Chinese equities

What is in store for Chinese equities in 2019?

Mike Shiao
CIO, Asia ex Jap
Hong Kong

Key takeaways

- We believe Chinese equities represent some of the best structural opportunities across global markets.
- Following the correction in 2018, we believe the risk-reward picture has turned exceptionally favorable.
- We believe corporate fundamentals will remain strong given solid support from the domestic market.

There has been a disconnect between sentiment and fundamentals when it comes to Chinese equities in 2018. Market sentiment has been weak (driven by the changing relationship with the US and moderating growth), while economic fundmentals remained decent. China was on track to deliver its growth target despite moderation, widely known as a result of economic transitioning towards high quality growth.

Looking into 2019, our view on Chinese equities remains the same: We believe they represent some of the best structural opportunities across global markets, and the risk-reward is attractive now given:

- Economic growth that's expected to remain stable on the back of strong consumption.
- A solid and competitive domestic market to strengthen corporate fundamentals.
- Appealing valuation trading at close to a 10-year low.

Economic growth to remain stable in 2019

The Chinese economy continued its steady expansion in 2018 with gross domestic product (GDP) growth well on track to achieve the government's target of around 6.5%. We expect the economy to remain stable in 2019. China aspires to become a moderately prosperous society by 2020, with GDP doubling from its 2010 level. We believe China will set an appropriate growth target that will allow it to stick to its plan.

We expect consumption and services to keep gaining importance in driving economic growth thanks to rising income and growing household wealth. In the first three quarters of 2018, 78% of GDP growth was driven by consumption compared with 64% during the same period in 2017. [1]

We believe there remain structural needs for fixed asset investment, particularly infrastructure investment in China. We believe investors should bear in mind that even though China has made tremendous improvement, it still lags behind its developed peers on infrastructure as a developing country.

We expect the trade sector to face macro headwinds due to moderating global growth and rising tariffs, but we expect the impact to be limited as its contribution to GDP growth has been low in recent years.

Consumption to drive long-term economic growth

We have long been optimistic about consumption in China. First of all, we believe the Chinese government is deeply committed to promoting domestic consumption as a key growth driver as it not only leads to more balanced and sustainable growth in the long run, but also addresses the growing demand of Chinese people for better lives.

Secondly, Chinese private consumption as a share of GDP was only 39% as of 2016, much lower than global average of 58.4%. We believe it has great potential to keep rising going forward. [2]

Lastly, we believe a dynamic ecosystem in the consumer and technology sectors has been formed in China by structural trends, such as rising Internet penetration, an improving transportation network, and changing perceptions of Chinese consumers (e.g., young consumers spend more on leisure and sports and are more willing to use credit). We believe those trends will continue to drive strong growth of related companies, making consumption a highly investable theme within Chinese equities.

1 Source: JP Morgan research.
2 Source: Citi Research.

Solid domestic market to support corporate fundamentals

There have been concerns among investors that Chinese companies might not be able to extend their strength amid trade tensions. However, we believe corporate fundamentals will remain strong given solid support from the domestic market.

China is now the second-largest economy in the world. With a population around 1.4 billion, it represents a sizable market that encompasses many exciting opportunities.

We believe Chinese consumers are looking for upgraded and more sophisticated products as they are getting richer, which will lead to Chinese companies moving up the value chain to address the changing demand.

In addition, we believe the competitive landscape now is very different from the past when few state-owned enterprises dominated the market. There are more private companies now, in particular in the consumer-related sectors. We believe Chinese companies will keep pursuing innovation in order to stand out from the competition, and they will eventually become more mature in managing corporate affairs.

Continued reform efforts to tackle structural bottlenecks

2018 marks the 40th anniversary of China's economic reform and opening-up. We believe what China has achieved during the past 40 years is now widely acknowledged, but what is underappreciated is that it has never been a smooth journey to remain committed to reforms amid challenging times.

We believe the Chinese government's reform efforts will continue. In particular, we believe deleveraging and supply-side reform continue to be important. We believe China has made positive progress in stabilizing the growth of debt and expect deleveraging to remain important in helping support the sustainability of economic growth in the long run.

We believe supply-side reform will continue as well, and strengthened environmental policies will play a crucial role in supporting further reduction in overcapacity in the energy and materials sectors. Meanwhile, we believe the government will make a balancing act between launching reforms and maintaining economic growth, and we expect to see some easing measures continue in 2019.

Appealing risk-reward given valuation at close to 10-year low

Following the correction in 2018, we believe risk-reward has turned exceptionally favorable for Chinese equities. They traded at 9.9x 12-month forward price-to-earnings (P/E) as of mid-October, close to 10-year low. [3]

Given the appealing valuation, we believe investor confidence will eventually be revived once earnings growth is confirmed to remain on a solid ground. MSCI China companies achieved earnings growth of 17% in the first half of 2018, and market consensus expects it to remain steady in the second half of 2018 and 2019. [4] We believe the consumer, internet and health care sectors will lead earnings growth, as they can continue to benefit from structural economic growth drivers in consumption and services.

Trade tension warrants closer monitoring

Trade tension was a top issue that weighed on sentiment in 2018, and we believe it deserves continued attention from investors.

We believe China and the US remain in a negotiating process, and given the complex nature of the issue and its connection with US domestic politics, we expect things to turn quickly on either side (not excluding a substantially positive scenario).

We believe China remains competitive in the industrial sector. It plays a key role in the global supply chain that is difficult to be replaced thanks to its competitive advantages in land, labor and productivity, but it is undeniable that there is still ample room for the country to improve on the technology front.

3 Source: Goldman Sachs Global Investment Research. As of Oct. 15, 2018.
4 Source: Citi Research.

Conclusion

We believe the Chinese economy will maintain stable growth in 2019 on the back of strong consumption, providing a supportive backdrop for Chinese companies to deliver healthy earnings growth. We believe continued innovation will lead to rising competitiveness of Chinese companies, which makes them continue to be our top choice among Asian equities.

Important information

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are forward-looking statements, which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs.

Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.