INTERNATIONAL >

Is China Investable?

November 20, 2023 • Jeffrey Kleintop

Reasons prompting concern around investing in China may be improving, but volatility is likely to remain characteristic of Chinese stocks in 2024.

The three primary concerns investors have had about China for most of 2023 are:

- Companies pulling out of China to "de-risk" their supply chains, which may act as a drag on long-term growth and innovation and result in increasing isolation.

- After years of disappointing growth tied to COVID lockdowns, China's government may not have been aggressive enough in implementing stimulus after reopening this year to offset the drag from collapsing property developers, lengthening the outlook for below target economic growth.

- China's strategic confrontation with the U.S. could veer from economic competition into actual conflict.

As a result, China's stocks have been among the world's worst performers in 2023, with a year-to-date loss of 9% for the MSCI China Index. That could change in 2024.

Better November

Chinese stocks have perked up in November, making modest gains off the October low for the year in the MSCI China Index, after three important developments helped ease the worries among investors:

- First, shortly after shuttering its Jeep plant in the country, Stellantis announced in a press release a $1.1 billion deal for a stake in China's Leapmotor. This was one of two recent deals between legacy auto giants and Chinese electric vehicle companies that may be prompting investors to reconsider the investment prospects for China's businesses.

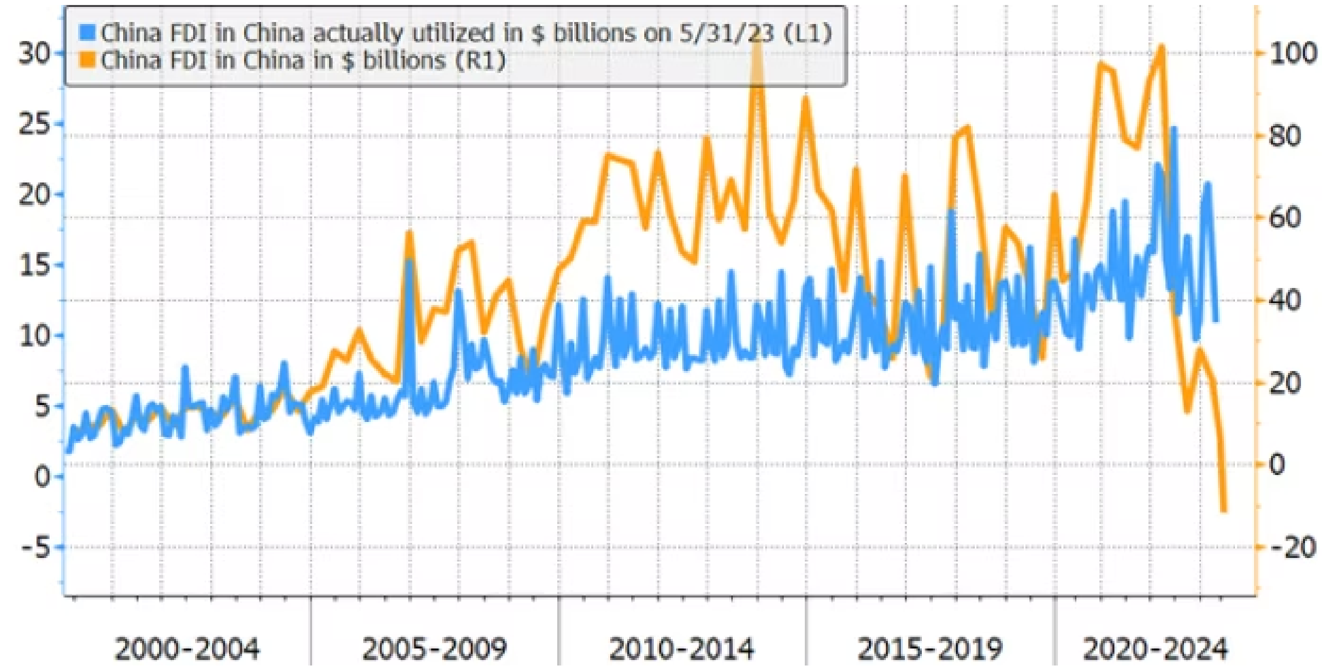
- Second, the announcement of a new major fiscal stimulus package in late October has, after months of smaller tweaks to policy, signaled a more pro-growth policy stance by China's government.

- Third, U.S. President Biden met Chinese leader Xi on November 15, after a summer of meetings among high level officials, indicating the downward spiral in U.S.-China relations is at least on hold.

Corporate investment in China

The popular notion that western businesses have been pulling back on their operations in China in 2023 seems mistaken, after taking a deeper look. Foreign direct investment (FDI) into China has collapsed to a two-decade low, as measured by the balance of payments data depicted in the chart below by the orange line. This broad measure of FDI includes not just investment in plants and equipment but also foreign firms' retained earnings (profits that are kept in China). It is calculated on a net basis, meaning that any repatriation of earnings by foreign firms out of China to their home countries will lower this measure of China's FDI. Fortunately, China's Ministry of Commerce publishes a separate measure of FDI that excludes retained earnings, focusing only on investment by foreign businesses utilized in production, shown as the blue line in the chart below.

Western business investment in China: two stories



Source: Charles Schwab, China's Ministry of Commerce, State Administration of Foreign Exchange of China, Bloomberg data as of 11/15/2023.

It is tempting to attribute the plunge in the orange line to "de-globalization" or "de-risking" and extrapolate the trend with very negative implications for China's growth and innovation. But we believe the real reason is that foreign firms opted to keep an increasing portion of their retained earnings within China until the second quarter of last year when yields in the U.S. rose above those in China. Companies have been taking more of their cash earned in China and moving it outside of China, where yields are more attractive. So, rather than companies pulling operations out of China, the data is reflecting this move of retained earnings and reveals that utilized FDI in China is growing in line with its pre-pandemic trend. The data shows that businesses continue to view China as investable.

Economic stimulus

Signs are emerging that China's government is finally beginning to invest more in its economy—and that it's needed.

China's property market remains a drag on consumers (as we discussed in China: Contagion or Contained?). Last week's Single's Day, the world's biggest shopping day, as well as earnings reports by internet giants Alibaba, JD.com, and Tencent revealed only modest growth in consumer spending in China.

na's consumer confidence remains near multi-decade lows

Source: Charles Schwab, Macrobond, China Economic Monitoring & Analysis Center (CEMAC) as of 11/15/2023.

The October reading for China's Manufacturing Purchasing Managers' Index slipped just below 50, the threshold between growth and contraction. The weakness was mainly driven by the eight-day Golden Week holiday at the beginning of October, which bolstered travel and tourism activity, and the services index, but disrupted factory production.

After sticking to conservative and targeted policy adjustments this year even as economic growth was disappointing, China appears to have changed course. On October 24, the Standing Committee of the National People's Congress (NPC) approved issuance of an additional one trillion RMB (0.8% of GDP) in central government bonds to fund infrastructure projects, with about half to be spent this quarter. The infrastructure spending is intended help offset the weak housing construction and support heavy industry. Importantly, the spending will be done at the central government level, rather than forcing local governments to shoulder more spending that they can't afford and suggests the government could continue with more expansionary policy into 2024.

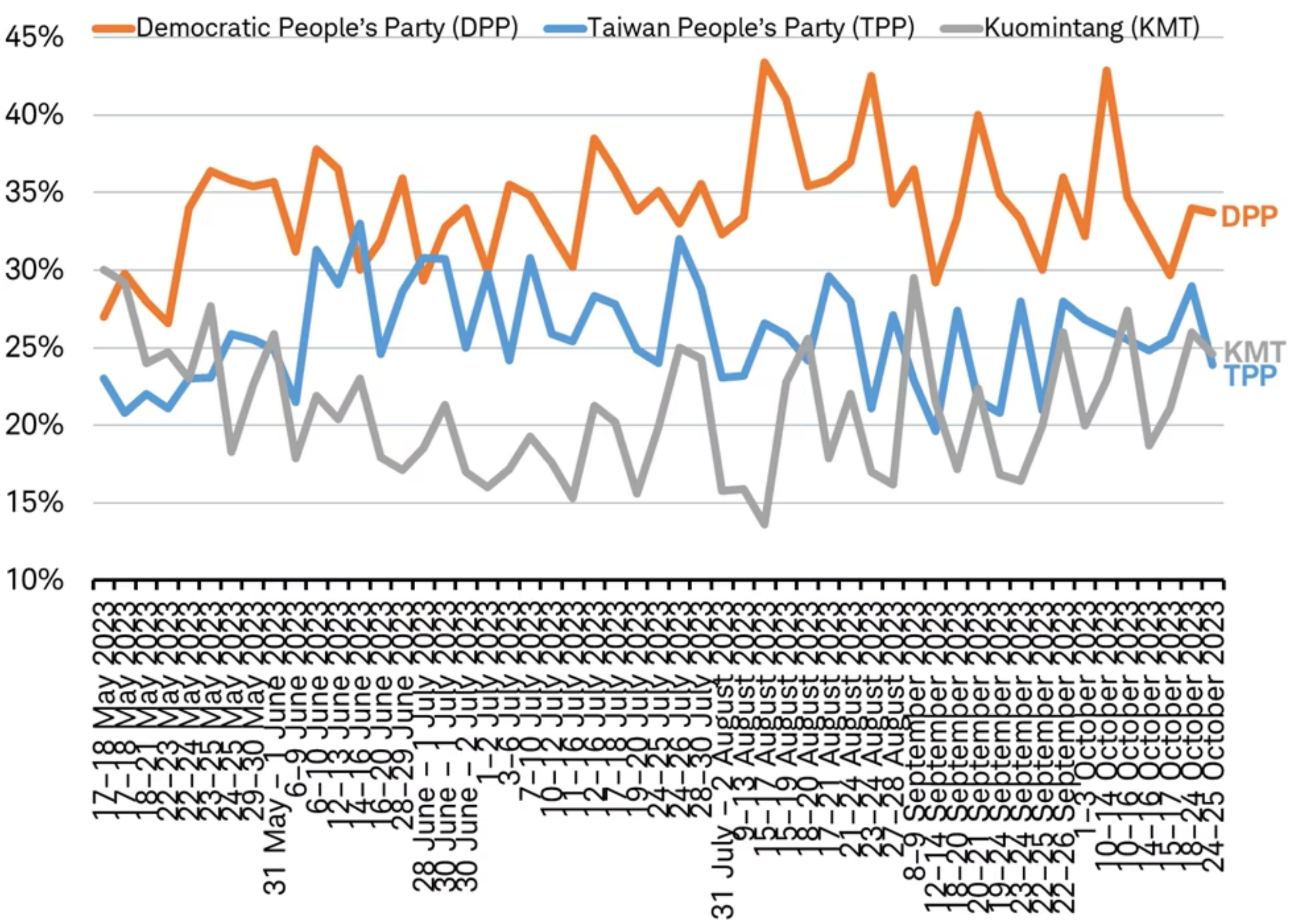
Biden-Xi meeting

Last year's visit to Taiwan by Speaker Pelosi, which resulted in China cutting off communication between China and U.S. military leaders, and the late January incursion of a Chinese balloon into U.S. airspace, which caused U.S. Secretary of State Blinken to cancel a planned visit to China, led to a freeze of basically all working-level contacts between the two governments. But, more recently, the two countries have been investing in their relationship.

This investment took the form of high-level meetings between officials of the two countries this summer, leading up to a face-to-face meeting between Presidents Biden and Xi last week. The recent resumption of functional, even if not friendly, U.S.-China contacts has helped alleviate some of the near-term geopolitical worries heading into 2024, a year with elections in Taiwan in January and the U.S. in November.

Perhaps more likely to lower U.S.-China tensions in 2024 was last week's decision by Taiwan's two main opposition parties, the pro-China Kuomintang (KMT) and the Taiwan People's Party (TPP), to run on a combined ticket. While the situation is fluid and such a combination might not happen, together the KMT+TPP would likely defeat the ruling pro-independence Democratic People's Party (DPP) in the presidential election on January 13, based on recent polling shown in the chart below. Such an outcome could lead to a significant relaxation of Taiwan's posture towards China since both opposition parties are friendlier towards China than the ruling DPP.

Taiwan 2024 election polling



Source: Charles Schwab, various polling agencies as of 11/17/2023.

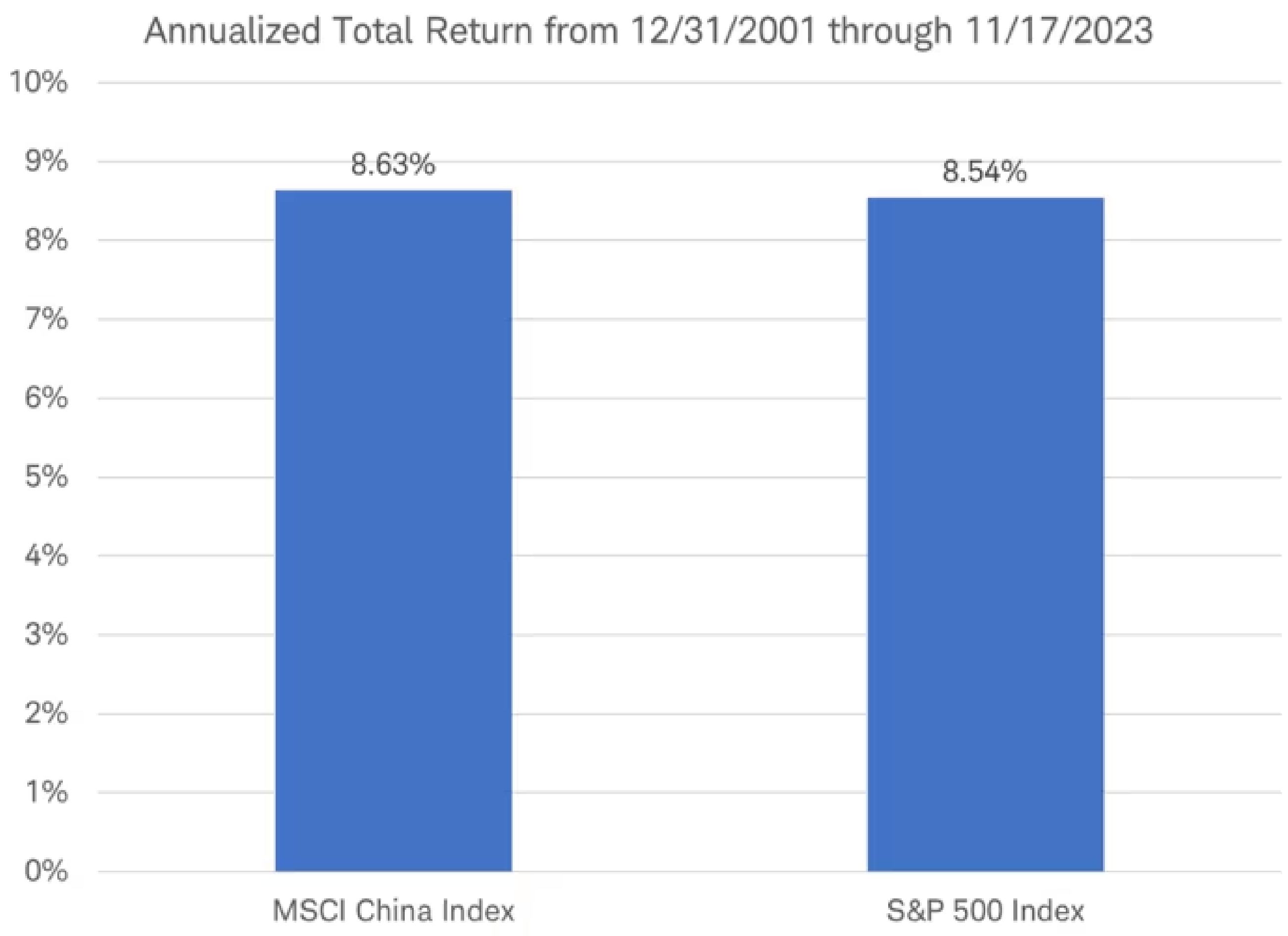
Results of various polls over past 6 months conducted by: Formosa, TBVS, TPOF, MirrorMedia, ETtoday, RW News, SETN, udn, CMMedia, Kpoint Survey and Research, QuickseeK, ACEL, Z.media, Newtalk, BCC-Gallup, C News, NCPF, Fount Media.

Investable?

This year, investors may have feared that China was becoming un-investable. Exchange traded fund (ETF) flow data from Blackrock shows U.S. investors have pulled back on their investment in Chinese stocks following this year's performance slump. But at the same time, Western businesses have continued to invest in their China operations, Chinese policymakers have invested more in China's economic growth, and the Biden administration has invested in its relationship with China's leadership.

China emerged more fully on to the world's stage when the country entered the World Trade Organization in 2001. From the end of 2001 through the end of last week, the MSCI China Index has slightly exceeded the 8.5% annualized total return for the S&P 500®. But over those 22 years, China's stock market has been notorious for providing its gains in short surges of strong performance, amid longer stretches of underperformance that can give rise to concerns over investability. An example of this was during the three-month period from the end of October 2022 to January 27 of this year, when the MSCI China Index jumped by 59.5%. This makes attempting to time the investability of China's stock market very difficult, as well as timing investment in overall emerging market (EM) stocks since 30% of EM exposure is in China.

Long-term China and U.S. stock market total returns



Source: Charles Schwab, MSCI, Bloomberg data as of 11/17/2023.

Indexes are unmanaged, do not incur management fees, costs and expenses, and cannot be invested in directly. **Past performance is no guarantee of future success.**

China may have a brighter outlook for 2024 should investability concerns ease, domestic growth stabilizes, and export growth improve as the global manufacturing recession slowly recovers. These drivers may combine to lift corporate profits and the price-to-earnings ratio of the MSCI China Index which is in line with its 20-year low at nine times forward earnings estimates. Some investors may even reevaluate and jump back into China's stock market. But a brighter outlook does not mean China's stocks will deliver steady gains in 2024 with China's historical volatility likely to combine with 2024's unique challenges to make for a bumpy ride.

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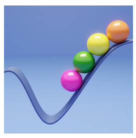

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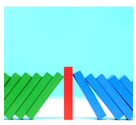

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The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs) and covers about 85% of this China equity universe.

The China Consumer confidence index is based on a survey of adult individuals from 20 cities all over the country, covering both the consumers' degree of satisfaction about the current economic situation and expectations on the future economic trend. The Index measures consumer confidence on a scale of 0 to 200, where 200 indicate extreme optimism, 0 extreme pessimism and 100 neutrality.

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