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REJUVENATED CHINA – SHARES POISED FOR SUSTAINABLE RALLY

New Beginning After a Lost Decade

The sharp rebound in Chinese stocks so far this year has surprised many investors. Notwithstanding the false dawn in first half of 2015, when domestic equities momentarily perked up, the Shanghai Shenzhen CSI 300 Index—one of China's main equity barometers—has generally underperformed many equity indices around the world, particularly those of the US, for the past 10 years.

With the latest upturn, will Chinese stocks finally start to perform in line with strong GDP growth? Our research leads us to an affirmative answer, as we see an emergence of structural changes in the Chinese economy that would support the positive case for domestic equities. Incremental money flows from properties to equities, improving earnings quality, increased participation from foreign institutional investors and more innovative Chinese companies getting listed in the country's stock markets are other drivers that should sustain the momentum of a rejuvenated equity market.

But before we delve into why mainland China equities could see a sustainable uptick, let's first look at some of the underlying reasons that have weighed them down in recent years.

China's Economic Growth Model Led to Poor Earnings Quality

For many, it seems puzzling that China's earnings per share (EPS) and returns on equity (ROE)—two of the main drivers of equity performance— didn't meaningfully correlate with the country's strong nominal and real economic growth over the past decade.

The divergence between economic growth and stock market returns in China could have been indirectly caused by the global financial crisis in 2008. On 9 November, 2008, the Chinese government, in an attempt to mitigate the impact of the financial crisis on its economy, launched a massive RMB 4 trillion economic stimulus plan to invest in the country's infrastructure, real estate and social welfare system. That significantly altered China's economic growth model, which became largely driven by infrastructure and property investment over the past decade.

An economy where GDP is driven by high levels of investment tends to push too much capital into less productive areas, resulting in a dip in overall economic efficiency. In recent years, that was what happened to China, where there is a potential property bubble and an overall real estate glut.

Moreover, the massive infrastructure construction and property investments in China, spurred by government spending, benefitted mostly the state-owned enterprises (SOEs) and government-linked agencies. With rising SOE dominance over several of China's key domestic industries, many privately-owned Chinese companies—starved of funding—started to take a backseat in the country's investment-driven economy, post-2008.

At the same time, an inefficient use of resources was prevalent among China's SOEs. The diminishing role of the private sector in driving the country's economic growth also led to declining ROE, weaker EPS growth and poorer earning quality. A confluence of factors ultimately led to lacklustre share price performance in China in recent years.

The underperformance of China A-shares to US stocks over the past decade shouldn't be too surprising. After all, the outsized performance from the US stock market since the financial crisis was largely due to the strong surge of a small number of large technology stocks, which for a long time had very high ROEs.

Impact of Indirect Financing

The investment-driven economic growth model of China after the financial crisis relied heavily on continuous financing from state-controlled banks and trust companies. That caused China's total debt ratio to swell dramatically and also led to a precarious shadow banking problem in the world's second-largest economy.

In China, the government sets the direction of bank lending and state-owned banks' first priority is to facilitate the financing needs of government entities and SOEs. As such, financing costs of preferential loans (where borrowing rates are artificially set at low levels) to government entities and SOEs tended to be lower as compared with those of ordinary commercial banking loans.

This diluted the profitability of large state-controlled banks, whose shares are key components of China's stock markets. With the dominance of indirect financing in China in recent years, the role of the A-share stock market as a primary funding platform for companies gradually diminished.

De-Rating of A-Shares

Mainland China stock markets, which are dominated by big-cap SOE names, are quite different from foreign equity markets that comprise mostly of private companies operating in a market-driven economy. Although the number of SOEs listed on the China A-share market isn't overwhelmingly large, the profits of these companies could account for more than 40% of the entire market's profits.

Yet, many domestic and foreign investors of China stocks aren't attracted to SOE names, whose corporate governance tends to be weaker versus their non-SOE counterparts. In addition, the business interests of SOEs' top executives and board members aren't always in line with those of public investors.

The general lack of investor interest in China SOE-related stocks, which have seen dreary growth in earnings and profits in recent years, eventually led to a de-rating of these counters over the past decade. As big-cap SOE stocks tend to be key components of mainland China stock indices, their de-rating inevitably impacted the country's overall stock market in a negative way as money started flowing out of China equities.

At the same time, with property prices in China soaring after the country's massive economic stimulus plan in late 2008, many Chinese—spurred by expectation of higher real estate prices—have continued to flock into this popular asset class. This trend has redirected money flows away from stocks to real estate. As a result, mainland China equities have remained an out-of-favour asset class with Chinese investors for a prolonged period.

Impetuses for China Stocks to Trend Higher

It is true that China A-shares didn't do particularly well over the past several years. But we believe that China equities, which have rebounded strongly of late, could trend higher on a sustainable basis. There are several reasons that could lead to a re-rating in these equities.

Firstly, China's property bubble could be nearing its peak. China's top leaders realised the dangers of runaway property prices two years back and have since taken efforts to manage the country's real estate prices more carefully. If the cooling of China's red hot property market is successfully maneuvered, the resources of the government and capital of families will gradually flow out of real estate. Mainland China equities could benefit from increased inflows as money moves out of properties.

Next, China's debt ratio is way too high. The debt binge, via continuous financing from state-controlled banks to spur growth in China's economy, is unlikely to continue. As such, the country has to rely more on direct financing via its equity and fixed income markets to fund its businesses and economic growth initiatives. That will be a big positive for China's equity market.

China's economy has had overinvestment, resulting in too much capital chasing returns. Smaller amounts of capital should yield higher returns, particularly as the authorities are encouraging lending to be directed to the private sector. An entrepreneurial mind-set in a strongly growing economy without irrational competition is a very positive combination for equity markets.

The domestic stock markets have tended to be driven by retail investors, who trade on momentum rather than valuation. With the growth of a Chinese institutional market and increasing participation from foreign investors, we expect domestic equity markets to mature and trade in line with fundamentals. That should reduce volatility and allow good companies to outperform.

Moreover, to shift to a more sustainable growth model, China—after its 19th National Congress in October 2017—has turned to innovation and upgrading of its manufacturing and consumption sectors to drive growth. That could improve earnings quality of listed private sector companies in China, potentially leading to higher valuations.

Lastly, the US has proved that its equity market can provide the best funding platform for innovative companies. The next Tencent, Alibaba or other innovative Chinese firms are very likely to be listed on the country's A-share market. That's why we are confident that returns for onshore China equities will be much better going forward after underperforming over the past decade.

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