# GEARING UP FOR THE NEXT LEG OF THE CHINESE RALLY

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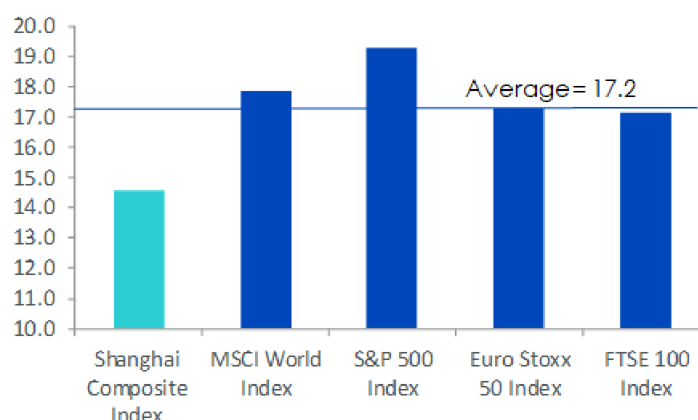
The year of the Pig–associated with wealth and fortune– appears to have arrived in time for the world's second largest economy. Evident from the 22.8% upside performance of the Shanghai composite Index (as on 30 April 2019), China is now the second best performing global equity market this year. Equity market valuations at 14.5x price to earnings ratio appear discounted in comparison to the global equity markets allowing plenty of room for further upside.

**Figure 1a and 1b: Comparison of Shanghai Composite Index performance versus price to earnings valuations**

| Performance | -1M | -12M | YTD | PE Ratio* |
|---|---|---|---|---|
| Shanghai Composite Index | -3.1% | -0.6% | 22.8% | 14.5 |
| MSCI World Index | 12.5% | 10.3% | 13.1% | 17.9 |
| S&P 500 Index | 19.0% | 17.1% | 14.9% | 19.3 |
| Euro Stoxx 50 Index | 1.2% | -2.4% | 11.5% | 17.3 |
| FTSE 100 Index | 3.9% | -1.1% | 9.9% | 17.1 |

** Based on current price and 12-month trailing earnings*




Source: Bloomberg, WisdomTree, data available as of close 30 April 2019.

**Average value is representative of the shown indices. Historical performance is not an indication of future performance and any investments may go down in value.**

**What is behind China's equity rally?**

The positive sentiment emanating from the ongoing trade negotiations between the US and China has played a strong role in the Chinese equity market outperformance. Adding momentum to the equity market rally, MSCI's decision in February to increase the inclusion factor within its index for China A shares from 5% to 20% by November 2019 could not have come at a timelier occasion. It surely adds impetus to China's stock markets.

This gives China an official recognition of the progress made in developing and opening their capital markets. It also acclaims China's integration into the global financial system which began with the Renminbi and its inclusion as the fifth reserve currency in the International Monetary Fund's Special Drawing Right (SDR) basket in 2016. More importantly, Beijing's effort to shore up Chinese credit growth via both monetary and fiscal stimulus has helped restore confidence in the business cycle.

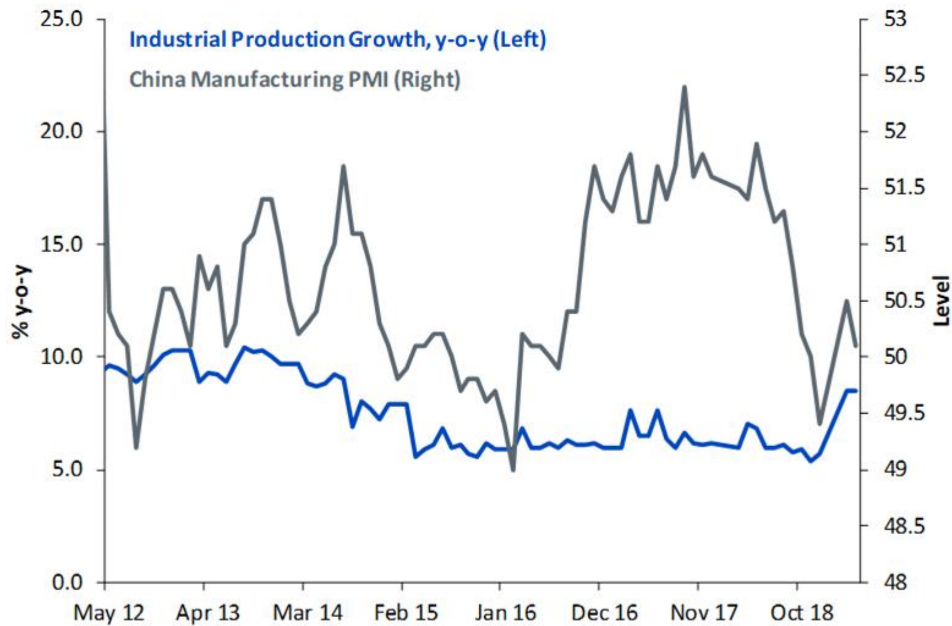
On the monetary front, The People's Bank of China (PBOC) cut the reserve requirement ratio (RRR) in January, expanded existing lending facilities and open market operations. They also introduced a Targeted Medium-lending facility thereby supporting the private sector. In our opinion, the recent monetary easing steps have been of a smaller scale in comparison to the measures taken during the global financial crisis as the government aims to stabilise rather than re-accelerate Chinese growth. The policy statement from the Politburo[1] meeting on 19th April, signalled that top policymakers would dial back policy support on the back of better than expected economic performance in Q1 2019.

On the fiscal front, the government delivered on March 5th a bigger than expected tax cut, promising to cut the top rate of the value added tax, which applies to the manufacturing sector from 16% to 13%. The central government also announced plans to increase infrastructure spending—centred around the aviation sector and railway network and a doubling of bond issuance quota for local governments. Considering all the tax breaks, the official fiscal stimulus remains conservative as the deficit is budgeted to expand from 4.1% to 4.3% on a cash basis.

**Stabilisation resumes**

In response to the authorities' supportive policy measures, there have been green shoots reappearing across China's macroeconomic data in March compared to the weakness in activity data seen in late 2018, which suggests that the worst of China's slowdown could be behind us. China's official manufacturing Purchasing Managers Index (PMI) in March surpassed expectations rising to 50.5 and softened to 50.1 in April, coming in above the neutral mark for the first time since October 2018.

**Figure 2: Manufacturing activity past its trough**




Source: Bloomberg, WisdomTree, data available as of close 30 April 2019.

**Historical performance is not an indication of future performance and any investments may go down in value.**

The credit cycle, an important gauge for Chinese credit growth continued to rebound, with headline credit growth rising 11% Year on Year (YOY) in March. The improving credit growth has been well correlated with corporate earnings growth with a lag of 1-2 quarters. This should buttress Chinese corporate earnings which have recently reversed their downward revision trend.

In line with the governments agenda, bank lending to the corporate sector rose and mortgage lending stabilized at 18% YoY. The property sector also proved resilient, highlighted by stronger construction starts that rose 18% YoY and sales volumes that were up by 1.8% YoY in March. Aided by a pickup in industrial production and property investment, China’s GDP grew by 6.4%, a shade above market expectations.

**Figure 3: China’s export growth holding up well so far**

Source: Bloomberg, WisdomTree, data available as of close 30 April 2019.

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In sharp contrast to declining global trade volumes, Chinese export growth beat expectations, rising 21.3% YoY in March owing to the Chinese New Year seasonality. Despite fears of the impact a stronger currency could have on Chinese exports, the Chinese Renminbi has strengthened this year, up 2.5% as on 29 April 2019. Chinese import growth was weaker up by 0.3% YoY owing to softer imports of semiconductors led by the weakness in the global smartphone market. Similarly, automobile and smartphone production continued to contract albeit at a slower pace in the last couple of months.

**The next leg of the rally**

The strength of the recent activity data suggest that Beijing has proven successful at using its policy tools to stabilise the Chinese economy. Looking ahead, the balance of probability is tilting in favour of the People's Bank of China implementing a less accommodative policy stance even though the rest of the world's central banks are remaining quite dovish. We believe the Politburo would be justified in doing so as they placed more emphasis on stabilising growth and a greater need for structural reform.

While we could continue to see short term setback's in Chinese equity market performance along the way like the correction of -5.64% witnessed at the start of the week of April 22th by the Shanghai Composite Index, these short-term corrections are healthy and avoid the repeat of the 2015 crash and subsequent intervention by Chinese regulatory authorities.

In our opinion, the next leg of the Chinese equity market rally will be strengthened by the improving prospect of a US-China trade deal, fair but not-stretched equity market valuations and MSCI's three-tranche China A share inclusion schedule.

Source

1 Central Politburo of the Communist Party of China: group that oversees the Communist Party of China.

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