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Tyler Mordy,
President & CIO

@TylerMordy

ASK TYLER

INVESTOR MISTAKES: MISREADING CHINA

China's stock market is soaring this year (the CSI 300 is up nearly 40%). Is it too late to buy?

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Italian film actress and singer Sophia Loren once famously said that "mistakes are the dues one pays for a full life." In the world of investing, as in life, the trick is not to repeat the same ones twice. Yet investors seem to make similar missteps with disheartening regularity. Even the well-staffed professional portfolio manager labors under a long list of occupational hazards: the vice-like grip group think effortlessly secures on the collective conscience, the itchy trigger finger, and, of course, the seductive lure of linear extrapolation.

Where may these mistakes be occurring today? Look no further than China. The bulls (if we may speak for the handful of them still holding their day jobs) are almost extinct. Bear sightings are far more frequent, making regular appearances in Western media.

But after a grizzly last year, Chinese stocks have soared in 2019. What gives? The collective sigh amongst China doomsters is almost audible. It is certain to be yet another episode of speculative activity lacking any observable fundamental drivers, they are saying. A deep correction awaits.

Actually, history would be on their side. A quick look back at China's stock market history supplies excellent material for the thriller section of your local bookstore. The most recent boom-bust episode ending in mid-2015 saw a rapid 150% rise in the local index, only to be short circuited by clumsy policy intervention (involving widespread stock suspensions and state-owned purchases). Hardly a comforting view.

We get it. China comes with risks. But leaning on historical precedents when powerful secular changes are underway rarely serves investors well. Chronic "China crash" false alarms have diverted attention from the ongoing positive transformation occurring in what will soon be the world's largest economy. The most important facts about China today are not past problems of slowing growth, heavy-handed intervention and rising leverage. Rather they are the shift away from exports and capital spending to consumer-led growth, improving margins and financial liberalization. These developments take time.

Over the medium term, the outlook is encouraging. The onset of policy easing was largely ignored in 2018, overshadowed by a tit-for-tat trade tussle with the US. Yet the impact of widespread reflation (cuts in the reserve requirement in April 2018, followed by fiscal stimulus and easing credit policies over the past several months) is now firmly showing up in the data. Chinese GDP expanded by 6.4% in the first quarter and high-frequency macro variables are improving across the board, ranging from investment and production to retail sales and exports. So much for 2018's panic and predictions of a pronounced downturn.

But while growth momentum has been triggered by policy easing, the economy is likely to develop a virtuous cycle of improving business confidence, private sector investment and, ultimately, higher corporate profits. Policy reflation will evolve into a more sustainable earnings-driven theme.

Investors do not have to pay up for this growth either. Equity valuations of both onshore and offshore Chinese stocks remain near the lower range of historical norms. Bank stocks are deep value plays. And, contrary to the feverish sentiment and high valuations reached in 2015, margin debt, transaction volumes and investor positioning all remain relatively muted.

Of course, risks still remain. In recent years, Chinese policymakers have oscillated between managing cyclical growth and longer-running structural issues. The deleveraging campaign that started in 2016 created a larger-than-expected slowdown (and, contrary to consensus views, was more important in reducing growth than trade wars). Current policy reflation is a direct response to the credit crunch caused by these initiatives.

But these policy flip-flops create higher macroeconomic volatility and increase the risk of a big policy mistake. If growth accelerates too much this year, Beijing could return to tightening just as quickly as reflation occurred.

Yet hard lessons have been learned. Policymakers undoubtedly feel the hand of recent history and, at the very least, have a better grasp of a simple concept: most policy tools are blunt instruments. So-called “targeted measures” rarely work as intended … in China or other countries. More encouragingly, it cannot be ignored that China still runs relatively traditional monetary policy. While advanced economies like the US and the Eurozone have long been experimenting with gateway policy drugs like quantitative easing and its freakish offshoots, China remains solidly conventional. What’s more, by not pushing the bounds of monetary policy and blowing out their central bank balance sheet, China has a far greater ability than most Western countries to stimulate in the event of a downturn. This remains their ace in the hole.

INVESTMENT IMPLICATIONS

Adding it all up, a rapid Chinese rebound similar to 2016 is unlikely. Rather, the outlook is one of stabilizing growth. But that will be enough to steady a faltering global growth narrative. Why? Simply because China’s calculus has changed. Growth of roughly 6% on a USD $14 trillion dollar economy contributes far more to global GDP than two decades ago when it was growing at 10% on USD $1 trillion.

And markets are made at the margin. China’s stability will be positive for their domestic equity market. But it also reduces risk for global equities, especially in the Eurozone which were hit hard by last year’s contraction in global trade given its heavy trade linkages with Asia. Investors should expect positive surprises this year and initiate long positions in Eurozone stocks (which remain the “most hated in” the world according to Bank of America’s latest fund manager survey — we are happy to take the other side of that trade).

Looking out further, the ascent of China as an independent economic center of gravity is a boon for investors. With diverging economic trajectories and monetary policies (especially from the United States which, in the post-war period, has functioned as the de facto leader of world order and economic stability), macro trends in China are highly diversifying. Chinese assets reflect this showing low correlation to rest-of-world stocks and bonds.

In recent years, however, there has been limited urgency to diversify geographically, especially for those overweight US assets (read: almost everyone). But as China’s market opens and becomes more accessible — in part facilitated by the development of China-focused ETFs — these diversification benefits become more important.

Yet Chinese assets remain deeply underweight amongst global asset allocators. But consider where the smart money is heading. Canada’s Pension Plan Investment Board (arguably Canada’s most well-resourced fund) plans to more than double the proportion of assets it allocates to China in the next seven years (from about 8% of its assets to 20% by 2025). Keep your mistakes small and don’t miss this trend.