China markets rally

Investment event | 2 October 2024

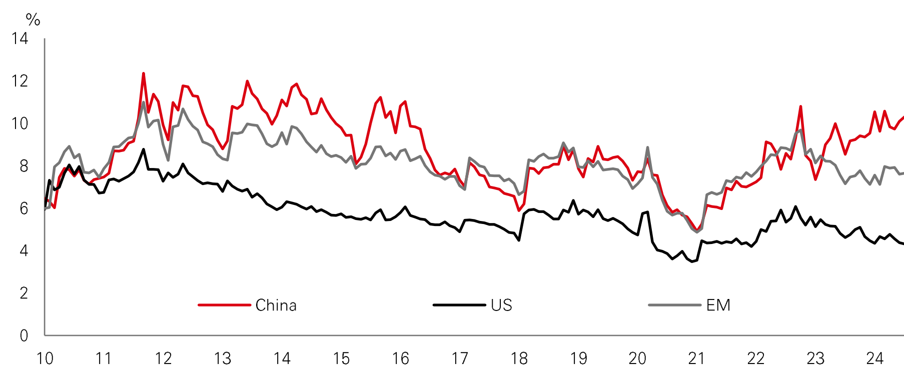
Following last week's announcement of a comprehensive set of stimulus measures, markets in China have responded with a significant rally. Stock markets such as the Shanghai Composite index have gained over 20% since the policy measures were unveiled, resulting in September being one of the best months since the 2015 surge in investor enthusiasm (Figure 1).

Figure 1: Monthly performance of Shanghai Composite index

Source: Bloomberg, as of 01 October 2024. Past performance does not predict future returns.

These gains are impressive. Even so, the starting point was one of consistent underperformance of China stocks versus other emerging and developed market counterparts. For a while now, investor sentiment towards China has been damaged by a disappointing economic recovery following the pandemic reopening and government efforts to rebalance the economy, impacting the crucial property sector. Some global investors perceived policy efforts over the past year as piecemeal and reactive. This left China stocks trading at a significant discount versus other markets (Figure 2), providing room for a dramatic market move on better-than-expected news.

Figure 2: China, EM, and US 12-month forward earnings yield



Source: Bloomberg, Macrobond as of 01 October 2024. The level of yield is not guaranteed and may rise or fall in the future.

Clearly something has changed over the past week. The latest stimulus measures are significantly more forceful than previous government support, and importantly China's authorities have signalled more is to come, especially on the fiscal front. As we highlighted in our recent Investment Event (*China unveils stimulus package)*, further fiscal stimulus will be a crucial component in a sustainable economic recovery, and by implication for risky asset markets.

What next for China markets?

The recent rally is of historic proportions, implying some caution is warranted in the near-term. And there is still major uncertainty over the impact of recent stimulus measures in the context of structural headwinds (poor demographics, the multi-polar world, and significant overcapacity). Arguably, the property market slowdown and pockets of weakness in the labour market means the country's consumers are stuck in a "confidence trap" which requires even more forceful stimulus to overcome.

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Our view:

We reiterate our positive view on emerging markets, with a preference for Asia stocks and credits, and local-currency EM debt

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Some investors have also been concerned about tighter regulations – especially in the tech sector – which could impact the outlook for corporate profits.

But with the government showing more willingness to reflate the economy, and the global economy likely heading for a soft landing, we think there is now scope for a stabilisation in investor perceptions around China's economic outlook. That means if the so called "policy put" is back, the stock market outlook has improved.

As with other emerging markets, policy rate cuts by the US Federal Reserve provide extra room for the PBoC to ease policy without triggering currency instability.

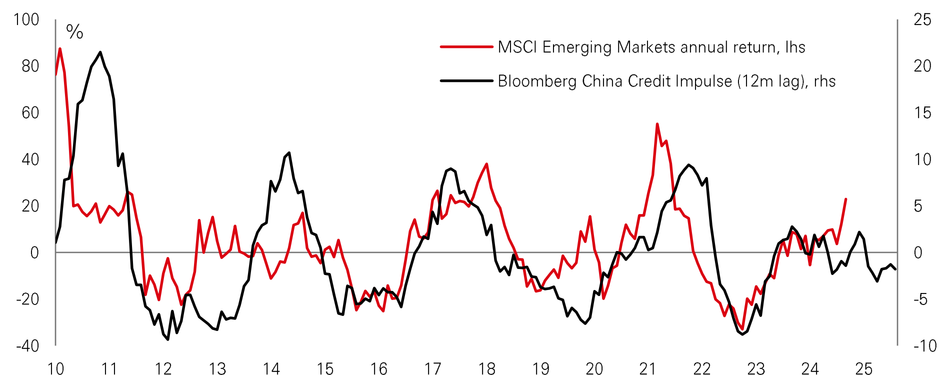
And what about global markets?

Interestingly, the spillover to global markets from the recent events in China has been broadly muted. The MSCI ex China index is up just 1% since the stimulus announcement, the MSCI ASEAN index is down, while the S&P 500 has been broadly flat.

Going forward, we think the possibility of a turnaround in China's economic fortunes would bode well for many Asian trading partners as well as markets in Europe that are dependent on Chinese consumer demand. Major EM commodity exporters – particularly in the industrial metals complex - would also clearly benefit from a pickup in China's construction activity.

Traditionally, an upturn in China's credit impulse - which measures the change in new credit or bank lending as a percentage of GDP – can be seen as a leading indicator of emerging market stock performance (Figure 3). For us, this contributes to a positive view on emerging market equities alongside other potential tailwinds to EM asset performance such as a weaker US dollar, reasonable valuations, and an EM-DM GDP growth premium.

Figure 3: MSCI EM and China credit impulse



Source: Bloomberg, Macrobond as of 01 October 2024. Past performance does not predict future returns.

Key takeaways

Recent China stock market action marks an impressive revival of fortunes. And we think there is still scope for gains over the medium-term as the country's economic outlook stabilises amid still reasonable valuations. Nevertheless, on the cyclical front, further policy stimulus and a global economic soft landing are likely to be required to unlock further value in the country's equity markets. And structural reforms aimed at rebalancing the economy and addressing demographic challenges remain necessary conditions to achieve high-quality and sustainable growth.

For China's bond markets, PBoC policy easing amid still subdued inflation provides room for a further move lower in yields, having already fallen a long way amid concerns over deflation (Figure 4). But a stronger economy would pose obvious challenges, reflected in the recent pickup in yields.

Figure 4: China 10-year government bond yields

Source: Bloomberg as of 01 October 2024. The level of yield is not guaranteed and may rise or fall in the future.

Overall, recent developments in China back up our view that global market performance will continue the "broadening out" trend established in Q3, reducing US tech dominance. We reiterate our positive view on emerging markets, with a preference for Asia stocks and credits, and local-currency EM debt.

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