China's money printer is finally going 'brrr'

China is rallying but caution is warranted...

Update
24 October 2024

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The Money Printer Go Brrr meme went viral in 2020, after extraordinary stimulus was unleashed by both the US Federal Reserve and Congress in the wake of the coronavirus pandemic, leading to bubbles in certain stocks.

Most developed countries followed in America's footsteps by supporting their economies and stock markets, with China a notable exception. The country has finally caught up and launched their own version of a stimulus package that sent Chinese stock markets surging.

In this context, one story that caught my eye this week was the news that the US-based asset manager Franklin Templeton had launched three emerging markets funds, two of which excluded the biggest component of the EM complex: China.

It appears there's plenty of demand for EM ex-China solutions and plenty have already jumped on this particular bandwagon. The likes of BlackRock, Amundi and Stewart Investors, among others, already offer products.

Perhaps that's not surprising. Chinese stocks started their seemingly inexorable plunge about four years ago and can be broadly put down to two main causes: the government's crackdown on big tech firms as well as the booming gaming and private education sectors; and the property crisis sparked by the default of the developer Evergrande.

At one point, the Chinese market had lost two-thirds of its value and to-date, investors in the MSCI China Index have seen almost a quarter of their investment wiped out during a period where US stocks have soared 30% and India's stock market has gained 46.5%.

It's contributed to lacklustre demand from investors around the world. Domestic investors became cautious after a large chunk of their personal wealth was wiped out by the property crash, while international investors have been reticent given the seemingly high possibility of government interference in their investments.

Hence, emerging markets ex-China. One might say the country's woes remind them of Japan, which suffered not one but two lost decades, which followed a tremendous financial bubble that saw the Tokyo Imperial Palace grounds estimated to be worth more than the entire real estate value of California.

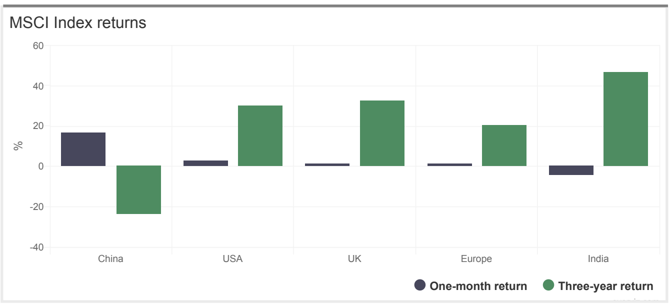
In fact, I've seen some data flying around on social media comparing China's stock market today to Japan's back then. The similarities are eerie, but you might call them 'chart crimes', so I won't recreate them for you today.

From doom to boom

That brings us up to today. Despite the doom and gloom surrounding Chinese stocks, the country actually has the best performing stock market over the past month (granted, a short period over which to assess anything).

The MSCI China Index is up 16.4% in local currency terms in the past month, well outpacing most other major stock markets. MSCI USA, for instance, has gained just 2.8% in that time.

Fig.1: Role Reversals



Source: FE fundinfo. Returns to 22/10/2024

The turn in events can be put down to a stimulus package introduced by the Politburo, led by President Xi. It included a number of measures to tackle issues on deflation and property, notably changes to policies on deposit requirements for second homes and mortgage rates as well as introducing a social housing policy to help reduce unsold inventories.

Interest rates were cut by 50 basis points, with a further 25 basis points guided to be cut in the near future.

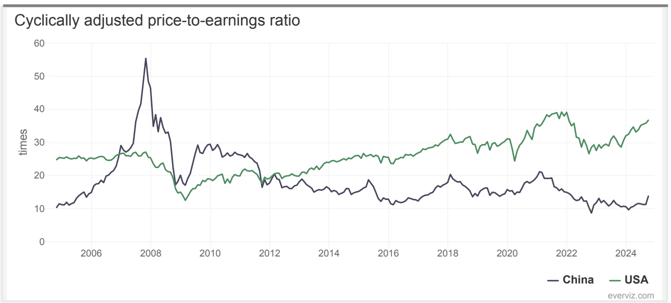
The initial pop saw the MSCI China rally 40% in the space of a month from mid-September, though that's fizzled out somewhat with the index down 11.5% since early October. The shares of China-focused investment companies saw similar price movements during that period.

The strong rise and drop in markets show that expectations may have gotten ahead of reality, and it would be unsurprising were we to see more volatility ahead.

Regardless, the China market is on a significant discount to peers. To the end of September, the MSCI China had a forward price-to-earnings (PE) ratio of 10.8, versus 13.2 for the MSCI Emerging Markets ex China Index and 19 for the MSCI World.

MSCI China's cyclically adjusted PE (CAPE) ratio, which compares today's stock price with the average inflation-adjusted earnings over a 10-year period, remained just above 20-year lows at 13.7 to 30/09/2024, according to Barclays, a 62.6% discount to the MSCI USA. It's hard to believe that 17 years ago China traded at a 100% CAPE premium to the USA.

Fig.2: China Remains Cheap As Chips



Source: Barclays Research

In addition, the consumer remains in relatively good shape and if the stimulus measures prove supportive to house prices, which is a big store of wealth in China, confidence could return to markets.

That said, if we're taking the comparison with Japan further, Japan's market saw numerous 40% or 50% rallies – even a doubling of the market at one point – during its long and arduous bear market. After every bear rally, the market went on to settle at a lower low than the previous one. This suggests some caution is warranted.

Punchy weightings

One could invest in any of the China-focused investment companies to ride the wave if one expects the market to carry on rising on the back of stimulus measures, but perhaps the best way to play any Chinese recovery is through broader emerging market or Asia-focused investment companies. That way you don't get the full volatility of Chinese shares, at the same time as benefitting from growth in other dynamic economies such as India, Indonesia and Taiwan.

There are a few trusts worth noting. **Fidelity Asian Values (FAS)** has a punchy 31% weighing to China. FAS's increasing allocation here has been driven by stock specific factors rather than a macro call, with the managers finding many good businesses trading on attractive valuations, having experienced temporary earnings weakness. They believe that sentiment is at a historic low but can reverse. FAS also has 7.7% in Hong Kong.

JPMorgan Global Emerging Markets Income (JEMI) has 24% in China and a further 5.1% in Hong Kong. At the start of this year management had initiated new positions in JD.com and Tencent as both companies started paying a dividend, meaning they are focusing more on the shareholder.

This plays into the managers' belief that the corporate life cycles in China are changing, as companies are recognising the slower growth environment, and responding by streamlining capital allocation, including a focus on dividend policies.

Some less obvious plays include **Fidelity Emerging Markets (FEML)** and **Ashoka WhiteOak Emerging Markets (AWEM)**.

FEML's September factsheet shows the fund has 11.5% in China and 13.6% in Hong Kong, but this is supplemented by an investment in Naspers, a South African internet company that has a large stake in Tencent and is held as a proxy for that company. FEML has also used its options book to increase exposure to China, which essentially gives it a cost-effective way to take out insurance against a rally in the China market.

On the face of it, AWEM, too, is well underweight China and Hong Kong because it has only 15.2% of its portfolio in stocks listed on the China and Hong Kong markets. However, a number of off-benchmark positions takes its underlying economic exposure to China and Hong Kong to 21.8%. These include the French luxury goods firms LVMH and Hermes.

Clearly, China represents one of the cheapest markets in the world from a valuation standpoint, which may appeal to the more contrarian of our readers. Yet, as we know from years of investing experience, just because something is cheap doesn't mean it can't get any cheaper. Caveat emptor.

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