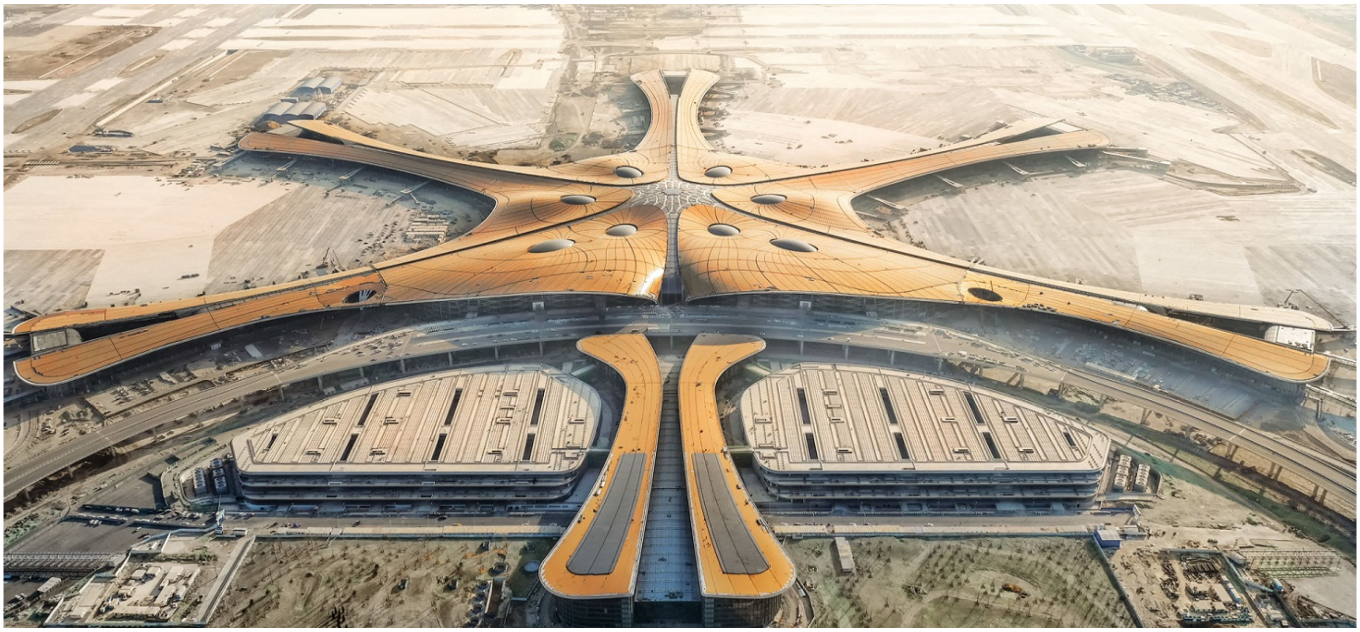

In CIO's view, the China stock rally has run ahead of a narrow macro recovery and lackluster corporate earnings outlook. (UBS)

Chinese equities: Comeback or a head fake?

13 May 2024, 6:40 pm CEST, written by UBS Editorial Team

Chinese stocks seem to have reawakened. Since the beginning of April, they delivered a total return above 10% in US dollar terms. Since their late January lows, major Chinese equities indexes have all rebounded sharply with MSCI China, Nasdaq Golden Dragon, and CSI 300 index gaining close to 27%, 22%, and 14% in US dollar terms, respectively.

CIO thinks a combination of drivers is contributing to the positive performance. First-quarter macroeconomic indicators have printed better than feared. Additionally, the economic and regulatory policy tone has become more supportive. For example, a set of guidelines around capital market development that is typically published once a decade were released in April, in an attempt to address investor concerns around minority shareholder interests and quality of listings. As well, the April Politburo meeting signaled policymakers' intentions to address existing housing inventory issues, leading at least some analysts to expect more aggressive supply-side property stimulus.

This combination of developments seems to have, at least modestly, reignited investor interest in Chinese stocks amid historically light positioning and a mixed global backdrop. According to EPFR data, global mutual funds held around a decade-low allocation in Chinese equities of 5.5% at the end of 2023. After persistent outflows in recent years, data from both EPFR and the Institute of International Finance show that Chinese stocks once again began to see net inflows this year.

In our view, the China stock rally has run ahead of a narrow macro recovery and lackluster corporate earnings outlook. Property-related indicators continue to trend downward, which will likely keep weighing on consumer sentiment. And as a result of weak demand, deflationary pressure has so far persisted.

On the corporate fundamental front, the downgrade in 2024 consensus earnings growth forecasts may have more room to go and the 1Q24 result season is likely to underwhelm market expectations. We currently forecast EPS growth of 8%

for MSCI China in 2024, 4 percentage points lower than consensus expectations. We think the inflection point on earnings dynamics will only come if key macro headwinds start to fade. First, we think a stabilization in Chinese property sales, and eventually home prices, is necessary. Second, we look for sustained evidence of broad-based reflation in both the CPI and PPI, which could indicate a fuller recovery in economic activity and corporate capex. Third, a wider consumption-led recovery expanding from services to goods should take place.

In absence of these catalysts, we think Chinese stocks offer limited upside in the near future and we are not confident they can outperform emerging market peers. We're also watching increasing trade tensions along with technology restrictions from the US, as these could become more noticeable headwinds as the US election season heats up.

In this context, we believe investors should maintain exposure to China in line with strategic allocations. Those looking for tactical opportunities should consider a barbell-style tilt toward cash-returning defensive SOEs as well as onshore Chinese stocks.

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Original report - **Chinese equities: Comeback or a head fake?, 13 May 2024.**