On the Ground Views Regarding the Recent Chinese Stimulus Pivot

Local Views

October 24, 2024

ABS GLOBAL INVESTMENTS

SUMMARY

September 2024 marked a significant pivot in the tone of the Chinese government with regards to their intentions to support and stimulate the economy and capital markets. Until late September, Chinese authorities hesitated to announce meaningful measures to shore up the economy, limiting their initiatives to smaller and often insufficient actions. In response, Chinese equities moved sideways for most of 2024 with spurts of volatility as investor sentiment fluctuated between optimism at the hint of potential policy action and disappointment regarding its size and reach.

All of this changed in September when Beijing authorities announced a large and broad set of policy initiatives, including monetary and fiscal stimulus. Furthermore, they also seemed to provide assurances that they would do whatever is necessary to boost the economy, including more consumption-oriented incentives. The market was quick to react to this meaningful and determined policy shift. At its peak, the market had climbed over +30%.

Since the first signs of this policy pivot, investors have been on edge waiting for more details on how the government will implement its pledged support. Volatility has climbed as each headline disappoints or fuels optimism with the Chinese outlook. As of October 21, the MSCI China Index was down –4.5% for the month as the lack of details soured sentiment. We asked three of our local partners based in China to share their perspectives on the Chinese policy pivot and insights on their repercussions for equity investors.

KEY INSIGHTS

- **A CRITICAL INTERVENTION:** "The domino effect is palpable: local government coffers are depleted, infrastructure investments are stalling, and a backlog of payments to enterprises is forcing businesses into dire straits. The result? A vicious cycle of layoffs and salary cuts. It's against this backdrop that recent Politburo policies, aimed at safeguarding the real estate sector, emerge as a critical intervention." – Shanghai based Manager with a Value Bias

- **CONTINUED POLICY MEASURES AHEAD:** "Judging by the management style pattern of the current top leadership and the policy actions and tone taken so far, we believe Beijing will continue to roll out result-driven fiscal and monetary and other issue-specific policies particularly around local government debt resolution and property market until satisfactory macroeconomic performances are thought to be reached." – Shanghai based Manager with a New Economy Bias

- **MARKETS POISED FOR REVERSAL:** "Amidst this turbulence lies opportunity. Chinese stock valuations are at global lows, with the CSI 300's 3% dividend yield surpassing the risk-free rate. H-shares are trading at even steeper discounts, 20-30% lower than their mainland counterparts. With pessimistic scenarios already priced in, the market seems poised for a reversal." – Shanghai based Manager with a Value Bias

- **COMPANY FUNDAMENTALS WILL LEAD THE NEXT LEG OF THE RALLY:** "While the initial market response to stimulus initiatives was a broad rally that benefited stock prices and valuations across all sectors, we believe that company fundamentals will drive the next leg of the market's recovery." – Hong Kong based Portfolio manager with a GARP Bias

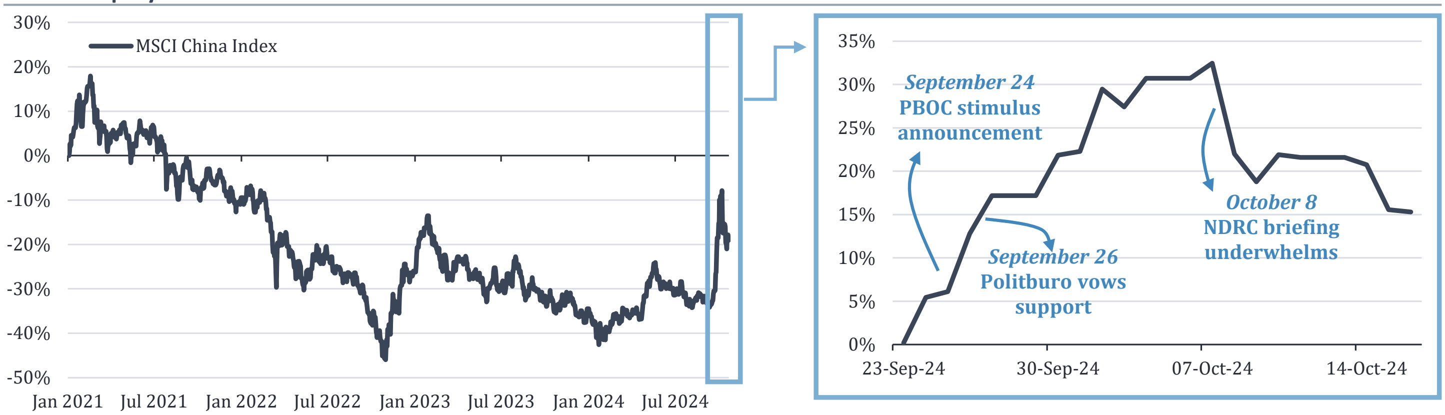
AN OVERVIEW OF CHINA'S STIMULUS PIVOT

September's string of policy initiatives started with the People's Bank of China (PBoC) unveiling the most aggressive monetary stimulus package since the pandemic. These measures were followed by a surprise Politburo meeting chaired by President Xi Jinping himself. This meeting was scheduled to occur in December and its unexpected re-scheduling indicated a sense of urgency to China's latest policy moves. The last time this meeting was held outside of the regular schedule was in March 2020 shortly after the Covid outbreak. Beijing authorities not only announced a broad and large collection of stimulus measures but also seemed to provide assurances that they would do whatever is necessary to boost the economy.

Key measures included:

- *Monetary Policy:* Reserve requirement ratios were cut by 50 basis points, freeing almost $1trillion for new lending. In addition, policy rates were cut by 20 basis points.
- *Real Estate Market:* Mortgage rates were cut by 50 basis points, and down payment requirement cut to 15% for first and second properties. In addition, all tier 1 cities announced they would ease homebuying rules.
- *Stock Market:* The PBoC created an RMB 500B facility to use its balance sheet to support the stock market. More specifically, this measure allows non-bank financial companies, including asset managers and insurers, to swap their bonds for cash to invest in the stock market
- *Fiscal Measures:* Local governments were encouraged to issue bonds totaling RMB 4 trillion for infrastructure and social development.

Chinese Equity Performance: 2021 - 2024



Source: Bloomberg as of October 21, 2024. https://www.bnnbloomberg.ca/business/international/2024/10/16/chinas-wild-stock-market-swings-hurt-a-21-trillion-bull-case. Past returns are not a guarantee of future results. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

The market reacted quickly to this meaningful and determined policy shift aimed at revitalizing China's economy and stock market. In September, the MSCI China Index was up +23.9%. Consumer and real estate stocks led the rally with gains of over +30%. From a share type perspective, Chinese ADRs experienced the greatest gains for the month, up +31%. These stocks benefited from foreign inflows and their bias towards consumer-oriented sectors. Meanwhile, the A-shares and H-shares climbed +23% and +18% during September.

However, since the first signs of this policy pivot, investors have been on edge waiting for more details on how the government will implement its pledged support. Volatility has climbed with each headline, indicating that Chinese authorities face high expectations from investors. Anything short of detailed fiscal plans as ample as the monetary policies announced in late September has disappointed investors. Indeed, when the National Development and Reform Commission (NDRC), China's economic planning agency, reiterated plans to boost the economy but fell short of providing details, the market fell by almost -8%. As of October 21, the MSCI China Index is down -4.5% for the month.

While we consider these developments to be a positive catalyst for the Chinese economy and equity markets, we maintain caution in our outlook. We expect it will take another quarter or two to see how and whether these stimulus measures translate into earnings and growth. More importantly, we want to see whether these policies can restore consumer confidence and unlock the substantially large household savings that have grown materially since the pandemic. A recovery of corporate spending and investments can also sustain this rally further.

Overall, we expect Chinese equity markets to remain volatile driven not only by Chinese policies but also by geopolitical noise surrounding the US elections. In the meantime, Chinese equity markets remain undervalued resulting in interesting opportunities for local specialists with a deep understanding of underlying market opportunities.

LOCAL PERSPECTIVES: SHANGHAI BASED PORTFOLIO MANAGER WITH A VALUE BIAS

China's economic deceleration finds its roots in the real estate bubble bursting that commenced in late 2021. This seismic shift has sent ripples through the entire economy, with housing prices plummeting by 30-40% - a decline reminiscent of global real estate crashes. In 2021, land transfer income constituted a staggering 30-40% of local government fiscal revenue. In 2024, projections suggest this figure will dwindle to a mere 20-30% of its 2021 levels. This dramatic downturn has far-reaching consequences, affecting not just the real estate sector, but also upstream and downstream industries and consumer spending patterns.

The domino effect is palpable: local government coffers are depleted, infrastructure investments are stalling, and a backlog of payments to enterprises is forcing businesses into dire straits. The result? A vicious cycle of layoffs and salary cuts. It's against this backdrop that recent Politburo policies, aimed at safeguarding the real estate sector, emerge as a critical intervention.

Central government's latest stimulus policies in late September and October show a significant strategic shift. Their initial post-pandemic strategy counted on organic economic growth and robust foreign trade to offset real estate woes. This approach mirrored pre-2011 European debt crisis tactics, eschewing bailouts for fiscally strained provinces and demanding budget cuts. However, just as the European Central Bank's blanket guarantee of government bonds was hailed as a crisis-averting move, China's new policy of supplanting local government hidden debt with central government bonds marks a pivotal shift. While the efficacy of this approach remains to be seen, one thing is certain: asset prices are poised for an upswing.

Analyzing global real estate bubble patterns reveals some consistent trends:

1. *Cyclical Nature:* Real estate prices invariably rebound, often surpassing previous bubble peaks. The infinite nature of paper currency supply underpins this cyclicality.
2. *Government Intervention:* Crisis resolution typically involves increased government leverage, supplanting household debt. Post-crisis, government leverage ratios often surge by 20-30 percentage points. With China's central government leverage at 40% (or 100-120% including local and hidden debts), there's ample room for maneuver.
3. *Price Stabilization Mechanism:* During crises, while property values rarely plummet beyond 30%, mortgage rates often see a 300 basis points reduction. This dynamic bolsters purchasing power, eventually stabilizing and reversing price trends.

China's current stimulus measures align closely with these global patterns.

As asset prices rebound, the specter of deflation recedes and corporate profits rise. Given that real estate constitutes the lion's share of Chinese household wealth, its stabilization will inevitably propel the stock market upward, reversing the decline triggered by the real estate collapse since mid-2021.

The Chinese government's pivot towards real estate salvation and deflation prevention marks a paradigm shift in its post-2019 strategy of curbing property bubbles and suppressing inflation. Once set, this new direction is likely to see escalating efforts rather than mid-course abandonment if initial measures fall short.

Amidst this turbulence lies opportunity. Chinese stock valuations are at global lows, with the CSI 300's 3% dividend yield surpassing the risk-free rate. H-shares are trading at even steeper discounts, 20-30% lower than their mainland counterparts. With pessimistic scenarios already priced in, the market seems poised for a reversal.

As the adage goes, "The darkest hour is just before dawn." For astute investors, China's current economic landscape may harbor significant opportunities. The stage is set for a potential reversal and the promise of substantial returns with it.

In conclusion, while China's economic challenges are formidable, the government's strategic pivot and historical patterns of real estate recovery suggest.

LOCAL PERSPECTIVES: SHANGHAI BASED PORTFOLIO MANAGER WITH A NEW ECONOMY BIAS

China equities, both listed on-shore and off-shore, staged a significant rally in late September catalyzed by a pivot in central government's attitude and approach to address weak economic growth, deflationary pressure, and low societal confidence. These events significantly boosted investors' appetite for China equities after a prolonged bear market. They sent the markets into a speedy run-up with record-setting trade volume in both Hong Kong and A-shares markets reached on the last day before and the first day after the Oct 1-7 week-long national holiday period respectively.

However, the market has given back about half of the late September gains so far in the first half of October. Investor conviction remains somewhat low. Judging by the management style pattern of the current top leadership and the policy actions and tone taken so far, we believe Beijing will continue to roll out result-driven fiscal and monetary and other issue-specific policies particularly around local government debt resolution and property market until satisfactory macroeconomic performances are thought to be reached. Significant changes in fiscal/national budget policies need to go through legal process, in particular approval by the National People's Congress Standing Committee which is scheduled to meet later in Q4. The regularly scheduled Politburo economic meeting in December is the other key event throughout the rest of this year where clearer policy details can be expected.

Besides the domestic challenges and dynamics, we think China's strategic relationship with and positioning relative to the US is also an important part of policy calculations. The start of the US interest rate down cycle in September probably have helped nudge the leadership towards more easing since then, and the US election results in November and their implications for China look likely to be an important policy consideration going forward.

Equally important, listed companies have continued to take steps to improve shareholder returns through higher dividend payout and share buybacks where valuations are deemed attractive. Starting with off-shore listed large Internet names and now spreading to broader market with clear "guidance" to enhance investor returns by on-shore regulators (who apparently borrowed a page from Japan stock exchange's recent playbook to boost the market there), we think this is a very important positive development in China capital markets. Valuations have gone up since late September but remain low historically relative to the profit outlook, and equity risk premiums in both onshore and offshore markets are at very high levels. After the correction we have seen so far in October, we are bullish about the prospect of China equities in the coming months.

LOCAL PERSPECTIVES: HONG KONG BASED PORTFOLIO MANAGER WITH A GARP BIAS

Unprecedented Policy Announcements

The strength of the policy announcements at the end of September is unprecedented. Not only was the Politburo meeting called at an unconventional time but the tone of the announcements following the meeting was very supportive to capital markets which we have not seen in the past decade. Indeed, in recent years, fiscal policies and other supportive measures have been delivered with caution as authorities seemed to fear that these measures could directly interfere with the capital markets and drive them out of control. This time policymakers not only supported capital markets, but also assured investors that more policies would follow if the latest initiatives were well received by the market.

Policies Designed to Specifically Target Key Issues in China

The latest policy measures undertaken by Beijing address some of the most critical problems in the economy, i.e. housing issues & deteriorated wealth from declining asset prices, etc. While micro-economic improvements will take time, consumer confidence has already shown signs of reversing. In fact, sharp changes in consumer trends can already be witnessed when comparing data before and after the Golden Week holiday which occurred on October 1-7, 2024.

Signs of a Healthy Early-Stage Bull Market:

We expect the Chinese capital markets to gradually improve after the recent policy announcements. Looking at Chinese equity markets, almost all sectors experienced better sentiment and inflows. We believe this broad-based upward trend across sectors to be a sign of a healthy bull market ahead.

Company Fundamentals Will Lead from Here

While the initial market response to stimulus initiatives was a broad rally that benefited stock prices and valuations across all sectors, we believe that company fundamentals will drive the next leg of the market's recovery. We believe it is only rational to be patient and continue to look for signs of improvement through on-the-ground research work.

Positioning as the "Spring Season" Starts

Looking forward, we expect Chinese equity markets to continue climbing, albeit with increased volatility. From a positioning perspective, we continue to pursue a barbell approach focused on a combination of internet and value stocks, which we believe will allow us to weather the current volatile backdrop. As and when the market allows, we expect to increase exposure to stocks in consumer, pharmaceutical, and real estate management industries.

DISCLOSURES

This presentation includes the opinions of ABS Investment Management LLC, shall not constitute investment advice, an offer to sell, or the solicitation of any offer to buy, and should not be relied upon for any investment decisions.

This material contains forward-looking statements about possible future results, based on assumptions and expectations, subject to risks, uncertainties and change at any time. Past returns do not guarantee future results. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction.

The MSCI information is provided "as is", may only be used for internal use, may not be reproduced or re-disseminated in any form, and may not be used as a basis for or a component of any financial instruments or products or indices. MSCI expressly disclaims all warranties, without limitation, with respect to this information. Additional important disclosure information available at www.msci.com.

ABS Investment Management LLC ("ABS") is doing business as "ABS Global Investments". ABS is a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended. Registration with the SEC does not imply any specific skill or acumen. Submission ID: 3967446