China Bulletin: Market View

China's equity market is consolidating after huge gains over the past year, followed by a sharp correction. Some indices gained over 60% from March 2020 to February 2021, driven by China's strong recovery from Covid-19. Then fell up to 15% as overstretched valuations corrected. The market will continue to benefit from China's improving fundamentals and supportive economic policy. Growth is supported by strong external demand despite the global slowdown, as shown by China's production and export data. The recovery of global supply chains is unlikely to derail this trend, as global demand and capital expenditure should rise in the wake of higher commodity prices and a more friendly US trade policy.

China's policy makers have vowed to fine tune their policy decisions to avoid a drastic shock to the market in part from uncertainty surrounding the global recovery and the Fed's cautious attitude. It is difficult to assert that the market valuation is back to a reasonable level and is now ready for a rebound after the recent correction. However, structurally some sectors and strategies do have chances to outperform.

A low volatility strategy is still recommended as the return is more sustainable in the long run - and more suited to today's Chinese equity market. As the chart shows, the minimum variance index has delivered a similar return to the Shanghai Shenzhen 300 Index since 2020, but with much lower volatility. Although growth will remain steady and support the equity market, the looming exit of supportive policy and expected implementation of stricter asset management regulation may intensify market volatility in the near future. Additionally, China's economy has been in the best shape since the trough in 2015-16, and a more balanced recovery can be expected, implying a more balanced equity market, rather than being driven mainly by the largest companies.

Sector wise, we would recommend internet stocks and commercial banks. Alcohol, healthcare, and new energy names delivered impressive returns in recent years. However, this has led to most institutional investors chasing these shares, pushing their valuations to unsustainably high levels. Internet names will suffer from the anti-trust campaign temporarily, but their growth remains exceptional and they have much fairer valuations. The anti-trust campaign will help to maintain a competitive environment and enable more sustainable growth in the long term. Commercial banks, on the other hand, will benefit from the improving asset quality and higher rates of return on assets.

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