Citi Global Wealth Investments

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Necessary Elements of a China Turnaround

David Bailin
Chief Investment Officer, Citi Global Wealth

Steven Wieting
Chief Investment Strategist and Chief Economist

Ken Peng
Head, Asia Pacific Investment Strategy

Calvin Ha
Senior Asia Pacific Investment Strategist

Key Takeaways

- **Rebuilding Trust:** Over more than three years, Chinese authorities have rolled out a slew of policy measures to bolster markets. Most recently, curbs on short selling, more ETF purchases, and incentives to boost consumer are being implemented in an attempt to increase investor confidence and reverse the direction of the market. These measures appear similar to what has been done before and that is unlikely to create a change in sentiment.
- **What will it take: Improved governance and a boost to demand**. New policies are needed to improve the profitability and investor friendliness of Chinese companies. Chinese regulators could take a page from the Tokyo Stock Exchange's recent governance reforms and encourage dividends and buybacks, while implementing rules to prioritize shareholder interests. Stimulating consumer demand has also been missing in China's arsenal thus far.
- **For Investors:** A tactical rally is possible given depressed sentiment and valuations, but a sustained recovery is dependent upon increased demand and improved corporate governance. If policymakers do steer towards this direction, we would prioritize growth sectors, with high cash levels and negative net debt, as these are the most likely to lift dividends and buybacks. However, if these issues are not addressed, investors are unlikely to be interested to return other than for tactical trading.

Potential Portfolio Implications

New policies are needed to reverse Chinese deflation and improve the long-term profitability and return on equity for Chinese companies. If better governance becomes an aim for listed companies based on policy directives, we would prioritize growth sectors including IT, healthcare, consumer staples, telecommunications services, and consumer discretionary, with high cash levels and negative net debt. We remain neutral on Chinese shares presently.

The Long Road Back Begins with Trust

" 'Rebuilding Trust'...recognizes three things. First, trust was once prevalent...Second, the foundation of trust has now been eroded...Third, rebuilding trust is essential."

– Premier Li Qiang at Davos on January 17, 2024

Outflows Continue

Many China investors are anxiously awaiting further governmental actions to turn around financial markets. Their patience is wearing thin. Over the past 5 years, the MSCI China increased 60%[1] on the early successes of their "Zero-COVID" policy and then lost 58%[2] from the highs seen in February 2021, due to a major real estate crisis and series of regulatory missteps. headwinds and property crisis.

Global investors have reduced holdings materially and sold a net $2.5bn worth of mainland Chinese equities in January 2024[3]. It has been the sixth consecutive monthly outflow since August 2023, marking the strongest and longest net outflow since the Stock Connect between Hong Kong and mainland China started in 2014. Although Chinese retail investors have historically been responsible for roughly 70%[4] of the Chinese shares' turnover, they are now leaving too. In some days of this year, Japanese funds that are listed in China have seen 20%[5] premium to their net asset value as domestic investors turned to foreign funds for capital gains.

Policy Missteps and a Real Estate Crisis

Over the past four years, China's current administration has been willing to derail national champions in the name of "common prosperity." From e-commerce to online education to car-hailing, China has impacted corporate decision-making, sacrificing rapid growth in revenues and profits for greater state control. As technology emerged as a national security issue for the West, Western governments sought to isolate their markets from China's tech products.

At the center of China's malaise is an unresolved real estate crisis. China's highly indebted property developers remain undercapitalized and at risk of default. More than 700 unfinished projects await completion nationally.

A Lack of Profits and Poor Governance

The largest contributors to China's equity market underperformance are also structural. When we look at the root cause of the fall in China's markets it is profits and losses. Earnings and dividends have both fallen to 2011 levels (**FIGURE 1 &2**). The absence of demonstrable growth is the primary reason institutional investors have become highly skeptical of any policy that does not change the future trajectory of corporate results.

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1 Source: Bloomberg, MSCI China from February 21, 2019, through February 17, 2021

2 Source: Bloomberg, MSCI China from February 17, 2021, through February 23, 2024

3 Source: Reuters, https://www.reuters.com/markets/asia/why-chinas-national-team-wont-save-spiralling-markets-2024-02-05/

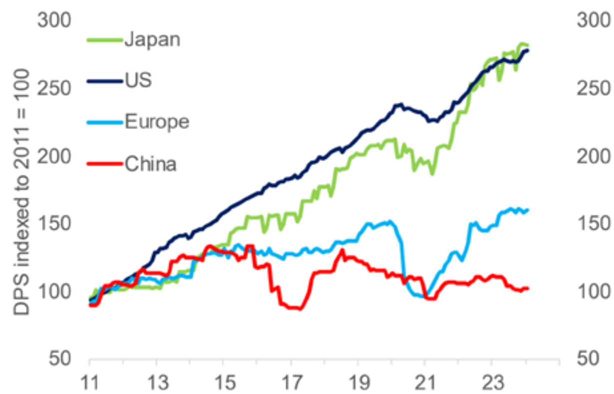
4 Source: Reuters, https://www.reuters.com/markets/asia/chinas-cratering-markets-drive-mainstay-retail-investors-away-2024-01-26/

5 Source: Wall Street Journal, https://www.wsj.com/finance/stocks/chinese-investors-are-pouring-into-the-u-s-japan-386be98e

FIGURE 1: Earnings and dividends per share have not grown for 13 years

Source: Bloomberg as of 31 December 2023.

FIGURE 2: Dividends per share had not grown for Chinese equities since 2011, while Japan led the pack with near tripling followed closely by U.S.



Source: Bloomberg, as of 8 February 2024.

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Policy Fatigue

After the Lunar New Year holiday, Chinese authorities attempted to boost their ailing economy and markets with a rare 25bp mortgage rate cut. Prior to the holiday, numerous policies were initiated including actions by Central Huijin, China's sovereign fund, promising more ETF purchases, further curbs on short selling, encouragement of state-owned enterprises to purchase equity, a potential market stabilization fund and even a visit by President Xi to the stock exchange. Other major policies over the past year were focused on stimulating supply side activity, such as major regional infrastructure development.

We doubt that these policies alone will be sufficient to change the course of the economy given the headwinds China faces in its real estate markets and the skepticism of sophisticated investors. Here is what we think must change.

What it Will Take: Strengthening Governance

Corporate governance refers to the rules that align corporate management with the interest of shareholders. In the past 22 years, China's GDP grew by 12x, while equity indices grew by only 3x, implying that equity investors earned just a fraction of China's cumulative economic growth. However, China's market capitalization surged by 27x as corporate issuers raised nine times more financing relative to shareholder returns. By comparison, this ratio is 2x in the US and 1.5x for Japan (**FIGURE 3**).

To help fix this problem, Chinese regulators could take a page from the Tokyo Stock Exchange's recent governance reforms to encourage dividends and buybacks. As the state is the owner of many companies, this could also be a more efficient use of government fiscal resources, rather than use huge fiscal actions to buy stocks.

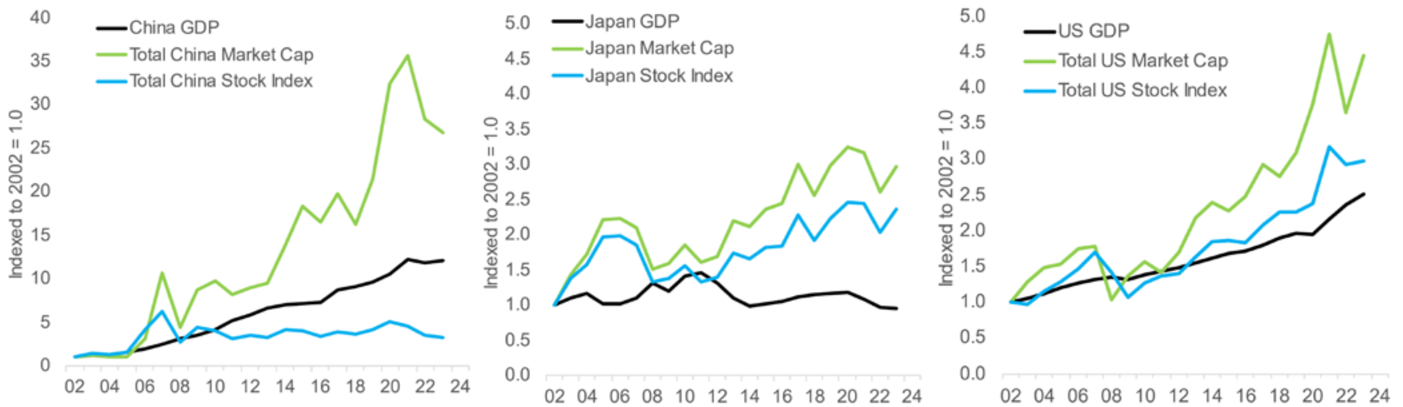
There is also a lot of cash sitting on the sidelines in China. MSCI China member companies have cash and short-term investments amounting to 38% of their market cap[6]. In many growth industries like IT, healthcare, and telecommunications the companies are debt free, meaning that cash can be effectively deployed for buybacks and dividends without increasing credit risk. Chinese cash hoard is much greater than Japan, U.S., or its EU counterparts (**FIGURE 4**). This type of action would likely be more effective for company shareholders and government than the recent stimulus plans.

[6] Bloomberg, as of 31 December 2023.

FIGURE 3: Chinese equity market cap surged 27-fold in past 22 years, while the index gained 3x and GDP 12x

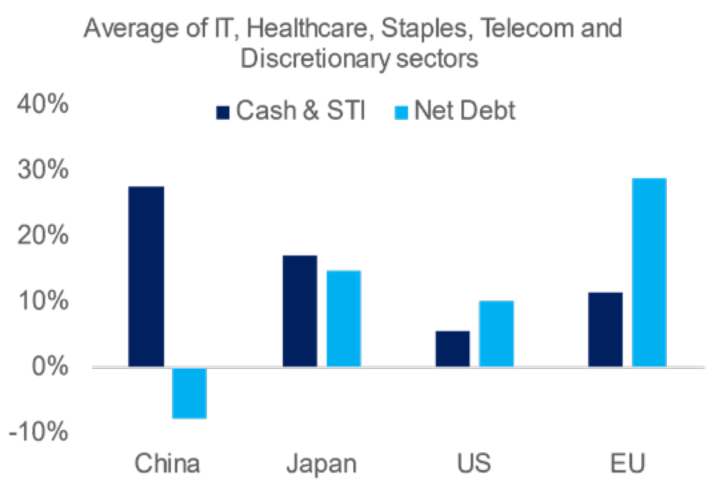
Japan had significant equity growth, comparable to the US, with limited dilution, despite GDP declines.

US equity market cap gains also outpaced index markedly, though both outpaced GDP



Source: Bloomberg as of 31 December 2023. China equities include Shanghai, Shenzhen and HSCEI indices. Japan equities refer to TOPIX. US equities include NYSE and NASDAQ composites. GDP is nominal and all data are in USD. Data begins in 2002 due to data availability. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

FIGURE 4: China's growth industries have by far the highest cash and lowest net debt relative to major developed markets.



Source: Bloomberg, as of 31 December 2023. STI: short-term investments. Data for MSCI China sectors. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary.**

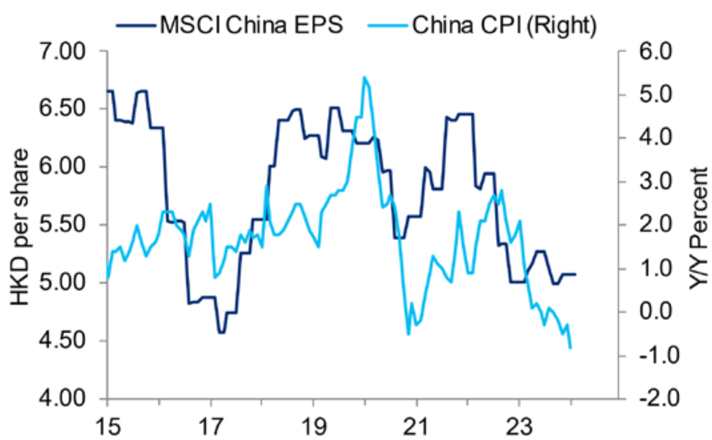
What it Will Take: Driving Demand

Stimulating consumer demand has been a missing strategy in China's arsenal. China is presently experiencing deflation. This causes consumers to delay purchases in the anticipation of lower future prices. The most recent policies continue to emphasize infrastructure and industrial output that increase supply rather than demand – and this is unfortunately deflationary. Over time, current deflation and further deflationary policies create a dangerous slippery slope for a market with weak earnings and high debt levels (**FIGURE 5**).

China is also facing the challenge of population decline. Its population fell by 2.08 million in 2023, its second straight year of decline representing the largest drop since the Great Leap Forward in the early 1960s. The number of births fell to just nine million, half of the 2016 figure, and the lowest on record since the founding of the People's Republic of China in 1949[7]. At an annual birth rate decline of 10% with a 3% annual rise in deaths, China could suffer declines of 100 million people over the coming 15 years. This represents a further, major headwind to increasing demand on everything from homes to cars to appliances.

This demographic trend is unlikely to be reversed, but incentivizing childbirth may help slow it down. With the trillions slated for stabilization funds and infrastructure, investing in childcare could be a much more cost-effective demand stimulus, consistent with national security and resource sustainability objectives.

FIGURE 5: Deflation weighs on profitability, to reverse the earnings trend, China must restore demand and positive inflation.



Source: Bloomberg, as of 8 February 2024.

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For Investors: Hard to be Short, Hard to be Long

Given how depressed sentiment is towards China, any substantial policy boost could help lift its markets. As we noted previously, shorting China is the second most popular trade, according to the Bank of America Global Fund Manager Survey (**FIGURE 6**). With a forward PE ratio of 8.5x, MSCI China valuations are more than 1 standard deviation below historical mean (**FIGURE 7**). Compared to the U.S. at 20.5x, Chinese equities are nearly 60% cheaper.

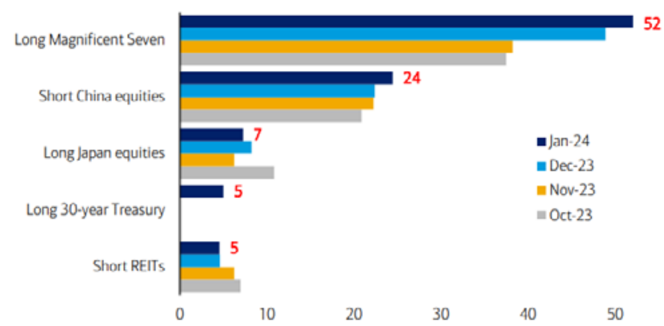
Beware, a more significant stimulus package may cause a short squeeze in markets that could lift Chinese markets even if fundamental conditions have not recovered. A return to average valuations ***without*** any earnings growth would imply a 34% upside. And just one year ago, the index was at the historical average of 11.5x (**Figure 12**).

However, if there is no change in governance, a rally is likely to be swift and short. The key is whether new policies can lift China out of deflation. If return on equity is going to be a more important goal for listed companies based on policy directives, we would prioritize growth sectors including IT, healthcare, consumer staples, telecommunications services, and consumer discretionary, with high cash levels and negative net debt, (FIGURE 5), as these are the most likely to lift dividends and buybacks.

Given a clouded policy landscape, we find it hard to have strong conviction in the timing and magnitude of any potential Chinese equity market rally. We therefore continue to suggest clients maintain a neutral weighting within globally diversified portfolios. For moderate risk portfolios, this implies about a 2.5% allocation to Chinese stocks.

[7] Source: Haver Analytics, as of 8 February 2024.

FIGURE 6: Short China equities is the second most popular trade for global fund managers, some squeeze is possible if significant policy is announced



Source: Bank of America Global Fund Manager Survey, as of January 2024.

FIGURE 7: MSCI China forward PE ratio is at a paltry 8.5x, or 1.2 standard deviation below mean. A return to average valuations, without any earnings growth would imply 34% upside.

Source: Bloomberg as of 7 February 2023.

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