China A-shares 2024 outlook

January 2024

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What can we expect in 2024?
Entering 2024 we expect to see more policy support for the China A-shares market, a gradual recovery in investor confidence and structural opportunities in certain industries.

We believe the series of policies to boost the economy that were introduced last year will bear fruit in 2024. While the regulations supporting the property sector may not be enough to ensure a long-term growth trend, we believe these actions can help ensure the sector achieves a soft landing thus decreasing the drag on economic growth compared to 2023.

There is a strong likelihood that the consumption downgrade trend will persist for another one to three years until property prices can stabilize. This is being driven by the negative wealth effect, weak wage growth and high youth unemployment. Consumer confidence varies between different income groups. China's middle class are the least confident consumers given that property accounts for a larger proportion of their net wealth.

There are three catalysts that we believe may help to revive low consumer confidence in 2024: the possible distribution of consumption vouchers in March to boost spending during the post CNY lull, stronger wage growth and an improvement in the labor market if we see economic recovery gain momentum, and a potential pick-up in the birthrate in the auspicious Year of the Dragon which may spur household spending.

Although property and consumption dragged down macroeconomic growth in 2023, at the micro level, we still see the global competitiveness of Chinese companies increasing. We believe the upgrading of China's industrial value chain is an unstoppable trend. Whether it is the surge in exports of new energy vehicles or the launch of self-developed mobile phone chips by China's tech giant breaking through Western technology curbs, China's technological innovation and cost advantages are enabling domestic companies to become strong competitors in advanced manufacturing.

We expect China's continuous upgrading in advanced manufacturing-related industries will bring more import substitution and export opportunities to A-share companies. We also anticipate that China' world-leading green industries such as electric vehicles, solar and wind power will bring opportunities for A-share companies to expand overseas and become new growth drivers.

On the geopolitical front, diplomatic relations between China and the West have improved recently, but the 2024 U.S. election is likely to bring some uncertainty. US interest rates have peaked and are expected to trend downward in 2024, which will help encourage fund flows to emerging markets including the A-share market.

Historically we have seen A-share growth sectors generally outperform value sectors as rates start to fall. The depreciation of the US dollar will also provide more room for China's monetary policy to continue to support economic growth in 2024 (via lowering the reserve ratio and interest rates).

We believe the property sector slowdown will last for some time and do not expect strong GDP growth recovery any time soon. However, 2024 is expected to a better year than 2023, promising many structural investment opportunities for investors.

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Where are we seeing structural investment opportunities?
We are optimistic about China's advanced manufacturing and pharmaceutical sectors in 2024.

Advanced manufacturing
The upgrading of the domestic advanced manufacturing industry is being driven by the strong growth potential of new industries and advancement of homegrown technology.

We believe the humanoid robotics sector has a lot of room to grow in the next five to ten years. The initial stage of this development will focus on commercial applications as breakthroughs in AI foundation models will promote the commercialization of robots. In the long term, as the technology matures and labor costs rise due to a shrinking workforce , humanoid robot applications will gradually expand to the consumer market where it has huge growth potential.

The first step would be to greatly reduce production costs with the help of China's midstream and upstream industrial chains. At the same time, the Chinese government has recently announced several policies to support the humanoid robot industry. We are positive on robotics supply chains that have less overlap with industrial robots, such as the humanoid robotic hand supply chain.

Pharmaceuticals and biotech
The domestic pharmaceutical sector has performed poorly in the past three years. In the first two years the sector was affected mainly by volume-based procurement and geopolitics. In 2023, the concern has been around the anti-corruption campaign in public hospitals.

Looking ahead to 2024, the impact of the anti-corruption campaign is gradually dissipating. We expect high-performing pharmaceutical and medical device companies to gain more market share as companies with high selling expenses and low R&D capabilities will be kicked out of the competition and the industry's profit margin is expected to improve as sales expenses reduce.

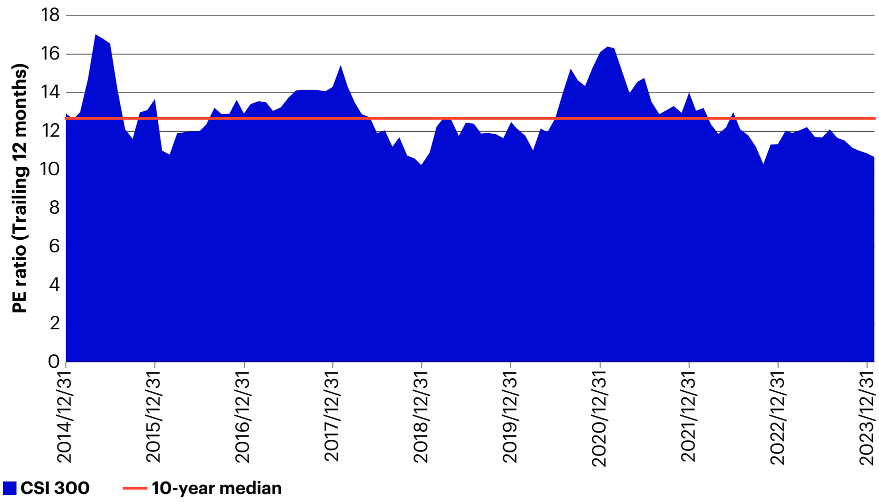
We foresee the impact of volume-based procurement to reduce in 2024. This will be particularly salient for pharmaceutical companies as most of their drugs have already been included into the drug reimbursement list and the impact of drug price reductions will be lower.

The growth of global biotech funding has slowed over the past one to two years due to the impact of higher interest rates in the US. However, as rates are likely to fall in 2024, we expect this will promote the recovery of global biotech funding growth and will have a positive impact on China's biotech sector.

After nearly three years of adjustment, valuations of China healthcare companies are well below the 10-year average. We believe long-term demand in this sector is a certain outcome, driven by China's aging population, and therefore the risk reward profile of the healthcare industry is currently at an attractive level.

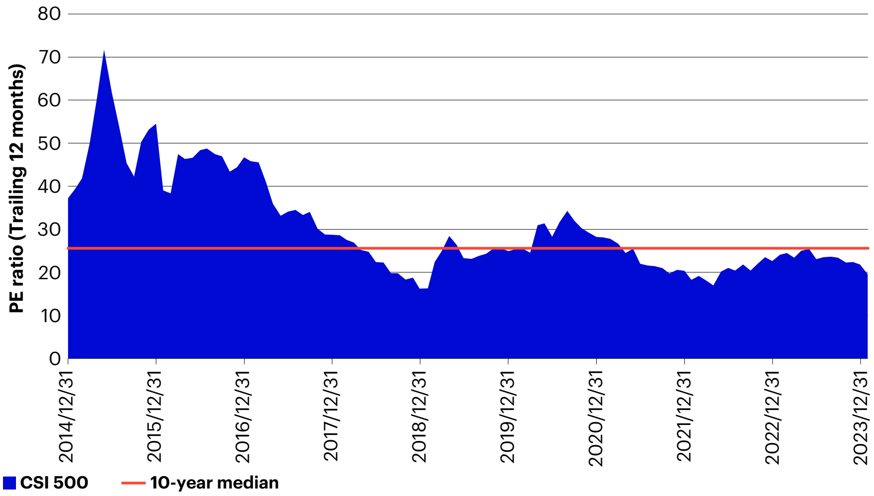
China A shares outlook
Overall, we believe value factors will continue to outperform should Chinese market sentiment rebound, driven by the large historical discount the market is currently at as well as by valuation re-rating trend of Chinese state-owned enterprises. At the same time, an economic rebound may lead to a tactical outperformance for both leverage and growth factors in 2024. At 10.8x P/E, China's large cap valuations are now at their lowest levels since 2018 and are significantly lower than the 10-year median levels. The valuations of mid cap and small cap stocks are also below their respective 10-year median levels. This historical discount is persistent across all major industries, especially among banks, insurers, and real estate firms.

Figure 1 – Trailing 12 months PE ratio of China large cap companies (2014 – 2023)



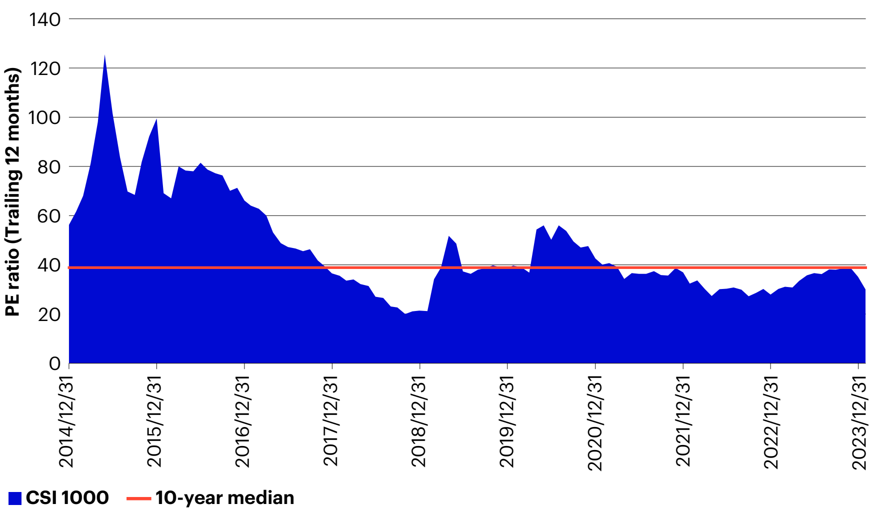
Source: WIND, data as of December 31, 2023. Note: Data based on CSI 300 Index.

Figure 2 – Trailing 12 months PE ratio of China mid cap companies (2014 – 2023)



Source: WIND, data as of December 31, 2023. Note: Data based on CSI 500 Index.

Figure 3 – Trailing 12 months PE ratio of China small cap companies (2014 – 2023)

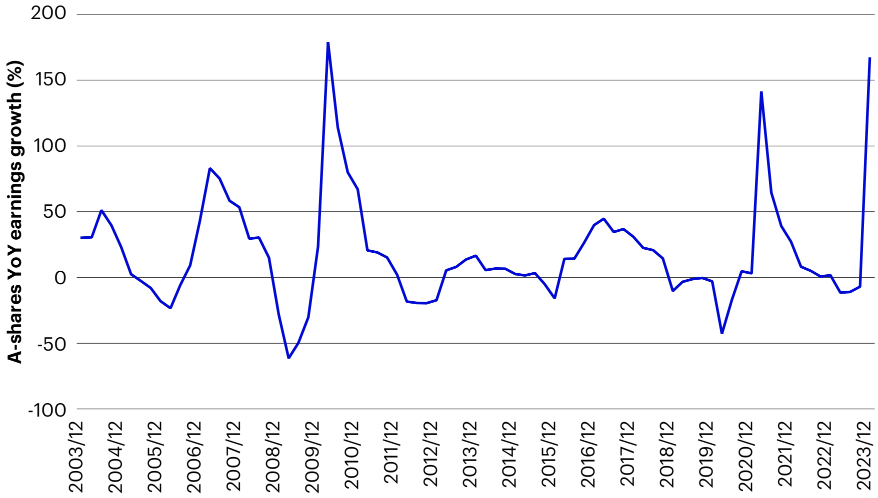


Source: WIND, data as of December 31, 2023. Note: Data based on CSI 1000 Index.

The weak economic growth trends over the last two years have exerted pressure on corporate earnings growth. As earnings downgrades are now showing signs of bottoming out, we expect valuations to find support in the near term. The probability of a broad-based earnings recovery in 2024 should not be ignored given the strong fiscal and monetary stimulus measures that have been put in place.

If China's economy could regain a more stable growth momentum, we expect earnings revisions or analyst sentiment factors will improve. Despite a declining interest rate environment, more leveraged companies have been weighed down by the poor economic sentiment in 2023. We expect the leverage factor to rebound in tandem with higher lending growth and an improved liquidity backdrop created by the People's Bank of China's looser monetary policy in 2024.

Figure 4 - A-share companies overall YOY earnings growth (excluding financials and oil companies)



Source: WIND, data as of December 31, 2023.

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Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When investing in less developed countries, you should be prepared to accept significantly large fluctuations in value.

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