Investment Insight
Chinese New Year

Morningstar Investment Management EMEA

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For Financial Advisers to use with their clients

China has been in the spotlight as investors look back at a poor 2023 and wonder if the year of the Dragon will bring a rebound or more of the same. Most have abandoned China and labelled it uninvestible, after a three-year bear market, a property crisis and disappointing growth.

The challenge is to set aside behavioural biases, and construct realistic potential outcomes based on the data, and then estimate how much weight to put on each scenario. This starts by recognising that our behavioural instinct is to give way too much importance to recent experiences, in this case disappointment, when thinking about what could happen. The evidence from our Morningstar flows data is that these biases lead investors to make bad timing decisions that detract value. In our latest "Mind the gap" study*, returns were lower when flows where taken into account vs the underlying fund return.

To put the facts about China today into perspective, we need to look back at the last 3 years. In early 2021, China was a market darling, clocking up two years of high returns. Property market challenges, extra US trade restrictions, high debt levels, severe COVID lockdowns and the pendulum swings in government policy were all known but overlooked by investors.

Since then, economic growth has disappointed, impacted by stringent COVID lockdowns and the fall-out from the residential property boom and bust. Corporate profits have also been hit by the late 2021 "common prosperity" regulatory crackdown that added severe restrictions on gaming companies and private education companies and sanctioned or targeted high profile powerful corporate executives. Debt limits were imposed on property developers. Foreign investors swung from bulls in 2021 to bears by 2023, dramatically scaling back their exposure.

So where has three years of a bear market left us today? Well, here are five current facts that paint a very different picture from when the market peaked. First, profit margins are at the low end of their historic range and rising. Second, valuation measures are at the low end of their historic ranges too. Third, measures of sentiment point toward pessimism, including profits expectations, net flows and positioning. Fourth, government micro economic and macroeconomic policies have eased to be more supportive of the economy and companies in general, including gaming. Fifth, the market composition has changed. Many major companies are dominant franchises with low levels of debt, while the banking sector and property development sectors are much smaller parts of the market than in the past. These five factors tell us that China is a pariah market, one that has priced in greater risks, weaker growth and discounted any eventual cyclical recovery. These are the hallmarks of a good investment opportunity. We hold more in China than usual, noting that many other portfolio opportunities have performed well including Germany, US small companies, Emerging Market Bonds and Japan and there are increasing signs of extreme optimism in leading US stock market companies. *https://www.morningstar.co.uk/uk/news/240490/buy-and-hold-or-time-the-market-mind-the-gap!.aspx

Unless stated otherwise, all data sources are from Morningstar Direct as at 29/02/2024.

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