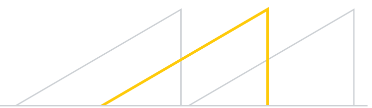
GIB ASSET MANAGEMENT

Why the upcoming US presidential election can mean good news for China

By Kunal Desai, CFA

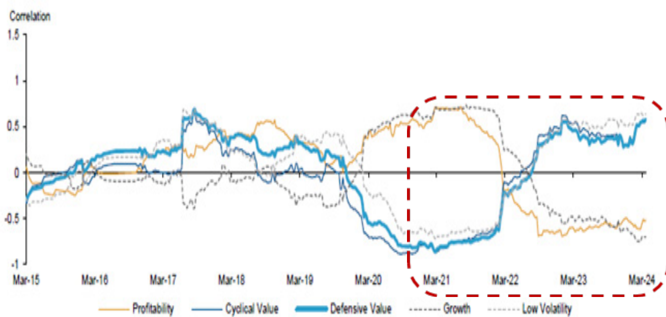


China has provided its challenges for active managers in recent years. For us, attribution has been driven by negative stock selection rather than asset allocation – a function of the continuation of 'Defensive Value' as the overarching style outperforming in the Chinese market. This has meant that Defensive and Cyclical Value have been the places to be, whilst Growth and Profitability have struggled as a style for the last two years. State Owned Enterprises (SOE), Banks, Utilities and Energy have been the leading sectors, whilst Consumer-related industries and Technology have lagged materially.

Structural views on investing in China have not meaningfully shifted in recent months, despite the near-term market recovery. Sentiment remains constrained by i) stubbornly weak domestic demand; ii) RMB FX weakness; iii) patchy and uninspiring policy support with a primary focus on doubling down on 'new productive forces' for the supply side rather than broad stimulus to revive the demand side. Within this climate, 'cash today' vs 'cash tomorrow' has implied shorter duration, cash heavy, dividend yielding businesses in the Defensive and Cyclical Value have registered stronger performance since March 2022.

Correlation with Momentum: Defensive and Cyclical Value outperforming Growth & Profitability.

Chart 1[1]: Performance by Style Factors in China



This has been painful for the strategy given our overarching focus on higher quality businesses, armed with deeper competitive advantages that provide conviction of reasonable compounding power. Despite their shorter-term outperformance, SOEs and Cyclical Value are not appropriate for our strategy. Whilst both offer some portfolio protection within an environment of intensely uncertain regulatory upheaval through attractive dividend yields, we are skeptical of their longer-term investment qualities. Recent announcements of SOE reforms mirror previous initiatives that have delivered mixed results. There is a further risk that SOEs will increasingly be called up for 'national service' to satisfy policymakers' economic and social priorities. Most obviously this will be focused on the creation of jobs to absorb a cohort of underemployed youth – which will likely jeopardise corporate productivity and profitability.

The domestic demand issues in China are nothing new and are likely well priced in given the extreme relative valuations. Incremental growth catalysts will be important as Profitability and Growth styles remain sensitive to any signs of a resumption in near term growth expectations. As this comes through, subsequent share price performance can be explosive through a combination of broad-based earnings upgrades and material valuation re-rating. So what's required to precipitate a change in policy direction and re-energise consumption sentiment?

Much will depend on the trajectory of export growth in China. For Chinese policymakers, internal expectations are framed around delivering 5% GDP growth, but not to over deliver. In 1H 2024 GDP growth reached 5.0% - in line with targets – however slowing recent momentum implies that the annual growth target might slip without a step up in policy support. Exports and manufacturing investment have so far been the driving force of the GDP growth target. GDP in the industrial sector grew 5.8% YY in 1H24 when power production climbed 5%. China's trade surplus reached $435bn, the highest on record over the same period. Manufacturing capex grew 9.5% YY, driven by the strong demand from new energy. Finally, production of Electric Vehicles and solar panels grew by 34% YY and 18% YY respectively. The chart below summarises the constituent drivers and impediments to Chinese GDP growth. Whilst Exports and Manufacturing have been beacons of strength, the property market and domestic demand have intentionally been less well supported. This has had an impact on consumer sentiment which has hurt our basket of portfolio companies.

[1]Factset, Macquarie, July 2024

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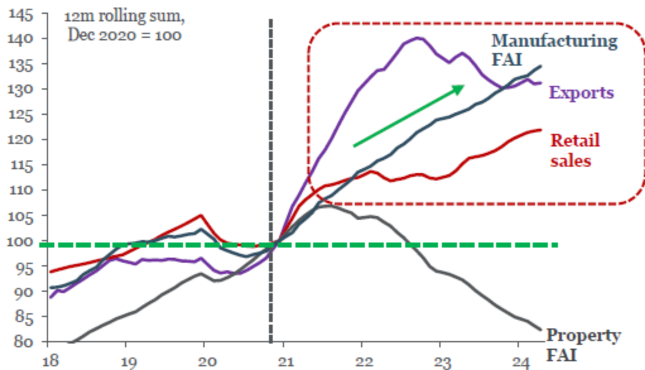
Exports and Manufacturing have supported the Chinese 5% GDP target – can this change?

Chart 2[2] : Drivers of Chinese GDP Growth

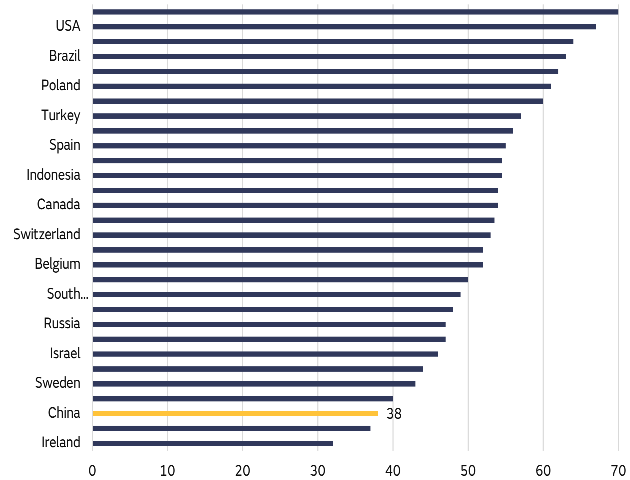


Consumer data continues to disappoint. Property investment fell 10% YY in June with consumer retail sales only climbing 2% YY (below consensus expectations of 3.4%). Behind weak consumption is soft household disposable income, which slowed to 4.5% YY growth in Q2'24 (down from 6.4% the previous quarter), the slowest pace since early 2023.

In short, this two-speed growth model still prevails, under which policymakers rely on external demand, export growth and manufacturing capex to achieve growth targets. When could such a two-speed model come to an end? A slowing global economy or rising trade protectionism. Were the latter to manifest (a high likelihood outcome as a new US President emerges), policymakers in China would be 'forced' into a shift towards aggressive policy support towards the hitherto sagging property market. Consumer animal spirits would be likely revived. Our basket of portfolio companies which are aligned with Quality, Growth and Profitability would see a dramatic resurgence at the expense of Defensive & Cyclical Value.

Room to grow: Consumption as a share of GDP is materially lower than global peers

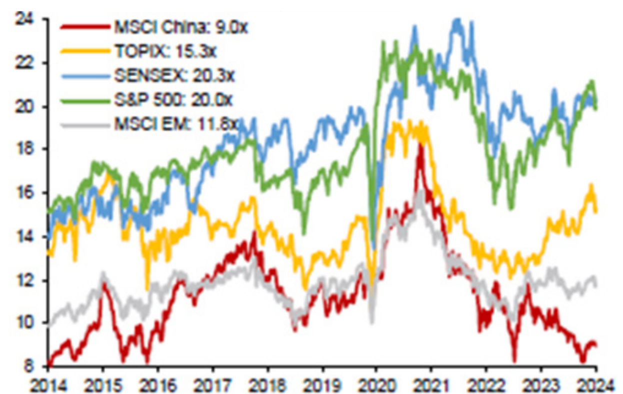
Chart 3[3]: Private consumption % of GDP



Our weighting towards China sits at 24.7% which is marginally lower than the Index's weighting of 25.5% and materially higher than many of our peers. Our timing of adding to China through early 2024 was reasonable since Chinese equities have improved from the nadir in late January. The asset class remains historically cheap related to other emerging and developed market peers. The MSCI China 1 year forward P/E discount to MSCI EM remains at (-2) standard deviations below the 10-year average.

Historically cheap valuations versus China's own history and other peer markets.

Chart 4[4]: 12 month forward P/E



[2] Bloomberg and Macquarie, 2024
[3]CEIC, CLSA
[4]Bloomberg 2024
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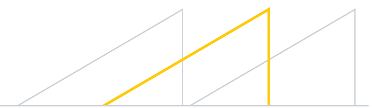
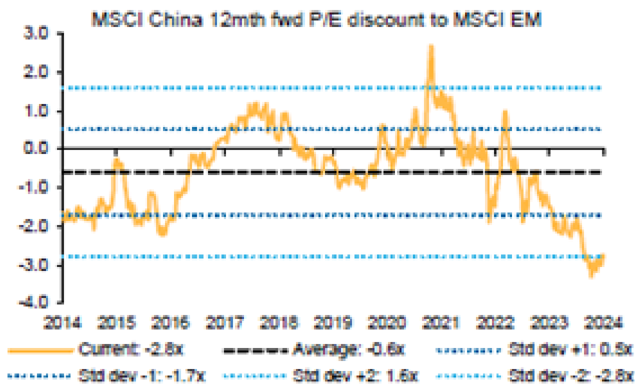
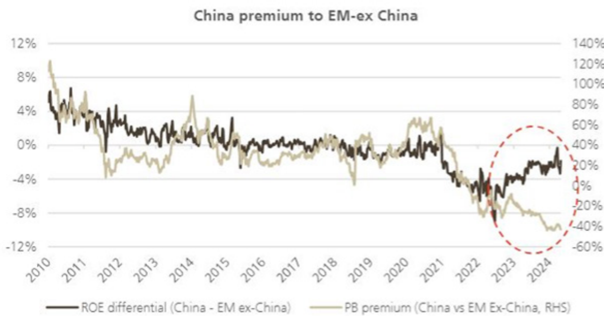


Chart 5[5]: MSCI China 12 month forward P/E discount to MSCI EM



Whilst extreme valuations are supportive and reasonably well understood, corporate profitability and fundamentals are beginning to surprise positively. We believe this has been less well understood. MSCI China ROE expectations are catching up with the rest of emerging markets despite valuations continuing to slide lower. This improvement in ROE expectations (some explained through engagement-driven shareholder friendly capital allocation) are being largely ignored by the market.

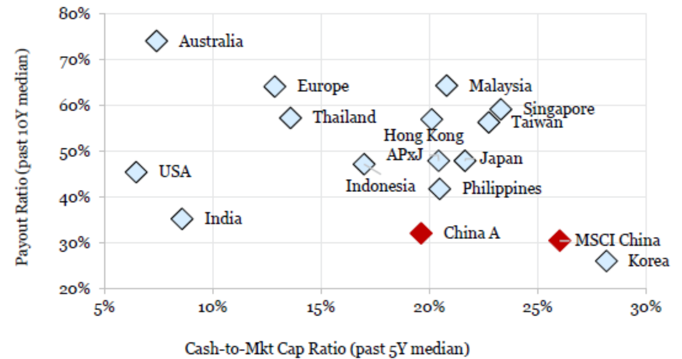
Chart 6[6]: ROE Expectations



The self-help story for Chinese corporates remains particularly attractive – valuations have de-rated largely on terminal growth downgrades (which can change with a shift in policy priorities) and a higher cost of capital (geopolitics-driven country risk premia). Corporate fundamentals and business balance sheets are healthy, and as the chart below shows, China provides best in class optionality for an improvement in capital returns to shareholders. Cash balances as a percentage of market cap are high, whilst payout ratios are low. Free cash flow yields continue to climb. This aligns with our engagement work with portfolio companies where Strategic Capital Allocation decisions to improve shareholder returns through higher capital returns is a potent lever to pull.

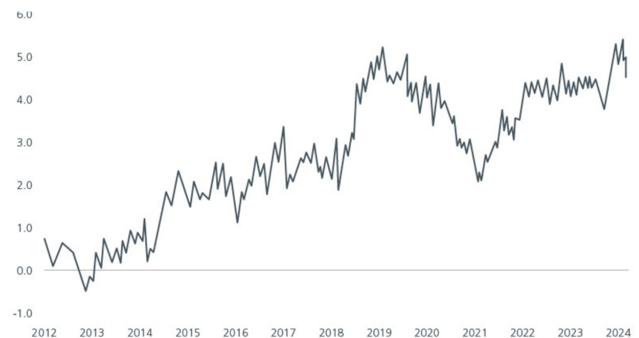
Chinese self help: companies are in a strong position to return cash to shareholders

Chart 7[7]: Payout Ratio vs Cash-to-Market Cap Ratio



Free cash flow yields at multi year highs

Chart 8[8] FCF Yield %



Timing the bounce in China tends to be a difficult exercise with recent market upticks quickly fizzling out. Whilst fundamental factors have not performed well over the last three years, we believe we are now approaching the point where the market is willing to reward growth and sustainable return on invested capital (ROIC) again. This will be helpful for our portfolio companies – many of whom have seen valuations de-rate to the lowest levels in a decade despite balance sheets and competitive positioning improving to levels not seen before. We continue to retain exposure to high conviction, bottom-up ideas powered by the fruits of value unlock through our active engagement approach.

We must be patient – and believe better times are ahead.

[5&6] Bloomberg 2024

[7*8] NBS, MoF, Bloomberg, Goldman Sachs, Macquarie, MSCI China & GIB AM analysis Q2 2024

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