GW&K INVESTMENT MANAGEMENT

GLOBAL PERSPECTIVES

Are Chinese Equities Still Investable?

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Highlights

- China's stock market has been hit this year by Covid-19 lockdowns, a property crisis, an energy crunch, and a stringent regulatory clampdown. Are Chinese equities still investable?
- Market signals are giving a clear answer: yes. Chinese equity valuations have fallen in response to recent developments, but are not extremely depressed on a relative basis to other markets.
- A shift toward more expansive policy could help China's market recover, although a revival in many stock multiples awaits greater industry-specific clarity about the regulatory framework.

China's Perfect Storm: Lockdowns, Property Crisis, Energy Crunch, and Regulatory Clampdown

After strong performance in 2020, China's equity market has been one of the world's worst performers in 2021, with a loss of 16.3% as of September 30. In contrast, the MSCI World Index of developed market (DM) equities posted a gain of 13.4% over the same period. China's market has been hit by a perfect storm of factors that have not only dampened the growth outlook but have also cut the multiples investors are willing to put on future earnings. These factors include:

- Severe economic impacts from Beijing's "zero-Covid" strategy in recent months as recurring waves of Covid-19 prompted stringent lockdown measures by many local governments.
- Restraints on lending to property developers that pushed China's largest property development company to the brink of default on $305 billion of liabilities (1.9% of GDP).
- Rolling production cutbacks due to an energy crunch amid a coal shortage and a push to meet strict emission targets.
- A sweeping regulatory clampdown on internet platforms, fintech, video games, off-campus tutoring, ride hailing, data privacy, food delivery, crypto miners, and e-cigarettes.

A variety of economic data in recent weeks highlights China's growth slowdown. For example, China's official services Purchasing Managers' Index (PMI) slumped to 45.2 in August from 52.5 in July, plunging into contraction below the 50-threshold for the first time since February 2020 **(Chart 1)**. August retail sales were anemic as well with sales up only 2.5% on a year-on-year basis, the slowest pace of growth in a year.

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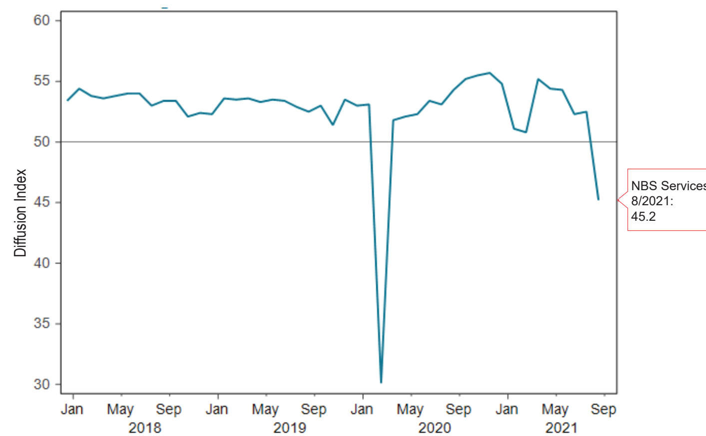
Home sales by value in August were down 19.7% from a year ago, reflecting tighter government regulations on the property market and the impact of Covid-19 restrictions. Such data has prompted economists at Goldman Sachs to estimate that China will post zero GDP growth on a sequential basis for the third quarter. That represents a severe growth recession for an economy that typically grows in the 5%-to-6% range.

Chart 1: China Services Economy Takes a Hit: August Official Services PMI Plummets



Source: GW&K Investment Management, China National Bureau of Statistics, and Macrobond

China's official Services PMI plummeted to 45.1 in August from 52.5 in July, reflecting the impact of rolling Covid-19 lockdowns and pronounced weakness in property markets.

Against this backdrop, the question of whether Chinese equities are still investable recently has been raised in the financial media.[1] The renowned investor George Soros has gone so far as to argue that capital flows to China should be curbed because they will lose money for investors and imperil U.S. security interests by propping up President Xi's regime, which is "repressive at home and aggressive abroad."[2] Not mincing words, Soros asserts that "the U.S. and China are engaged in a life and death conflict between two systems of government: repressive and democratic."

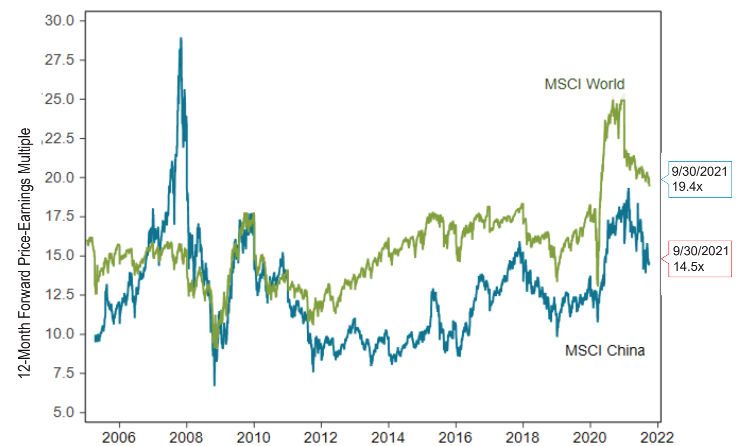
What is the Market's Verdict?

Such stirring rhetoric may resonate with many since some of China's recent regulatory actions have been extreme. For instance, the government's decision to outlaw the for-profit, off-campus tutoring industry essentially zeroed out the future profits of a $120 billion industry with little warning to investors.

Concerns that President Xi's drive toward "common prosperity" may dampen the entrepreneurial drive that has powered China's growth are not unfounded. President Xi's overriding quest for re-election to a record third term at the 20th Party Congress in fall 2022 may well have its own domestic political logic. However, his sharp pivot toward state control of the economy appears to be taking a substantial gamble on the economy's future dynamism.

That said, despite the painful underperformance of China's equity market this year, relative equity valuations render a clear market verdict: China's stocks remain investable. Note that the MSCI China Index is now trading at a 12-month forward price-earnings ratio of 14.5 times compared to 19.4 times for the MSCI World Index of developed market (DM) equities **(Chart 2)**. Using data going back fifteen years, a gap of 4.9 multiple points does not even represent a one-standard deviation discount of Chinese equities relative to DM equities **(Chart 3)**. A similar analysis could be made using price to book value for the MSCI China and MSCI World Indexes. And the results would not change much using indexes of China's domestically traded "A-share" stocks, which have only minor representation in the MSCI China Index.

Chart 2: China is Cheaper Than MSCI World on a Comparison of 12-Month Forward PE Multiples

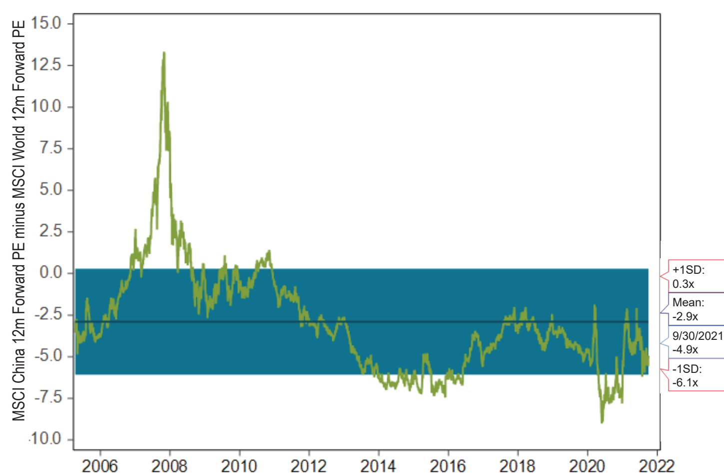


Source: GW&K Investment Management, Bloomberg and Macrobond

The MSCI China Index trades at a 12-month forward price-earnings multiple of 14.4 times compared to 20.0 times for the MSCI World Index of DM equities.

[1] Robert Armstrong, "Is China Uninvestable?" *Financial Times*, September 8, 2021.
[2] George Soros, "Blackrock's China Blunder," *Wall Street Journal*, September 6, 2021

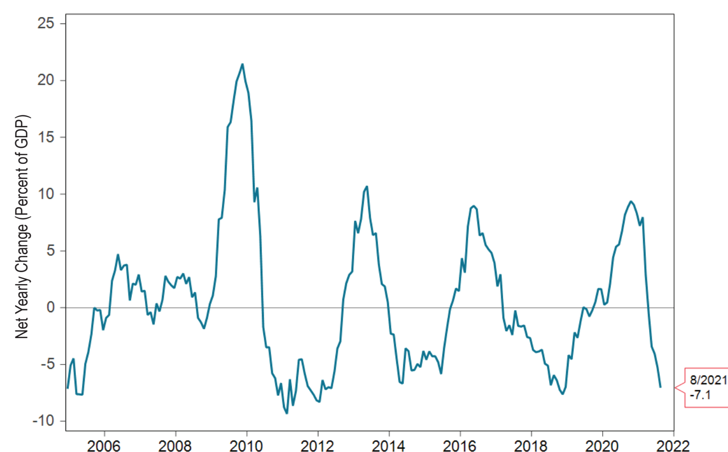
Chart 3: MSCI China's Discount to MSCI World is Not Exreme on a 12-Month Forward PE Basis



Source: GW&K Investment Management, Bloomberg and Macrobond

MSCI China's 12-month forward PE multiple is trading 4.9 points below that of MSCI World's. That is hardly extreme by historical standards and not indicative of a market investors consider "uninvestable."

Chart 4: China's Negative Credit Impule is at the Bottom of the Range China's Government has Tolerated



Source: GW&K Investment Management, Bloomberg and Macrobond

China's deliberate credit restraint helped trigger the Evergrande crisis and associated economic weakness. The crisis should prompt credit easing aimed at restoring growth in 2022.

If market participants collectively were to believe that China's stocks were not investable, we would expect forward multiples on those stocks to be trading at far larger discounts. Likewise the gap in multiples between Chinese equities and DM equities would logically go to some extreme value – like three standard deviations – as opposed to the modest valuation discount that we now see.

Moreover, some portion of the current valuation discount of Chinese to DM equities may well reflect temporary or cyclical factors. These include the energy crunch, the "zero-Covid" lockdowns that hit the economy in recent months, and the deliberately engineered credit curbs **(Chart 4)**. That suggests that the valuation de-rating of China's market related solely to the regulatory clampdown has been relatively modest overall, despite its outsized impact on certain sectors like Information Technology.

There is a very specific "investability" question of whether U.S. investors will continue to be able to trade Chinese equities in the form of American Depositary Receipts (ADRs) that are either listed on U.S. exchanges or trade through so-called "over-the-counter" methods. That is because the U.S. Congress passed a bill last December that will require those companies to be subject to full U.S. financial audit reviews within three years, which China's government says it will not allow.

Many of these securities are already dual listed on both Hong Kong and U.S. exchanges. For now, the U.S.-listed and Hong Kong-listed securities continue to trade at parity. That indicates that market participants consider them as fungible in the sense that U.S.-listed Chinese ADRs can be readily converted to Hong Kong-listed shares and vice versa. This suggests that markets believe an agreement can be reached within the three-year deadline. GW&K's investment analysts and traders are watching this issue closely in case pricing begins to diverge.

Will the Evergrande Crisis be a Catalyst for Stimulus?

To the extent that much of China's recent market malaise has been due to strict curbs on credit growth and the severe economic impacts of on-again, off-again Covid-19 lockdown measures, we think China's economic and market outlook could improve

significantly in the year ahead. Despite current market jitters regarding the apparent insolvency of China's giant property developer, Evergrande, we expect the government to step in to prevent disorderly debt recovery efforts, reduce systemic risk, and limit contagion in financial markets. Although its total liabilities of $305 billion are nearly 2% of GDP, most of those liabilities are likely to be assumed by Chinese local governments or state-owned enterprises (SOEs). It is widely believed that the government's priority will be to protect homebuyers, suppliers, employees, and retail investors. Note that Evergrande's bank debt and corporate bond debt of about $70 billion is relatively small in the context of a Chinese banking system with $45 trillion in assets.

Fortunately, most large Chinese property developers are financially healthier than Evergrande. That means that the government should be able to ring-fence Evergrande's risks and prevent large collateral damage to the economy. If that view is mistaken, and the economic fallout from Evergrande's restructuring is more material, then it could well be the catalyst for a more significant monetary and fiscal easing than the market is currently expecting.

In any event, as seen in **Chart 4,** the so-called "negative credit impulse" from China's recent debt curbs is already about as large as the authorities have tolerated in recent years. If history is any guide, we should see a substantial rebound in the credit impulse in 2022, which would be a leading indicator for better economic and profit growth going forward. Likewise, the hit to the production side of the economy due to the energy crunch could be quickly alleviated by some combination of a relaxation of energy use targets, a higher level of coal imports, and an easing of electricity price caps on loss-making power utilities.

We also believe that Chinese authorities will not want negative economic news to be dominating headlines in 2022. One reason is that the Beijing Winter Olympics are scheduled for the first quarter next year, when China will be aiming to showcase its strengths to the world. Perhaps more importantly, China's 20th National Party Congress is scheduled for the fourth quarter of 2022. That represents a twice-in-a-decade event when President Xi Jinping intends to formalize his leader for life status and perhaps appoint successors as well.

Although China's "zero-Covid" strategy has recently curbed growth as the nation struggles with the highly contagious Delta variant, China has made great strides vaccinating its population. According to UBS, China is currently on track to have nearly 90% of its population fully vaccinated by the end of this year from a current level of 76%.[3] So the dampening impact of rolling lockdowns on China's economy will presumably fade over the next year in response to vaccination efforts. As in other nations, vaccinations represent a form of economic stimulus by promoting the economic reopening process.

The remaining wild card, is of course, the impact of the broad-based regulatory clampdown on both economic dynamism and valuation multiples. It is worth noting that most of the economy is unaffected by the high-profile regulatory measures. Regarding valuation multiples, my portfolio manager and analyst colleagues believe that greater industry-specific clarity about the regulatory framework may be needed before many stock multiples can recover. That's because very specific regulatory changes have been applied to a number of industries, each of which requires its own analysis from a bottom-up perspective.

If anything, the current environment underscores the potential payoff from careful research to identify companies and industries that are well aligned with Beijing's agenda. Despite recent challenges, our EM investment team believes strongly that China's market remains richly endowed with valuable business franchises that are well positioned to benefit from a resumption of economic growth and from the government's focus on promoting a consumer-led pattern of growth. Our team's bottom line is that China remains an entrepreneurial and dynamic economy with the potential to deliver strong investment returns in the future.

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[3] Arend Kapteyn, "Global Economic Perspectives – Global Vaccine Tracker," *UBS Global Research*, September 24, 2021.

Disclosures:
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