Five questions about Chinese markets

We discuss the main issues impacting Chinese equity markets and ask if it looks a buy…

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Some are saying they are the best tariffs they have ever seen. They say: "Kepler, these are the best tariffs the world has ever seen. Ever." But be that as it may, we have to admit they will have some negative implications. China is certainly one of those countries facing headwinds, with 34% tariffs slapped on its exports to America. But is this already in the price of the battered Chinese equity markets? Here we ask the key questions that need to be considered.

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1. How exposed Is China's stock market to Trump's Tariffs?

We think any impact on the Chinese economy and stock market is likely to be limited by a few factors. China's exports to the US have fallen in recent years, as a percentage of the total and in absolute, dollar terms. In 2017 19% of China's exports were to the US, but this had fallen to 14% in 2024. However, these figures have to be taken with a pinch of salt. Exports to countries such as Mexico, Vietnam and India have soared since the pandemic. Some of this is for onward sale into America, and so tariffs will be felt down the chain. Vietnam and India are amongst those countries hardest hit by the new tariff regime, with charges of 46% and 26% respectively on exports to the US, and presumably the motivation is at least in part to prevent China shuffling its goods through these countries surreptitiously. Mexico is subject to tariffs of 25% on most goods under a previous executive order, although these may be negotiated down.

However, some of this shift in Chinese exports reflects a concerted attempt to reduce reliance on the US market after the trade war that picked up during Trump's first presidency. And American tariffs could well see other countries and regions seek to increase reciprocal trade to offset any impact, with this trend accelerating. We think it is important to note how Chinese and European politicians have been courting each other in recent months, both looking for ways to offset any negative effects of US policy. For example, EU trade commissioner Maroš Šefčovič as well as the heads of Mercedes and BMW have recently visited China by invitation.

Importantly, China's overall dependence on exports has plummeted too, having peaked just before the 2007 financial crisis. In 2006, exports were worth 36% of Chinese GDP, but they fell to 19.7% in 2023, according to the World Bank. The UK actually exports more in relative terms, with exports worth 32% of GDP in the same year. The US, by contrast, is much less dependent on foreign trade, generating exports of only around 11% of GDP. As a consequence, the Chinese equity market is heavily weighted toward domestic-oriented sectors rather than export-reliant industries.

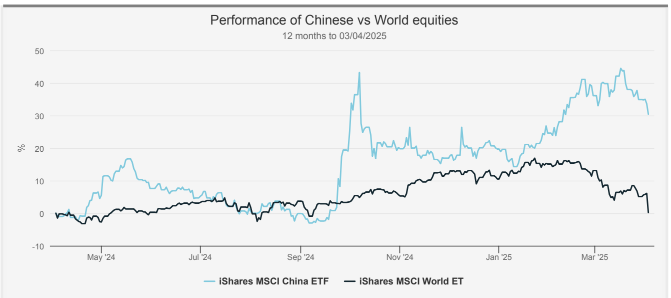
Another protective factor China can take advantage of is the currency. Notably, the Renminbi fell by 7% during the trade war kerfuffle of Trump's first administration, reducing the impact on volumes. The Chinese Communist Party will have to tread carefully, as Trump's administration has warned it views currency 'manipulation' as hostile, but there is certainly scope for a devaluation to lessen the blow.

Overall, we think China's sophisticated domestic economy as well as its acquisition of new trading partners should cushion any economic impact, while the authorities may allow the currency to sink too. This gives us confidence that any impact on the country's equity market will be moderate rather than catastrophic. We think this could mean the case for holding Chinese equities on valuation grounds and in anticipation of a rotation out of the US still holds. But is the market still cheap?

2. Are Chinese equities cheap?

It is with some trepidation that we discuss performance figures in the midst of the turmoil as the market is still digesting the impact of the new regime! Before 'Liberation Day', Chinese equities had had a remarkable bounce to start 2025, and were up c. 30% over the past year (on a total return basis, like all the figures given below). As the following chart shows, the MSCI China Index even briefly retested the highs seen last September after the government announced a stimulus package, although it has slightly retraced this move.

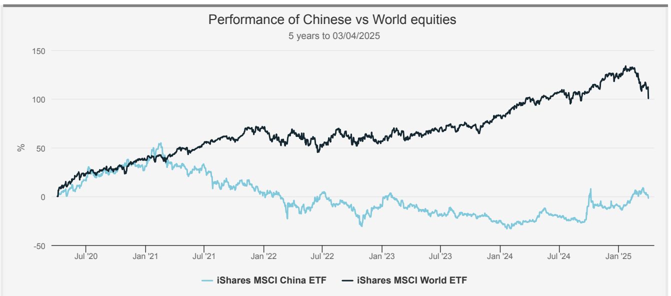
Fig.1: Performance Of China Vs World Equities Over One Year



Source: Morningstar

Investors would have been much better off in the Chinese market than the developed markets over 12 months, but the same can certainly not be said looking back five years. As the chart below shows, Chinese equities were barely flat over this period, while the developed world index had doubled. The picture worsened markedly for both indices as the impact of Trump's tariffs were felt earlier this week.

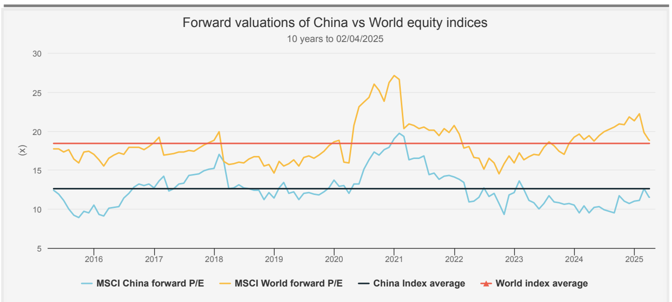
Fig.2: Performance Of China Vs World Equities Over Five Years



Source: Morningstar

Looking at valuations, though, Chinese equities do not, at a market level, look strikingly cheap. The chart below shows the forward P/E (using Bloomberg estimates) of the MSCI China Index and MSCI World Index over ten years. The China index's valuation is only marginally below its average for the past decade, and the recent sell-off has taken the developed indices back to their ten-year average too. A slump in earnings over the five-year period has pushed prices lower. Analysts will have tried to reflect any tariffs they expected to come into play, but forward earnings estimates will certainly change now that the tariff regime is in force, so it is possible the valuation should actually be a little higher than this once the likely impact has been fed through.

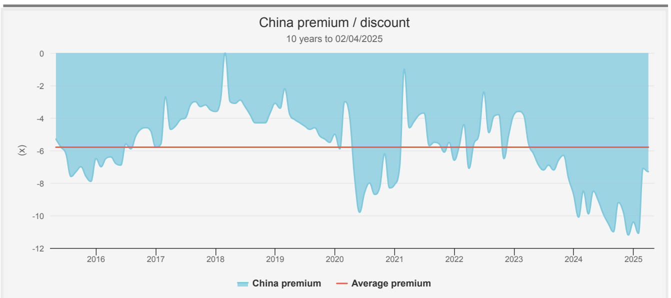
Fig.3: Valuation Of China Vs World Equities



Source: Bloomberg, Kepler calculations

We think it is usually much more useful to compare an index's valuation against its own history than against international peers, as the make-up of the index on a sector, industry or other level can influence relative valuations. Meanwhile, relative valuations can be quite stable over time thanks to embedded market-level risk factors – such as politics and corporate governance. It is interesting, though, to look at how the valuation premium of one market over another changes over time. The chart below shows the gap between the valuation of the two indices, and the average gap, over ten years. There has been an average gap of six turns between the forward P/E of the two indices over this period, and only twice, for brief periods, has the gap very briefly disappeared or come close to doing so. The gap is only slightly wider than its average at the current moment.

Fig.4: Premium Of MSCI China Over MSCI World

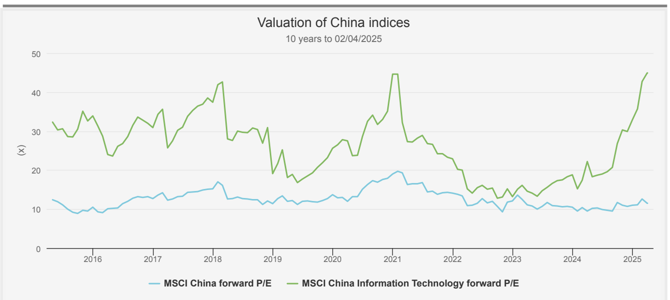


Source: Bloomberg, Kepler calculations

All this is at an index level, but digging down a little further shows some wide dispersion that could offer opportunity. Specifically, managers we speak to argue that the best opportunities they are seeing are in the more domestic-oriented companies that have been out of favour in recent years given the weak Chinese economy. For example, Nitin Bajaj and Ajinkya Dhavale, co-managers of **Fidelity Asian Values (FAS)** remain overweight China in their regional portfolio. They are focusing on the domestic, old economy sectors where the rally has had less impact. The managers argue there is real value in the Chinese consumer-related names, and overall are overweight consumer discretionary in the region which is driven in part by their China holdings. They have rotated exposure into companies such as Yihai International, the largest condiment producer for Chinese soup-based hot pot cuisine. It is the main supplier of soup bases for Haidilao, a leading Chinese hot pot restaurant chain that relies on Yihai for nearly 80% of its domestic demand. The managers highlight that this firm has executed well, and its fortunes are unlikely to be affected by a China–US trade war. In contrast, they think the tech-names are momentum driven and so they are largely steering clear.

While Nitin and Ajinkya's overweight to China helped during the recent run-up, their focus on domestic names hasn't. The Chinese market seems to have been driven at least in part by a surge in the tech companies after the DeepSeek reveal. This saw a Chinese AI company claim it could produce a model of equivalent quality to OpenAI and its US competitors with much less investment in computing at the training phase. In turn, this led to a surge of optimism about the ability of Chinese online companies to benefit from AI, while Nvidia and the US megacaps looked pricey and in danger of facing serious competition. The chart below shows the remarkable rise in the forward P/E of the Chinese information technology sector which illustrates this driver perfectly.

Fig.5: Valuation Of China And China It Indices



Source: Bloomberg

Ian Hargreaves and Fiona Yang, managers of Invesco Asia Dragon (IAD), also entered the year overweight China. In particular, they like high quality consumer-facing names like Sands China, a Macau casino operator, China Resources Beer, dairy producer Yili and e-commerce firm PDD. They expect consumer names to benefit from last year's stimulus measures, while the valuation measures in some cases remain particularly cheap. For example, CRB's P/E fell from around 40x in 2019 to closer to 15x by the end of 2024. They also own Transsion Holdings, a Shenzen-based manufacturer of low-end smart phones that are sold in emerging markets such as Africa. We think this is a good example of China's success in finding other trading partners to the US, a trend we expect to continue. Additionally, we highlight a recent note from ING Economics which shows that while Chinese PMIs illustrated expansion, the figure for exporters illustrated contraction, which means that domestic growth is driving the Chinese economy. These figures are pre-tariffs, and there will be some implications through the economy of the new regime, but they do illustrate that the domestic Chinese economy is improving. All told, we think there is indeed plenty of value left in the Chinese market, particularly in domestic sectors which should be more insulated from any direct impact of tariffs, notwithstanding the last year's rally.

3. How significant were the September stimulus measures?

The Chinese authorities have already shown their ability to influence their domestic market, launching a significant stimulus package in September 2024 which led to a remarkably sharp rally. We think there is potentially a lot more to come. Indeed, Ian Hargreaves and Fiona Yang tell us they think policy makers have been deliberately holding back some further actions to unleash once Trump's next move became clear.

To recap, in September, the authorities cut the reserve requirement ratio for banks, allowing them to expand credit further, and launched targeted liquidity injections of RMB 300bn into the banking system. They have also expanded a consumer goods repurchase scheme reminiscent of the old 'cash for clunkers' policy of Barack Obama. Chinese consumers can receive cash for trading in old consumer goods for newer models. Initially focused on the EV market, the scheme has been expanded to cover all sorts of white goods and electronics too. Notably, the Chinese EV market is a key export success. Russia is the largest customer, with the Middle East another fast-growing market. We think this is a good example of China diversifying its export markets away from the US. Linda Lin and Sophie Earnshaw, managers of **Baillie Gifford China Growth (BGCG)** have leaned into this sector, and they highlight that the quality and affordability of Chinese EVs is driving success around the world. They own CATL, the world's largest battery manufacturer, and BYD, which has surpassed Tesla to become the global leader in EV sales.

Linda and Sophie argue the stimulus measures of last autumn marked a decisive turning point for the markets. They point out they have already led to a 10% rise in property sales, reversing a 30% contraction. They also highlight some new measures targeting the equity markets specifically. The authorities are pressuring listed companies to conduct share buy-backs, using up to 5% of their profits to do so, to boost market confidence. There were also tax breaks and R&D subsidies announced. However, the managers note that the rally since the policies were announced has been driven by a surge of optimism by retail investors. While they think the impact will be positive, they note that on an economic basis, the authorities are targeting a transformation of the economy which will take time. And when it comes to the market, they note volatility is likely to remain high and so a long-term perspective is required when investing in the country. We will be publishing a full note on the trust in the coming weeks, please **click here** to register to be notified. Dale Nicholls, manager of Fidelity China Special Situations, argues that sone stability in the housing market is likely to be necessary to see consumer confidence return. In our recent update, we highlighted how FCSS was heavily exposed to the consumer story, with 80% exposure to domestic earnings. This includes companies such as Mao Geping Cosmetics which IPO'd late in 2024. This is a so-called local champion that has been taking share from Western equivalents and tapping into the growing wealth of Chinese consumers.

4. What does the Chinese government want?

Investing in China means getting a grip of the Chinese Communist Party's policy goals. These are communicated through their five-year plans, with the latest running from 2021 to the end of this year. Preparations are already underway for the next five-year plan which will be announced in 2026. So, when Linda and Sophie talk about the government's transformation plans, this is a large part of what they have in mind.

We think one of the critical components of the current five-year plan is the 'Dual circulation strategy'. This essentially means reducing the reliance of the economy on overseas markets and technologies, and boosting the domestic cycle of consumption and production. The 'dual' circulation refers to the country not setting out to ditch entirely external-focused cycles, but putting more resources into fostering the domestic cycle. Externally, the Party did intend to lower barriers to trade, and China has made some progress with some countries, if not the US. More importantly, it set out to grow the domestic economy and see it become more sophisticated. This has helped increase its self-sufficiency and therefore, we believe, its resilience to US trade barriers.

Another policy goal was to 'Build digital China'. China has focused on boosting its domestic digital economy, with global giants Tencent, ByteDance and others developing during this period. The US fears Chinese competition in this sphere, and the potential for Chinese apps to present a security risk. ByteDance owns TikTok, which has been banned in some US states. The Trump administration has also threatened to either force the sale of its US business or see the US government buy 50% of it. Linda Lin and Sophie Earnshaw point out that its 60m US users are dwarfed by the more than 120m it has in both Brazil and in Indonesia. In the domestic Chinese market, the equivalent app, Douyin, has 750m users. This means that what happens to its US business is really not so important for the future course of the country and the equity. ByteDance is an unlisted company and the second largest position in BGCG. Its valuation has been marked up repeatedly over the past year. Tencent makes up a further 12.7% of the portfolio (as of the end of January). Tencent was designated a military-linked company by the US in January, but the shares are up 20% since. We think this may be a sign that the market is less inclined to demand a political risk premium for investing in Chinese equities. Notably, as of its last annual report, only 30% of Tencent's revenues came from outside China.

The managers of **JPMorgan China Growth & Income (JCGI)** also remain committed to the technology sector, both hardware and software. We think it is interesting that two of the country specialist trusts have such high conviction in this area, in contrast to the regional managers discussed earlier. The JCGI team point out that there is still massive oversupply in the Chinese real estate market which is a drag on that sector and on the financial sector in particular, although the authorities are committing plenty of resources to deal with this problem. They point out that capital discipline has become much better in China during the recent lean years, which means they were able to build a position in Alibaba last year while it was yielding approximately 8%. They view the more cyclical and value-exposed stocks as having had their run, and think the higher earnings growth – boosted by the potential of AI – makes tech and related sectors highly attractive. They are also significantly overweight the domestic China A-Shares market, taking advantage of their locally based team to fish in this often overlooked pond of companies typically more exposed to the domestic economy.

While the Chinese technology sector is not cheap, it also doesn't look heavily exposed to US trade either, so any recovery in the domestic economy should be more important for it. Additionally, we await the next five-year plan with interest. It seems likely it will retain a focus on developing China's digital economy, with a focus on the AI revolution, and we think it is notable the Chinese specialist trusts remain keenly focused on this area and the potential for it to deliver superior earnings growth.

5. What if China invades Taiwan?

We think political risk is a major reason investors have steered clear of China since Russia invaded Ukraine. In this tense atmosphere, severe impositions on the ability to trade with the country have been a real possibility. Meanwhile, the Chinese authorities destroyed the domestic private education system almost overnight in 2022, fearing that it was interfering with another one of its key five-year goals, the better distribution of wealth around the economy. This was a favourite sector of the overseas active manager, and so lots of investors were badly burned, and will quite rightly fear the communist party again asserting its ultimate power within the country to do what it wants with any assets within its borders. The ultimate political risk has been unmentioned so far though, and that is a potential invasion of Taiwan. What if China invades Taiwan?

We have seen many fund managers struggle to answer this question. We suggest it isn't a very useful one to be asking oneself. If China invades Taiwan, your investments in Chinese equities would indeed probably take a slight hit, to put it mildly, but so would the rest of your portfolio. The US is pledged to provide military support to Taiwan in aid of its self-defence, but not to be a belligerent on its side. Nevertheless, direct conflict would be a real possibility. China and the US are nuclear powers and the two largest military forces in the world, so it is fair to say that the implications would be widely felt in asset markets. If war broke out, maybe Unilever would fall by less than Moncler, but we venture to suggest losses would be made across the board at first. Investors would probably do best to put all their money in gold, short-term Swiss government bonds and tins of baked beans if they really fear war. Otherwise, we think it is probably not something that can rationally be incorporated within share prices. Additionally, we suspect no fund manager has any particular insight on its likelihood, and perhaps no more than the man in the street given that communism and common sense both independently would suggest China wouldn't telegraph any such intentions if it had them. One LinkedIn post your author was recently presented with (unsolicited) suggested that investors should consider the 80% probability of a major earthquake off the coast of Japan in the next thirty years when building exposure to Japan. Theoretically, one could also probability-weight the possible impacts of alien contact too. However, in our view, it is better to focus on more mundane matters and deal with any extreme events if or when they truly seem imminent.

Conclusion

Overall, we think China could well be set up to see a rotation out of US equities in the coming years as investors come back into the market, having completely capitulated a few years ago. That said, it didn't look cheap at an index level heading into the tariff announcements, and so earnings growth in the new regime and a successful domestic recovery are likely to be critical if good gains are to be made. We think investors are likely massively underweight China, and a slight correction of this could provide strong technical support to the market too, particularly if China attempts to take advantage of the US tariff regime to build stronger trading relationships around the world, a step we think would provide more strategic advantage than initiating a world war over a recalcitrant island.

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