



CHINA INVESTING: WHAT COMES NEXT?

A three-stage recovery is underway.

On December 31, 2022, T. Rowe Price's China Evolution Equity Strategy celebrated its third anniversary. In this recent Q&A session, Wenli responds to questions that were foremost on the minds of our clients in 2023.



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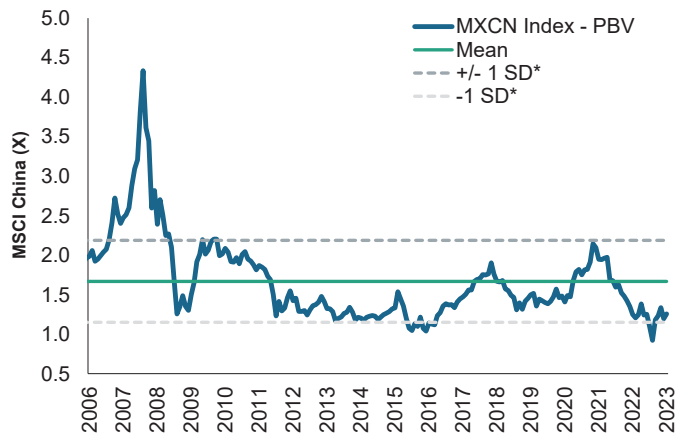
Q1: Is it too late to join the China rally?

Following the end of zero-COVID, China equities bounced 40% to 50% from last November's lows, leading some investors to ask whether it was too late to participate. However, the Q4 rebound was from very depressed levels (Figure 1). In terms of valuation metrics, such as price-to-book value (PBV) or price-to-earnings (PER) ratios, China equities are still far below their historic averages. They also appear cheap relative to other markets. According to the latest consensus analyst forecasts, growth in earnings per share (EPS) in China this year is projected to be one of the highest among the world's major stock markets. The risk-off episode in February followed by a global banking scare in March did not leave China equities unscathed. The MSCI China Index is 10% off its January peak (as of April 11, 2023), potentially providing a good entry point for investors. So no, it is not too late to join the rally in China stocks, in our view.

This favorable forecast earnings differential stems primarily from China's unique position within the business cycle compared to other

FIGURE 1: China Is Still Trading at Attractive Valuations

MSCI China (MXCN) Index 12-month forward price-to-book value (PBV) ratio



As of March 31, 2023.

Past performance is not a reliable indicator of future performance.

Actual outcomes may differ materially from estimates.

*SD = Standard deviation.

Source: Bloomberg Finance L.P. and MSCI

countries. Other economies are grappling with the emergence of high inflation, forcing central banks to tighten monetary policy significantly. That is not the case with China. Thanks to post-COVID reopening, the Chinese economy is starting to rebound. While economic activity is picking up pace, inflation in China is low. In fact, inflation has remained benign in China since the pandemic.

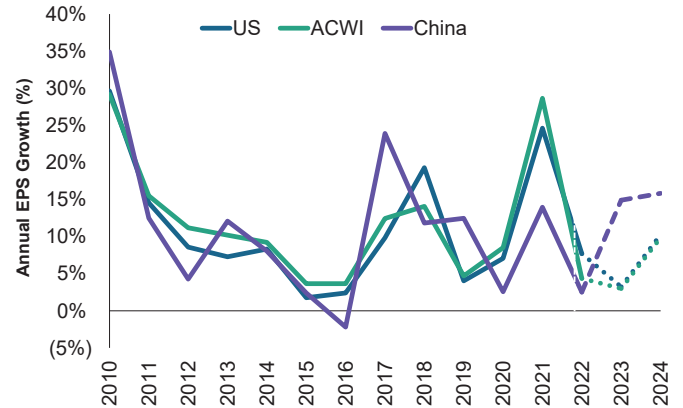
China is in a very different stage of the business cycle compared to other major economies thanks to the rapid COVID reopening. As a result, I believe economic growth is likely to accelerate this year and possibly next year also. Because the economy is accelerating, we do not expect Beijing to add strong economic stimulus at this point in time. Much better for the government to wait and see how strongly the reopening rebound unfolds.

Q2: What do you expect from China's economy in 2023?

We believe a consumption recovery and an improvement in private investment are going to drive a better macro-economic outlook for China this year. We believe that we are in the very early stages of China's cyclical recovery, which still has a long way to go. The March housing data suggest that the property sector—a major drag on activity last year—has stabilized and is finding its footing, supported by the raft of government policies since November. Beyond the general recovery expected in consumer spending and some cyclical areas this year, over the medium term China's growth drivers are expected to shift more towards technology, high-end manufacturing, and consumption upgrading.

FIGURE 2: China Is Also at a Different Stage of the Profit Cycle

MSCI China Index earnings growth forecast



As of March 31, 2023.

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EPS = Earnings per Share.

ACWI = MSCI All Country World Index; US = S&P 500 Index; China = MSCI China Index

Source: Goldman Sachs Research and MSCI. Please see Additional Disclosures page for information about this MSCI information.

In 2022, we saw a sharp decline in corporate earnings which were dragged down by the rolling COVID lockdowns and by the slump in China's residential property sector. I believe that the earnings picture for China going forward will be very different. The consensus estimate is that China's earnings growth may accelerate from low single digits to mid double digits in 2023. However, I believe there is potential room for further upside to this number, representing a positive surprise to investors. I think there is a realistic chance of this happening because China's economic reopening has taken place much faster and more smoothly than anyone expected. Indeed, China's corporate earnings growth in 2023 could be the highest it has been in over five years (Figure 2).

Currently, a strong herd immunity has developed in China since the end to the zero-COVID policy in early December. We have very quickly seen a strong recovery in consumption, especially for smaller ticket items, such as apparel, restaurants, cinema entertainment, etc. For larger ticket items, such as home appliances, autos, home property, etc, these are improving as well, but at a more gradual pace. This is also the case for private investment, which is also seeing some gradual improvement. However, I believe consumers as well as business owners are going to need some more time to gain greater confidence in the economic outlook before they spend on large ticket items more aggressively or spend to expand their businesses again.

Provided the economy stays on an improving trend, we may expect that at some point in the second half of the year, small- and medium-sized private

companies will start investing in their facilities and operations again.

Q3: You see economic reopening taking place in stages. Why is that?

Since the announcement of reopening in November 2022, China very quickly achieved herd immunity from COVID. With China’s rapid reopening, the first reaction for investors was to buy travel agencies, airlines, restaurants, hotels and Macau gaming stocks, which are pure reopening plays. They also bought mega-cap internet stocks, or the most familiar names. The direct COVID-off beneficiaries have enjoyed a significant rerating. For many of these names we have started to reduce exposure, although we think there is still room to run for select businesses in this category.

I believe the first phase of the recovery trade from China’s opening is largely over, but the second stage has only just started. It will likely be driven by the recovery of general consumption, names such as shopping malls, apparel, sportswear, home appliances, and furniture. Over the past two to three years, many of these areas suffered both from earnings deceleration and from a significant multiple derating when they missed earnings estimates last year. However, I think that both of these negative factors are going to go into reverse this year. The majority of these businesses are trading on very reasonable valuations. At the same time, we are projecting an earnings acceleration and with this, hopefully, is likely to come some multiple expansion. Many of the stocks in the general consumption category appear well positioned in 2023 in our view,

because they started the year on very reasonable valuations.

We are seeing green shoots in the spending on many small ticket items, and this is likely to spill over to larger ticket items as consumer confidence recovers. It is important to note that Chinese households accumulated enormous excess savings during the pandemic years, estimated to be in excess of RMB 4 trillion. We don’t expect them to spend it all, but if they spend just a fraction, it is going to be a powerful boost for the economy.

The third stage of the reopening trade could be about private investment. Business confidence tends to follow when consumer confidence recovers. As more entrepreneurs open new businesses, we will likely also see demand for upstream equipment, machines, software etc, so we are also finding more opportunities in industrials. When business confidence comes back, areas such as advertising and recruitment might see a more meaningful pickup towards the end of the year. While the initial risk rally was focused on high-beta names, I think the next phase of the China rally will really be about finding alpha, which will suit our bottom-up stock picking style.

Q4: What is your view on the property sector in 2023?

The property supply chain accounts for close to 20% of China’s GDP, and the decline in housing new starts last year was a major drag for the overall economy. But policies from the government have effectively helped the market to stabilize. We see signs of both improvement and divergence within the sector. Opportunity in the

FIGURE 3: China's Recovery Still Has Room to Go

We see a three-stage recovery taking place



As of March 31, 2023. For illustrative purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action. Sources: Financial data and analytics provider FactSet. Copyright 2023 FactSet. All Rights Reserved. Bloomberg Finance L.P.

FIGURE 4: Property—The Worst May Be Behind Us

City primary (new home) property sales (year-on-year % change)

China 28-City Primary Property Sales



As of March 31, 2023.

Chart truncated to omit early 2021 COVID distortions.>

Sources: CRIES and Morgan Stanley Research (left), Bloomberg Finance L.P. (right).

sector, we believe, has shifted from construction and new building materials to property management, after-sales service, and home renovation. Overall, the property sector is going to be a smaller part of the economy from now on. As a result, China's trend growth rate might be slower.

However, what's also important is that the growth drivers for the Chinese economy will naturally shift over time—they will not stay static in such a dynamic, rapidly evolving economy. I believe that increased reliance on domestic technology, high-end manufacturing and consumption upgrading will each need to make a higher contribution to drive economic growth going forward.

Property sales have struggled now for over 18 months, triggered initially by stricter government oversight and regulations. Since late 2022 residential property has shown more signs of stability, and we think that the central and local government support measures have succeeded in putting a floor under the sector. There is still some uncertainty, as the front-end of the property supply chain—land purchase and new housing starts—remains at historically low levels. There are some divergences within the sector, with secondary home sales having been positive for six months, while housing completions and furniture and appliance sales have started to improve more recently.

Q5: What is everyday life like in China now?

We recently took a large party of our investors on a field trip in China. It was their first visit since 2019 before the pandemic began. I think most of them were pleasantly surprised by how rapidly social and economic conditions in China had normalized. To put this into perspective,

New Property Support Measures Announced in November 2022

- 1 Financing for project completion
- 2 Debt funding to address developers' liquidity
- 3 Equity financing to improve balance sheet

there were key economic areas within China, such as Shenzhen, where lockdowns during 2022 had been comparatively rare. Hence the economic damage due to the zero-COVID policy last year in their case was moderate. However, the global media focused exclusively on the worst-affected cities and regions, such as Shanghai and Xinjiang. This gave the world an extremely negative picture of conditions in China under the pandemic. But I think the average impact of lockdowns will have been much less.

In December, Beijing abruptly ended all COVID restrictions. Within the short space of a few weeks, around 80% of China's population had succumbed to COVID infections. In my own case, eight out of nine family members caught COVID within one week. Fortunately, this chaotic phase soon passed, and China acquired herd immunity. So far, there has been no sign of a major second wave and the probability of one occurring is seen as low. From a social mobility perspective, travel, hotel and entertainment data show China has returned quite close to pre-pandemic activity levels.

Q6: What about geopolitical tensions between China and the U.S.?

Increased strategic competition between China and the U.S. is structural and is not going to go away. For investors, the important thing is for strategic competition between the two countries to become more predictable. Agreed "policy guide rails" are one way of better managing the China-U.S. relationship. Our job as investors then is to analyze which areas are most likely to benefit from supply chain reconfiguration and which areas are likely to suffer, as

there will be both winners and losers. In the mature node area of semiconductor production, Chinese firms have actually been gaining market share due to local substitution in place of imports. Government policy since the 20th National Congress of the Communist Party of China has increasingly stressed the importance of supply chain security to Chinese firms.

In other areas where the production of low value-added manufacturing items is moving to countries with lower labor costs, such as Vietnam or Malaysia, it is Chinese companies that are leading the move offshore. China continues to attract significant Foreign Direct Investment in areas where it is competitive, such as renewable energy and electric vehicles, and this appears unlikely to change purely on account of geopolitical tensions.

Q7: Might the recent U.S. banking turmoil spill over to China?

China has made significant ongoing efforts to defuse financial risks in the past few years including reducing non-performing loans within the banking system, especially at smaller banks. These efforts have been under-appreciated until today.

Most banks in China are state-owned and are thus under the direct scrutiny of the government. Chinese financials are also mainly funded by relatively sticky domestic deposits and the securities-to-total asset ratio is low. This makes China's financial system relatively immune from the events that have recently shocked the U.S. banking system, notably the failure of two smaller banks, Silicon Valley Bank and Signature Bank, and the need for the Fed to step in as lender-of-last-resort.

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We believe there is opportunity to find future winners in the Chinese stock market, where we focus on two elements: fundamentals and mispricing. With the flexibility that we have to build a portfolio that is very different from the benchmark, we have a good opportunity to generate alpha potential and capitalize on the many inefficiencies of this exciting but immature market.

T. Rowe Price's China Evolution Equity Strategy has a unique design. By excluding the 100 largest stocks by market cap from the China universe, it differs from the majority of China mutual funds in the market. China is a deep market with over 6,000 public companies listed onshore and offshore, in which 60 to 70 stocks are mega caps with a market capitalization above USD30 billion¹. Popular China benchmark indices are focused heavily on these mega caps which represent just 1-1.5% of the total stock universe. This means that the market is still largely underexplored by foreign investors, an inefficiency which the China Evolution Equity Strategy seeks to address.

While some investors may have been disappointed that China's economy didn't rebound from reopening at an even faster rate, economic activity data for January, February and March support the view that recovery is under way. Although China announced a deliberately cautious 5% GDP target at the National People's Congress in March, there is potential for this to be exceeded. New premier Li Qiang has demonstrated clear pro-business pragmatism, and this could facilitate a gradual comeback of private confidence. According to the IMF, China is set to contribute one-third of global growth in 2023, once again performing the heavy lifting for the world economy. ■

¹ As at December 31, 2022. Sources: MSCI, HKex, Wind, Morningstar, and FactSet. Calculations by T. Rowe Price.

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