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Highlighting Interesting Investment Research

You May Already Be Invested In The Next Bull Market

We have slowly started seeing positive signs emerge from China, and this, coupled with some of the cheapest valuations we have seen in our investment careers, has stirred our animal spirits.

So, what have we seen changing in China?

Amidst the backdrop of a stock market that is down 40% in 3 years, a slowing economy and a property bust, most Western investors have been anticipating a big bang stimulus announcement to rouse the economy. So far, they have been disappointed.

However, we have noted more subtle news flow emanating from Chinese officials. Specifically, announcements around the stock market, where:

- The Chinese sovereign wealth fund has started buying domestic exchange-traded funds.
- The Chinese Securities Regulatory Commission (CSRC) has encouraged institutional investors to participate in the stock market with greater effort.
- The Ministry of Finance has halved stamp duty costs on stock purchases.
- The CSRC has reduced margin requirements for stock investments.

- The Cabinet has issued guidelines for a high-quality stock exchange and called for a higher proportion of stock-focused funds in the mutual fund industry.
- Regulators have changed the risk weighting of stocks when assessing insurers' capital adequacy.

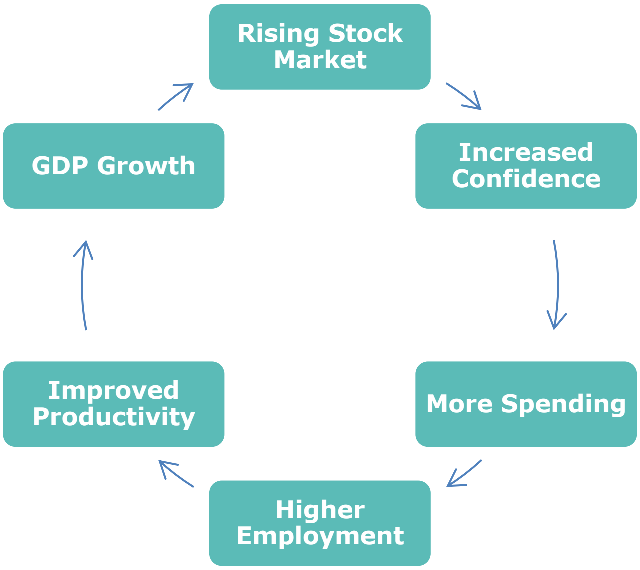
So, why is this important?

Chinese investors are significantly underinvested in stocks, and households have 70% of their wealth invested in residential real estate, with a large portion of the balance being invested in cash. Household cash balances have increased by 65% since 2020 and now sit at $7.4trn, more than

Germany's or Japan's GDP. Chinese households became fearful after covid and have hoarded cash ever since.

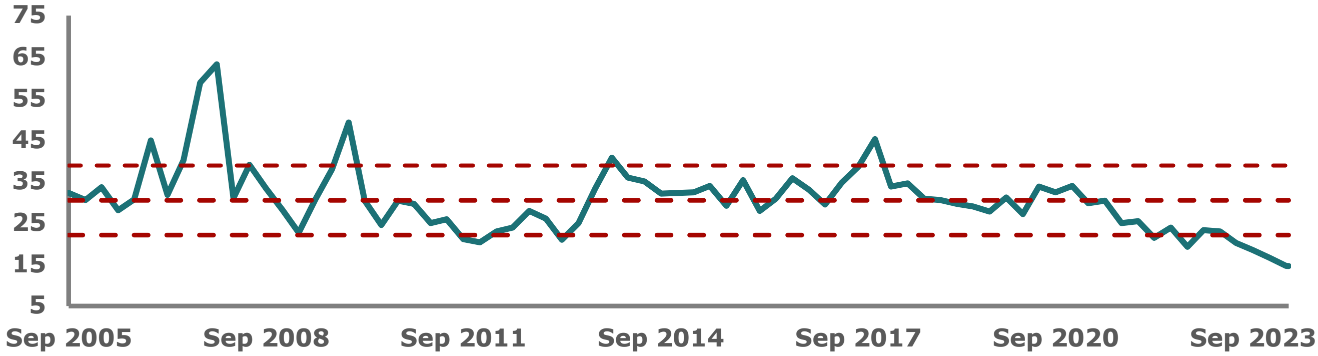
Given the extremely low base, a change in the investing habits of Chinese institutions and households towards stocks will have a meaningful impact on stock prices.

This would set off a virtuous cycle and create a positive feedback loop. A rising stock market makes investors feel wealthy and imbues them with a sense of confidence, which encourages spending. When this is done at scale, it raises employment and productivity and drives GDP growth.



We sense the market may be missing the potential structural change from the abovementioned regulatory changes. Chinese stocks are trading at historically low levels when compared to peers. Chinese stocks are 70% cheaper than Japanese stocks, 67% cheaper than Indian stocks and 64% cheaper than US stocks. The combination of a low base and highly undervalued stocks could result in well above-average returns.

Tencent - Forward P/E Ratio*



Source: Independent Securities Research, Bloomberg

To illustrate the valuation dynamics of some of the large Chinese technology stocks:

- Tencent's forward P/E ratio* of 15x is the lowest it has been in 20 years.
- Alibaba's net near cash represents a third of its market capitalisation, and the imputed P/E ratio* of the core business is a low single digit.
- JD.com's net near cash represents 80% of its market capitalisation, and the imputed P/E ratio* of the core business is a low single digit.

From a macroeconomic perspective, the current slowdown in the Chinese economy can be viewed positively. Much of the growth over the last two decades was caused by debt-fueled infrastructure and housing spending. The current duress will help purge past excesses and ensure that capital is deployed optimally in the future and that debt levels are reduced to acceptable levels. These are traits of a sustainably growing economy. At the same time, we have seen significant investment in its future as China evolves to advanced manufacturing and offers cutting-edge technological solutions and products. We also don't buy the Chinese demographic timebomb argument, as most countries globally face a similar issue, and China will likely augment its lead in manufacturing automation because of this. The nature of employment will change from dull, repetitive industrial tasks to compassion-based care as the Chinese population ages.

There is also a misconception that the Chinese economy is struggling tremendously. While it is true that growth has certainly slowed down from the go-go years, and certain sectors such as housing are under severe strain. However, in the main, Chinese economic data is relatively good, even when compared to the United States. For instance, GDP growth for 2024 will be higher than the United States and inflation is also lower in China. China has a current account surplus, its fiscal deficit is lower than the United States, and its general gross government debt to GDP ratio is lower.

Through serendipity, most South African investors already have high exposure to China because of their exposure to Tencent through Prosus and Naspers. Of course, JSE-listed commodity businesses are also highly sensitive to the vagaries of the Chinese economy. There are also China-focused exchange-traded funds listed on the JSE. Therefore, South African investors may already be invested in the next bull market.

Global financial markets are in no man's land at the moment. Interest rates remain high, yet central banks are nervous about reducing them as US inflation has proven stubborn at the 3.0% handle. Coupled with this, there is heightened geopolitical risk with the upcoming US elections, the Ukraine war and the ongoing tension in the Middle East.

Against this narrative, Chinese equities could surprise and quietly outperform. South African investors inherently have material exposure to this region, and any outperformance would be a welcome gift for battle-scarred South African investors who have endured a long and frustrating period of underperforming global stock markets.

*The price/earnings (P/E) ratio provides a measure of a stock's valuation. The long-term average for global stocks is 18x, but a stock’s P/E ratio needs to be considered in terms of its quality, growth prospects, and risk, among other things.

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