Is China’s rebound for real?

Goldman Sachs Exchanges

Kinger Lau, Chief China Equity Strategy, Goldman Sachs Research

Hui Shan, Chief China Economist, Goldman Sachs Research

Allison Nathan, Senior Strategist, Goldman Sachs Research

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Allison Nathan: After better-than-expected economic data kicking off the year and a blistering start for the equity market, where does China go from here?

I'm Allison Nathan and this is Goldman Sachs Exchanges.

The world's second -largest economy has had a difficult couple of years plagued by the ongoing property crisis and disappointing economic growth. But more encouraging economic data in recent months and a sharp rally in Chinese equities have begun to catch the eye of investors. Joining me to discuss how the economy and capital markets in China are evolving are my colleagues in Goldman Sachs Research, Hui Shan, chief China economist, and Kinger Lau, chief China equities strategist who are both based in Hong Kong. Hui, Kinger, welcome back to the program.

Hui Shan: Good to be on.

Kinger Lau: Thanks for having us.

Allison Nathan: Kinger, I'm going to come to you first because, obviously, we had seen Chinese equities underperforming for a pretty long period of time. But in the last few months we have seen them rallying sharply. So, talk to us about what's driving the rebound.

Kinger Lau: Well, thanks Allison. Let me try to put things into context. You know, the China offshore equity markets, i.e., Chinese companies listed in Hong Kong and the US, have started to perform well after the Chinese New Year rallying almost 30 percent since the trough in late January and has been the best-performing equity market globally in the past three months. And at the same time, the domestic Asia market has done also quite well, up about 15 percent during that period.

Now at a high level, we think a few key ingredients have gone into the rebound. Number one, better-than-expected economic growth in the first quarter, real GDP growth came in at about 5.3 percent, stronger than consensus expectation. And subsequently, consensus GDP growth for the full year has been revised up. And I guess Hui with more to stay on that in a moment.

And number two is really the direct government sponsorship in equities where, based on our estimate, more than 200 billion RMB has been deployed by the so-called national team to intervene in the Asian market. And that has effectively changed the risk/reward perception for investors on Chinese stocks.

And number three, this is a theme that we've been emphasizing for quite some time, which is that the policy put option has been exercised, including the pro-growth messaging from the April Politboro meeting and the recently announced equity market reform initiatives from the State Council.

So, against a backdrop where policy expectation has improved, I think what we have experienced is a process where investors are pricing out the left tail risks and better in equity valuations, thereby driving the rerating recovery over the past month or two.

Allison Nathan: That's interesting, Kinger, that investors find that as a source of, you know, optimism. I mean, I see your point. Less downside risk. But is there any sense though that because the government is in there as a backstop and is actually buying, that this is really just propping up the market? And so, the rally, you know, isn't necessarily sustainable driven by fundamentals?

Kinger Lau: Well, I think first of all, if you look at who's buying Chinese equities, I think I'll be more specific and divide our comments into the domestic A-share market and the offshore Chinese equity market.

Now, as I mentioned, the government has been quite proactive in the A-share market, especially underwriting a downside put option to equity investors. Although, domestic retail and mutual fund buying in the A-share market has been quite modest so far. But in the Hong Kong market, we have observed quite balanced participation between hedge funds and mutual funds mandates globally in the past one month, as opposed to just short covering and opportunistic positioning that really dominated the flow picture in the last few market recovery episodes.

So, what I'm trying to say is that, obviously, the government backstop has been quite effective in the A-share market. But if you look at the Hong Kong market, I think the recent recovery has been backed or supported by some fundamental reasons.

Allison Nathan: Right. And just to be perfectly, perfectly clear, I know you said this, but we aren't seeing any type of government intervention in the offshore Hong Kong market? It's the fundamentals and it's this mix of investors coming in?

Kinger Lau: You're right.

Allison Nathan: Okay. Understood. So, I mean, putting that all together, do you think that rally is sustainable? We have seen tremendous upside, as you said. Can fundamentals support the type of move we've seen? And do we see more upside ahead?

Kinger Lau: After the 30 percent rally in the Hong Kong market and 15 percent rebound in A-shares, I think that the sustainability of the rally will depend on one key word which is delivery. First, it's about delivery of earnings. And, you know, bigger picture here is that, Allison, we are still in an earnings downgraded cycle for the aggregate market. And we need corporate profits to come through to provide more fundamental support to the recovery.

But a good thing here is that we have seen some early signs that earnings are improving, especially in the internet and consumer related parts of the equity universe. And second is policy delivery. And in particular, when and how the promised policy easing that we got in the housing market, as well as equity market reforms will be implemented. And on that, we think the forthcoming Third Plenum that will be held in July will be the key to watch as I'm sure it will attract a lot of attention from investors as this is probably the venue where investors will get more visibility about policy easing and reforms for the years ahead.

So overall, I think the path ahead is still very much policy dependent. But we still think that the tactical market set up looks quite compelling considering that equity valuations for China remain quite inexpensive. You're talking about ten times the forward earnings for offshore equities. And about 12 times for the A-share market, which are, roughly speaking, one standard deviation below mid-cycle averages.

And on top of that, investor positioning continues to be quite conservative. So, equity flows have certainly improved in the past month or two. But both hedge funds and mutual funds mandates' allocation to Chinese equities remain at the low end of the five-year range.

So, putting everything together, we are still looking for about 10 percent upside for the A-share markets based on our indexed target for CSI300.

Allison Nathan: Understood. And you also mentioned that we are still in an earnings downgrade cycle. So, you know, we do expect to see, as you said, about 10 percent upside in the index. So, you are assuming the earnings are going to improve?

Kinger Lau: Yes. Allison, we are slightly below consensus in terms of earnings. For this year we are forecasting 8 to 9 percent EPS growth for Chinese equities depending on which indices you look at. Consensus is looking at but 12 to 13 percent. So, again, we're slightly below consensus. But assuming that our forecasts prove to be correct, and valuations do not change from here, so just by riding on the earnings accrual curve, you'll get about 10 percent upside from the Chinese stock market.

Allison Nathan: But if you're below consensus on earnings, but yet you have 10 percent upside, what squares that view?

Kinger Lau: Well, the simple answer to that is that we expect some further or moderate further expansion in multiples in Chinese equities. Again, even after the 30 percent rally, MSCI China is still trading at ten times forward earnings, which is one standard deviation below historical averages.

Allison Nathan: Right. So, you think there's going to be some resetting of that valuation to some extent.

Kinger Lau: Yes.

Allison Nathan: Understood. It seems that other forecasters have turned more bearish recently. Are they just less focused on this policy? Less optimistic on the earnings side? What do you think is driving those views? Or what's the biggest push back you've gotten to your views?

Kinger Lau: Well, I wouldn't say we have received a lot of push back. But precisely to the question you asked about the durability of the rally, I think that's the main concern and the debate or main debate among investors. And again, I think the deciding factor here would be policy delivery. So, if the authorities come up with a comprehensive and forceful plan to address the structural overhangs and the structural imbalances, then we think the recovery has more legs to go. But if the policy turns out to be another disappointment, then obviously it's difficult to extend the rally. So I guess the concern out there is really about how committed or how forceful the policy reaction function could be.

Allison Nathan: Right. And so, maybe people who are more cautious are just a bit more skeptical on that policy execution.

Kinger Lau: Yes.

Allison Nathan: Hui, when you listen to what Kinger's saying and you observe this market performance, which has been nothing but stellar in the last few months, how does that square with your view on the economy right now?

Hui Shan: So, in terms of the fundamentals in the economy over the past couple of months, I don't think we have seen dramatic changes. With the benefit of hindsight, with the market going up so much, I think it tells you the beginning of the year, sentiment towards China growth or towards risks from the property sector must be super pessimistic.

When we came in this year, we said that the government is going to try to get to 5 percent growth. That is going to be challenging. They need to do a lot of work. But I think a lot of investors are of the view, just think about the headlines we saw day in/day out - housing bust and there could be a financial crisis following, youth unemployment rate so high that the government stopped publishing the data, so on and so forth. So, I think the starting point is a very pessimistic view on China.

And then as Kinger was saying, once we saw the Q1 GDP number above government targets for this year, and we saw not only just official data seems to be better than expected, if you look at exports data, which you can verify with trading partners' data, exports in volume terms are up 10 percent year on year in the first quarter.

And then you look at the travel data during long holidays in China. People are going out and traveling around. And that doesn't seem to suggest consumption collapsing amid this big housing downturn.

So, I think your starting point, very pessimistic. And after looking at data and evidence and realizing perhaps it's not as bad as people feared. And I would think the fundamentals, they are weak, but they are not deteriorating. It's just expectations moving up from a very low level to where the reality is. And that may be enough of a factor driving up the market performance.

Allison Nathan: And I think what you just said is very important in the sense that there does seem to be some skepticism about some of the official data. But you are seeing some of that strength that's come through backed up by other indicators that, you know, we feel confident are reflecting a pretty realistic picture of the situation.

When we think about the go forward, we always think about the first part of the Chinese year with new year and a lot of different events that could stimulate the economy. If we think about the go forward, do we think that the better growth performance that we've seen can be sustained?

Hui Shan: It's interesting. When we looked at our forecast for this year's growth, we have been above consensus for quite some time. When we introduced 2024 outlook, we were above consensus and we said if the government is aiming for around 5 percent growth, one way or the other they will try to deliver it.

Put it differently, we are seeing not as much uncertainty on the top line GDP growth number because of the systems works such that once they have a target, they're going to work toward it. But there is tons of uncertainty in terms of how the composition, which part is going to be outperforming? Which part is going to be underperforming? For example, how much are experts going to grow or slow? How bad will the property market be? How much is the government willing to spend on infrastructure to offset weakness elsewhere? The compositions are very hard to predict.

And fast forward standing in May right now of 2024, exports are even better than our relatively constructive view coming into the year. But housing was worse than we expected. If you look at the top 100 developers' reported data, first quarter, their sales down 50 percent year on year. So, ironically, because the property sector has been so weak, perhaps that's one catalyst for the government to finally decide to accelerate easing or increasing easing. Hence, that's another catalyst for investors to focus on China and become more positive on Chinese risk assets.

And also, because exports have been so successful, we're hearing more noise about tariffs, trade tensions, and so on. So, I mean, going forward the dynamic will be very interesting to watch because the reality about housing is very weak, but the bad news becomes good news, and the government is doing more. Whereas on the trade side, trade tensions are clearly on the rise. But at the same time, Chinese exports are holding up very well.

Allison Nathan: And Chinese policymakers have actually been pretty innovative lately in thinking about how to tackle these property market problems. Talk to us about what they've been doing and the implications of that.

Hui Shan: I think this is the important shift in mindset. I think previously the government was of the view, if you read documents, they always say we want a market-driven solution to the property sector problem. But in reality, property is the largest sector in China. And it's in a sharp decline. And a market-driven solution will not work. Market-driven solutions, without government intervention, think about as a bank, you would not want to lend to a developer or real estate sector no matter how many times policymakers are urging you because you don't want to make a loan that goes bad and you have to hold the bag for the bad loans. And if you're a household, you don't want to buy property because you think prices are still going down.

So, the market-driven solution doesn't work. And I think the critical shift we saw over the past couple months is that the government, the central government needs to do more. We need to get rid of the excess supply. We need to have government coming in, buy these empty apartments to rebalance the market. We have too much supply and not enough demand. And so, we need to boost demand and reduce supply, accelerate the timeline for prices to find a bottom.

So, I think that thinking is correct. And as Kinger was saying, now the question we're asking is implementation delivery. Are they going to put enough money in this program to rebalance the market soon enough? And are they going to be able to prevent people with multiple empty apartments all of the sudden coming in thinking this is the window of opportunity for me to sell my extra apartments? So, there are a lot of implementation questions. But I think the mindset shift that we need to deal with excess supply problem is a very important one.

Allison Nathan: Right. And just to be perfectly clear about this initiative they have announced. They essentially, it seems to me that the central government is proposing that they fund local government purchases of excess housing supply. Is that right?

Hui Shan: We're not there yet. So far it still is a local-based program. Different cities are experimenting with different schemes. In some cities, it is that local government and local government financing vehicles come up with money to buy a property from someone, an old property. And then give the money for them to buy a new property from the developer, so the trade in or replacement demand type of program. In other cities, they might be giving you some kind of discount. If you buy property, we'll try to cut your taxes or fees. In some other cities, it could be the local government buys the empty apartments directly from developers and then turns them into some kind of social housing or other uses to take them off from the normal owner-occupied housing market. We're still waiting for the size, the location, and the exact design of these programs.

But at the end of the day, we believe that the central government is the only entity that has the capability to provide the funding and push this through, where local governments are financially constrained. So, it is part expectation and part ongoing at the local basis.

Allison Nathan: Understood. So, Kinger, another area where Chinese policymakers have been active are in the capital markets. We have had these Nine Measures, which are intended to bolster capital markets. Talk us through what the implications of what that could be.

Kinger Lau: So, Allison, I think the Nine Measures are quite significant and consequential to the stock market. Specifically just a month ago the state council announced the once every decade policy opinions, aka, the Nine Measures, which will guide the development of the Chinese capital markets in the years to come.

So, overall, we see three key policy objectives from the document. A, strengthening supervision. B, raising the quality of listed companies. And C, enhancing investor protection. And overall, these policy objectives or focuses are largely consistent with the broader economic and strategic directions set out by President Xi and other senior policymakers in China.

Now, in terms of the market implications, we estimate that we could potentially get 40 percent valuation gains in our blue sky scenario, assuming that Chinese equities can match the existing global leaders on three dimensions: shareholder returns, corporate governance standards, and long-term institutional investor ownership in the stock market.

And in a less aggressive scenario where China only improves through the regional averages along these dimensions, the potential rerating gains could still reach around 20 percent. So, in other words, we believe that there is quite significant policy-driven upside for value to be unlocked from the stock market if the necessary capital market reforms actions come true.

Allison Nathan: Right. But that's going to be a slow process. A long process. And when would you see some of that actually being realized?

Kinger Lau: Based on the recent conversations with regulators, I think the policy announcement momentum will be quite strong in the months ahead because they recognize that they need to come up with some specific and concrete measures to really deliver the promises they made to the market.

So, from our perspective, I think more specific policies on improving shareholder returns, on raising dividend payouts or encouraging more buybacks are under way.

Allison Nathan: Got it. But on the US side, President Biden has had a busy week. He's announced sweeping new tariffs on a range of Chinese imports. So, Hui, does that matter for the Chinese economy?

Hui Shan: The Biden administration just announced after the section 301 review, they announced tariffs on Chinese goods worth of $18 billion USD. And the types of products include mainly EVs, batteries, solar cells, semiconductors, and some other strategic items.

By itself, this announcement is not a huge deal for the Chinese economy because just putting things in perspective, China exported around a half a trillion US dollars of goods to the US in 2023. And we're talking about $18 billion USD of products being tariffed. Even that $18 billion, not everything is effectively 2024. Some of the items if the US is having a hard time sourcing alternative suppliers, the effective date is 2025/2026. So, in that regard this is not an immediate and important negative impact on China's growth per se.

But I think the fact of that the Biden administration is raising tariffs, and then we have upcoming elections. And in the scenario Trump wins the election and he has suggested he would increase tariffs by 60 percent on Chinese products, that would be a much bigger deal for China. And we estimate that without other offsets, then that could cumulatively subtract 2 points of GDP from Chinese economy in that scenario of a 60 percent tariff on everything China exports to the US. So, certainly, a significant downside risk.

At the same time, I would also say on the China side looking at experience from 2017 to 2023, I think the reaction function might be slightly different. So, after President Trump took office in 2017, he started various investigations on trade-related issues. And in early 2018, the trade war started. And during the span of 2018 to 2019, the US imposed tariffs on over $300 billion dollars worth of Chinese exports to the US. And rates varying between 7.5 and 25 percent on these products.

And in 2018/2019, China probably was more nervous about downside risks to the economy just because this was the first time of a US/China trade war. But after six, seven years, Chinese exports are doing fine. The US trade deficit continues to widen. Chinese trade surplus continues to widen. So, I think this time around, policymakers in China may be calmer and may not react exactly the same way as they reacted in 2018 and 2019.

And another point to make is that Chinese products are just very competitive. A lot of different dimensions and different products. So, in the near term, we're still constructive on Chinese exports and exports contribution to GDP because we don't think it's that easy to stop Chinese exports.

In the long run, if Chinese trade surplus continues to grow and this trade imbalance continues to accumulate, I think more trading partners will be pushing back and we're going to see more tariffs, higher tariffs from more countries to rebalance global trade flows. But in the near term, we don't think that Chinese exports will be hugely impacted.

Allison Nathan: So, when we put this all together, Hui, Kinger, what does the risk/reward look like for investors at this point?

Hui Shan: I think from a fundamental point of view, I would say the good news is not that good and the bad news isn't that bad. Meaning at this point, the investor sentiment towards fundamental may be more in line with the reality. Even though the central government is willing to spend money and come up with a credible package to support the property sector. We're still talking about a huge housing downturn in China, which will take time to see fundamentals materially improve.

But when I say bad new isn't that bad, because if you think about where the housing market is versus where house consumption is, they divorced. If you still use the mentality of in the housing downturn, there's negative wealth effect, consumption is going to collapse, then the financial system is going to implode. Don't use that framework to think about the Chinese property market. The bad news is not that bad because we are in a very different dynamic. Consumption can continue to carry on without a booming housing market.

So, I guess what I'm saying is that we feel comfortable with our 5 percent real GDP growth forecast this year. I think the risks at this point are more balanced.

Allison Nathan: Kinger?

Kinger Lau: So, for the equity market, certainly the risk/reward profile isn't as attractive as it was three months ago given how much the market has rallied. But looking ahead, if the policy momentum continues to be strong and looking where we are on valuations and investor positioning, we still believe that the tactical set up for further gains for the offshore market remains quite compelling. But more strategically, we still feel more comfortable with the A-share market because this is the market where the sensitivity to policy easing has been relatively higher than the offshore market. And from a liquidity perspective, I think we are talking about more sticky, more anchored capital in the A-share markets as opposed to the Hong Kong market, which is still very much dominated by foreign investors.

Allison Nathan: So, I'm taking away from this that, look, I like how you put it Hui, bad news is not always so bad because there are other parts of the economy outside of the property market that have shown to be humming along reasonably well. And reasons to also be somewhat positive on the equity market, although recognizing it's already run up a lot.

Hui, Kinger, thanks so much for joining us.

Hui Shan: Thanks for having us.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Thursday, May 16th, 2024. I'm your host, Allison Nathan.

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