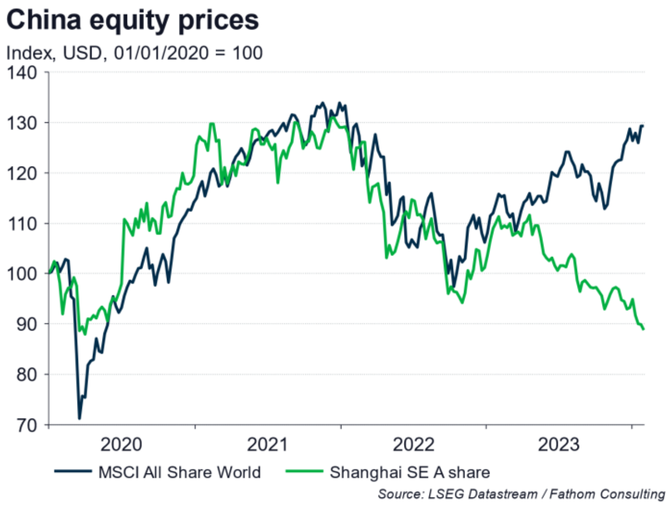
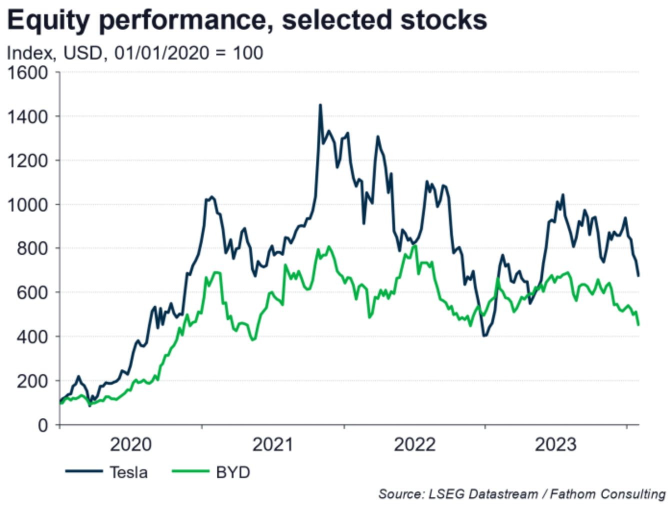
Investors wary of Chinese equities

5 February 2024

Brian Davidson

The price of Chinese equities has been on the slide for nearly a year now, in an increasingly marked divergence from the bullishness around US and other global equity markets.





A range of short-term factors, including a weak outlook for China's GDP growth, deflation and trade tensions with key trading partners, have caused concern among foreign investors. Data from China's State Administration of Foreign Exchange show that China's FDI liabilities declined for the first time on record in Q3 last year. In other words, foreign investors, on balance, took money out of China.

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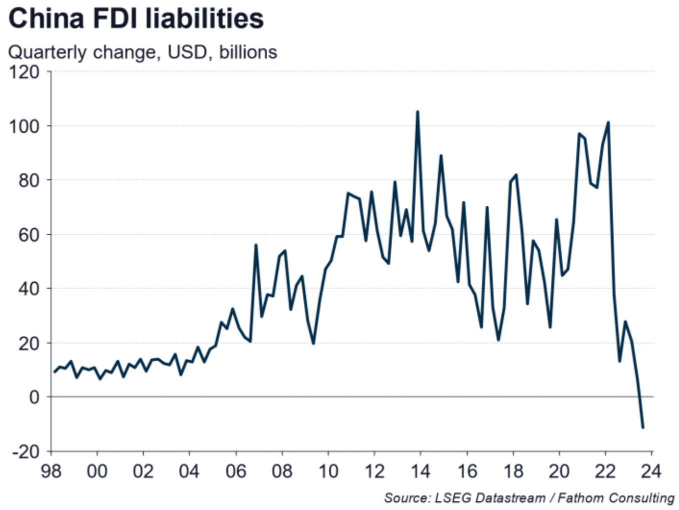
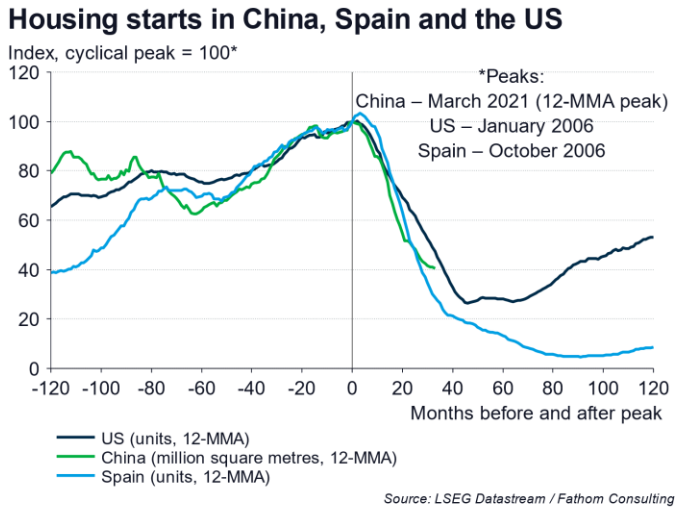


Longer-term economic challenges, including a failure to rebalance away from investment and exports towards domestic consumption, high debt levels and an ageing population, have also dented investors' confidence. The housing market bubble remains a source of both short- and long-term anxiety too. As the chart below shows, the trajectory of China's housing market over the last few years looks remarkably similar to the trajectories of the US and Spanish housing markets in their respective crashes, which started in 2006 and lasted for several years. That suggests that the worst may be yet to come for China's market, despite the careful juggling act its policymakers are attempting to perform to balance the risks.



The pace of decline in housing starts has recently started to slow, offering some tentative signs of encouragement that a crash might be averted. Chinese policymakers have some room for manoeuvre since interest rates and bank reserve requirements could be cut further, especially with the CPI and PPI both in deflationary territory. The challenge is that easing monetary policy when debt levels are already so high risks exacerbating the problem of misallocating capital, doing nothing to improve China's underlying problem with overcapacity of housing, which continues to threaten further problems down the line. Analysis by Fathom suggests that increasing debt levels beyond where they are in China today will not only fail to boost growth but may in fact damage the country's long-run growth potential. The dilemma is not new, but investors seem to be waking up to the difficulty of this challenge.

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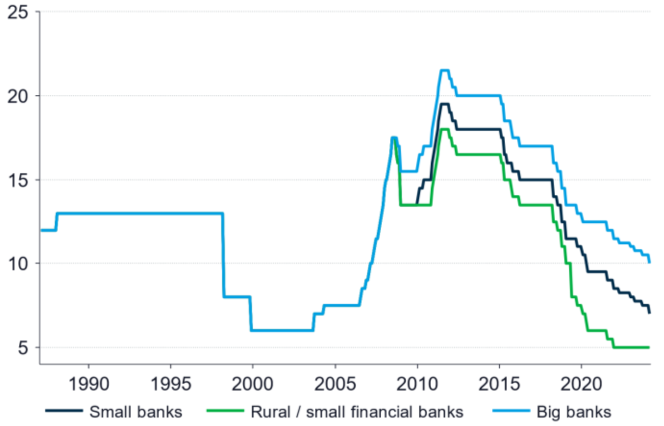
China CPI and PPI inflation

Twelve-month percentage changes

Source: LSEG Datastream / Fathom Consulting

China reserve requirement ratios

Per cent



Source: LSEG Datastream / Fathom Consulting

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