Chinese Equities: A Question of Timing

Increasing exposure to Chinese equities today requires a long time horizon, or a willingness to be tactical amid what will be a difficult few years

- A case can be made that Chinese equities are attractive today based on low valuations and may rally strongly if policymakers apply additional stimulus to support the slowing economy. However, we are concerned about the timing, as markets may be underappreciating the near-term risks to the Chinese economy.
- Should China fail to push through structural reforms and take economic pain now, Chinese equities may remain stuck in a prolonged sideways bear market similar to Japan in the 1990s.
- Investors in Chinese equities today can take comfort that valuations offer long-term upside and the potential for China to avoid Japan's fate, but should be prepared for more volatility.

It has been a dizzying year for Chinese equities. After tumbling sharply earlier in the year, Chinese equities sprang back to life over the summer, with the MSCI China Index[1] rebounding 19% from the beginning of May through early September, only to sell off again alongside global markets in September and October, largely wiping out gains for the year. Yet amid the volatility, Chinese equities remain above their 2013 lows and the price action is displaying the positive trait of higher-highs and higher-lows that technical analysts view as a sign of a strengthening uptrend. The onshore A-share market has performed

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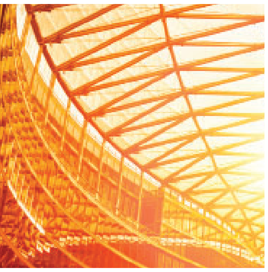
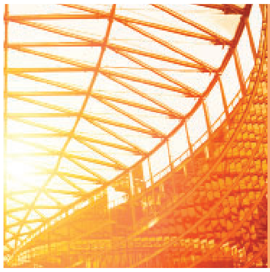
[1] The MSCI China Index tracks Chinese companies listed in Hong Kong and readily available to foreign investors. These companies are included in the MSCI Emerging Markets Index. The MSCI China A Index tracks stocks listed on the A-share markets in Shanghai and Shenzhen, which are only partially open to foreign investors.





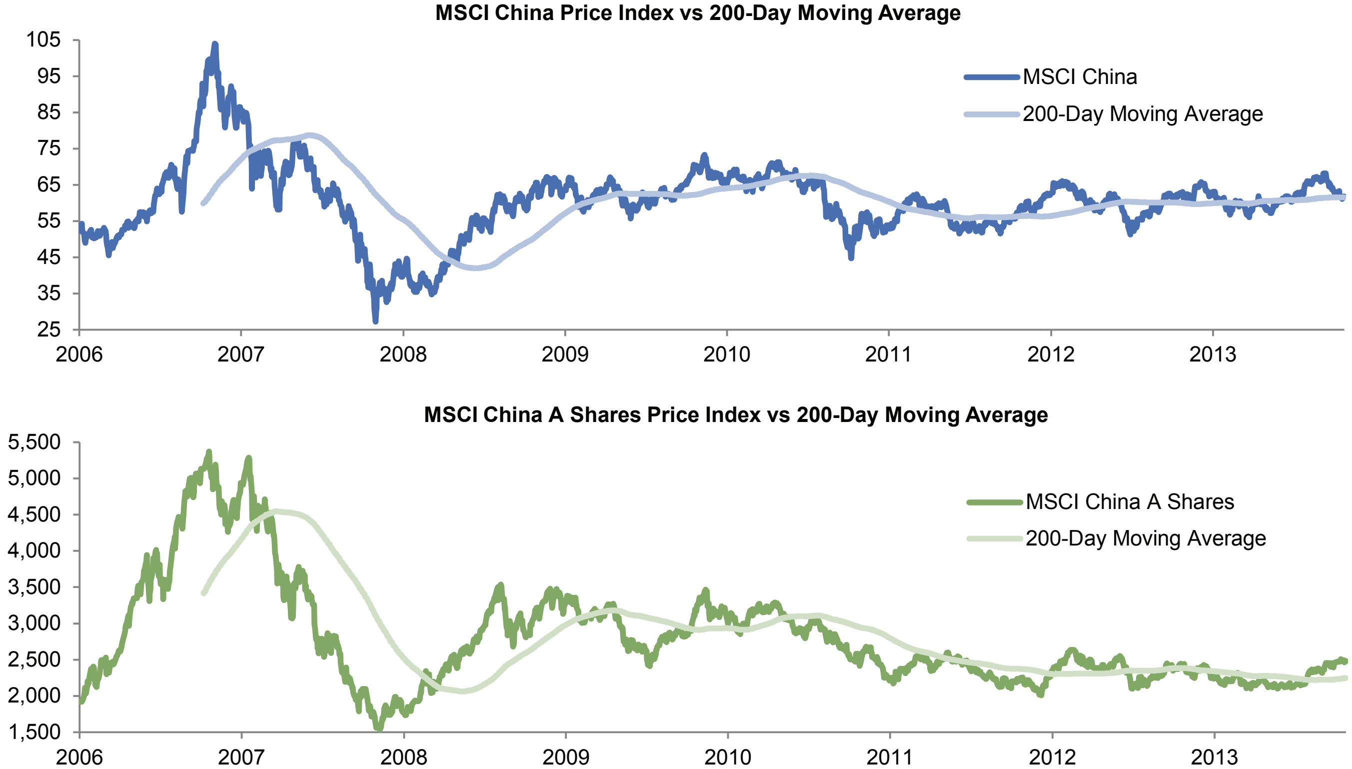
even better, ignoring the recent global sell-off and street protests in Hong Kong to continue rising (Figure 1). On a relative basis, Chinese equities have begun to tentatively outperform developed markets equities and appear to be bottoming after a five-year decline.

A compelling case can be made that Chinese equities are attractive today based on low valuations and a view that they will rally strongly if policymakers are forced to apply additional stimulus to the slowing economy. We remain nervous about the timing and are concerned that investors are still under-discounting the potential for additional stress to emerge in the Chinese economy and rattle markets.[2] We are also concerned that Chinese equities may remain stuck in a sideways bear market much like Japan in the 1990s, as China's economy still faces considerable headwinds in the intermediate term that will continue to weigh on equities.

Still, as Japan's long bear market has illustrated, powerful equity rallies can still occur amid a lackluster macro outlook, especially when valua-

[2] For more, please see our companion research note: Aaron Costello et al., "China: Prepare for Stress," Cambridge Associates Research Note, October 2014.

Figure 1. Performance of Chinese Equities
December 31, 2006 – October 20, 2014



tions are low and policymakers stimulate. China may be able to avoid Japan's fate by taking the economic pain now and allowing reforms to support growth over the longer term.

Thus, investing in Chinese equities today is a question of timing—low valuations offer some comfort that investors will profit from *eventual* mean reversion, but investors should be prepared for more volatility in the near term.

A Bifurcated Market

The past five years have been difficult for Chinese equities. The market has stagnated and vastly underperformed global equities since 2010 when the People's Bank of China (PBOC) began tightening monetary policy following the massive credit-driven stimulus of 2008–09. As a result, GDP growth has slowed steadily as credit and investment has been curtailed.

Yet poor index level performance obscures what is going on beneath the surface (Figure 2). Namely, the market has been punishing those sectors most at risk from China's economic rebalancing away from investment-led growth. Small caps and consumption plays such as e-commerce Internet stocks, health care, and telecoms have done well while financials, industrials, and materials have done poorly. On the mainland market this is perhaps best captured by the performance gap between the Shanghai stock exchange, bastion of large-cap state-owned enterprises (SOEs), and the Shenzhen stock exchange, which is tilted toward smaller private companies (Figure 3).

Figure 2. MSCI China Sector Performance
December 31, 2009 – September 30, 2014 • December 31, 2009 = 100

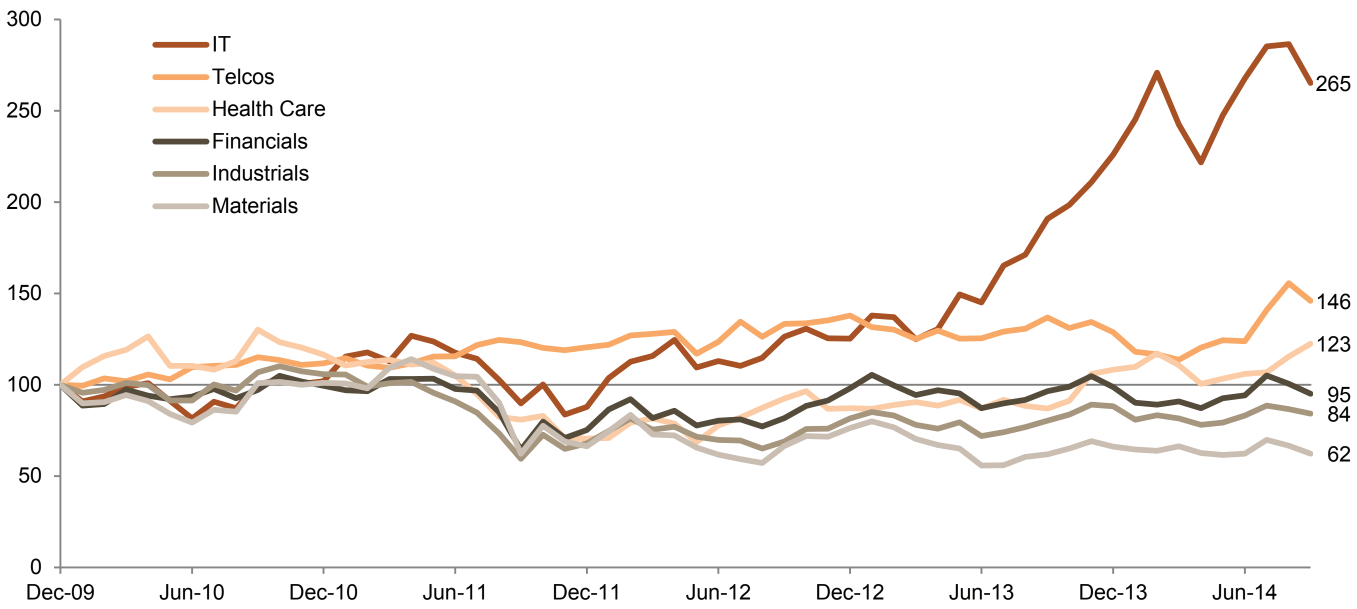
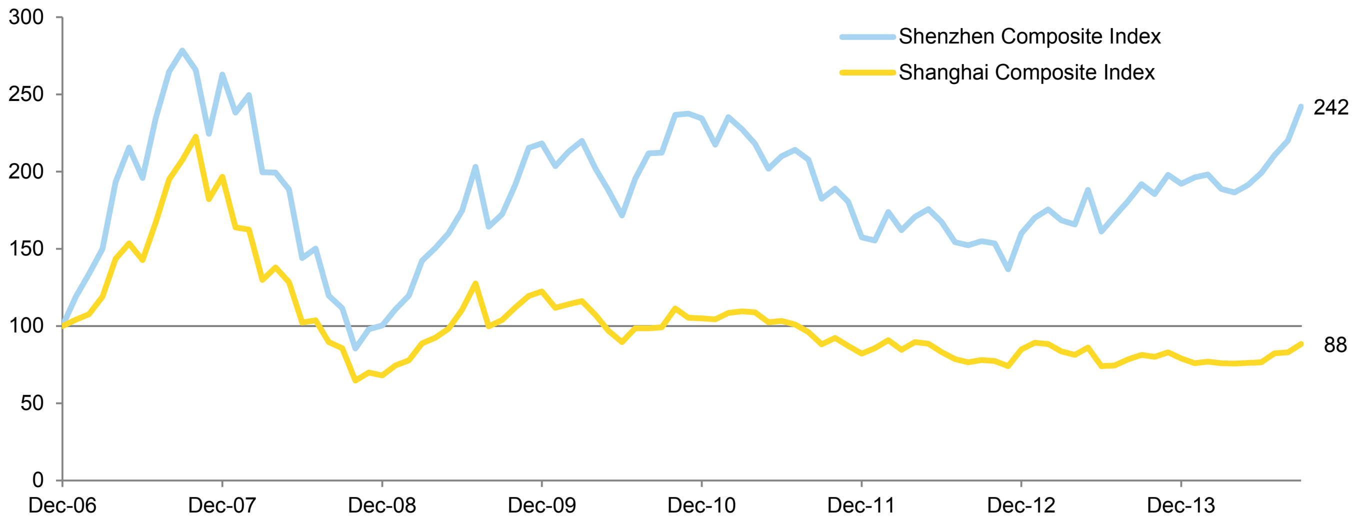


Figure 3. Performance of Shanghai and Shenzhen Composite Indexes
December 31, 2006 – September 30, 2014 • December 31, 2006 = 100



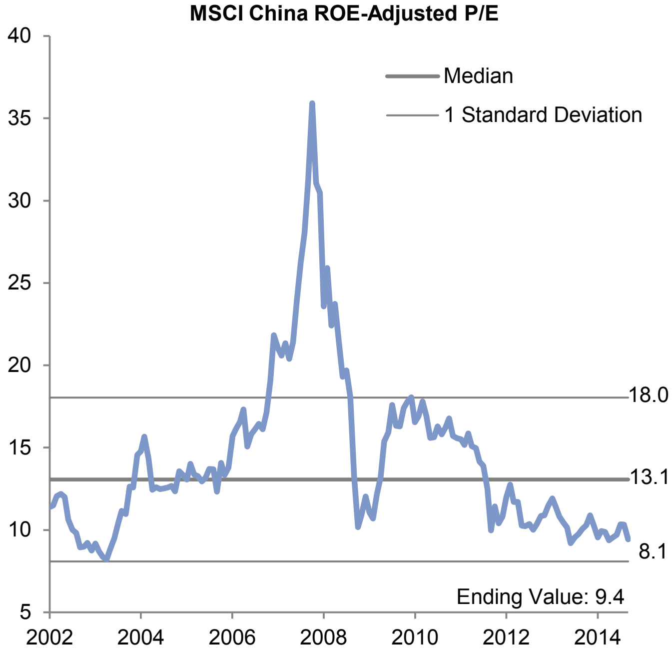
Stated more simply, "Old China"—as represented by large-cap industrial stocks and banks—is in a deep bear market, while "New China" is doing just fine.

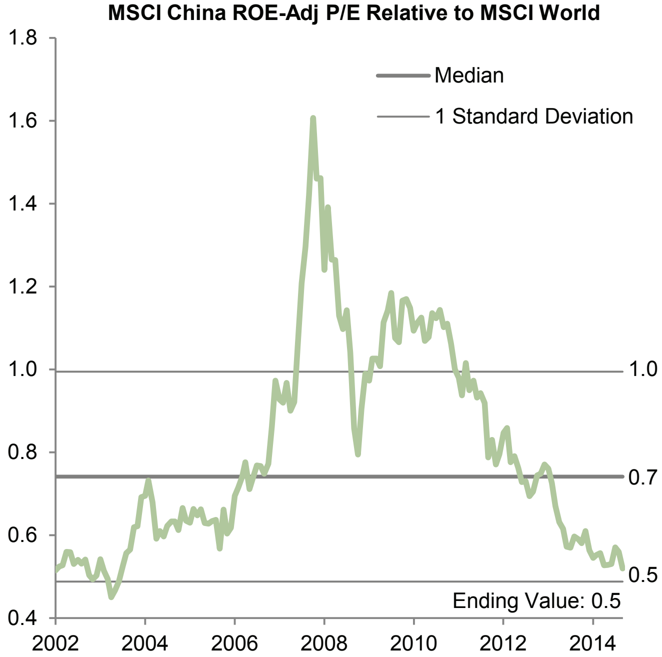
This divergence is the direct result of the new administration's stated policy intentions. As outlined in the most recent five-year plan and affirmed at the November 2013 Third Plenum, policymakers will now focus on the "quality of growth" rather than the pace of growth. To achieve a more balanced economy, priorities will shift away from promoting heavy industry and construction. Key reforms involve liberalizing the financial sector; reducing the influence of SOEs; and enacting supply-side reform such as reforming taxes, government spending, and urban household registration—all in an effort to support consumption and the private sector.

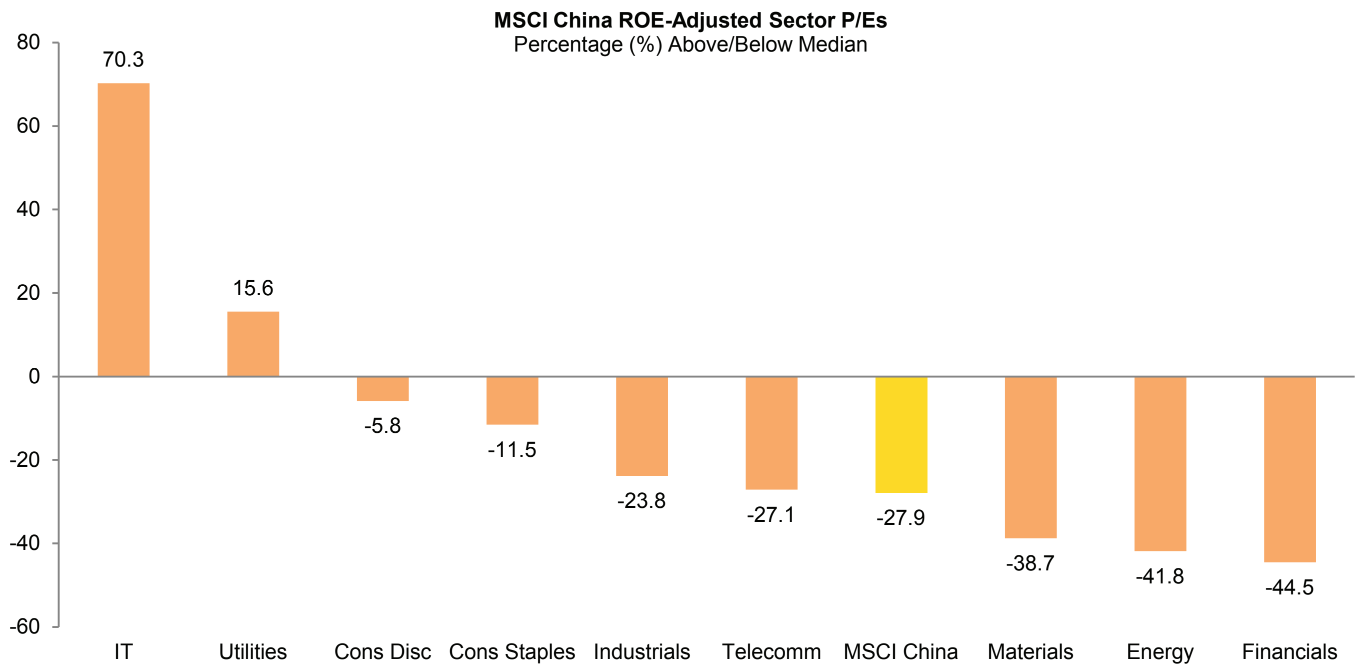
This shift in priorities and sector performance complicates the valuation picture. The return on equity (ROE)–adjusted price-earnings (P/E) ratio for the MSCI China Index is currently 9.4, compared to a median P/E ratio of 13.1 over the post-2001 period (Figure 4).[3] This implies the market is 28% undervalued and back to its 2003 level of valuation. On a relative basis, the index

[3] Given the significant changes in the composition of the MSCI China Index since its inception, we prefer to focus on the post-2001 period. For instance, over the 1993–99 period, there were no energy or telecom stocks, while the financial sector was composed of only one real estate company (China Vanke). Also, before 2000, the index only included H-shares and B-shares, and excluded Red-chips and P-chips. The inclusion of Red-chips in 2000 saw the index market cap jump from $4.9 billion to $66 billion, with nearly 60% of the index attributed to China Unicom, which had exceptionally high valuations. This distorts index valuations over the 2000–01 period, as telecom stocks collapsed. Index composition was also radically changed by the listing of bank stocks over 2005–06, which now account for over 30% of the index.

Figure 4. Chinese Equity Valuations
January 31, 2002 – September 30, 2014







trades at a 50% discount to the MSCI World Index, compared to a median historical discount of 70%. China is also one of the cheapest individual emerging markets; only Russia and other Eastern European countries are cheaper.

However, this undervaluation is concentrated among the energy, financial, and materials sectors (which account for nearly 70% of the market), which are roughly 35% to 45% below their recent medians, while the consumer plays are far from depressed, especially Chinese tech stocks (Figure 4). Small-cap stocks also look pricey, especially relative to large caps. The pattern is the same for the A-share market.

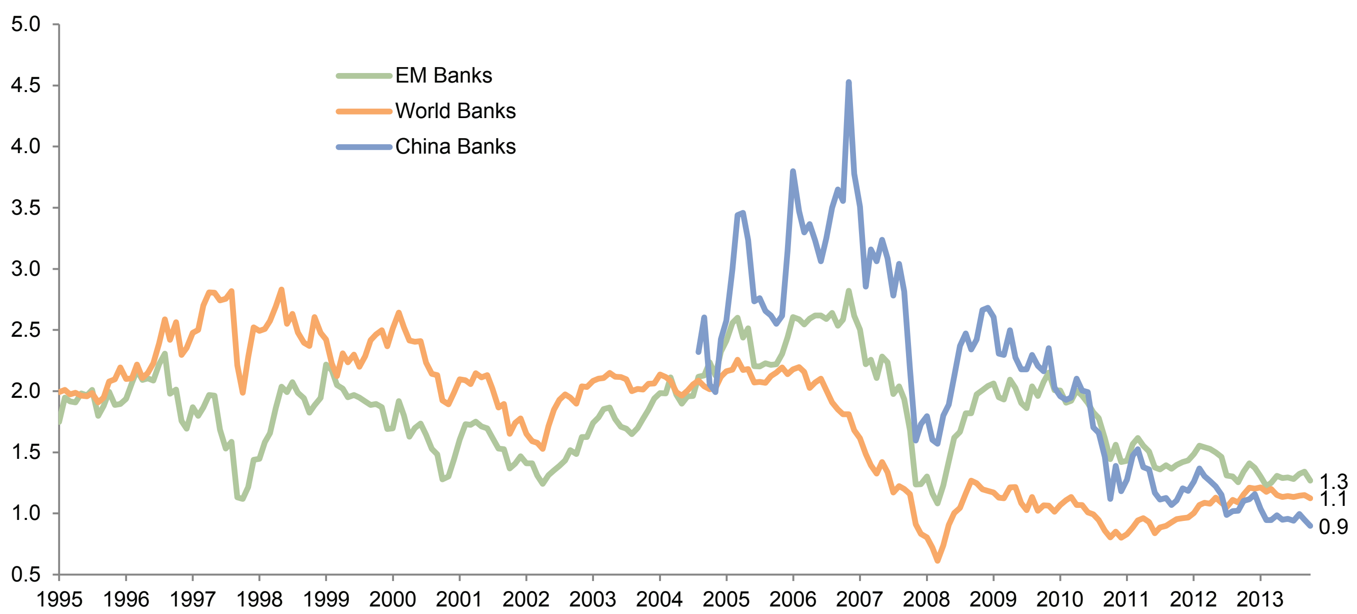
Thus the dilemma for investors today: what appears cheap is unattractive, while what's attractive isn't cheap!

Are Banks Attractive?

The outlook for the financial sector is especially important given that it accounts for more than 30% of market cap. Even after the recent rally, the major state-owned banks trade at 0.9 times book value (Figure 5), even lower than the trough level for emerging markets banks during the 1998 Asian financial crisis. At the same time, ROE for Chinese banks remains very strong at nearly 19%, implying the market expects profitability will weaken substantially going forward.

Views remain polarized as to whether Chinese banks stocks are attractive. Valuations clearly price in considerable headwinds to margins from increasing financial liberalization and risk from rising non-performing loans (NPLs). NPLs are currently low, at 1% of bank assets, but this is a

Figure 5. Bank Valuations: Price-to-Book Ratios
December 31, 1995 – September 30, 2014



lagging indicator given the rapid expansion of bank balance sheets. Goldman Sachs estimates that the major banks have provisioned for NPLs in the 10% of assets range.

The bears would say that during China's last debt crisis in the late 1990s/early 2000s, NPLs swelled to between 20% and 30% of bank assets, and while today's valuations are low, they are not yet at equivalent depressed levels to those of US and European banks in 2008. Chinese banks have undergone recent rounds of capital raising, yet more will be needed to shore up balance sheets, increasing the dilution risk facing investors.

The bulls counter that the major Chinese banks have an implicit government guarantee and should not be compared to Lehman Brothers or Citigroup in 2008. At the same time, Chinese banks offer an outsized 6.8% dividend yield compared to 3.1% for banks globally. Investors are effectively paid to own Chinese banks, while ample loan-loss provisioning provides a decent-sized cushion before write-downs hit profits.

Our view is that while the major state-owned banks do not face the same bankruptcy risk as European and US banks, the coming hit to profits from write-downs and slowing loan growth will be larger than expected and may persist for some time. This, combined with additional capital raisings, will continue to weigh on banks, capping their upside over the next few years.

What's Next for Chinese Equities?

The consensus view is that Chinese equities will continue to rally as policymakers shift to a "pro-growth" stance given the near-term risks facing the economy. The sharper-than-expected slowdown in GDP growth this year and emerging defaults in the shadow banking system have already forced the PBOC to ease interbank rates and let the renminbi depreciate, and authorities unveiled another set of "mini-stimulus" measures focused on affordable housing, railway spending, cutting corporate taxes, and easing lending requirements for rural banks. Chinese equities are already behaving as if "bad news is good news," shrugging off the weaker-than-expected third quarter GDP growth data.

While Chinese equities are overdue for a rally, and stock prices lead the economy and economic data, we are concerned that any tentative rally is not sustainable.

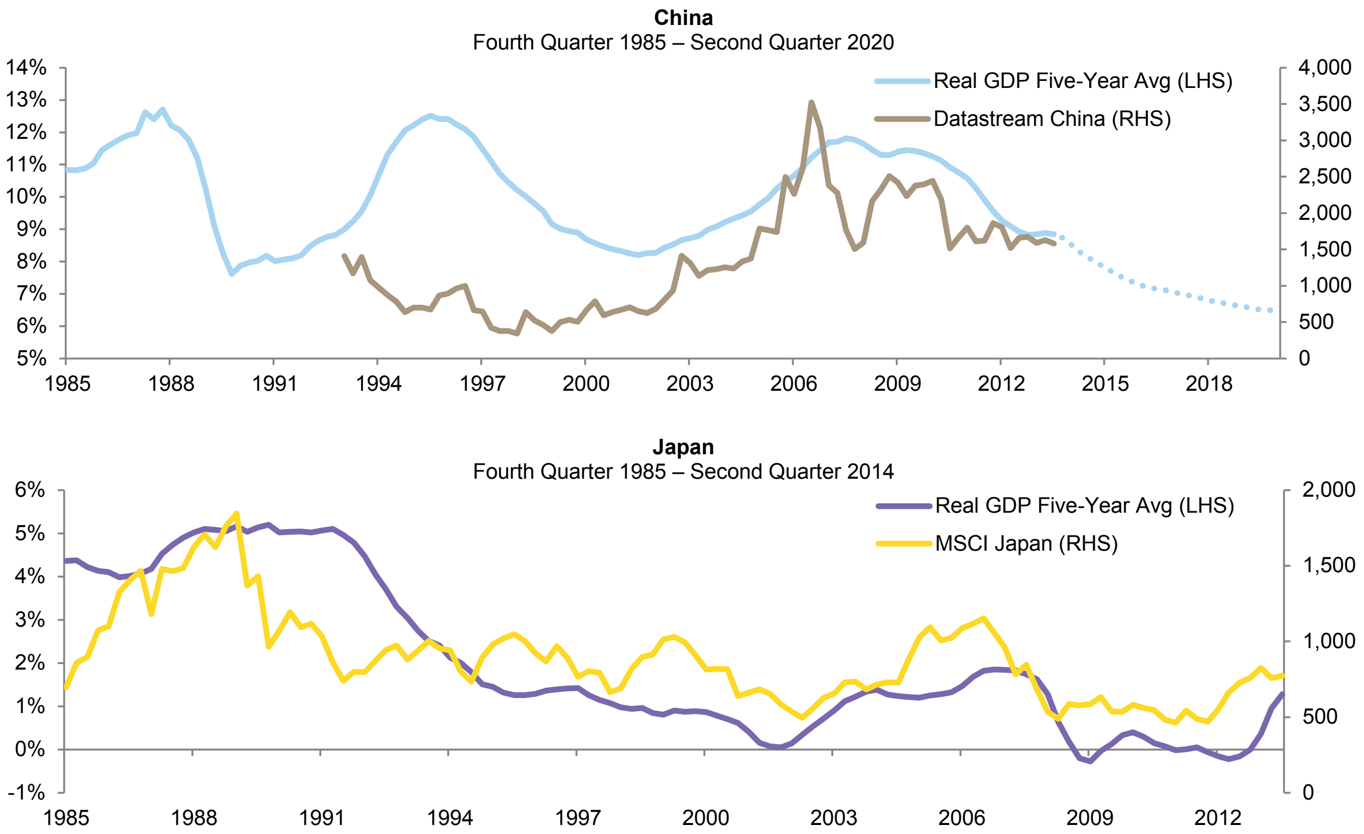
- Markets are underappreciating the near-term risks to the Chinese economy. A weakening housing market and the burden of refinancing bad debts may see growth slow further and still rattle markets, especially if policymakers prove less accommodative than expected. Markets may need to panic first to force policymakers to act, as has been the pattern over the past five years, including late 2011, mid-2013, and earlier this year.
- Even absent a seriously deteriorating macro backdrop, the rally may ultimately falter if current stimulus triggers a rebound in growth that ultimately sees the PBOC

resume its monetary tightening—again, the pattern of the past few years.

- At a fundamental level, increasing monetary and fiscal stimulus would be harmful to the real economy, as it would exacerbate the existing structural problems and imbalances in the Chinese economy that have been weighing on the Chinese stock market (e.g., bad debt in the system and overcapacity in the industrial/SOE sector that have weighed on corporate profits).

Could China Turn "Japanese"? The parallel between Chinese equities today and Japan's post-bubble experience is worth exploring. The Japanese stock market ground lower for decades as Japan's economy dealt with the aftermath of a real estate bubble, industrial overcapacity, and a banking system full of hidden NPLs—making Japan synonymous with "value trap." The steady decline in Japanese real GDP growth acted as an anchor around the neck of the Japanese stock market; China faces a similar prospect, even on relatively benign consensus forecasts of trend growth slowing to 6.5% by 2020 (Figure 6).

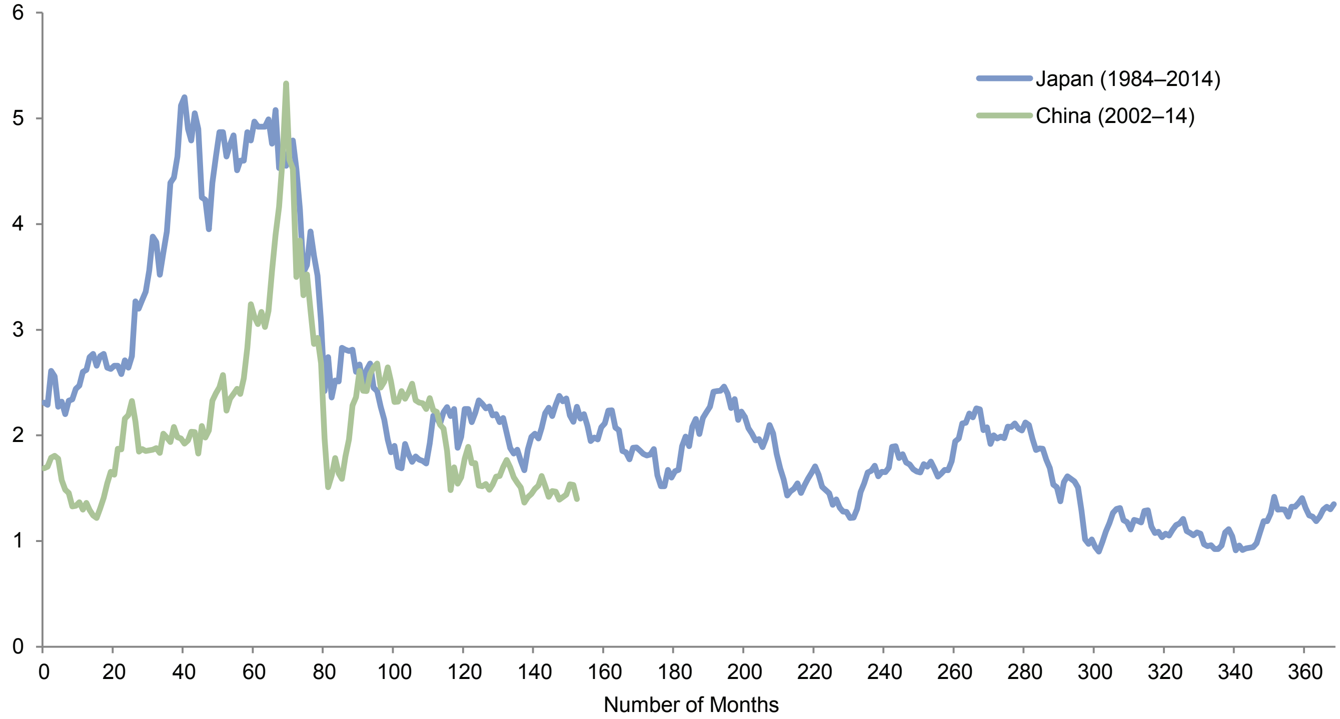
Figure 6. Real GDP Growth vs Equity Levels



In 2007 Chinese valuations reached levels comparable to the peak levels in Tokyo in 1989, with investors paying 5 times book value. What's even more striking is how rapidly the Chinese stock market bubble inflated—Chinese stocks took only two years to go from fairly valued to insanely valued. China has also outpaced Japan on the downside, with the 2008 collapse sending valuations much cheaper than Tokyo reached in 1990 (Figure 7).

Encouragingly, Chinese equities today are cheaper than Japanese equities were five years into their post-bubble slump. This implies that investors are not blasé about the risks and could mean Chinese equities are overdue for a rally, just as Japan experienced in 1995. However, despite periodic upturns in the economy, Japanese equities continued to grind lower over the rest of the 1990s and into the 2000s. This was especially the case for Japanese banks, which saw their valuations steadily decline for over a decade, eventually bottoming at a price-to-book ratio of 0.5 in 2003. Like in China today, the major Japanese banks also had implicit government guarantees and were deemed "too big to fail." And indeed, no major bank did fail in Japan, but this did not spare shareholders from poor returns. The same fate may befall Chinese bank investors.

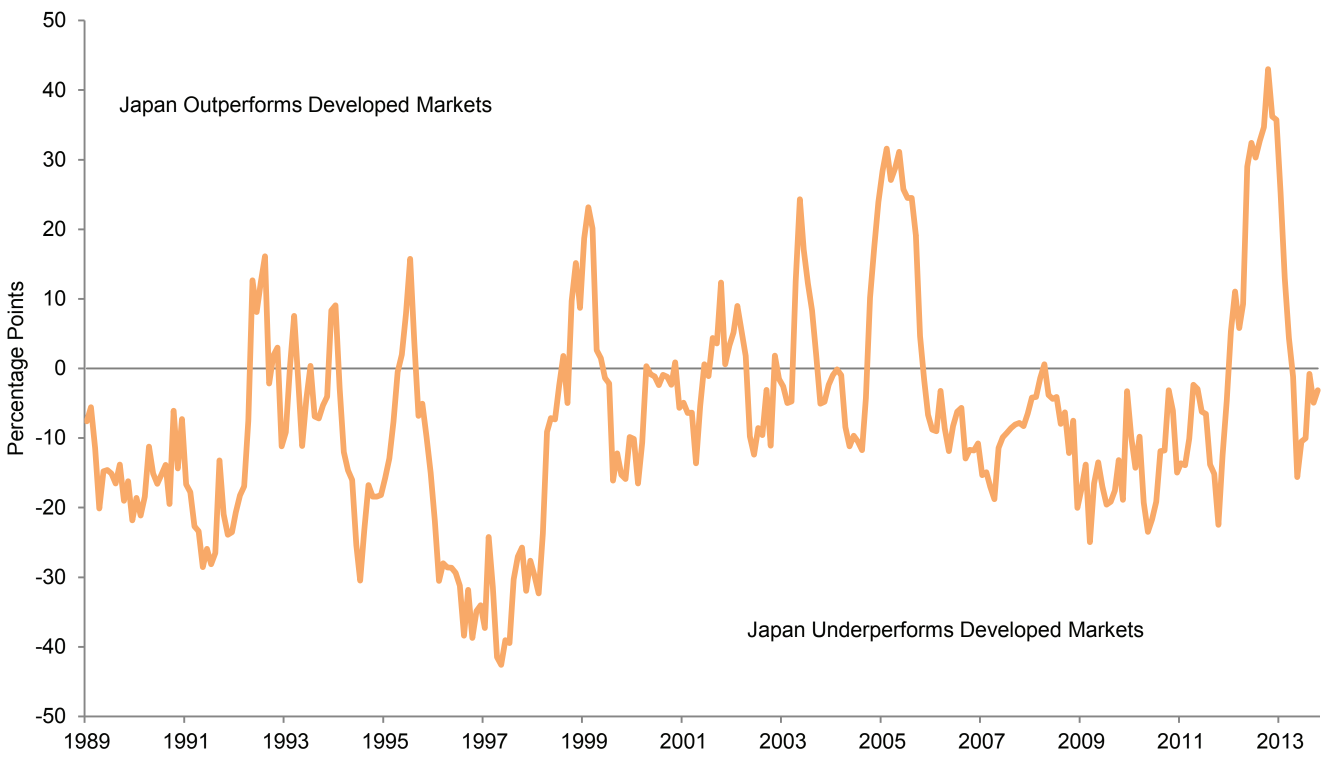
Figure 7. Price-to-Book Ratios in the Run-up to and Fallout from Bubbles
As of September 30, 2014



A key difference between Japan and China is profitability. Even during the boom years, Japanese equities generated low ROE compared to most markets, and especially China. A key reason why the Japanese market ground sideways for decades was that ROE continued to fall as banks propped up ailing "zombie companies" that refused to shed labor and were slow to combat overcapacity. In the post-bubble economy, few Japanese companies went bust and lifetime employment was maintained, which sapped growth from the economy.

Still, the Japanese stock market did enjoy periodic sharp rallies amid temporary rebounds in growth, driven by government fiscal stimulus (Figure 8). But ultimately these proved fleeting once stimulus was withdrawn. Many market commentators take comfort in a view that China will always stimulate if growth falters in order to preserve "social harmony." Yet this is the mistake that China must avoid. Companies must be allowed to fold, defaults and unemployment to rise, and banks must take write-downs on bad debts instead of rolling them over. China must start taking the pain now, to preserve the future. If not, there is a real risk of China, and Chinese equities, turning "Japanese."

Figure 8. Performance of Japanese Equities Relative to Developed Markets Equities
December 31, 1989 – September 30, 2014 • 12-Month Relative Total Return • Local Currency



Implementation

Given a higher potential growth rate and corporate profitability, China may avoid Japan's fate, depending on how reforms are implemented over the coming years. Still, increasing exposure to Chinese equities today requires a long time horizon, or a willingness to be tactical amid what will be a difficult few years.

From an implementation standpoint, investors should determine to what extent they are already exposed to Chinese equities and whether an additional overweight is desired. For example, China already accounts for nearly 20% of the MSCI Emerging Markets Index. Thus, investors overweight EM equities on a passive basis are by default overweight China. This is especially the case if EM allocations are implemented via value-biased managers, many of which are currently overweight China.

Active China equity managers have the ability to potentially add value through stock selection, which will be key to navigating a challenging environment, although this is not guaranteed in volatile markets. Asia ex Japan active equity mandates are also an interesting implementation option—they will have large China allocations, but also the flexibility to change exposure to Chinese companies in response to market valuations and dynamics, as well as adding value through stock selection. The same can be said for Asia-focused or greater China–focused long/short hedge funds, which could provide a more defensive China exposure. Of course, nimble tactical investors interested in capturing undervalued beta are best serve by implementing via low cost passive exposure to offshore (Hong Kong–listed) Chinese equities.

A strategic case can be made for increasing exposure to China via the under-owned, but rapidly opening, A-share market.[4] While the A-share market has the advantages of a larger and somewhat different opportunity set, it also has several pitfalls (higher volatility, lower-quality companies, more costly implementation) that make this market not for everyone. We strongly favor active management for A-share exposure given the greater potential for value add, but again stress such allocations require higher risk tolerance and a long-term horizon.

Conclusion

The Chinese economy faces considerable headwinds as it seeks to reduce its reliance on investment-led, and increasingly debt-driven, growth. To some extent the Chinese stock market has largely priced this in—Chinese equities have been underperforming for five years and appear undervalued, especially those sectors most at risk from economic rebalancing. Historically, buying equity markets priced at less than 10 times earnings has been rewarded over the long term. A case can be made that Chinese equities will rally in the near term as policymakers shift to a more "pro-growth" stance and stimulate the economy.

[4] Please see Aaron Costello et al., "The Door Is Opening: An Overview of the Chinese A-Share Market," Cambridge Associates Research Report, 2013.

However, we are concerned that such a rally will be short-lived and that global markets will be rattled by slowing growth and stress in China, as policymakers are reluctant to stimulate and exacerbate current problems. Investors need to be cognizant of this timing risk, as well as the risk that should China fail to push through structural reforms and take economic pain now, Chinese equities may remain stuck in a prolonged sideways bear market similar to Japan in the 1990s.

Still, even amid such an outcome, equities can enjoy powerful rallies. This is especially the case when valuations are low. Investors in Chinese equities today can take comfort from valuations, and the potential for China to avoid Japan's fate, but should be prepared for more volatility. Any panic-driven sell-off would represent a good entry point for investors. ■

Contributors

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Exhibit Notes

Performance of Chinese Equities
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

MSCI China Sector Performance
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Performance of Shanghai and Shenzhen Composite Indexes
Source: Thomson Reuters Datastream.

Chinese Equity Valuations
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All sectors are valued based on post-2001 median except for consumer staples, which is valued based on its post-2003 median. The health care sector has been omitted due to poor historical data.

Bank Valuations: Price-to-Book Ratios
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Real GDP Growth vs Equity Levels
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: China GDP projections begin in third quarter 2014.

Price-to-Book Ratios in the Run-up to and Fallout from Bubbles
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