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China equity outlook 2024

Opportunities amid pivot to advanced manufacturing, technological self-sufficiency

By the Asian Equity Team
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2023 in review: reopening hopes fade, economic unease sets in

China equities, which turned in negative returns in 2023, have had a very volatile year. In early 2023, optimism and great hope of a fast reopening in China following the COVID-19 pandemic sparked widespread market excitement and fuelled expectation of a recovery toward more steadfast and robust returns. These expectations reached a peak during end-spring and the start of summer when China's second quarter (2Q23) GDP numbers came in at 6.3% on a year-on-year (YoY) basis, tracking ahead of the Chinese government's 5.0% growth target and causing many investors to raise their return and growth expectations for the full year.

However, by the end of summer, with the Chinese manufacturing purchasing managers' index falling below 50 and trade growth in the world's second largest economy falling to negative territory, it became clear that expectations were exceeding reality. In response, the Chinese government released more liquidity into provincial and municipal economies through the issue of renminbi (RMB)1 to 1.5 trillion in special refinancing bonds to replace high interest local government bonds. These and other supporting measures helped push 3Q23 real GDP growth to 4.9% YoY and above the expected 4.5%.

Towards the end of 2023, the Chinese central government stepped up its fiscal support for the economy, announcing an issuance of RMB 1 trillion additional sovereign debt to support infrastructure investment. This latest support measure, in our view, should boost the likelihood of the Chinese government's 2023 growth target of 5% being met.

Will China's property woes go the way of Japan in the 1990s?

China's deteriorating property sector has continued to be an area of weakness for the Chinese economy and remains a drag on overall market sentiment. Of late, some economists and market observers have started to draw similarities between the country's property deflation and that of Japan in the 1990s, suggesting that Chinese equities could follow the same protracted downcycle as Japanese stocks had endured during Japan's post-bubble era.

We would highlight that while there may be some similarities, there are also very important differences. Importantly, Japanese stocks traded on a lofty price earnings (PE) multiple of 60 times at the market peak in 1989 versus a PE multiple of 20 times for China stocks during the highs in early 2021. Second, Japan's trend profit growth was much lower in the late 1980s than Chinese growth at present. The yen also doubled in value post the 1985 Plaza Accord*

*The Plaza Accord joint agreement was signed on 22 September 1985, at the Plaza Hotel in New York City, among France, Japan, the UK, the US and West Germany to deliberately depreciate the US dollar in relation to the countries' currencies by intervening in the foreign exchange markets.

and stayed strong even after the market peaked, while the renminbi is now widely regarded as being undervalued. Moreover, Chinese household exposures to equities are currently lower than those in Japan in the 1990s.

Nonetheless, on other measures, cautiousness is still warranted on the troubled Chinese property market. For instance, housing prices in China's first-tier cities are 20 times the average national income But in Japan, major cities' highest housing prices at their bubble-era peak were only 11 times the average national income. Also, 70% of urban Chinese assets are estimated to be in property versus only 54% for Japanese assets in the 1990s. Even given mounting challenges, we think the government of the People's Republic of China (PRC) has been proactive in trying to counterbalance the property sector fallout and, as such, has announced a number of measures to try and stabilise the Chinese real estate market. These measures include the removal of home purchase restrictions, lowering of down payment ratios and mortgage rates, along with "urban village renovation" programmes. We are hopeful that such proactive steps will set the foundation for a gradual recovery of the Chinese property market.

Navigating US regulations, rebuilding ties

On the geopolitical front, tensions between the US and China continue to heighten as friction over technology (tech) access, especially in the age of artificial intelligence (AI), remains an area of conflict. In 2023, the US further tightened tech-related regulations, with more PRC corporate entities being deemed as military-linked; as a result, Chinese companies have less access to AI chips and high-end gaming chips, especially those of global AI chipmaker Nvidia. The latest round of US tech sanction on China appears strategic, seen to be dealing with "loopholes" as Nvidia had designed its H800 AI chip specifically for the Chinese market soon after the previous set of regulations were announced by the US Department of Commerce back in November of 2022.

But even with more restrictions, businesses in the US and China, as always, will look to find ways to adapt to this new environment, finding the most effective means to grow their businesses commercially, in our view. This is evident with many of China's largest tech conglomerates, like Lenovo, setting up whole legal and risk divisions to comply with the new US regulations in order to remain as profitable as possible.

While technology access is likely to remain a sticking point between China and the US, soon the two nations may find common ground in other areas. A number of US officials and top businesspeople continue to look for ways to mend ties with China. For example, the governor of California—going beyond the customary duties of a visiting official—recently toured around China and met a number of very senior Chinese officials. Other top-level officials, like US Treasury Secretary Janet Yellen and US Commerce Secretary Gina Raimundo, have also visited China, suggesting that a gradual reconciliation in ties between Beijing and Washington may be slowly taking place. On top of this, Chinese President Xi Jinping's meeting with US President Joe Biden at the APEC summit in San Francisco in November 2023 will hopefully spur a more cooperative era of further engagement between the two superpowers going forward. We think progress between China and the US could be made especially in less conflicting areas, like climate change. Sino-US communication could also improve in the area of defence, where military tensions have been dangerously high in recent years.

Building an edge in high-end technologies and advanced manufacturing

In a more challenged regulatory environment, China has been working hard to develop high-end technologies on its own with a focus on "leapfrog technologies", which can make the country more self-sufficient and give it a global competitive edge. Proof of Chinese tech successes became evident in 2023 with Huawei's recovery and successful demand growth of its new M60 smartphone, which comes with an in-house designed 7-nanometre chip. Huawei's recent achievements combined with Xiaomi's launch of its own mobile operating system, plus the successes of various Chinese technology companies overcoming technology barriers on their own, continue to give investors confidence that China will remain a robust international competitor in a number of technologies and consumer products.

Today, China continues to lead the world in production prowess and technological capability in a number of key sectors. For example, China is the world's leader in electric vehicle (EV) production, with 60% of global EVs now produced in the country; it is also a leading exporter of EVs worldwide. China also leads the world in high-speed railway equipment production and has started to export locomotives and its technological expertise globally, especially in the developing world. In addition, the country is a global leader in a number of green energy products, such as battery power, solar cells and module production. All in all, China continues to build brand recognition in

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these strategic areas. BYD, for example, is now a leading global EV brand in a number of global markets, while international brands like automakers Volvo, MG and Polestar are all making good inroads in the international marketplace under Chinese ownership.

More importantly, China has been moving from an export manufacturing-driven economy to more of a domestic consumption-driven economy over the past 20 years. And while this trend continues its long march, the next pillar of growth for China is advanced manufacturing. Automation has been a key focal point of economic expansion for some time for the country, but with COVID-19 disruptions and the China plus-one deglobalisation pressures, the challenge now for the world's second largest economy is to become even more efficient and competitive .

In recent meetings with global manufacturers in China, we observed that they are moving some of their manufacturing out of China to ASEAN countries due to tariffs and geopolitical concerns. But these manufacturers acknowledge that many non-China production bases are as much as 50% less efficient compared to their production hubs in China. This is due to a combination of economies of scale, levels of automation and supply chain maturity, all of which continue to remain a big relative advantage for China-based manufacturing.

Areas of opportunities and risks

As this rebalancing within China takes place, we believe that there are a number of investment opportunities. In particular, as China moves toward becoming technologically self-sufficient, growth prospects for sub-sectors such as unique hardware, semiconductor and software application are likely to improve as local tech manufacturers look to source more components and systems from domestic vendors.

Other interesting areas are China-based international companies that are adaptive, innovative and competitive and are increasingly looking to go global, such as BYD. We also are seeing a move toward cash return proxies and management incentives as firms in China become more governance-aware. Some Chinese companies are already taking advantage of current low valuations to announce stock buybacks, while other are declaring higher dividends. Lastly is a trend toward constant technology upgrades and innovation, which as we previously mentioned, are leading to competitive advantages for mid-tier firms, especially in areas like EVs, smartphones and pharmaceuticals.

Becoming overly thematic in your investment focus in China, however, has its pitfalls. For example, renewables—solar and wind energy productions and their respective supply chains—have long been a favoured sector in China. While Chinese companies do have comparative advantages in these areas, the challenges start to mount when they approach the international markets, where the US levies high tariffs on solar panels and EV exports into Europe could become subject to tariffs.

However, well-run Chinese companies are well aware of these roadblocks, which have been factored into their long-term planning. They continue to find ways to work within a challenging global environment, for example by building offshore subsidiaries in countries like Vietnam and Mexico to work around the tariffs and overcome trade barriers. With China's immense scale of production, expertise and know how, patents, and growing brand recognition—especially within the renewables sector despite the near-term challenges—we think there is still great room for growth, both domestically and internationally, especially over the long term and in the face of growing climate change-driven demand.

Geopolitics are sure to remain a front and centre risk for investors in emerging markets and China in 2024 and the years to come. 2023 saw geopolitical tensions, already simmering due to the Russia-Ukraine war, heightened further as a large-scale conflict erupted between Israel and Hamas. In the Greater China region, the Taiwan Straits remains the potential tripwire for further global conflicts, but we are quite confident that the risks of a Taiwan incursion by China remain quite low. China has consistently been pragmatic toward economic and political problems and likely realises that a military option—only likely to be taken if provoked—is a worst choice.

Recent moves by the US toward reengagement with China are also likely targeted at abating tensions between the two nations, which are reestablishing direct communication between their military establishments. Progress on this front in the coming months will be watched closely. Elsewhere, the upcoming Taiwanese presidential election in mid-January 2024 could also help ease tensions with China, especially if it results in a change of party leadership. However, this may be doubtful given that Taiwan's incumbent Democratic Progressive Party currently is leading in the polls.

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In summary, we believe China continues to offer long-term sustainable returns for investors who are willing to brave the near-term (political or economic) challenges. China's world-leading technologies, such as renewables and EV production, now appear to be "on sale" at very affordable prices with most, if not all, China equity indices trading at multi-year lows. Any positive changes through 2024 could spur the current out-of-favour China stock market to outperform.

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