fair or objective about the major challenges relating to inflation in their own economies.

Looking through the fog

"For the savvy investor who has a deeper understanding of China, they are still going to see a vast economy that still enjoys some significant drivers of growth, and they will still seek out access points to participate in key themes," Gary stated. "These themes could be the solar and the green dream, as we can call it, or batteries of the future, or EVs, and other new technologies. China is global champion in some of these key sectors, and you will struggle to find that type of dominance elsewhere around the world."

He observed that people bought the tech sector so heavily in the US market because the US could first take that technology in its huge economy and then they could build out their proposition globally with massive economies of scale. "And that model, that evolution could well play out in China, which in some major sectors fur the future has the technologies and the know-how to drive that next phase of global growth," Gary commented. "China has some companies which are ultra-competitive on the global stage."

On balance, opportunities abound

Gary then said there is clearly a risk of investors missing out. "Chinese equities are evidently cheap, and if you are an EM investment manager, you are likely worried about your positioning in China, because you know it's so cheap. The day that there is a rebound, you're short, and you're going to show massive underperformance. That means we expect some short covering within the next three to six months probably; well, the timing is not clear, but it surely will come. In

short, over the next 12 months, I think China could surprise us in terms of its absolute returns."

Gary then addressed the worries about over-extended sectors such as property in China. "Again, one needs to see this in context," he said, "and assess these issues relative to the major structural problems I alluded to in the US and the Western economies, which remain largely ignored. I see that China sees their own problems and has the will to tackle them. Yes, the Chinese property sector is really troubled, and it cannot be fixed overnight, but I also think that the government has the will and the capability to tackle those problems. However, it will hurt in the shorter or near-term, and it will take time."

China has solid appeals

Gary drew his comments towards a close by noting that within the EM universe, China, in his view, holds out the potential for upside and that there will be incremental advances in good news and participation and market performance. He said even the biggest bulls in India might feel that the market there has gone too far and will be looking around for alternatives ahead.

"People are sitting there saying they have cash to invest and wondering how to reallocate for 2024, and if China can navigate its way to providing people with a good sheet of potential positives, or at least a stabilisation situation, I think people will enjoy some upside," he stated. "Right now, it could be too big and too cheap to ignore."

Be brave, there is upside

His final word was that he still sticks to his view that over 12 months, investors can be brave enough to buy Chinese equities, but he noted that there are also those valid alternatives out there that might achieve good results with less direct Chinese linkages.

"You can participate in ways that might not appear so obvious," he said. "For example, investors could buy luxury goods companies that benefit from reinvigorated Chinese travel and consumer spending. They could look at the commodity sector and buy some Australian mining companies that will benefit from the good news that will emerge from China."

And there is a hedge in that approach, he added, as they are buying relatively safe stocks through participating in developed market plays on a potential rebound in Chinese demand. "But as I said and looking at the current valuations, I am a believer in the direct route as well," he concluded. ■

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