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CSOP Expert Sees the Glass Half Full for China's Economic Juggernaut and Market Valuations

The core of the thesis articulated by Bruce Zhang, Portfolio Manager at CSOP Asset Management, in a presentation at the Hubbis Singapore Investment Forum, is that the government needs to do more to bolster confidence and oil the wheels of optimism, and has plenty of ammunition to do exactly that. He explained that China's equity market has solid fundamentals, a solid earnings history and potential, and low valuations, all of which should act as the springboard for an upward revaluation if and when the right conditions arise. He expressed his confidence that the government and the private sector – which accounts for 60% of GDP and 80% of investment – and the consumer will all act more decisively to fuel China's sluggish recovery, which is far slower to materialise post-lockdown than most China-watchers had anticipated. He argued that when the switch is flicked – and that should be in the near foreseeable future - the upward trajectory should be one that private investors will not want to miss out on. He noted that private investors had, even during these difficult times for China equities, been consistently adding money into Hong Kong-listed Chinese funds and ETFs in expectation of the tipping point when valuations start to rise again. And he explained why the key is confidence and consumer spending, especially as the multi-decade thrust of an export-led economy is shifting to more of a domestic model.

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Bruce opened his talk by explaining that consumption is core to China's future and indeed to stock market valuations. To help explain this, he offered delegates a big-picture scenario of the global macroeconomic environment, and of China's situation.

The Global Macroeconomic Landscape

He explained that the quite recent Federal Reserve hikes after four decades of falling or near zero rates were a rude shock to everyone. He said this era of aggressive rate hikes seems to be drawing to a close, signalling a potential positive catalyst for the broader US market indices development for the equity markets. And even if rates do not fall, at least they are not likely to rise much further.

This 'higher for longer' scenario is supported by strong US demand, meaning that the authorities still need to be very wary of inflation (which as yet is far from fully contained) ramping up again. Bruce said the perfect scenario ahead is a soft landing where inflation tapers off further but the US maintains a robust labour market and strong average hourly earnings.

As things stand, the US consumer is in a good place, despite higher rates. They feel secure in their jobs, they have solid growth and income from financial assets, and the housing market is largely holding up rather well. The optimism is especially high amongst the baby boomers, who have low debt, high savings/investments and lower outgoing than those in their 30s to 50s. All in all, the environment is one of surprising resilience, Bruce commented.

The threat to US markets? High valuations

As to market conditions, he explained that high valuations in the market indices are more threatening to prices than the fiscal and financial conditions.

He noted that the danger lies in the huge price rises of the 'Magnificent 7' technology-related stocks, which count for a disproportionate percentage of the overall S&P500, which had on their backs been driven to levels above its ten-year average, which is incredible when considering that until late 2021, those years were all largely boom years for equities.

This means that the risk premium for the S&P 500 is waving a red flag for investors, especially if the 10-year Treasury yield were to head above 5%.

The Chinese Economic Landscape

Bruce then switched his attention to China, reporting that few of the same factors exist. Inflation is subdued, and there is still talk of deflation. Rates are relatively low and China's public debt to GDP is such that it could leverage up easily and keep rates low, or even ease. There is the potential for policymakers to use a variety of policy tools at their disposal to help things along their way.

Seeing the glass half full, Bruce observed that there are a number of positives around technology, manufacturing and even the property market, which is less worrisome than it was earlier this year as regulations and government action help protect consumers and at the same time support the (often over-leveraged) developers.

He also sees the brighter side of global geopolitical tensions, which although they remain a concern, have not morphed into a huge problem for China.

All these elements combine to place China's economic recovery at a pivotal juncture. Bruce identified three key factors that will influence prices, focusing his attention also on the Hong Kong market for Chinese stocks. He said these factors include fund flows, macro fundamentals, and forex rates.

Fund Flows and Market Sentiment

Taking the first of these, Bruce observed that there is a strong impetus towards EM, partly because of high valuations in the US and also questionable potential and political resolve in Europe. He reported that many active fund managers had been upping their allocations to EM in recent times. On the other hand, passive fund flows are not following suit, and are not likely to until China's economic recovery gains strength and market indices rise, a combination that will bring with it

far larger passive inflows, and rising weightings to China.

Interestingly, Bruce noted that an anomaly in that more investors have been buying into China ETFs on the Hong Kong market in recent years, indicating that they are prepared to be patient in their confidence that China's GDP juggernaut will again soon revive its mojo.

He also pointed to the stock buyback strategies implemented by China's largest tech giants, moves that are aimed at enhancing investor confidence, returning capital to shareholders, and optimising capital structures. "This approach seems to be resonating positively with investors, even though the economic recovery has been less than stellar and is still in the balance somewhat," he explained.

Challenges in the Chinese Economy

Picking up further on those comments, he drilled down into the reasons for China's still-stalled economy, while at the same time expressing his confidence things will change.

Exports have been declining this year, at the same time as weaker domestic consumption and investment combined, partly in the face of the stressed property sector, which accounts for as much as 40% of the downturn in activity. But he held out hope in the form of government action to support the sector, which had been gradually relieving some of the downward pressure.

He also noted that China might follow Japan's path but at an even greater scale and pace, from demographic tailwinds to headwinds as the population ages. But again, he remains positive, pointing to China's property, equity and FX valuations all far below what Japan had ballooned to by the late 1980s when the stock markets collapsed.

And China is well behind where Japan was in terms of urbanisation rates, which in Japan had reached 90% decades ago, while China's urbanisation rate is only about 60% today. This indicates continuing new demand for urban property, driven by migration from rural areas, rising population mobility between cities, and more and wealthier first-time homebuyers.

The year-to-date rebound in retail sales and domestic consumption had, Bruce reported, been largely driven by sectors like tourism and social related activities (eating out and leisure), but he said he anticipates a more robust rebound

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in consumption when the property sector shows more signs of stability, which will lead to some relief and greater optimism.

China's Monetary and Fiscal Policies

Bruce also briefly surveyed the monetary and fiscal policies that China is employing to mitigate its economic headwinds. For example, the central bank has urged commercial banks to lower deposit rates to draw more money from cash savings, and at the same time, thereby also boosting returns on lending by the banks, as spreads rise further above the cost of funds, and therefore ploughing more money into the economy potentially. Additionally, there is more spending on infrastructure and other sectors to offset the property sector's weakness.

China's glass is more likely to fill up further

In conclusion, Bruce said that the government's 3rd Plenary Session and the Central Economic Work Conference are events of note ahead, with investors anticipating more robust activity from the state and authorities to buoy economic growth with more and stronger supportive policies. Without this, he fears the stock markets might become mired in volatility and languish at low levels.

Additionally, Chinese government bonds are viewed as a relatively safe haven, given the potential for lower rates to stimulate the economy and China's powerful balance sheet. Moreover, the RMB is at an eight-year low versus the dollar and has really few places to go other than sideways or up, especially as China is not thrusting so heavily toward exports but more towards domestic consumption.

Get ready...

Bruce's final word was that equities will prosper if the right conditions prevail, especially some of the leading State-Owned Enterprises (SOEs) and specific sectors receiving direct support from the Chinese government, including chip producers, high-tech companies, and new energy firms. This will also propel Hong Kong's China stocks trading on the Hang Seng, especially the Hang Seng Tech index. ■

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