China Equities 2019: Fundamentals Sound, Sentiment Is Wild Card

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by Andrew Mattock
of Matthews Asia

Amid macro concerns including trade conflicts and fears of slowing growth, Chinese equities were highly volatile in 2018. The declines in equity prices seem to have been driven largely by sentiment. Two decades of investing in China has taught me to look past sentiment and take a closer look at what's happening on the ground. For example, online shopping reached a record high this year during Singles Day, China's version of the U.S. shopping event Black Friday. On November 11, 2018, online sales in China for Singles Day totaled US$42.4 billion, a 27% increase over 2017. Consumer spending patterns, especially in discretionary areas such as electronics, entertainment and clothing, tend to hint at where China's economy is heading.

To get to the real story, we look at the underlying drivers of growth. We also aim to understand the intrinsic value of the businesses we own, as well as those we are considering buying. Long-term value is created by businesses that can weather market turbulence, grow their market share and compound earnings over time. The view on the ground can begin with simple questions: What goods and services are local consumers buying? What stories are being overlooked or misinterpreted by the global media? What opportunities require local research and language skills to capture? What does earnings growth look like for companies we are researching? What companies are generating actual cash flow and genuine profits? By looking at individual businesses from the bottom up, we seek to identify the companies with the most attractive potential for sustainable, durable growth over the long term. Here are some of the trends we are following for 2019.

Consumption broadens to lower tier cities

China is famous for its megacities. Tier one cities, such as Beijing and Shenzhen, have populations of more than 15 million. Tier two cities can range from 3 million to 15 million inhabitants. Things start to become interesting in tier three cities, which can range from 150,000 to 3 million residents. Tier three cities, often satellites to larger cities, are fueling much of the consumption growth in China. For China's businesses, these cities are providing an entirely new base of consumers. Job creation is growing in tier three cities, incomes are going up and consumption is rising. These cities have traditionally been underserved by businesses and represent pent-up demand for everything from dating apps to Indian food restaurants. Entire ecosystems of basic consumer services don't exist yet in these cities, from golf courses to sports bars. And returning to the travel theme, we're starting to see direct flights to Tokyo originating from tier three cities.

Earnings growth still in early stages

Between 2012 and 2016, corporate earnings in China experienced little or no growth. Earnings then ramped up considerably in 2017 and remained sound throughout 2018. In my view the drivers of that growth still have a long way to run. Even if earnings moderate slightly, they are likely to be supported by a healthy economy. This favors companies that can tap into the growing consumer spending that accompanies rising incomes.

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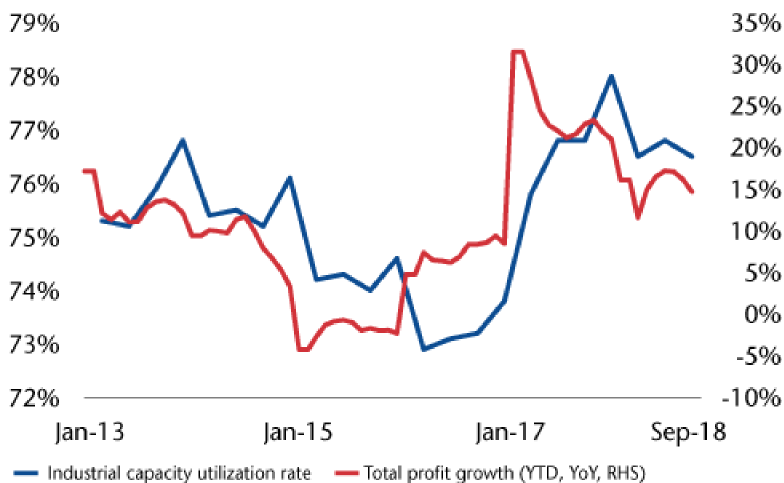
Figure 1. Stock Market Soft, But Corporate Earnings Growth Strong

Industrial profits up up 14.7% YoY in the first nine months of 2018, vs. 22.8% in 2017, 8.4% in 2016 and -1.7% in 2015 during the same period



Source: CEIC

Quality of companies improving

What's interesting about the current market drop is that the quality of companies is much better than it was 10 years ago. Current valuations are near the market lows of 2008, but the quality of the marketplace is much improved, creating a buyer's market for long-term investors. Government micro reforms have fostered a healthier marketplace. For example, policy makers have nurtured the creation of a yield curve, a repo market, a local government bond market, wealth management products and peer-to-peer platforms. Policy makers are serious about cleaning up state-owned enterprises (SOEs), progress is being made to reduce environmental pollution and a recent anti-corruption campaign has been effective. The cumulative effects create a more level playing fields for market pricing. In this environment, developing compelling brands is becoming more important to retaining a competitive edge. We're seeing more sophistication in adapting products to suit different customer segments, from high-end to mass market.

Sentiment remains unsettled

Much of the negative sentiment has to do with uncertainty, particularly around trade conflicts between the U.S. and China. U.S. President Donald Trump's unconventional approach has injected a strong element of unpredictability into geopolitics, making market participants nervous. Markets simply don't like uncertainty. Should a trade resolution emerge, however, equity prices could quickly rebound. And even in the absence of a trade agreement, any pick up in earnings growth could nudge investors off the sidelines and back into the market.

Beyond investors' worries over tariffs, there are other risks to consider. A sharp decline in property prices, for example, could impact consumer sentiment and spending. To date, we've seen fairly prudent lending practices for mortgages, due to active government oversight of the mortgage sector. Mortgages in China typically require a much higher cash down payment than in the U.S. For example, when buying a vacation property or second home, a borrower may need as much as a 60% cash down payment. This is in sharp contrast to the U.S. where subprime lending played a major role in the 2008 financial crisis.

Taking the long view

Looking ahead, it can be helpful to distinguish between internal and external factors impacting China's economy. The internal factors are the micro-reforms, as well as the government's fiscal and monetary policy. The external factors are tariffs and investor sentiment. As China's economy is driven by consumption and not exports, the internal factors are much more important. China is largely in control of its own destiny, and that should cheer investors who have a long-term view. Should China's GDP growth slow below the government's target range, I expect policymakers to employ stimulus. Unlike the much of the rest of the world, China never experienced quantitative easing and isn't experiencing the lingering headache that occurs when you try to wean the markets from historically low interest rates.

What we've learned from past overreactions in equity prices is to stay more balanced and take the long view. Consumption is expanding to lower-tier cities, as China's middle class continues to grow and flex its spending muscles. The earnings

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rebound still has a long runway. And China's government has stimulus power it can tap. My optimism about the long-term growth potential of Chinese equities is based on my time horizon. China is likely to remain a major driver of global economic growth long after current trade skirmishes have come and gone.

Andrew Mattock, CFA
Portfolio Manager
Matthews Asia

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