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Five key investor questions on China answered

Robert Gilhooly, Senior Emerging Markets Research Economist, and Nick Yeo, Director and Head of Equities, China, Aberdeen Standard Investments.

Active Equities | Economics | China A Share | Long Term | Corona Virus | Thinking Aloud

RISK WARNING
The value of investments, and the income from them, can go down as well as up and you may get back less than the amount invested.

Amid the Covid-19 pandemic, our team considers the relative prospects for China's economic recovery and stock market resurgence.

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Will China experience a 'V-shaped' economic recovery?

We are still at the beginning of an enormous economic and social repair job. Governments worldwide are walking a tightrope between opening their economies quickly enough to support expansion, but not so quickly as to invite fresh waves of infections. But what the pandemic has highlighted is large differences in state capacity to manage this crisis by limiting its scale, before starting recovery. China was first in and first out (FIFO) of this crisis in terms of economic recovery, so it has a shot at a true 'V-shaped' recovery – where the economy returns to its pre-Covid-19 path. Indeed, China's second-quarter GDP numbers were very strong, with activity returning to levels reached in the fourth quarter last year. However, the latest outbreak in Beijing suggests progress may proceed in 'fits and starts', with the re-imposition of containment measures depressing consumption and confidence. Overall, we expect a cautious approach to spending by households, which would weigh on China's recovery and reduce the chances of a full recovery. In addition, amplification of US-China tensions could damage China's long-run growth – pointing to a recovery more akin to a reverse 'J' than a 'V'.

How will markets respond to China not publishing a GDP growth forecast this year?

This is the first year since 1990 that China has not set a GDP growth target. We see it as a practical and welcome response to uncertainties surrounding the growth outlook. Setting a relatively high target may have required much more stimulus than authorities would have been comfortable with, while too low a target may have risked a negative effect on confidence and markets. Moreover, the potential for a large external drag due to weak trade from the US and eurozone would be hard to offset without turbo-charging domestic-facing business. We don't think China will remove its GDP targets permanently, even though we would see that as a positive sign (i.e. quality before quantity). Authorities would have set a 6% GDP target if Covid-19 had not happened, suggesting little appetite for slower growth. How the labour market fares – rather than just GDP – will be a key determinant in how policy evolves. The severity of the global recession was priced in well before damage was visible on the ground. Policy support has since reduced the probability of the worst outcomes, allowing equities in particular to recover quickly. But markets will remain sensitive not only to economic data, but also to the path of the virus and the extent to which containment measures such as social distancing can be relaxed without leading to case numbers rising again.

What factors should investors be mindful of when it comes to China's economic restart?

China looks set to suffer less economic damage from the Covid-19 crisis than most major economies due to its effective countermeasures. Now the government is focused on rebooting its economy, aware that the global economy will take longer to recover. This earlier economic restart gives investors greater clarity on the outlook for Chinese company earnings than for stocks elsewhere. In addition, the customers and supply chains of domestically oriented companies are largely based in China, so the bulk of their revenues and costs are RMB-based. This means they will be relatively more insulated from the effects of the Covid-19 crisis and trade war.

If China suffers renewed contagion, what would the impact be on the A-share market?

All countries are at risk of fresh waves of contagion. But an authoritarian style of government – with its effective policymaking and policy apparatus – enables China to respond quickly and decisively to new outbreaks of Covid-19, making it well-placed relative to other countries. Recent tightening measures in Beijing provide an example of authorities' sensitivity to further outbreaks. Nonetheless, it's too early to conclude that the situation is under control. A full global economic recovery will take a long time, and if this pandemic drags on for a more prolonged period, we would worry about a demand backlash from Europe and the US. From a market perspective, stocks face volatility. But the A-share market has continued to outperform global bourses this year – perhaps an indication of investors' confidence in authorities' handling of this crisis to date. A severe outbreak would likely generate renewed volatility, although China retains the policy tools and room to deploy further support to help the economy through another shock.

Given this year's rise in the A-share market, should investors invest or exercise caution?

Although China's A-share market is among the best-performing bourses globally in 2020, the rally has come off historically cheap valuations. The MSCI China A Onshore Index is trading almost in line with its 10-year average now, yet remains at a 40% discount to the S&P500 Index on a price-to-book basis. So while we are mindful of valuations, we aren't seeing widespread exuberance yet. In reality, the A-share market is inefficient, dominated by retail investors who tend to be influenced more by news headlines than fundamentals. It's what makes this a stock-picker's market as mispricing opportunities are common. We urge investors to scrutinise companies closely and only invest in quality, which we define as a strong balance sheet and consistent, diversified earnings, good standards of governance and an experienced management team with a strong track record. They will be best placed to sustain their earnings over the long term. We believe the best approach is to gain exposure to companies in line to benefit from China's rapidly expanding premium-consuming class. We think higher disposable incomes will continue to spur demand for segments including health-care products, wealth management services and insurance. Meanwhile, structural growth drivers such as the adoption of cloud applications, 5G, digital interconnectivity, e-commerce and artificial intelligence also remain intact. So there are good long-term opportunities.

Full article can be found here:
https://www.aberdeenstandard.com/en/singapore/investor/insights-thinking-aloud/article-page/five-key-investor-questions-on-china-answered

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