J O Hambro Capital Management Group

James Syme
Senior Fund Manager

Paul Wimborne
Senior Fund Manager

Ada Chan
Senior Fund Manager

Evaluating the Future of Chinese Equities

Understand the short-term "voting" actions of foreign investors selling Chinese equities versus the long-term "weighing" impact of value investors.

KEY POINTS

- “In the short run, the market is a voting machine, but in the long run, it is a weighing machine.” - Benjamin Graham
- We have seen a powerful voting effect of foreigners selling Chinese equities without any obvious sign that the weighing effect of value investors buying is having any meaningful impact.
- This selling can be seen in various metrics, including A-H share premia, fund flows, and valuations.
- Until there is a sign that the negative sentiment and fund flows have improved, we will stay cautious and underweight Chinese equities.

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Benjamin Graham famously said, “In the short run, the market is a voting machine, but in the long run, it is a weighing machine.” In recent months, we have seen a powerful voting effect in Chinese equities without any obvious sign that the weighing effect is having a meaningful impact.

To see this more clearly, it is important to understand how Chinese equity markets are structured. China has possibly the most complicated equity market structure in the world, with listings split between the mainland, Hong Kong, and overseas.

China has three domestic stock exchanges, dominated by Shanghai (the others are Beijing and Shenzhen), principally for domestic investors. The exchanges predominantly trade Renminbi-denominated A shares, making the equity markets largely subject to Renminbi liquidity and interest rates. Due to capital controls, domestic investors have limited access to other equity markets, including Hong Kong.

Foreign investors, on the other hand, primarily have access to Hong Kong Dollar-denominated H shares listed on the Hong Kong Stock Exchange. Because of the currency peg, these are subject to a combination of Hong Kong Dollar and US Dollar liquidity and interest rates. Some Chinese companies are only listed in A shares, some only in H shares, and some are dual-listed.

Further complicating the landscape is Connect, a tightly controlled mechanism for foreign investors to access A shares via Hong Kong. Finally, there are Chinese companies listed on other capital markets, of which US-listed ADRs have been the most important. Since sanctions began in 2018 and the resultant decoupling, there has been an aggressive move to delist Chinese ADRs and they are less important than they used to be.

The voting mechanism at play in Chinese equities is the aggressive selling by foreign investors across the Chinese equity landscape. Several indicators reflect this trend, one being simple market returns. In the year to the end of January 2024, the MSCI EM ex-China Index returned +10.4% in USD terms, compared to a -27.7% return from the HKSE China Enterprise Index and a -17.1% return from the Shanghai Composite Index (the main indices for H shares and A shares respectively).

Relatedly, an index of the premia at which dual-listed A shares trade compared to their H share counterparts has been steadily rising since 2018. In the year to end January, this jumped from 34.5% to 56.8% as foreign investors sold shares with the same underlying fundamentals more aggressively than domestic investors. This selling can also be seen in the flows through Connect, with foreigners selling USD 1.4bn of A shares through Connect in January 2024 alone.

Similar trends emerge in the index fund space, with the main MSCI EM Index seeing its net asset value decline from USD 26.3bn to USD 17.0bn in the year to January. Conversely, the MSCI EM ex-China index saw its net asset value increase from USD 3.3bn to USD 9.3bn as investors fled Chinese equities.

Finally, and as previously noted, valuations of Chinese stocks are well below both their peers in emerging markets and their own valuation history. Chinese equities, particularly H shares, are extremely cheap across the board. However, with the current negative newsflow and sentiment, coupled with foreign investors 'voting' to abandon China, there is insufficient capital 'weighing' these apparent value opportunities. The 'long-run' in Graham's quote seems, for now, to extend past our investment horizon, and we remain cautious on China and underweight the market while the current environment continues.

Source: Bloomberg/MSCI/JOHCM.

The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries*. With 1,441 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets ex China Index captures large and mid cap representation across 23 of the 24 Emerging Markets (EM) countries* excluding China. With 675 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

*EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The Hang Seng China Enterprises Index (HSCEI) is a market capitalisation-weighted stock index which is compiled and calculated by Hang Seng Indexes Company Limited. The HSCEI tracks the performance of major H-shares. H-shares are Renminbi-denominated shares issued by People's Republic of China (PRC) issuers under PRC law and listed on the Stock Exchange of Hong Kong, the par values of which are denominated in Renminbi, and which are subscribed for and traded in Hong Kong dollars.