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A step in the right direction

FEML is positive but selective on China...

Update
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Recent stimulus measures announced by the Chinese central bank and government have been greeted with mixed reactions, but the attempts to breathe life into the country's stock and property markets will be positive for some areas.

The managers of **Fidelity Emerging Markets (FEML)** have been bolstering their exposure to China but are deliberately remaining selective.

A near-four-year bear market that sent stock markets down c. 50% from their peaks has finally spurred policy makers into action. Since the implosion of Evergrande, China's largest and most-indebted property developer, China's importance within the emerging markets complex has waned.

At its peak in 2021, China accounted for 40p in every £1 invested into a fund tracking the MSCI Emerging Markets Index. Today, that's down to 28p, with India and Taiwan snapping at their neighbour's heels. Around 19p in every £1 invested in MSCI Emerging Markets goes to each of those countries.

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Stimulus

The initial reaction to the People's Bank of China's (PBoC) measures was eyecatching and undoubtedly positive. It was essentially seen as China's 'whatever it takes' moment. The MSCI China rose c. 39% between 11/09/2024 and 07/10/2024 and the Hang Seng was up c. 35%.

The PBoC cut the key interest rate and the reserve requirement ratio, the amount of reserve banks must hold. There were also reductions in the minimum downpayments needed to buy properties alongside cash to support purchases of mainland stocks.

These are all positive developments on the monetary side. An initial fiscal package of c. 100 trillion renminbi ($1.4 trillion) was announced, but more is expected to come.

Thus far, markets have fallen back slightly, with the SSE Composite and the Hang Seng down 9.5% and 15.8% respectively from their post-stimulus highs.

Still, all told FEML's managers see the stimulus as broadly positive. On the back of September's announcement, the trust went from broadly neutral China and Hong Kong to mildly overweight.

FEML's exposure to China comes through investments in stocks listed both on mainland exchanges as well as Hong Kong's Hang Seng and also includes Naspers, the South African internet conglomerate that has a large stake in Tencent. In aggregate the portfolio is 1.4% overweight to the index on this basis as of the end of October.

The team's view is that the government will do whatever it takes to bottom out property prices and that the support for markets is meaningful, but it's very much aimed at reflating consumer confidence, rather than encouraging a build-out of construction, like its last big stimulus package a decade ago.

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As a result, FEML's move to become overweight certainly isn't a blanket bullish call on Chinese equities. Selectivity between the three buckets the Chinese market can be bucketed into (the consumer, banks and industrials) is key.

The winners...

FEML's long exposure to the China market has focused largely on consumer-oriented names, which plays into the managers' investment style of looking to invest in companies exhibiting quality characteristics such as high and sustainable returns, prudent balance sheets and attractive valuations relative to the benchmark index.

Chinese households currently have an elevated level of savings because they were able to squirrel away cash during the pandemic that they could not spend. However, the post-Covid spending boom seen in developed markets has clearly failed to materialise in China.

This is because the crisis in the property market has had a huge impact, given c. 50% of household wealth in China is in property. Consumers' propensity to spend their savings is not there, given how low consumer confidence has been. This has resulted in weak earnings results for some companies, and poor sentiment as foreign investors have exited the market.

If stimulus can successfully reflate the property market, consumer confidence may return, which would boost consumer-facing names.

One of these names is Haier Smart Home, which develops, makes and sells household electrical appliances such as fridges and washing machines. If rumours that the government is considering handing out vouchers to buy white goods are true, this could make Haier a potential direct beneficiary of stimulus.

VIPshop can be seen as a TK Maxx equivalent, selling excess inventory from big brands through flash sales on its website. VIPshop has c. 400 million users and can be expected to benefit from any uptick in consumer spending.

Holdings such as Alibaba, Anta Sports and Naspers can benefit too as these structurally winning companies return somewhere around 10% of their market cap to shareholders via share buybacks.

This is an important point: there has been a real and observable change in behaviour from Chinese companies to paying dividends and doing share buybacks. The total value of dividends and buybacks in the first seven months of 2024 was 2.2 times that in the whole of 2021 to 2023. This started with the government encouraging state-owned companies to improve their shareholders' returns in January and could be seen among publicly owned enterprises later in the year, too.

...and the losers

By contrast, FEML remains bearish on banks and parts of the industrials segment, as well as large pockets of the property market. The short positions FEML has within the property sector hurt at the end of September, as share prices soared rapidly, but the long-term, structural view on these heavily indebted firms remains negative.

Chinese banks are another area FEML is steering clear of. The banks look like they will be used as a conduit to reflate consumer confidence, allowing borrowers to refinance their mortgages at low rates, which will in turn reduce the banks' net interest margins (NIMs). The NIM is the difference between the interest a bank earns from its assets and the interest it pays out to its lenders and is, therefore, a key profitability metric.

One key point FEML's managers make is that the policy mix being used today is very different to that used in 2014, the last time China launched a big stimulus programme. Then, one of the key mechanisms was to boost property supply, which led to a commodity boom.

That's unlikely this time around, since the amount of new supply that can be launched by property developers is still being restricted. As a result, FEML remains bearish on any sectors that are geared towards the property market. These include parts of the industrial complex where overcapacity has been an issue, such as steel and cement. Electric vehicles makers also fit into this bucket, an area of the market where FEML has short positions.

The potential for tariffs

One potential fly in the ointment for a Chinese equity renaissance is the possibility of higher tariffs. It's possible that the new US administration will impose a 60% tariff on Chinese goods.

This will have implications for trade flows and growth, but tariffs are not new and China has already started to reroute trade away from the US. The share of China's exports going to the US has fallen from c. 20% in 2017 to 13% by 2023.

In addition, it's possible that higher tariffs also spur greater fiscal stimulus in China, which would further support consumer confidence.

Conscious of the risks, FEML tends to steer clear of export-dependent businesses with insufficient supply chain diversification that are therefore vulnerable to any increase

in tariffs. FEML's exposure to domestic-facing companies in the internet, sportswear, dairy and household goods industries should be less impacted, for example.

Of course, China is not the only nation at risk of having tariffs placed on them and they will be in focus during the upcoming renegotiation of the USMCA, the North American trade deal. Still, Mexico's new President has shown a willingness to cooperate with the US and the country's ties to the US have been bolstered by companies bringing manufacturing bases closer to home.

With Mexican equities trading at cheap valuations of c. 10 times price-to-earnings, c. 20% cheaper than the broad EM index, much of the negativity around tariffs is already priced in and FEML's managers see value in high-quality, cheaply valued Mexican companies.

Nonetheless, FEML's management is closely monitoring any new policy developments emanating from the new US administration.

Overall, it's likely there will be volatility in Chinese markets in the short term, but the stimulus measures look like a step in the right direction and FEML hopes to profit by using the full range of its toolkit.

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