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Spotlight on Emerging Markets

How should investors think about China now? Here's what we can learn from our EM team's five-point investing framework

A monthly insight from James Syme, Paul Wimborne and Ada Chan, managers of Pendal's Global Emerging Markets Opportunities Fund

CHINA has undergone major political change recently with the consolidation of Xi Jinping's power in his third term as leader.

Chinese equities have also aggressively de-rated in valuation terms this year.

So how has our view on China changed?

Our investment process is designed to be alert not just to market drivers – but also to changes and trends, surprises (positive and negative) and forecasts and surveys.

The philosophy behind that process emphasises a disciplined and repeatable country analytical process.

We therefore follow our core five-point framework in reviewing the outlook for Chinese equities in USD terms over the next two years.

Here's how that plays out.

What the data says

Growth in China is weak by historic standards. Strong exports are offset by very weak domestic investment and consumption.

Third-quarter GDP was up 3% year-on-year, with industrial production up 6.3% and exports up 10.7%.

But retail sales were up only 2.5% and property sales (for the 31 main listed players) were down 29% (all to September).

The crippling effect of China's "Three Red Lines" restrictions on lending to property developers continues to have a devastating effect on the sector. Meanwhile ongoing Covid lockdowns hurt confidence-hit consumers.

The outlook does not seem to be improving either. October PMI surveys weakened to 48.7 for non-manufacturing and 49.2 for manufacturing.

Can fiscal policy drive growth?

This December's Central Economic Work Conference can shift the emphasis of fiscal policy while keeping to agreed policy parameters.

Probably the most effective change would be to directly support for households, given the downturn in domestic consumption.

Targeted fiscal measures to support consumption have been successfully used in previous downturns – for example subsidies for rural purchasers of home appliance in 2008, or support for car-buyers in 2014-15.

But given the weight of real estate and adjacent sectors in the economy, this is unlikely to do more than help specific industries.

The liquidity and credit environment will need to do some of the lifting. But the ability to enact monetary stimulus is constrained by weak private credit demand and concerns about the exchange rate.

The capacity certainly exists. Despite global inflationary pressures the Chinese economy is heading into deflation.

PPI inflation trackers dropped into negative territory in October (after a September print of just +0.9%). Household and corporate excess deposits continue to collect in the commercial banking system.

This is likely to eventually lead to increases in credit quotas and cuts in interest rates.

But these are unlikely to work for two reasons.

Dual challenges

Firstly, private sector credit demand is extremely weak. Simply making it cheaper and more available is unlikely to change that.

This is a classic crisis of confidence, in which the central bank can end up "pushing on a string". Either policies change to create confidence, or fiscal policy must do the work.

Secondly, while the Three Red Lines restrictions on private sector property developers are still in place, the key sector that isn't borrowing will remain unable to do so.

In fact, credit conditions continue to worsen for private sector developers. Bond yields are climbing steadily for even the highest-quality issuers, suggesting the situation will get worse before it gets better.

The currency was at its all-time real effective exchange rate in the first quarter of 2022.

Although it is notionally supported by net exports – and protected by capital controls – it is likely to weaken relative to the US dollar. This is partly because of interest rate differentials, and partly because policy makers in East Asian exporters must keep their currencies reasonably in-line with the depreciating Japanese yen.

The Xi factor

Management and politics are the key, despite the previous three drivers.

President Xi Jinping has been appointed for an unprecedented third term. An overhaul of the Politburo Standing Committee saw market-friendly reformers (including Premier Li Keqiang) removed and replaced with members seen as Xi loyalists.

State media have begun referring to Xi Jinping as 'Core' leader while establishing his political views (Xi Jinping Thought) as doctrine.

This marks a move away from the 'Collective Leadership' system of Chinese politics that has been in place since the 11th Party Congress in 1978.

An economic focus on technology and quality of life adopted at the 2017 Congress remains in place.

The main changes at this Congress were on governance and national security, with emphases on international relations, geopolitics and reunification with Taiwan.

What does this mean for the economy, and a market looking for political and policy relief?

Unfortunately, we can see little positive in this recent Congress.

The policies that have dramatically undermined growth (real estate restrictions and zero Covid) and the political developments that have hugely increased investor perception of risk in China (clampdown on tech companies, support for Russia, cold conflict with the West) are likely to continue.

We believe China's policy choices in the past two years have broken its economy and equity market. We see no sign of the change needed to fix this.

What about valuation?

Valuation is the only point in our five-point framework that is unambiguously supportive of China.

But valuation alone is not a buy case.

In any market, ongoing economic growth and corporate earnings disappointments undermine the fundamentals to which valuation multiples are applied.

Worsening liquidity conditions justify lower valuation multiples. A poor currency outlook will reduce expected US dollar returns.

Most significantly, the downside to valuation multiples when politics goes bad is always much, much worse than you think.

In terms of hard numbers, the forward price/earnings ratio (based on consensus 12-month forward estimates) for MSCI China has declined from a February 2021 peak of 18.5x to 8.3x at the end of October. That compares to a recent average of 11.3x.

Other valuation metrics have similar patterns. Cheap, but not cheap enough.

We remain underweight China and defensively positioned.

Our investment process includes a monthly review of the key top-down drivers of USD equity returns for all countries.

We take no strategic views. No market is an automatic overweight and no market is automatically excluded.

We do not think that Chinese equities – whether A-shares, H-shares or overseas listings –are "uninvestable".

We remain alert to opportunities.

But Chinese policy and economic data has a long way to go before equities there are attractive.

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Find out more at **pend.al/GEMO**

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