



The importance of risk management in China



China update

China's equity markets posted solid gains in July, supported by improving sentiment and thematic sector strength. Mainland-listed A-shares outperformed Hong Kong-listed H-shares, reversing the relative outperformance seen in the first half of the year. The rally was led by themes such as computing power, "anti-involution" (efforts to curb excessive internal competition), biotech and new consumption.

- The MSCI China Index and the MSCI China A Onshore Index were up by 4.8% and 4.4% respectively.
- Macro-sensitive sectors, including home appliances, real estate, and food & beverage, remained muted.
- Inflows from retail, pension, and insurance investors remained strong, and average daily turnover surged to approximately CNY 0.8 trillion, up from CNY 0.5 trillion in June.

Macro-sensitive sectors, including home appliances, real estate, and food & beverage, remained muted, while defensive areas such as utilities and banks were relatively soft.

Brokers performed in line with improving market sentiment. Investor participation broadened despite concerns over potential selling by the National Team (state-controlled entities who are often called upon to purchase equities and support the market in times of stress). Inflows from retail, pension, and insurance investors remained strong, and average daily turnover surged to approximately CNY 0.8 trillion, up from CNY 0.5 trillion in June.

On the macro front, China's economy grew by 5.2% year-on-year in Q2, exceeding the market consensus of 5.1%. Exports proved resilient despite higher US tariffs, expanding 8.6% year-on-year in real terms. July's manufacturing PMI declined, but component data suggested that measures to reduce excessive price competition are taking effect: output sub-indices fell, while price sub-indices rose.

Retail sales growth moderated in June after several strong months, partly due to funding shortages in consumer goods trade-in programs in some regions. These constraints were addressed in July following the central government's injection of new funds.

On the policy front, the mid-year Politburo meeting reaffirmed the strategic priority of supply-side reforms. New measures aimed at tackling overcapacity and stabilising prices in key industrial sectors are expected in the near term. In a notable policy development, the government introduced its first nationwide childcare subsidy program, including direct cash handouts to families, free preschool education, and interest subsidies for consumption and service sector loans—policies likely to support domestic consumption in the medium term.

Valuation risk

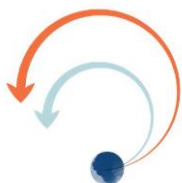
Positive views on China and its equities have been a stop-start phenomenon. The current environment is such that positive momentum is interrupted by the smallest of geopolitical news. When that happens, typically overpriced stocks with strong recent momentum are punished the hardest.



China's economy grew by 5.2% YoY in Q2, surpassing market expectations.



Exports rose 8.6% YoY despite higher US tariffs.



Policy support and sentiment continue to boost state-owned enterprises.



Active managers struggle to match index performance amid SOE gains.

Whilst this allows a patient investor to rebuild their position at a more attractive valuation, it is equally important to lighten the weighting at higher valuations before the cycle repeats itself.

As we mentioned previously, we've seen a new wave of Chinese consumer companies going public, many of which have performed exceptionally well thanks to innovative business models and real consumer demand. However, some of these stocks are now trading at over 50x earnings. Managers have noted that these lofty valuations may be driven by short-term sentiment, underlining why it's so important to stay disciplined and avoid getting caught up in hype.

Sector underweight risk

Since 2022, value stocks – especially state-owned enterprises (SOEs) in banking, telecoms and utilities – have done relatively well, driven by sentiment and liquidity rather than underlying fundamentals. This strength has been supported by coordinated policy moves and direct intervention by regulators, including the so-called "National Team" who typically buy equities at the government's request when markets are stressed.

While such efforts act as a "government put" for the market overall, they tend to benefit SOEs the most, making it challenging for active managers to keep pace with the index.

Historically, fundamental active managers have avoided large positions in SOEs due to rightful concerns around governance and a lack of alignment with private shareholder interests. Still, these companies could remain in demand for their above-average dividend yields, especially now that government bond yields are at historic lows. As government buying continues, SOEs are likely to remain a performance driver of the market.

As an active investor, a portfolio with a focus on higher-quality, growth-oriented companies should drive long-term outperformance. At the same time, we recognise the need to actively manage underweight positions in SOEs to ensure it does not negate alpha generation. We for example selectively add exchange traded funds and index-tracking futures or notes to mitigate the risk that a rally in SOEs detracts from performance.

In summary, an astute active manager should remain focused on managing a wide range of risks and aiming to strike a thoughtful balance between risk and opportunity.

Since 2022, value stocks have done relatively well, driven more by sentiment and liquidity than by their underlying fundamentals.