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MARKET INSIGHTS

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Chinese equities: analysis and outlook after a volatile and disappointing summer

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After rallying robustly by almost 10% in late July following the Politburo meeting, Chinese equities turned back down, hitting a low for the year. In so doing, they erased half of the almost 50% gain they had achieved after China's reopening was announced last November. What was behind this highly volatile phase? And what is the outlook ahead?

After the late July Politburo meeting, the market had been cheered more by words than actual deeds regarding official stimulus. Alongside a slight monetary easing, the government on 24 July had announced incentives for private firms to invest in key sectors such as transport, renewable energy, new infrastructures, cutting-edge industries, farming equipment and others. Local governments had submitted more than 2900 projects, totalling about USD 445bn, in which companies could invest – an amount that was actually quite modest in view of the current challenges and context. The Chinese authorities' main goal was to restore confidence in entrepreneurs, given that 80% of Chinese jobs are in the private sector and that the government is facing excessively high youth unemployment and miscontent among young people that is showing up more and more in social networks. Given its already heavy overall debt, the government was counting more on subtle measures to restore hard-hit overall confidence than on actual fiscal support.

This strategy, which was initially welcomed, ran into a combination of three factors:

- **The release of a series of economic indicators, which were so disappointing** that the government's 5% growth target for this year now looks out of reach. Many economists at large international banks have accordingly lowered their forecasts, and many now expect growth to fall short of 5% this year, including those at UBS, JP Morgan, Morgan Stanley, and Barclays.
- **The failure by one of China's largest real-estate developers, Country Garden, to make a bond coupon payment.** This serves as a reminder that the real-estate sector is potentially a big threat to both growth and the financial sector. Keep in mind that real estate accounts for 25% to 30% of GDP when including ancillary sectors, that it is the repository of most household wealth, and that is a major source of revenue for local governments.
- **Meanwhile, the non-payment of a coupon by a trust. A trust is a rather popular type of savings product in China** that is sold to rather high-end clients. Trusts promise annual yields of about 8%, often paying out coupons every three months. This particular trust is the "Zhongrong Trust", which is one of China's 10 largest. Zhongrong's default is due to illiquid and depreciated investments in real estate. Although they have shrunk in size in recent years under pressure from a risk-averse government, trusts in China amount to an estimated USD 2,000bn (about 10% of GDP) and their average exposure to the real-estate sector is estimated at 7%, with, of course, some disparities from one trust to another and probably some unknown sources of leverage.

All this explains why Chinese equities have hit a new low and why international investors are throwing in the towel – almost USD 10bn has flowed out of the Chinese equity markets in the past two weeks. This raises several questions.

- **How is the Chinese economy faring?**

Some sectors are doing very well. Tourism, for example, flourished this summer, driven by strong demand for domestic travel and very high occupancy rates in leisure and transport infrastructures. In manufacturing, positive momentum continues in electric vehicles, with domestic sales up by 31.5% from the same period one year earlier, and a 91.3% increase in export sales.

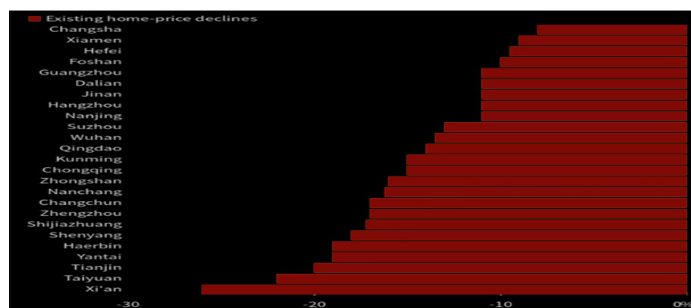
But, on the whole, the economic situation is very challenging, and July figures are especially disappointing. Growth rates of manufacturing output, retail sales and exports receded to, respectively, 3.7%, 2.5% and 1.2%. Consumption of cement, a bellwether of construction activity, shrank by 5.7%, year-on-year, after declining by just 1.5% in June. Loan applications are also down.

TWO FACTORS ARE WEIGHING HEAVILY:

1 - The real-estate sector

Real-estate sales plunged in July, down by 30% from their highs, and housing starts dropped by 60%. Construction activity has held up this year more or less, as the authorities have insisted that presold projects be completed. But one or two years out, the outlook in this sector is very glum. Real-estate prices have also fallen, by as much as 10% to 20% in some regions.

Real-estate prices have fallen

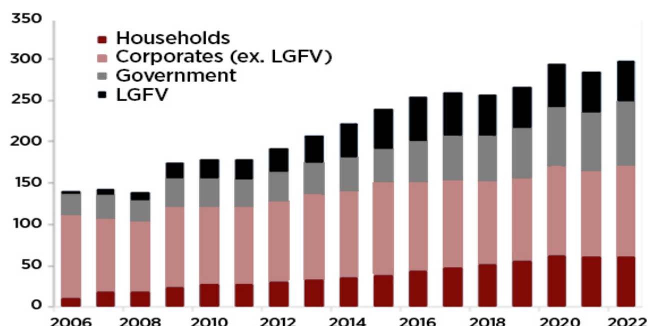


Source: Bloomberg - From November 2018 to March 2023

These declines are a big concern, as real-estate is so heavily indebted. China's total real-estate debt is estimated at USD 8400bn, or the equivalent of almost 54% of its GDP. 34% of this is mortgage debt and 20% is developer debt. Mortgage debt of individuals does not seem to be a major threat, as leverage is low, given the significant amounts required as down payments. The risk, rather, is in developer debt, which consists of bank loans and bonds. An estimated 75% of such debt is held by Chinese banks. For major banks, this amounts to about 3% of their total assets, vs. 5% for smaller banks. Based on various studies citing stress tests, major Chinese banks would appear to have the capacity to absorb losses on these loans, assuming that all other swaths of the economy do not collapse at the same time. This would not necessarily be so for smaller banks, which would need to be recapitalised. Meanwhile, debt issued by local governments is also a concern for the central government.

Prior to 2020, the real-estate sector accounted for 38% of local government revenue, with almost 7% from property taxes and 31% from land sales. According to the latest statistics, land sales have dropped by almost 46% since 2021. This trend is unlikely to improve, given the current excess supply and demographic trends (the Chinee population has peaked and is beginning to decline). This has resulted in two problems: it reduces regions' investment capacity and therefore weighs on growth; and it exacerbates credit risk on the very heavy store of debt issued by these local governments (see chart below). On this subject, the Chinese central bank is reportedly reviewing emergency credit facility measures to allow an orderly restructuring of these debts, which are held exclusively by domestic investors, something that would make a domestic resolution possible.

Chinese debt as a % of GDP by category of issuer (LGFV: local government financing vehicles)



Sources : BIS, WIND, Goldman Sachs Global Investment Research as of end 2022

2- The international geopolitical and economic context

The turn for the worse in relations with the United States is taking a toll, and not just in cutting-edge technologies targeted by various restrictions (e.g., the ban on US exports to China in some segments, boycotts of Chinese companies, etc.). The concept of "reducing China risk" is causing Western companies to shift their supply chains away from China and towards other countries, such as Mexico and other Asian countries. As a result, foreign direct investment in China dropped by 87% in the second quarter compared to one year earlier, to just USD 4.9bn, a low since 1998, i.e., since such figures have been kept. International financial flows have also receded. In the first seven months of the year, investors sold almost USD 30bn in Chinese bonds.

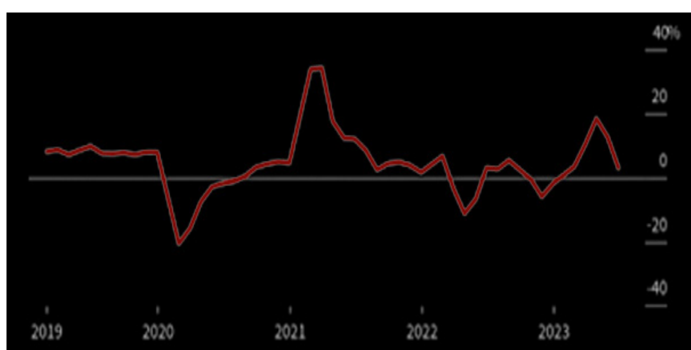
Meanwhile, the economic slowdown in the US and Europe is weighing on Chinese exports. This has exerted pressure on the RMB, the Chinese currency, which is down by more than 5% on the year to date vs. the dollar. For the moment, the Chinese monetary authorities are striving to prevent excessive volatility and seem to prefer a form of currency stability. There is nonetheless some additional downside risk.

Bottom line: confidence is lacking, both domestically and internationally. More and more observers are now comparing China to Japan 30 years ago and are raising the possibility of a sort of core deflation. Inflation is indeed close to 0% in China, and the latest price index release, in July, showed a 0.3% decline. The average growth rate needed to achieve the goal of doubling the size of the economy by 2035, i.e., 4.5% annually, now looks harder to reach. This is in contrast with

the average growth of 8% to 10% in the past decade. Chinese interest rates could therefore fall further, and, in any case, are likely to remain low for some time to come.

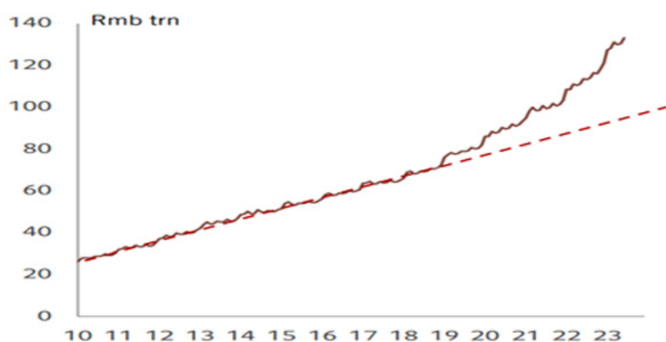
Against this backdrop, households' propensity to consume is low, with the exception of a natural post-Covid surge, and their savings rate is very high (see charts below). Will their savings flow into equities? That's what the authorities are hoping for. The share of equities in household assets is currently very low, at about 4%. Equity market officials have just halved transaction taxes to draw more interest. But when confidence is lacking...

Retail sales trends in China since 2019 (in %)



Source: National Bureau of Statistics as of end July 2023

Chinese household deposit accounts compared to their long-term trend



Sources: Pictet Wealth Management, WIND, as of end July 2023

• WHAT IS THE GOVERNMENT'S STRATEGY?

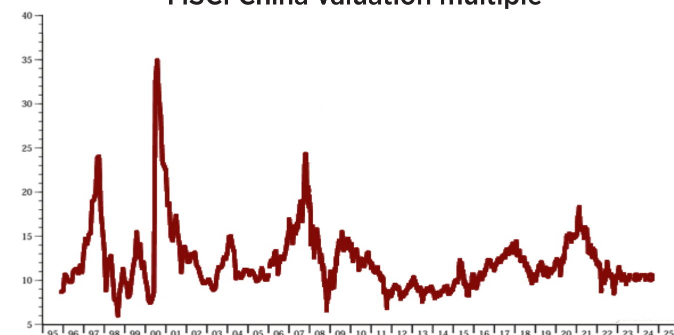
The government seems to be torn between the will to shore up the economy once and for all (corruption, excess leverage, etc.) and to address short-term growth issues. The goal of President Xi Jinping and his "Common Prosperity" programme is to target qualitative growth rather than quantitative, while trying to narrow the wealth gap, and while relying more on China's own internal strengths and its domestic market. But, on the other hand, he is pressed for time and by the discontent of a segment of the population, which is beginning to agitate and demonstrate here and there.

Until now, there has been no great stimulus plan of the type that the situation might require and the type we have seen in the past. **As things currently stand, we believe that new measures in support of the real-estate sector are inevitable to counter the negative vicious circle that is now being unleashed.** The government has several tools in its toolbox – including new tax cuts, a full cancellation of buying restrictions that had already been decided on to dampen market speculation, a reduction in the minimum down payment to 20%, including for tier 1 and 2 cities, where demand is strongest – which could at least help stabilise the market. In a sign that things could start moving, the central government has just proposed to local governments to set aside the rule that disqualified potential buyers who had already taken out a mortgage loan in the past. On the fiscal front, things could take longer, but the government could directly acquire highly depreciated housing stock, either to demolish it or to convert it into rental property. On a grand scale, this would have the merit of supporting activity and improving the market's supply/demand ratio. In an emergency, the central government would be the lender of last resort, although the Western world's quantitative easing[1] policies are not a model that the Chinese authorities want to follow, as it is suspected of maintaining bubbles.

• WHAT TO MAKE OF THE EQUITIES MARKET?

In some ways, weakness in Chinese equities looks like a capitulation. The last investors who believed in a rally seem to be throwing in the towel in light of China's highly challenging context. Valuations do look low, but, for the moment, it's a value trap!
Based on various estimates, the 12-month P/E[2] of the MSCI China index is about 10, hence in range that is historically low over the past 30 past years.

MSCI China valuation multiple



Source: Refinitiv as of end July 2023

In light of the economic situation, there are, of course, risks of downward revisions of earnings forecast for next year. **For the moment, as of 10 August, earnings are forecast to rise by 21.3% in 2023 and by 14.8% in 2024, according to the IBES consensus.** These forecasts are unrealistic. To date, 41% of MSCI China companies have reported their interim results. 33% of them have beaten forecasts; 37% have fallen short; and 30% have been in line. If earnings stabilised, the 12-month

[1] Quantitative Easing: massive purchases of debt securities by a central bank • [2] Price to Earnings Ratio. A stock market analysis indicator: market capitalisation divided by net income.

P/E would then be close to 12, which is reasonable in both absolute terms and in an international comparison.

Average market price/book value and two standard-deviations

Sources: Bloomberg, MSCI, T. Rowe Price from 28 February 2006 to 31 March 2023

Price/book value valuations provide similar findings and show that the market is rather undervalued by historical standards.

The Politburo's July findings also included the goal of "revitalising the capital markets" and "restoring investor confidence". The CRSC, the Chinese market supervisory authority, just held a seminar on 24 August with the heads of several financial establishments to encourage them to stabilise the equity market. Pension funds and the largest banks and insurance companies were asked to expand their equity investments and support economic activity. The names of participating banks and establishments were not released. In addition, the regulator plans to meet with some of the world's largest asset managers in an attempt to restore confidence.

In sector terms, growth stocks, such as techs, are likely to benefit from a low-rate environment. Healthcare is a long-term sector that we feel is rather promising, but it is currently highly volatile, due to a rather stringent anti-corruption campaign.

Conclusion

In short, China's economy is at a highly challenging crossroads. It is facing both temporary challenges (real-estate and the international context) and structural ones. Sustainably lower growth rates are likely in the coming years, but a systemic financial crisis is unlikely. The government has the wherewithal to halt the current crisis but appears to be reluctant to make full use of it for the moment. It may be forced to do so. Against this backdrop, interest rates will remain very low. The market as a whole has already priced in this challenging state of affairs. The market is not expensive, but to bring investors back confidence will have to be restored.

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