M&G Investments

M&G Insights

China: Opportunities for astute investors

February 2024

David Perrett

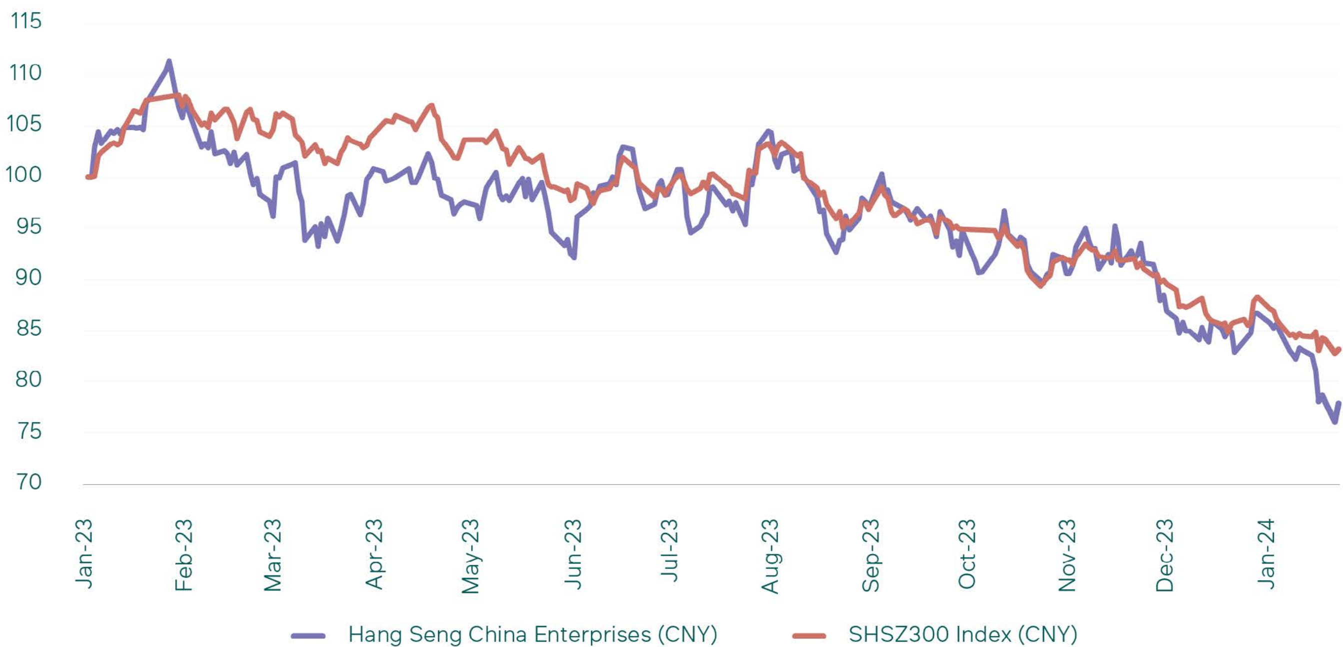
Co-Head of Asia Pacific Equities at M&G Investments (UK)

2023 was another tough year for Chinese equities. Globally, investor sentiment was kept in check by the US Federal Reserve's ongoing interest rate rises and the strength of the dollar. And locally, worries about weak economic growth and the problems in the country's giant property sector dented confidence as well.

This loss of confidence among both domestic and global investors was reflected in the poor performance of Chinese equities: much of the decline was due to de-rating rather than lower corporate earnings as risk premia rose. For the year, Hong Kong's Hang Seng produced a total return of -10.6% and the MSCI China delivered -11.0% (both in US$), with market valuations trading at their cheapest levels since the Covid pandemic. In fact, the pace of selling picked up later in the year and, amid increasingly fearful narrative from investors, has continued into January, as Graph 1 shows.

Graph 1: China-linked equity sales accelerate

Rapid price weakness



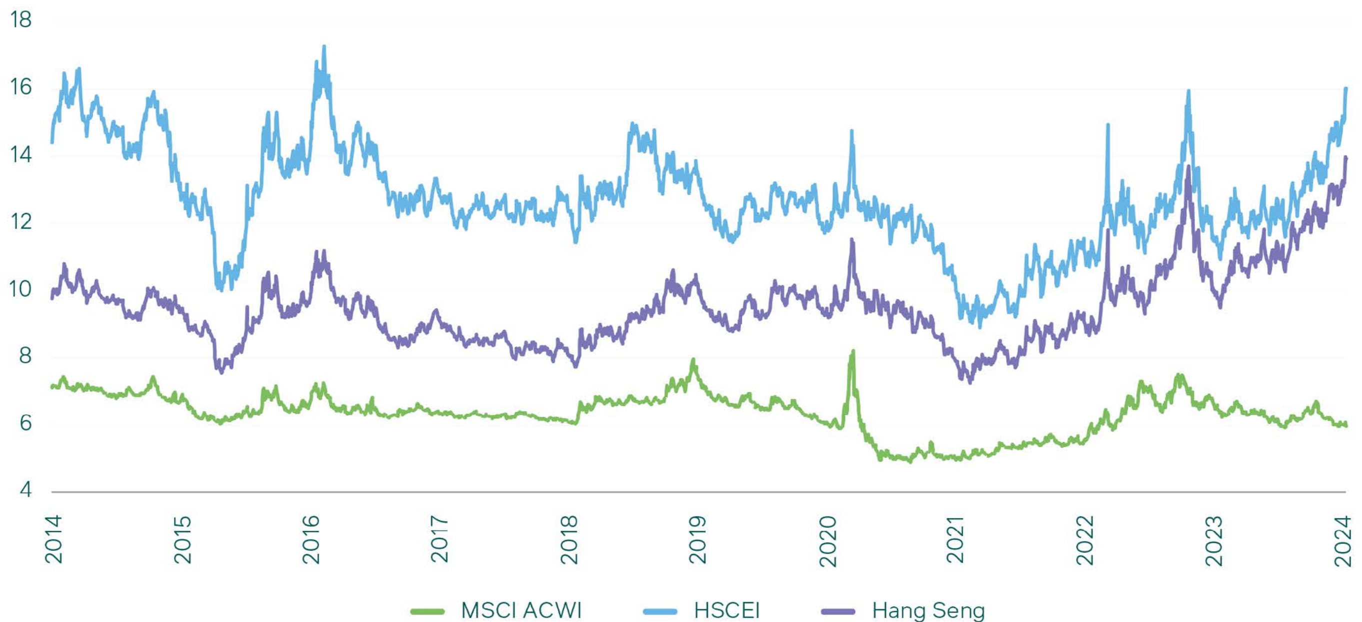
Source: Bloomberg, M&G Investments (UK)

Indiscriminate selling creates opportunities

While there are risks associated with investing in China, we believe that volatile markets driven by macroeconomic concerns can create interesting opportunities for disciplined, bottom-up stock pickers. In times of uncertainty and negative sentiment, such as those we have witnessed recently, stocks often get sold indiscriminately across the board, which can create a fertile environment for selective investors to identify undervalued companies. Looking at Graph 2, we can see that earnings yields have reached levels last seen at the peak of the Covid pandemic.

Graph 2: China/Hong Kong equity earnings yields at Covid-level highs

12-month forward earnings yield



Source: Bloomberg, M&G Investments (UK)

At present, we remain constructive on China for several reasons. We believe that pessimism about China's fortunes and the wider economic outlook, resulting in the current idiosyncratic sell-off, is presenting opportunities for active investors to find great companies at very attractive valuations. By focusing on near-term uncertainties and recessionary fears of weaker profits, we believe many investors are overlooking the longer-term prospects for companies that have powerful structural tailwinds behind them and an improving approach to delivering returns to shareholders. For example, we are seeing the pace of share buybacks increase rapidly and more disciplined corporate cost-cutting.

In addition, China is well-positioned for growth against the backdrop of deflation, easing policy restrictions, a persistent current account surplus and the high levels of savings they are well-known for. At the same time, the yuan is relatively weak, so while demand from the West is low currently, when it does pick up, China will be very competitive.

Another factor to consider is further supportive measures from the Chinese authorities. Among other moves, the People's Bank of China has been easing reserve requirements for banks to bolster lending activity, while most recently, China's cabinet pledged to take more measures to stabilise and strengthen market confidence, such as injecting more medium-and long-term funding into the capital market. Fiscal policy in the form of increased government spending is also expected to contribute to an improved economic environment.

Opportunities in the energy transition

Although there remain stress points in some parts of the Chinese real estate market and banking system, there are also exciting areas of structural growth, not least industries tied to the energy transition. Indeed, when we think about the impediments to arresting climate change and achieving net zero, it is easy to conjure up images of polluting developing Asian metropolises and associated industrial landscapes emitting carbon through large chimneys.

As always, there is an element of truth to such popular images, but with this comes the underlying reality that if the world is going to succeed in combatting climate change, Asia will be the key battleground. Very encouragingly, in 2020 China, as the world's largest emitter, pledged a net-zero goal by 2060. The end result of this pledge has been

truly staggering: China now leads the world in the installation of both wind and – especially – solar energy. It is also the world leader in existing installed electric vehicle (EV) fleet and production. It is expected that renewable electricity generation (wind and solar) in China will increase seven-fold between 2020 and 2060.

Despite this strong growth and promising future, all is not guaranteed to go smoothly. Ironically, after an initial wave of positive flows into Chinese energy transition stocks, this portion of the equity market has become increasingly treacherous. Huge increases in capacity for commodity renewable items like polysilicon have ultimately outstripped demand and led to falling prices and an incredibly competitive environment where only the fittest survive. Consequently, returns on invested capital have been crushed lower.

Seeking high barriers to entry, scale, or tangential beneficiaries

Against such a backdrop, we are adopting three broad approaches to navigate the difficult environment, while still identifying stocks that should benefit structurally from the energy transition megatrend. The first **is in identifying those parts of the renewable supply chain that enjoy high barriers to entry**, either through technology or regulation. We own stocks in this category which are well-positioned to benefit from decent top-line growth, while maintaining steady margins. A good example is Jiangsu Zhongtian, a niche cable maker listed in the Chinese A share market. Zhongtian specialises in both making the cables and then providing the engineering services, which connect offshore wind farms to the onshore power grid. The service it provides is both complex and critical in nature and, as a result, there are only three certified players in China, of which Zhongtian is one. The scale of the offshore build out in Chinese wind farms mean that these three cable and engineering companies are the largest in the world, which is allowing them to win lucrative export orders in an industry that is increasingly facing ever tougher capacity constraints on a global basis.

The second approach focuses on those **commodity-based producers that either have scale, vertical integration (supply their own key components at a low cost) or both, and thus have a structurally competitive cost advantage**, which will allow them to remain profitable through this period of intense competition. Importantly, with general negative sentiment towards all things China at present, both groups of stocks can be bought at undemanding valuation levels.

The final approach is to **identify sectors or industries that will benefit tangentially from the energy transition**. Shipping and shipbuilding are two such sectors. Shipping is a cyclical sector that experienced 10 very lean years from 2010, during which boom turned to bust so that ships ordered in peak demand years arrived in a depressed market sometime later.

Looking forward, shipping (especially bulk shipping) now has a much healthier demand/supply balance. Importantly, due to uncertainty about what will be the new climate-friendly fuel standard – methanol, ammonia or hydrogen – ship owners have been reluctant to order new ships, fearing any deliveries may become obsolete before their 20 years' useful life has expired. This is instilling an enforced supply discipline in bulk shipping that we have not seen in the past.

Similarly, shipyards are also benefiting from the energy transition. During the last decade, many yards were forced to close due to a lack of orders. This has reduced both physical and human capacity for building ships. As a result, remaining yards are in a strong position to cherry-pick the most lucrative of orders, given full order books out to late 2026 or even 2027. With literally thousands and thousands of ships that need to transition in the next 20 years, it is very plausible that an historically cyclical industry like shipbuilding will resemble, for a prolonged period, a structural growth story. In the shipping and shipbuilding stocks that we own, such a positive, structural outcome is by no means discounted by current valuations.

Adding greater value through engagement

As a last consideration, active investors like M&G who engage respectfully with companies – through what we call "value-added shareholdership" – can potentially add greater value to the companies they invest in, whether it be through better corporate governance, shareholder returns or improved sustainability actions. Value-added shareholdership is an additional and important way in which M&G seeks to add value for its clients.

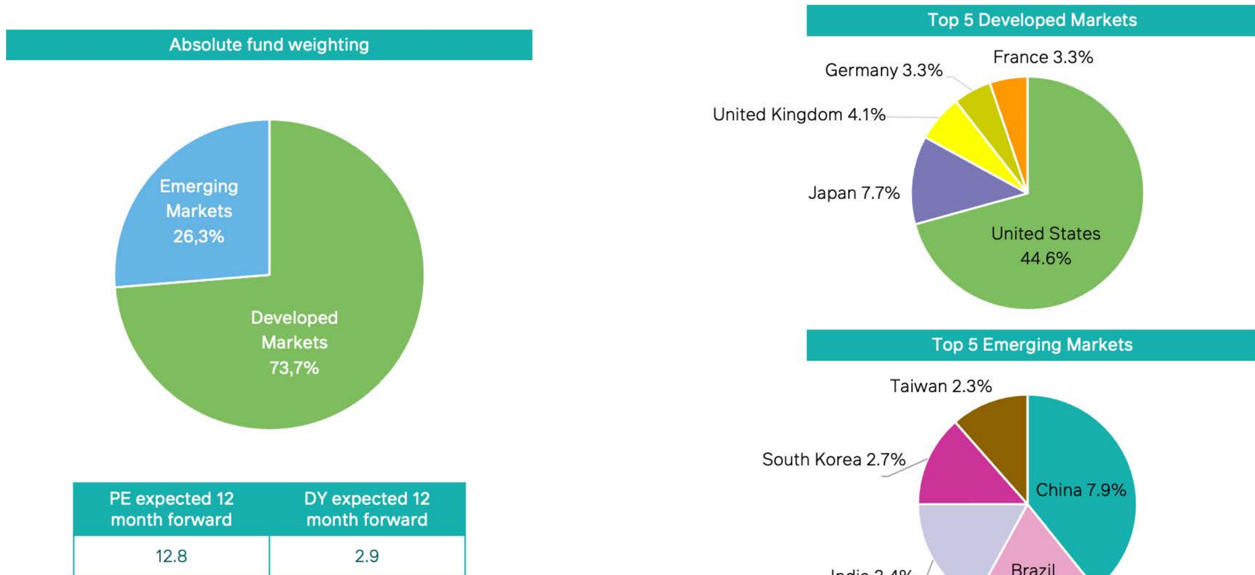
M&G Investments' China exposure

In summary, amid all the present uncertainty, we feel that current valuations in China offer a wide spectrum of exciting, long-term opportunities for engaged, bottom-up stockpickers like M&G.

Reflecting this view, the M&G Global Balanced Fund (and its rand-denominated Feeder Fund equivalent) is overweight Chinese equities compared to its benchmark with a 7.9% weighting out of the fund's total equity exposure (as shown in Graph 3). This holding has increased in 2023 as valuations have become more attractive, and we are considering adding further exposure on the back of the rapid January sell-off. The M&G Global Inflation Plus Fund (Graph 4) has similar positioning with a 7.4% weighting.

Graph 3: M&G Global Balanced Fund overweight Chinese equities

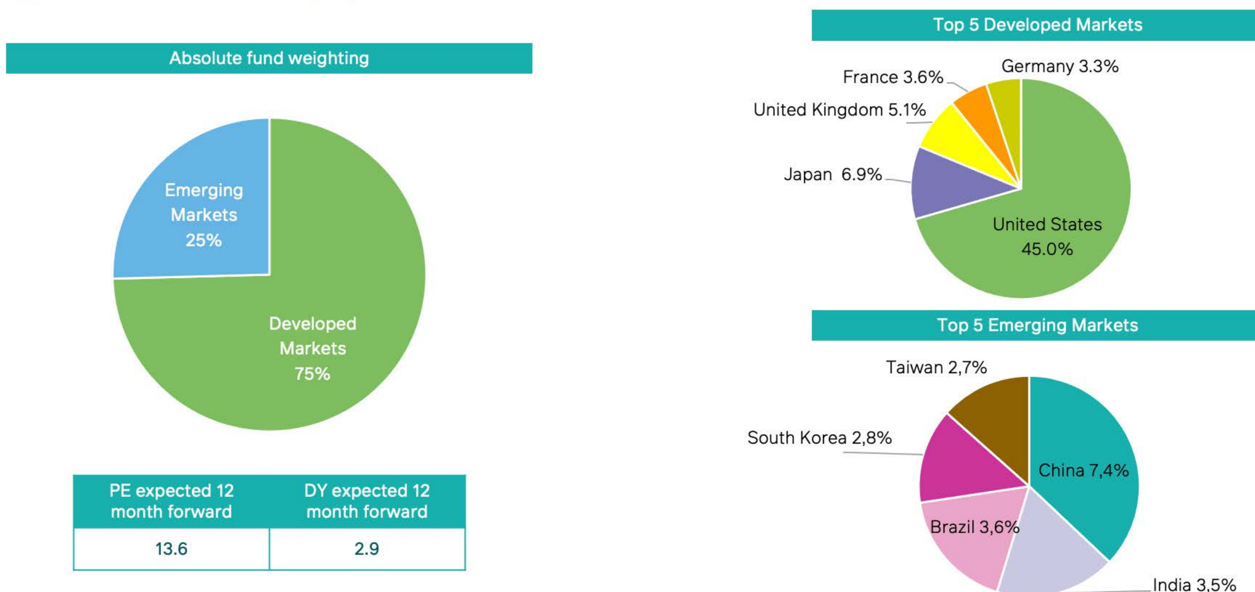
Regional breakdown: Equity carve-out



Source: M&G London 31 December 2023

Graph 4: M&G Global Inflation Plus fund overweight Chinese equities

Regional breakdown: Equity carve-out



Source: M&G London 31 December 2023

Disclaimer.

This document is for information purposes only and is not an offer to or solicitation for investors to invest in any of the capabilities or products offered by MandG Investment Managers (Pty) Ltd [M&G Investment Managers] (Registration no. 2013/051515/07) and MandG Investments (Namibia) (Pty) Ltd (Registration no. 1996/85) [M&G Namibia] or any of their associates, being MandG Investments Unit Trusts South Africa (RF) Ltd (Registration no 1999/005242/06) and MandG Investments Unit Trusts (Namibia) Ltd Registration no. 2007/609. M&G Investment Managers is an authorised discretionary financial services provider by the Financial Sector Conduct Authority of South Africa [FSP45199] in terms of the Financial Advisory and Intermediary Services Act, and has it's registered offices at 5th Floor Protea Place, 30 Dreyer Street, Claremont, 7708. M&G Namibia is an approved person in terms of section 4 of Stock Exchanges Control Act and has it's registered offices at 6 Feld Street, Windhoek, Namibia. Information given in this document has been obtained from, or based upon sources believed to be from an accurate and timely source but M& Investment Managers and M&G Namibia make no representations or warranty, express or implied, with respect to the correctness, accuracy or completeness of the information and opinions. This information is not intended to constitute a basis for any specific investment decision. Investors are advised to familiarise themselves with the unique risks pertaining to their investment choices. Investors should seek the advice of a properly qualified financial consultant/adviser before investing. The value of an investment will fluctuate and past performance is not necessarily an indication of future returns.