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Cautious optimism for China investors

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Overview of China's market

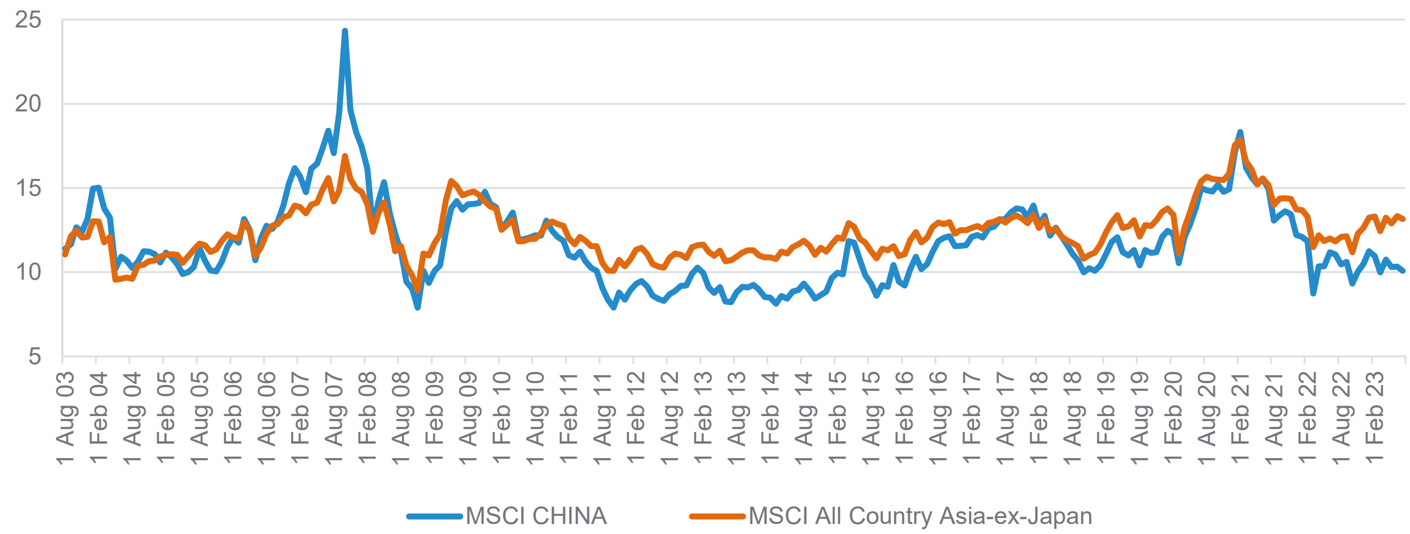
Mainland China's stock market has sold off sharply over the past month, with the CSI 300 index falling 7.7 per cent from the peak of the rally after the politburo meeting on 25 July. The Hang Seng Index in Hong Kong entered a bear market, down 22 per cent from this year's peak in January (Source: Fidelity International, 21 Aug 2023). And the renminbi has weakened against the dollar, nearing levels seen during the height of Covid-19 lockdowns. Despite this turbulence, it's important for investors not to lose sight of the broader context and potential for long-term investment opportunities.

Investors recalibrating expectations for GDP growth and policy support, following a spate of weak economic data and renewed stress in the financial and property sectors, has contributed to the recent market weakness. But beneath this challenging backdrop, there are reasons for cautious optimism for active investors.

Attractive valuation

Chinese stocks now offer appealing value compared to history and other markets in Asia. The 1-year forward price-to-earnings (PE) ratio for MSCI China is 10 times versus it's 10-year average of 11.4 times for example. That is close to the largest discount to the rest of Asia for the past 20 years. Moreover, the corporate earnings cycle has bottomed out across most sectors and double-digit earnings growth is forecast for MSCI China in 2023 and 2024 based on consensus median estimates.

12-month forward price-to-earnings (PE) ratio



Source: Refinitiv DataStream, IBES, 21 August 2023

But, as always, caution is warranted. While aggregate metrics reveal market valuation and earnings trends, they overlook the vast array of dynamics within the Chinese stock market. This diversity underlines the potential for active bottom-up investment strategies to add value.

Government to balance short and long-term objectives

Two crucial factors suggest a potential floor for market weakness and prospects for recovery. Firstly, the government has shown its commitment to instilling investor confidence and supporting the economy with continued and wide-ranging measures. While policy's role is important, investors must not lose sight of the government's aim to balance their short and long-term economic objectives.

Government efforts to bolster the property market, including lower mortgage rates and eased home purchase requirements, offer support. Further direct support for households, such as mortgage rate adjustments, could meaningfully stimulate a consumption-driven recovery. Nevertheless, a cautious approach to investing in property developers, particularly those in the private sector, is prudent while the physical market remains weak. Stimulus is unlikely to arrive in substantial scale, a targeted approach aligns with shifting economic drivers from infrastructure and property to manufacturing and consumption.

China’s growth story remains intact

Secondly, on-the-ground research conducted by Fidelity’s Portfolio Managers and analysts reveals that certain sectors and companies are more resilient than broad macroeconomic indicators suggest and the case for long-term investment opportunities remains robust.

Even in a slowing economy, industry consolidation persists, and market leaders secure larger market shares. Companies benefitting from domestic substitution, the move up the value chain and exhibiting some pricing power can now be found at more appealing stock valuations.

Pent-up demand remains among consumers, and they have much more choice across different price points and so can more precisely allocate their spend where they want. Trends like experience-based spending, health consciousness and premiumisation continue to grow. Resilience is evident at lower-end consumption and there are signs of recovery in high end luxury goods. Financials, particularly insurance, continue to benefit from rising penetration. Businesses offering real consumer value, strong branding, and communicate effectively to buyers can continue to grow.

China's impressive pace of innovation, coupled with automation opportunities driven by an aging population and the energy transition, continues to create interesting investment opportunities. Many of these lay within core industries that hold strategic importance for the government’s overarching agenda.

In conclusion, while the recent market turbulence is unsettling, attractive valuations, government commitments, and targeted policy support provide hope for a measured recovery. Despite challenges, we believe China’s growth prospects still outshine many global counterparts. The country remains a fertile ground for investment over the long term, driven by an expanding middle class, rising incomes and technological innovation.

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