

China: Is the Recent Runup in Chinese Stocks a Durable Rally or a Flash in the Pan?

In August of 2021, we decided China was un-investable and reduced our exposure to Chinese equities. In our blog "[From Beijing to Wall Street](#)", we detailed our rationale. In a short time period, the Chinese government had:

- Canceled the \$37 billion Ant Group IPO, a major shock to the market that later resulted in a restructuring of the company.
- Caused the billionaire founder of Alibaba, Jack Ma, to disappear for months after he criticized the Communist Party.
- Ordered app stores to remove the Chinese ride hailing service, DIDI, just days after the company went public, causing DIDI's shares to ultimately fall 50%.

These and other actions demonstrated President Xi Jinping's desire to reduce the power of the 'free market' economy. Instead, he promoted 'common prosperity', a program focused on bolstering social equality and economic equity. Essentially, Xi wanted to restrict the influence of wealthy entrepreneurs and increase the power of the Communist Party.

However, the Chinese government's actions fundamentally affected the ability of the Chinese companies to make money. Their economy slowed, foreign investors exited, and the Chinese stock market declined 40% over the next two years.

What Happened Next?

The Chinese Government, spooked by faltering growth, decided to take measures to reboot the economy and inspire consumer confidence. On September 24th, they:

- Reduced short term rates
- Cut bank reserve requirements
- Reduced rates on existing mortgages

More interestingly, the Chinese central bank made it easier for companies to engage in stock buybacks and for investment firms to increase share purchases.

The timing of the stimulus was likely influenced by the U.S. Federal Reserve's recent 50 basis point rate cut, allowing the Chinese to cut rates without putting more pressure on the Chinese currency. The prices of Chinese equities jumped in response to the change in tone from the Chinese government. Even after a recent pullback, the Chinese ETF, FXI China, is still up 20% from recent lows.

The Investment Case

Chinese equities are very cheap versus their U.S. counterparts. In fact, Chinese stocks have barely appreciated for 17 years, while the S&P 500 is up 270% since 2007. Further, active managers' exposure to the Chinese market is at multi-decade lows - which means institutional buying could drive up prices. **However, our primary rationale for *investing* in China now is political: the Chinese government needs businesses to succeed if they want to maintain power and make their economy grow.**

On the flip side, George Magnus points out "The bulk of household wealth resides not in stocks but in the beleaguered property market where prices are falling, and in low-yielding bank deposits. Therefore, confidence to spend requires a more stable property market, stronger income growth and a more robust jobs market."¹

We will watch carefully for things that might derail our thesis which include failure to resolve systemic problems such as high youth employment, the real estate overhang, weak productivity and deflation.

Remaining Flexible

We are wary of making major changes based on ephemeral events, but we must be open to changing our minds when we get new evidence. We suspect that change won't come easily or quickly, but the Chinese government will do what it takes to improve their economy and keep their leaders in power. Thus, we have initiated a position in Chinese equities. Tariff fear mongering by either or both U.S. Presidential candidates might give us an opportunity to increase our exposure in a selloff. **If we are correct again, and Chinese internal policies have more consequences for their domestic companies and consumers than do the U.S. threatened sanctions and trade tariffs, exposure to the Chinese market appears to make sense once again.**

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¹The Guardian, "China's plan to boost flagging growth is the very definition of economic insanity", George Magnus

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