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China's Enigmatic Equity Market

By Bo Brownlee, CFA

Equity investors' patience with China is once again being tried as the recent round of regulatory reforms has set off a sharp sell-off. Returns to equity investors have been disappointing since China's stock markets re-opened thirty years ago and investors may feel as though they are experiencing a sense of déjà vu with the latest regulatory tightening cycle. China's rapidly growing economy has failed to translate into superior returns for equity investors and the most recent reset highlights how elusive it has been for investors to participate in the country's explosive growth through its public equity markets.

Disappointing Returns

China's equities have been extremely weak performers of late with the recent bout of underperformance tracing back to late 2020. That was when China's government fired the first salvo in its crackdown aimed at reining in its large technology companies, while also addressing social fairness and data security issues. The cancellation of the Ant IPO at the behest of the Chinese government in November 2020 was the first in a flurry of increased regulations, fines and government-recommended corporate behavior. This "Common Prosperity" initiative broadened to include other industries such as online education and real estate development and has pared roughly $1 trillion in equity value from China's stocks, having fallen more than 18% YTD through August 20 and underperforming the rest of the world by a massive 35.5% over that period (all returns in local terms unless otherwise stated).

Even before the stock market rout of 2021, China's equities had been a disappointment to those wishing to tap into the country's phenomenal growth. The country's continued embrace of free market principles over the last decade facilitated the rise of a dynamic technology sector with a few leaders such as Alibaba and Tencent gaining market and index dominance, mirroring the experience in the US where a handful of giant tech companies have also come to dominate. Even with these phenomenal success stories, the results have trailed the rest of the world. While China's market returned a respectable 7.8%/year over the decade ending 2020, this still lagged the rest of the world's 10.7%/year return by nearly 3%/year.[1]

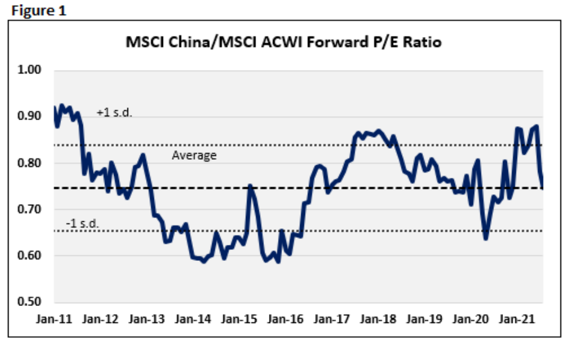
And the underperformance of China's equity market stretches back far longer than just the last decade and is even more spectacular

[1] Index returns for MSCI China and MSCI ACWI ex-China

over the longer haul. For the period in which there are reliable return data (1993), the MSCI China index has underperformed the MSCI All Country World index by 6.6%/year (returns in USD), returning just 2.2%/year. China's 2.2%/year return compares to 8.8%/year for the global index. Perhaps most frustrating, China's GDP grew at a rate of approximately 13.3%/year over this period.

Even before the recent regulatory crackdown when investor interests were more closely aligned with those of the Chinese government, equity investors were left feeling unsatisfied. If these investors were unable to fully share in the rapid growth of the Chinese economy while capital markets were embraced, that task has become even more difficult with the elevation of national interests over those of shareholders.

Figure 1



Sources: MSCI, Bloomberg, SECOR. Data as of 24 Aug 2021.

Figure 2

Sources: MSCI, FTSE Russell, Bloomberg, SECOR. Data as of 24 August 2021.

Cheaper, But Good Value?

China's disappointing market performance inevitably draws the attention of bargain hunters. Although its stocks are significantly cheaper today than they were in November 2020 when the Ant IPO was shelved, it is by no means clear that they represent compelling value. China's stocks sell at a discount to the rest of the world today, but they have typically sold at a discount, in no small part due to the risk of government interference we are witnessing today. The recent pullback in China's equities has only brought their relative valuation back to the average level of the last decade (Figure 1) despite the prospect of further tightening of the regulatory screws.

Furthermore, the discount among China's largest companies (and most vulnerable from a regulatory standpoint) relative to those in the US tells a similar story. Figure 2 above compares the relative Forward Price/Earnings ratio for China's Growth index versus its US counterpart. These Growth indices are more concentrated than each country's broad index with even heavier index weightings to their respective tech giants. The result is much the same however, as the recent drop in China's stocks has only drawn the relative valuation of its fastest growing companies back to near par with those of the US after commanding a large premium just prior to the recent drawdown.

It is worth noting that these valuations are based on analysts' expected earnings which may not yet fully account for the negative impact on earnings from the recent changes in the operating environment, especially for China's largest and fastest growing technology companies at the center of the crackdown.

Other Regulatory Tightening Cycles

Public companies in China have found themselves in the regulatory crosshairs on prior occasions, including a pair of notable instances when its market leaders were targeted. The first such instance targeted Telecommunications companies in 2001. Telecom stocks represented approximately 60% of the MSCI China index weight in the early 2000s, even more than the approximately 50% peak weight today's Internet sector enjoyed before the most recent clampdown. The second instance, which began in 2011, placed Banks in the regulatory sights. Financial stocks had by then taken up the mantle of index leadership, accounting for roughly 40% off the MSCI China index with four banks ranking among the six largest companies at the time.

The common thread in these instances is that as sectors grew into their dominant position the central government required them to assume greater social responsibility, altering their mission from maximizing shareholder value to serving the real economy.[2] For instance, China's telecoms were saddled with building one of the world's most extensive mobile networks, while also cutting fees. Today, these companies have one of the lowest average revenue per user versus global peers along with onerous levels of capital expenditures. Banks were required to make unsound loans to zombie companies that served perceived national interest, resulting in high credit costs and reserve allowances relative to global standards. These once-dominant telecom and financial companies predictably suffered lower margins, decelerating earnings growth, valuation multiple contraction and disappointing returns.

This history of requiring its most successful companies to serve both shareholders and the national interest should not be an insurmountable barrier to attracting capital going forward. China's massive economy, population and rapid economic growth will continue to provide a strong attraction for capital, despite the hurdles. China has the second largest economy in the world with a GDP of $14.7 trillion, nearly 3 times the size of third place Japan. And although growth over the next several years is expected to moderate to around 5%, such growth is still the envy of the developed world, putting China on a path to surpass the US around 2030. It is populated by 1.4 billion people with rapidly growing disposable incomes. Like in the aftermath of past episodes of regulatory tightening, capital will likely continue to flow to China when this wave has crested because of its unique growth opportunity.

Fuzzy Relationship between GDP Growth & Equity Returns

So why has China's strong economic growth failed to translate into strong equity market returns? The country does not appear unique in this circumstance. In fact, the intuitive notion that high GDP growth should lead to superior equity returns has been the subject of a body of research that has found a weak or non-existent leak between the two, while others have shown an even more counterintuitive result where countries that have experienced high economic growth

[2] BofA Global Research, Equity Strategy – China: With Great Power Comes Great Responsibility, 5 August 2021.

have tended to deliver relatively weak equity returns.[3]

There have of course been exceptions to these findings, maybe most notably the case of the US which has provided superior returns along with strong economic growth relative to other developed nations over the trailing decade. But the higher growth emerging market countries, even omitting China, have delivered inferior equity returns with the MSCI Emerging Market ex China index returning 9.3% over the decade ending 20 August 2021 versus 14.5% for the slower growing developed markets captured by the MSCI World index.

Probably the best explanation for the weak link between the economic growth and stock market returns is attributable to differences between the growth of aggregate earnings at the country level that figures in GDP growth and the growth in earnings available to public equity investors that drives equity returns. In countries such as China with a large public sector, stock market industry and sector composition can diverge significantly from the economy at large. While China has opened up to the outside world since the 1990s when it re-opened its stock exchanges, it still remains a relatively closed society in comparison to most of the world and as recent actions have reminded us, protective of key assets that it is reluctant to share with the rest of the world. Additionally, equity returns are influenced by other factors such as interest rates and the multiple that investors assign to the portion of earnings available to them, further muddying the link.

Another related explanation is that globalization has further clouded the link between earnings growth for the economy versus the stock market with many multi-nationals now earning a large share of their total profits outside of the country in which they are domiciled. As a result, parts of the production process for multinationals may not be included in a country's GDP. This potential decoupling probably does not help explain the poor performance of China's stocks relative to its GDP though, particularly as China's stock market has tended to be dominated by companies that have been primarily domestic-focused – first Telecoms, then Financials and most recently Internet-related.

Yet another potential explanation is that investors impound the superior growth outlook for the economy into the prices of the country's stocks.[4] This argument is similar to that explaining the superior long-term performance of low-expectation value stocks versus their high-expectation counterpart growth stocks. A notable historical example of this is the case of the fast-growing Japanese economy of forty years ago and its subsequent stock market torpor over the following couple of decades where equity returns badly trailed the rate of growth in the economy. China's explosive economic growth has certainly been no secret and it is possible that high economic growth expectations there have similarly

[3] Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, 2002, Princeton University Press, Princeton.; Bradford Cornell, Economic Growth and Equity Investing, Financial Analysts Journal, Volume 66, 2010; Jay Ritter, Is Economic Growth Good for Investors, Journal of Applied Corporate Finance, Summer 2012; MSCI Barra, Is There a Link Between GDP Growth and Equity Returns, May 2010.

[4] Jeremy Seigel, Stocks for the Long Run, 1998, Second Edition, McGraw Hill.

fueled overly optimistic valuations by its public equity investors. It is worth noting that China has a very large and very active retail investor base not renowned for its long investment horizon. The high expectations of this impatient investor group have likely contributed to the frustrations in converting China's strong economic growth into equally strong equity returns.

Many Flavors of Capitalism

The Chinese form of capitalism stands in contrast to that in the US where the mission of the corporation is to maximize value for its owners (although this has increasingly been questioned of late). A closer comparison is probably the model employed in much of Europe where corporations are more likely to serve not only shareholders, but also a range of stakeholders, and attempt a delicate balance of the two. While recent equity returns and levels of profitability of the European model have lagged those of the US, notable examples such as Germany, with a long-term track record more comparable to the US in these regards, support the notion that satisfying outcomes can be attained for all constituencies.

The pressure to serve society is even more explicit with China's state-sponsored capitalism and combining capitalism with an authoritarian regime is certainly concerning to Western eyes that witnessed failures of command economies in the Soviet Union and Cuba. Perhaps the closest analog of blending capitalistic and social goals is Singapore, albeit in a democratic state. But even here the returns have been disappointing with MSCI Singapore returning 4.4%/year since 1994, despite GDP growth of 5.8%/year over that period. Its return also trails the return of the global ACWI index by 3.3%/year (returns USD) over that period. Striking the balance between serving shareholders and society is also likely an easier task in a city-state of 6 million people rather than an emerging superpower with a 1.4 billion people, making even this analogy a weak one at best and further highlights how unique a case China represents.

Of course, the less restrained model of capitalism in the US has come with its own undesirable side effects, most notably social fairness issues, many of which are now boiling over and forcing much delayed reckonings. Additionally, a more hawkish Biden administration has signaled its intent to curtail the market power of the US tech giants which has the potential to derail their exceptional stock market performance and by extension the entire US equity market given their dominant positions. The two-party system of the US will likely blunt any potential regulatory impacts in comparison to the situation in China where the goals of the Communist Party can be implemented with little resistance. Whether concrete actions ultimately come to pass, it is hard to ignore that after years of a hands-off approach toward business, the regulatory winds appear to be shifting in the US. Should the US shift to its own version of a more inclusive form of capitalism, this could reduce any relative disadvantage China may face in attracting capital.

Opportunities & Challenges

A potential mitigant in the Chinese government potentially deepening or broadening the recent crackdown is the country's continuing need to attract capital to fuel its economic transformation. Despite huge strides over the past decades, median household income in China is still just $6,200, which is about average globally but well behind the level of countries classified as developed (e.g., US: $43,600, Japan: $33,800).[5] Unleashing the capitalistic spirits of its citizens has been a key driver of the progress that has been made in narrowing gap thereby ensuring its survival, although in a form that will continue to look strange to most Westerners.

With much of the low hanging fruit from economic liberalization, industrialization, favorable demographics, and urbanization having been plucked, the pace of growth will continue to decelerate. Although 5% economic growth would be the envy of most of the world, it is a far cry from the double-digit growth it routinely achieved a decade ago. From its now much larger base, economic growth will inexorably converge with the rest of the world.

Keeping the economic machine humming in coming years will not be without its challenges. As a result of decades of state-enforced fertility limits, China's population growth has moderated and will soon begin to shrink. A shrinking working age population and a surge in the elderly in coming years will divert resources that could otherwise be aimed at productive investment. Its rapidly growing defense budget will also remain hungry for resources and its extended residential real estate market has potential to become a major headache due to its outsized contribution to economic activity.

As economic gains moderate, improvements in productivity will be needed to reach its 5% growth target. This will require continued innovation in information technology, but the recent crackdown that has made life less rewarding for its richest citizens could send a chill through the next generation of innovators who may not be as motivated by the prospect of sharing much of the benefit of their creations with the state.

In its quest for technological supremacy, China's government has signaled its intention to focus on the "harder" areas of technology, such as artificial intelligence, robotics, data security, and biotech, and less on the "softer" areas such as social networking and gaming that they view as societal ills. In ignoring these areas, they run the risk of foregoing potential advances that may be transferrable to the very fields they wish to emphasize.

The continued need for capital and the sharp sell-off in its equity markets have triggered some recent damage control on the part of the central government in an effort to reassure investors. Government officials have recently made statements such as China aims to "strike a balance between… social fairness and competition and promote healthy development of the capital market" and the "Common Prosperity initiative does not mean absolutely equal."[6] Recognizing that they cannot completely alienate potential providers of capital, government actions that demonstrate these words will

[5] Jeremy Seigel, Stocks for the Long Run, 1998, Second Edition, McGraw Hill.

[6] China Vice-Premier Liu-He at SME Forum, 27 July 2021 and Government of Zhejiang Province spokesperson.

Sourced from Morgan Stanley Research, China's Regulatory Reset, 1 August 2021.

go a long way toward reassuring skeptical investors.

Conclusion

China's massive market and remarkable growth story has attracted investors since its stock markets re-opened in 1990, but equity investors have been disappointed by low returns that have failed to match the rapid growth of the underlying economy. The recent crackdown by China's government has surprised equity investors, evidenced by the recent sharp drop in the nation's stocks. Given the history of China's public equity markets, maybe it should not have been so surprising.

The market opportunity remains far too large to ignore and the opportunity set for active equity management should be sizeable as well for the discriminating investor who can successfully evaluate the outsized risks that accompany the outsized opportunity. The economic growth story, if not as compelling as when China re-opened its doors to investors, remains attractive relative to the rest of the world. If the relatively short history of China's stock markets serves as a guide, this robust economic backdrop coupled with embrace of capitalism by the Chinese people should continue to provide a fertile environment for investors to identify the individual companies that are likely to emerge with the potential to deliver superior performance for shareholders.

However, a history that is also filled with instances of shareholders' interests being subordinated to social goals in a one-party authoritarian state calls for caution going forward. The optimistic case hinges on the country's ongoing need to attract capital prompting authorities to balance their social objectives with the need to provide sufficient rewards for shareholders. The country's track record, however, shows little evidence of striking this difficult balance nor do recent events invite optimism. The potent combination of a fast-growing economy and the prospect of tapping into that growth through its most dynamic public companies will no doubt continue its irresistible pull to equity investors. Will they be able to adequately temper their enthusiasm? And will they be allowed to fully enjoy the benefits typically afforded shareholders around the world? I wouldn't bet on it.

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