Global Asset Management

Why GDP doesn't drive Chinese equity returns

The RBC Asian Equity team

China's growth rate is likely to slow in 2022 and come in 0.5%[1] behind the target figure of 5.5%, as Covid outbreaks continue to restrict society and disrupt the economic recovery.

Media headlines and forecasters have been quick to highlight that the Q4 2021 growth figure – 4% year-on-year – marks the slowest pace of expansion in 18 months. Should this be a worry for equity investors? We think not.

Why GDP doesn't drive equities

History has shown that GDP growth rates have little correlation to stock market performance over the longer term and we believe market dynamics are moving in a positive direction for stock market investing. The huge depth of the Chinese equity market means that irrespective of the macroeconomic overlay, there are significant bottom-up investment opportunities, while the globalised investor base, together with market reforms, could provide a boost to top-down returns.

Careful stock selection and carrying out in-depth due diligence are key to navigating this vast market, where headline growth figures reflect little of the expansive opportunity set.

Chinese equity performance drivers

1. An opportunity set too big to ignore
2. Private entrepreneurs are driving the economy's long-term direction
3. Market accessibility is improving
4. Increasing ESG accountability
5. Strong asset diversification

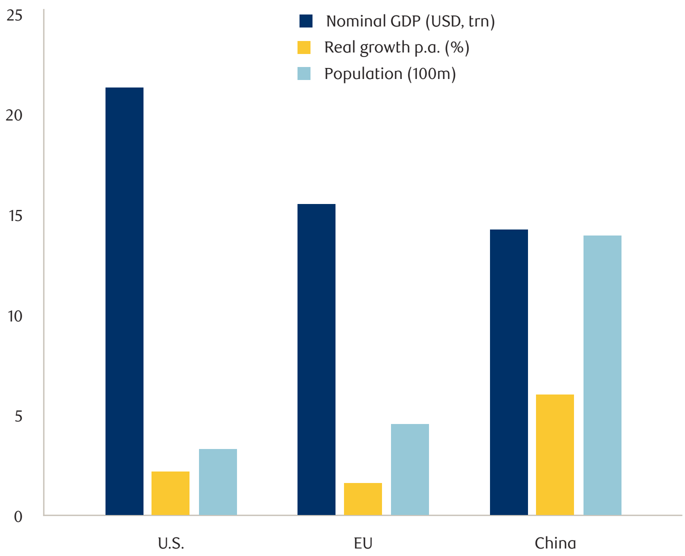
Five performance drivers for Chinese equity investing

1. An opportunity set too big to ignore

China is the world's second-largest economy at two-thirds the size of the US-based on GDP, with over four times the population (see Fig 1). The universe of listed companies is also almost as large as that of the US. China's equity market gives investors access to an immense opportunity set with depth and liquidity, but benchmark weightings leave investors under-exposed. Irrespective of future growth rates, China currently accounts for 18% of global GDP, 15% of the listed market capitalization globally but only 4% of the float-cap weighted MSCI ACWI index[3].

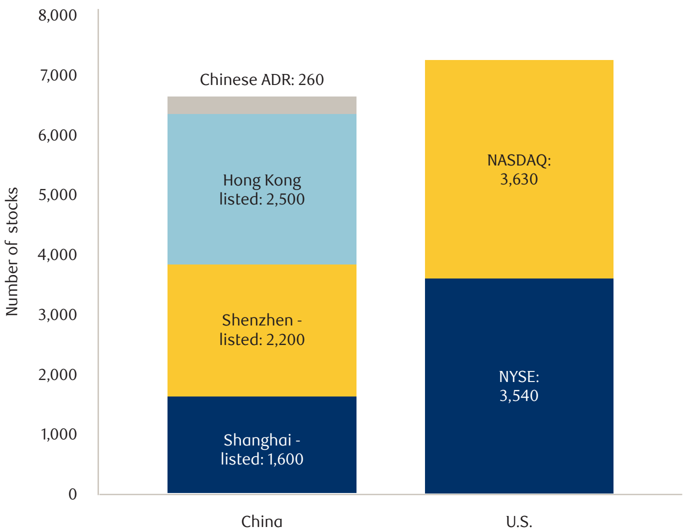
1 Reuters, April 2022.
2 Statista, May 2022.
3 FactSet, MSCI, IMF, World Bank, WFE, Goldman Sachs Global Investment Research, October 2021.

Fig. 1: China % of world, 2021 estimates



Source: World Bank, WIND, 20 October 2021. 2019 shown as latest figures.

Fig. 2: Number of listed companies in China vs. US



Source: RBC Global Asset Management, Wind, ADVFN.com, NYSE, January 2021.
Note: US-listed stocks included Chinese ADRs.

2. Private entrepreneurs are driving the economy's long-term direction

Historically, Chinese equity indices tended to be heavily skewed towards state-owned enterprises (SOEs). These typically have lower returns and less dynamic growth profiles than their privately-owned peers. The return-on-investment gap between SOEs and private companies widened from 4.5% in 2010 to 6% in 2019[4], suggesting private companies continue to gain a competitive advantage over their less dynamic state peers.

The performance divide is starting to be reflected in equity index composition. In 2020, five of the top 10 MSCI China Index constituents were private companies, compared with all 10 being SOEs in 2008[5].

More recently, private company regulation has become a key topic for investors, with high-profile reforms hitting the real estate sector particularly hard, alongside technology and education names. However, we don't see these changes having a sustained impact on equity performance.

The government is pro-growth and the Chinese economy is well diversified, with less reliance on exports to the West than many other leading economies. Given the breadth of the market, plentiful opportunities remain for quality stock-picking, irrespective of regulatory changes in individual industries.

3. Market accessibility is improving

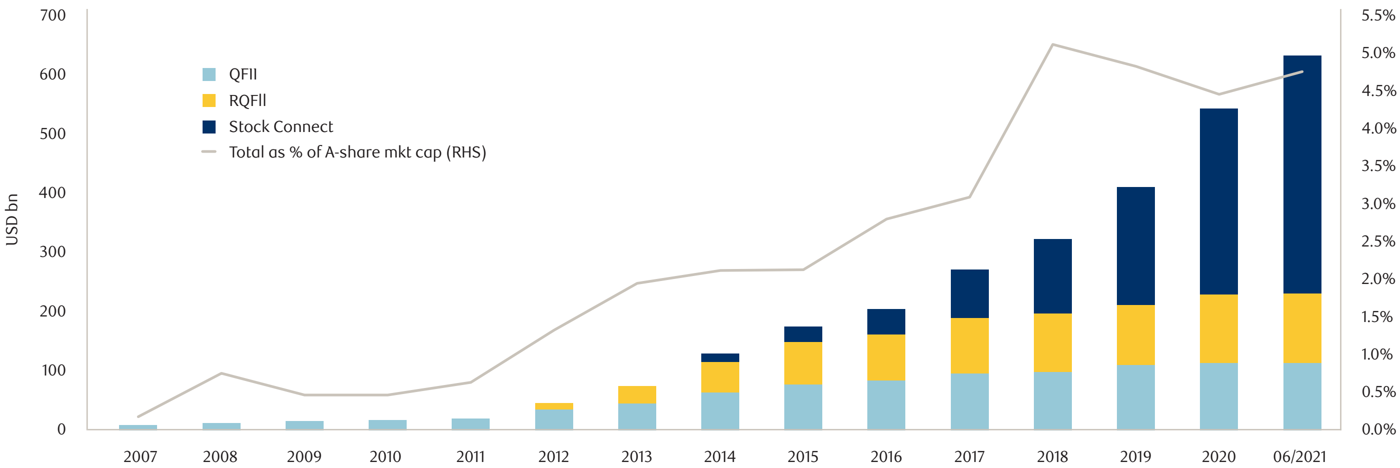
In the past, investors were concerned about finding good investments in China because the market wasn't considered 'open'. Company disclosures were often insufficient and governance was an issue. There are signs, however, that companies are becoming more transparent and focused on investor returns. The aggregate dividend payout ratio has been gradually increasing over the past five years and company buybacks are also on the rise, particularly in the private sector.

A closed capital account and lack of fungibility have historically been issues when investing in Chinese onshore equities. Before 2009, few foreign funds held the so-called 'Qualified Foreign Institutional Investors' (QFII) licence, which allowed them to access the Chinese onshore market (A-shares).

In 2012 and 2014, two schemes were introduced to allow better access to the onshore market – RQFII and Stock Connect. In 2020, the Chinese central bank completely removed the cap on foreign ownership through QFII in the onshore market, further increasing market accessibility. While still relatively small, the proportion of foreign participation in the onshore market has been growing at a fast pace (see Fig 3).

4 Bloomberg, UBS, March 2020. ROE of Chinese SOE in CSI 300 tallies to 8% (including financials) while private sector ROE is around 14%.
5 MSCI, 2021

Fig. 3: Development of foreign access schemes to A-shares & foreign holdings % of A-share market cap



Source: WIND, UBS, 30 June 2021.

4. Increasing ESG accountability

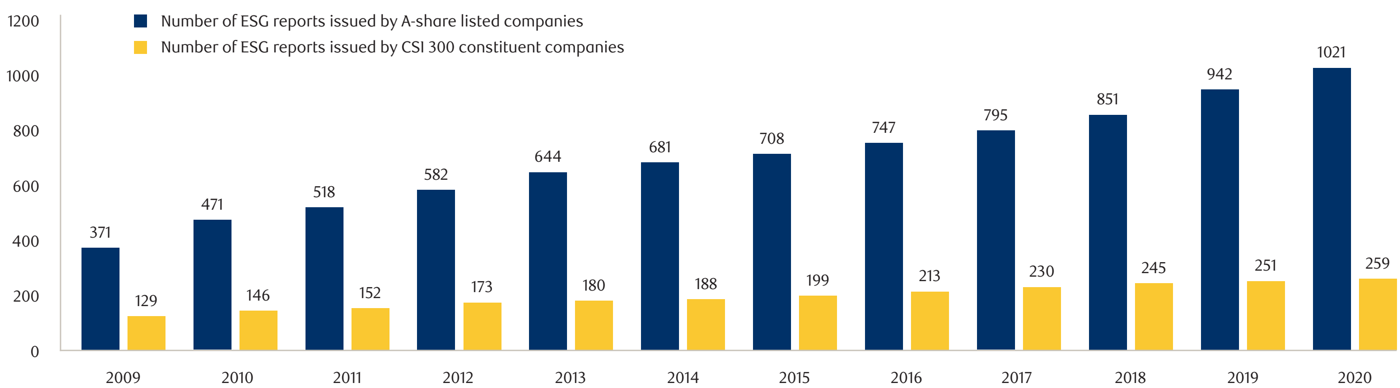
As the market becomes more internationally accessible, so the spotlight on ESG accountability intensifies. Foreign investors are pressuring Chinese companies to improve their oversight practices. While the overall ESG profile of Chinese companies currently substantially lags Western standards, it has improved and we believe that the influence of foreign investors is sparking green shoots in China.

The Hong Kong Stock Exchange made an early move in early 2020 when it required all listed companies to outline their boards' consideration of ESG risks and how they determine which ESG matters are material to the business. This saw the number of annual ESG reports published by A-share companies jump from 371 in 2009 to 1,021 by mid-2020[6].

As of January 2022, the Shanghai Stock Exchange required all 'STAR' market companies (China's version of the NASDAQ) to disclose ESG information in their annual reports. More broadly, Shanghai index constituents are being pushed to disclose their sustainable development plans and demonstrate how they align with China's '30-60' decarbonisation goals. We believe greater ESG awareness and accountability is a long-term positive trend for investors, society and the planet alike.

6 World Economic Forum, March 2021.

Fig. 4: ESG disclosure on the rise



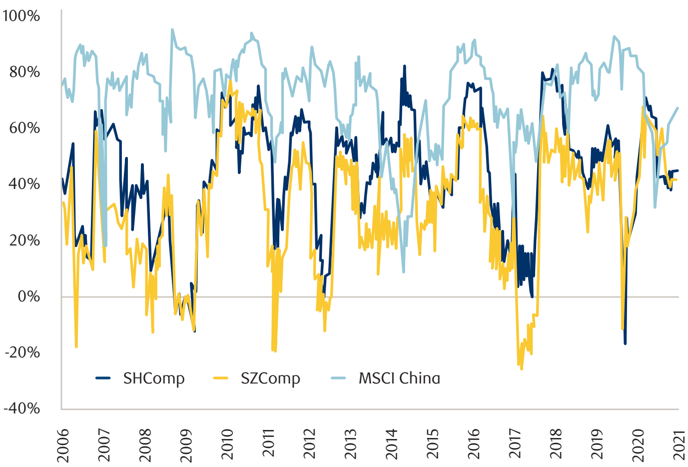
Source: Haymarket Media, April 2021.

5. Strong asset diversification

Among major markets, onshore Chinese equities have the lowest correlation with global equities. Even during the Covid-fuelled March 2020 sell-off, when many global equity market correlations increased above 90%, China A-Share correlation remained significantly lower at 56%[7].

We believe that being less correlated with other equity markets makes Chinese equities an attractive diversification tool for global asset allocators.

Fig. 5: Chinese equity indexes vs. MSCI World (26 weeks)



Source: Bloomberg, DataStream, Wind, UBS, RBC Global Asset Management, 30 June 2021.

Getting invested

While the debate remains lively regarding China's future and what its economy may look like in years to come, we can see clear trends that inform our positive view on the trajectory of Chinese equities. Foreign investors are underrepresented, yet China has a large economy and an even larger population that has a lower dependence on the global economy than many other regions.

We believe investors seeking diversification and idiosyncratic alpha would be well placed to consider increasing their exposure to Chinese equities, monitoring the development of financial market deregulation and index inclusion factors.

When considering investment risk factors, volatility in the Chinese market should not be overlooked, but it can be managed. We believe addressing it pre-emptively by investing via an active manager equipped with a strong stock-picking track record and disciplined risk management approach is the best way to cut through the noise.

We think investors should look for longer-term consistency in alpha sources, a performance history of excess returns in both up and down markets, plus in-house expertise for ESG and due diligence in order to maximise the China equity opportunity set.

7 MSCI.

Author

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