China is recovering – but more slowly

China update

May proved to be another challenging month for Chinese assets. Market sentiment was further dampened by rumours surrounding the city of Kunming's debt repayment difficulties, leading to apprehensions of a local government debt crisis. However, the government later refuted these rumours as a maturing bond was repaid in full.

For the month, the MSCI China A Onshore and MSCI China equity indices experienced declines of 7.3% and 8.4%, respectively.

Investors were concerned about a slowing and uneven recovery in the economy, with no new stimulus policy in sight.

Overseas liquidity also tightened, with US dollar interest rates rising to new heights, and capital chasing US mega-tech and Japanese stocks, causing further capital outflow from China and a depreciation of the Renminbi.

Defensive sectors, such as Utilities and Financials, outperformed during the month, followed by Information Technology. Moreover, the twin themes of State-Owned Enterprises (SOEs) revaluation and Artificial Intelligence (AI) remained prominent, although their momentum slowed down. Real Estate, on the other hand was the worst-performing sector due to weak sales and investment data. Additionally, the Materials and Consumer sectors underperformed due to lower-than-expected manufacturing PMI and lacklustre retail sales.

We still believe this is a year for the Chinese economy to recover, although the pace may be slower than expected.

Some other data, such as corporate earnings, the Caixin service purchasing managers' index (PMI), and recent holiday consumption, seem to paint a brighter picture than the headline data.

Global liquidity tightening is impacting China's markets

Chinese equities almost back to all-time low valuations

Therefore, we still expect to see more policy support from the Chinese government, and the scale and timing may surprise the market on the upside, similar to what happened last year when they decided to reopen after COVID.

Current valuations of Chinese equities are almost back to the all-time lows witnessed in October 2022, but we believe the risks are substantially lower. Despite improving fundamentals, many high-quality cyclical companies in the Machinery, Chemicals, and Materials sectors are below their October 2022 levels.

We believe companies like these should outperform over the medium to long term as the market focus returns to fundamentals and earnings growth instead of short-term sentiment.

Holding the contrarian view, we believe in the importance of remaining long-term focused by ensuring no drift in investment style even during periods of underperformance.

Despite a slower-than-expected pace, we maintain our belief in the Chinese economy's recovery this year.