Beyond China, CIO believes select quality equity segments sensitive to Chinese growth and consumption also stand to benefit from the stimulus measures. (UBS)

China takes action: What's next for equities?

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In the latest stimulative policy step, China's central bank late Sunday said it would reduce mortgage rates for existing home loans before 31 October, while first-tier cities Guangzhou, Shanghai, and Shenzhen said they would ease home-buying curbs. This follows last week's stimulus cocktail of stronger-than-anticipated monetary easing, more forceful policymaker direction, domestic stock market support measures, and new efforts to put a floor under the ailing property market.

Given the swiftness and the extent of the equity rally over the last week, we believe the near-term outlook is now more evenly balanced:

Chinese equities have more room to rerate. The stimulus-fueled shift in sentiment has been most visible in the Chinese equity market, with the MSCI China index rerating in the past week from a cycle low of 8.9 times 12-month forward price-to-earnings, to around 10.6 times. While a significant move, this remains below both the May year-to-date valuation peak of 10.7 times, and the post-pandemic high of 11.8 times in January 2023. The timing of the policy action, coming alongside the beginning of a US interest rate-cut cycle, should add to equity tailwinds and create additional room for monetary easing. A stimulus jolt to both consumer and industrial activity should also help backstop earnings revisions, which are already either on a stable trend or edging higher.

Follow-through needed to sustain the rally. Investors considering China exposure must also recognize that the full scope, scale, and implementation of stimulus remain uncertain, and that from a growth perspective, a fundamental turnaround will likely require additional fiscal support for the property market. Past equity rallies, as in May 2023, have fizzled out when key stimulus or policy changes failed to match their initial promise. Part of our own optimism this time around reflects our anticipation of significant additional fiscal and monetary support, including 50-100 basis points of cuts to banks' reserve requirement ratio (RRR) and 20-50bps of policy rate cuts by end 1H25. We also anticipate multiple rounds of fiscal stimulus worth CNY 2-5tr, focused on affordable housing and investing in social welfare. Sufficiently large stimulus could allow GDP growth targets to remain anchored around Beijing's preferred 5% level in the coming years.

FOMO—fear of missing out—is not an investment strategy. The speed of the rally has drawn global attention, and is pushing many investors to reassess bearish expectations for China's outlook. As detailed above, we think this could be a potential game-changer for China. At the same time, the pace and scale of the initial move suggests a significant global short-covering event for what is ultimately a smaller constituent of the investable global equity market. Even with the rally in China equities so far, emerging market (EM) equities have underperformed developed market counterparts year-to-date on a total return basis as of Friday, and by a significant margin over the last few years. By launching its stimulus now, China may be seeking to preempt US-election-linked growth risks. However, harsh export tariffs under a second Trump presidency, or incremental national security and tech restrictions under Biden and Harris remain very real prospects.

So, on balance, we are more optimistic than we were at the start of last week thanks to better policy coordination and resolve, but we think the trajectory forward will depend on the relative level of fiscal support, policy execution, and capital market buying. In the fourth quarter, we expect low-single-digit percentage further upside for Chinese equities, with the risk of volatility into the US election. Further out, subject to the shape of trade policy under the new US administration, we see scope for high-single-digit upside in 2025.

Within Chinese equities, for investors considering adding exposure, we recommend focusing on growth via leading internet and consumer names. Key internet platform players have shown strong margin improvements in recent earnings releases and should continue to do so, in our view. Should consumption begin to turn around given the stimulus efforts, that should also result in top-line upside for leading names in the internet sector. To account for lingering risks, including from geopolitics, we also maintain some exposure to defensive, high-yielding names in the state-owned-enterprise-concentrated telecoms, energy, utilities, and financials sectors. Within Asian fixed income portfolios, we recommend investors switch from China government bonds into other quality local currency Asian bonds. Beyond China, we think select quality equity segments sensitive to Chinese growth and consumption also stand to benefit from the stimulus measures. These include diversified Australian miners and consumer names, North Asian tech leaders, and European luxury. We also recommend investors hedge CNY exposure ahead of the US election.

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