



# China Outlook: Stabilization First, Improving Later

Policy easing to bear fruit in 2020.

December 2019

## KEY INSIGHTS

- China's economy should first stabilize in 2020 and then improve gradually as the year unfolds.
- We expect a pause in deleveraging and a switch from tax cuts to infrastructure spending in a more determined effort to boost the economy.
- Valuations are attractive. As a policy-driven market, A-shares could respond positively to further easing ahead of an improvement in earnings.



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There was a broad-based slowdown in the Chinese economy in 2019 arising from weaker exports, fixed investment, and property. Real gross domestic product (GDP) growth fell from 6.4% year-on-year in the first quarter to 6.2% in the second quarter and 6.0% in the third quarter, the lowest since 1992.<sup>1</sup> Economic forecasters expect growth will fall below 6.0% next year, the minimum if Beijing's long-held target of doubling China's GDP over 2010 to 2020 is to be met.

Beijing has not been panicked by a slowing economy into introducing another massive stimulus package as in 2008 or 2015. We think this signals a more mature policy approach, where official targets can be missed if circumstances dictate that is prudent. The Chinese economy's deceleration since 2011 is partly structural in nature and is expected to continue.

Structural factors affecting growth include property peaking as a growth driver, a falling labor supply and aging population, the switch from manufacturing to lower-productivity services, and a share of world trade that is no longer increasing. We believe that despite this less favorable background, China can continue to transition its economy successfully, balancing growth stabilization with deleveraging efforts while managing the impact of trade tensions, which seem likely to persist beyond the U.S. presidential election next November.

As investors in Chinese equities, we look for leaders in industries that are undergoing consolidation, as well as gaining market share. For the longer term, we view China as a potentially rich source of high-quality companies, with leaders that are successfully moving up the value chain, pushing out the boundaries of innovation.

<sup>1</sup> Source: Societe Generale: Country Briefing—China, November 26, 2019.

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# 85%<sup>2</sup>

The share of China's private sector in total urban employment.

Western financial media comment often focuses on the problems of China's state-owned enterprises (SOEs). We think this is misleading since China's SOEs and heavy industry are unrepresentative of the modern economy. It is the private sector today that drives the business cycle in China, accounting for 85% of urban employment<sup>2</sup>, 70% of total investment spending, and 60% of GDP.<sup>2</sup>

## **Tariffs Not the Main Factor in China's Slowdown**

While President Donald Trump's import tariffs have hurt China, we do not believe they were the major factor behind the slowing economy in 2019. First, the loss of momentum in China's total exports in 2018/2019 mirrors closely that of other emerging markets (and also developed economies). This points to the weak global economy, not U.S. import tariffs, as a bigger factor in explaining China's economic slowdown. The global trade slowdown will also have contributed to the weak performance of export-oriented manufacturing investment.

Second, China's financial deleveraging policies have remained in place for longer than was expected at the start of the year. "Shadow banking" flows, for example, as proxied by the sum of trust loans, entrusted loans, and bankers acceptances, fell 8% year-on-year in October.<sup>3</sup> This partial credit crunch gave rise to strong financial pressures that fell mostly on China's private enterprise sector, such as property developers and manufacturing exporters.

Another significant drag on the Chinese economy in 2019 was the cyclical downturn in the automobile sector, a shock big enough to reduce annual GDP growth by 0.5% on some estimates. Demand for autos in China was down 5.9% year-on-year in

October,<sup>4</sup> with sales at their lowest level since 2015. We expect demand for autos to begin to stabilize soon, in which case the headwind to growth from autos should fade and later reverse in 2020.

## **Macro Economic Policy in 2020**

While China's government has accepted lower trend growth, we expect a pause in deleveraging in 2020 and a switch to infrastructure spending from tax cuts in a more determined effort to support growth. In 2019, Beijing probably wished to keep some powder in reserve until there was greater clarity on trade. We assume a "phase one" trade deal is agreed with the U.S. and that China will introduce further policy stimulus that may succeed in stabilizing the economy close to 6.0%.

We have not seen significant monetary easing from the People's Bank of China, China's central bank, in 2019. China's credit cycle troughed early in 2018, and there has been no strong acceleration since. There is good reason for this. Looser monetary policy could undo Beijing's efforts to stabilize the residential property market over the past two years, igniting an asset bubble.

We expect further modest cuts in short-term interest rates and in the required reserve ratio in the coming months. Monetary policy overall, however, is expected to play a subordinate role to fiscal policy in 2020. More fiscal stimulus measures are expected to be announced after the government's annual economic work program meetings in December. The decision to allow local and regional governments to bring forward some of next year's "special bond" quota (mainly used to finance infrastructure) is another sign that policy has switched from deleveraging to supporting economic growth.

<sup>2</sup> Source: HSBC Global Research, July 2019.

<sup>3</sup> Source: CLSA Infotax, November 12, 2019.

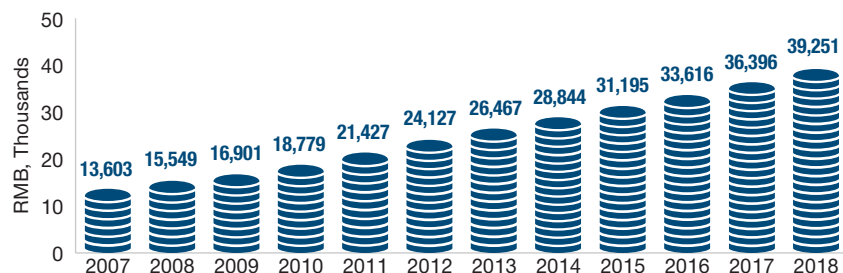
<sup>4</sup> Goldman Sachs: China Weekly Kickstart, November 22, 2019.

“Many of the China stocks that we favor are supported by domestic demand rather than by exports.”

## (Fig. 1) Strong Household Income Drives Consumption

Household Urban Disposable Income

As of December 31, 2018



Sources: Haver Analytics, China National Bureau of Statistics, OECD.

### Forget GDP, Follow Household Wealth

The correlation of the A-share market to real GDP growth is weak. Far more important for equities are nominal income aggregates, such as household incomes and wealth. These represent a more important growth metric for many domestic Chinese companies. The middle class in China continues to expand, with household income growing around 10% annually. Already, around 47 million wealthy middle class Chinese are in households with an annual income that is above USD 50,000 (RMB 351,500),<sup>5</sup> a number that is projected to increase over four times in the next 20 years or so.

Many of the China stocks that we favor are supported by domestic demand rather than by exports. Hence, the actual direct economic impact of the U.S.-China trade uncertainty on them may be quite limited, although sentiment can be more volatile. Investors should note that about 90% of listed enterprise profits in China are domestic. Only 10% are earned overseas, and the U.S. share is a mere 3% to 4%.<sup>6</sup> The uptrend in household income makes the story of the Chinese consumer one of the world's most

exciting for equity investors, and it still potentially has decades to run.

More and more Chinese households are buying products that are prominent in the western world, such as cars, electronics, cosmetics, and health insurance. They are also spending increasing amounts on food, vacations, and entertainment. “Premiumization,” or switching to higher-quality brands, is also a big theme, as Chinese consumers are discerning and are increasingly demanding higher-quality products.

China's aging population will eventually act as a drag on demand. But in the interim, demographics may actually boost consumer demand, postponing the day of reckoning for the one-child policy. Here's how: About 44% of adult consumers in urban China fall into the 40 to 64 years age bracket.<sup>5</sup> Many are “empty nesters” (i.e., couples, often with two incomes, whose only child has recently left home). China's empty nesters tend to have more discretionary income available, while many will have paid down their mortgages. Consumer surveys point to them shifting their spending to “experiential consumption” rather than more of the goods that they have already acquired.

<sup>5</sup> Source: HSBC Global Research, July 2019.

<sup>6</sup> Source: HSBC Global Research, September 2018.

“China’s domestic A-share market... provides a growing and exciting long-term investment opportunity for foreign investors.

This has important implications for the growth in demand for specific products and services, particularly services such as tourism and entertainment. These empty nesters want to stay fit and healthy, spend more on higher-quality food and beverage, travel more, and spend on home improvements. This is a rich vein for foreign investors to potentially exploit.

#### China A-Shares: A Growing Opportunity

Foreign participation in China’s onshore A-share market is still only at a low-single-digit level (around 3%),<sup>7</sup> even after inclusion in the key MSCI indices. Over the longer term, we are confident that international investors and fund managers will not wish to fall so far behind China’s new and rising benchmark weightings and will reposition their China mandates accordingly.

China’s domestic A-share market currently accounts for nearly 70% of the investible China equity universe.<sup>8</sup> It provides a growing and exciting long-term investment opportunity for foreign investors. There are many new opportunities to be explored

and potentially exploited, such as the small- and mid-cap space, which, in China, tends to be very liquid, if at times volatile. Foreign ownership of 3% looks anomalous and out of line with other Asian markets such as Taiwan and South Korea, which are around 40% foreign owned.<sup>9</sup> We believe that increasing foreign investor participation over time will not only help to underpin A-share returns, it will also support greater transparency, working with the grain of the efforts of China’s financial regulators to improve the quality of domestic markets.

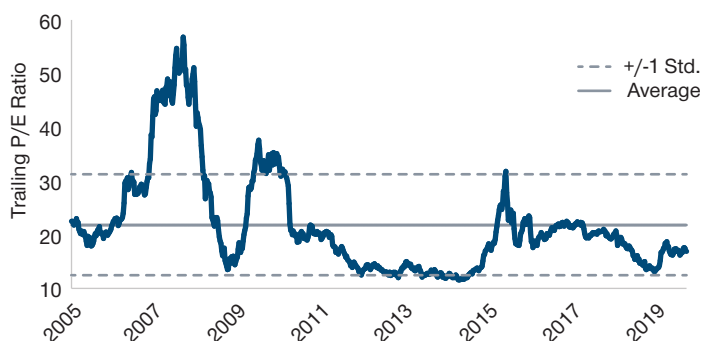
We also believe that an active, bottom-up investment style is the best way to approach the expanding investment opportunity set in China. China’s domestic equity markets today remain inefficient, dominated by retail investors given the narrow local institutional investor base and marginal presence of foreign investors. This offers good opportunities for bottom-up stock pickers to add alpha by choosing the right stocks. An edge in fundamental research should help foreign investors to identify good opportunities among China’s higher-quality domestic equities.

### (Fig. 2) China Equity Valuations Cheap vs. History

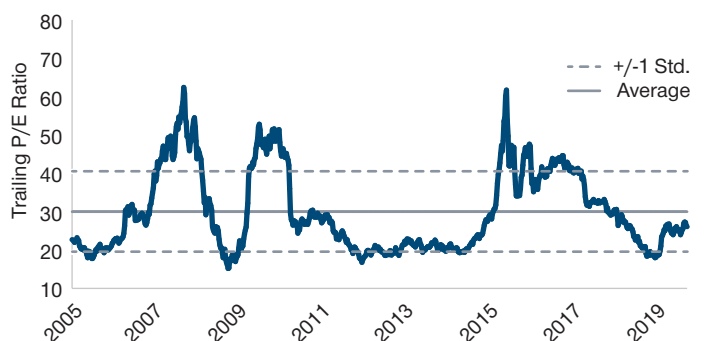
Trailing P/E Ratios Are Below Their Post-2005 Average

As of September 30, 2019

#### China A-Share Price-to-Earnings Ratio (X)



#### China A-Share Ex-Financials Price-to-Earnings Ratio (X)



Source: UBS Securities.

<sup>7</sup> Source: Goldman Sachs Research, May 2019.

<sup>8</sup> Source: Goldman Sachs China Research, May 2019.

<sup>9</sup> Source: Goldman Sachs China Research, June 2019.

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# 14%<sup>10</sup>

Consensus forecasts for earnings per share growth in 2020 for the CSI 300 Index of large-cap A-share stocks.

## Valuations Remain Attractive

Valuations in China have fallen significantly since 2015/2016. Even after this year's rebound (Shanghai Composite Index +18.5% in USD, as of November 22, 2019). China A-shares are still at very attractive levels. The market is trading below its post-2005 historical mean in terms of trailing

and forward P/E ratio, something that applies to few other major stock markets today (see Figure 2). The 12-month forward P/E ratio is 11.1X for MSCI China and 11.3X for the CSI 300 Index of top A-share stocks. Consensus forecasts are for earnings per share growth of 12% and 9% for MSCI China in 2019 and 2020, respectively, and 17% and 14% for the CSI 300 Index.<sup>10</sup>

## WHAT WE'RE WATCHING NEXT

We will be watching for signs of stabilization in China's domestic economy in the first half of 2020, especially with regard to private consumption and infrastructure investment. We will also monitor producer price index momentum closely for an end to deflation and a rebound in enterprise profits.

<sup>10</sup> Source: Goldman Sachs Research, November 22, 2019.

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