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As China recovers from the coronavirus, what's next for Chinese stocks?

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While the world battles the coronavirus pandemic, China has already made strides towards mitigating the virus's effect on its people and economy. Although the country is not yet out of danger, we expect China's economy to recover in the second half of this year – which could be another positive signal for China's domestically driven A-share market.

Amid so much uncertainty, don't overlook China A-shares

As the coronavirus pandemic grows increasingly serious in many parts of the globe, the true human cost is only slowly becoming clear. The ultimate economic effect will be difficult to assess as well, though we have already seen a dramatic slowdown in the global economy and an end to a multi-year bull market.

Yet although China was hit hard by this viral outbreak only a few months ago, we expect China's economy to recover in the second half of this year. As a result, while most investors are understandably cautious about taking risk amid so much uncertainty, we believe now is a good time to take a closer look at China A-shares – Chinese companies that are listed in domestic markets in Shanghai and Shenzhen, and made available to local and foreign investors.

After a coronavirus slowdown, corporate China appears set to rebound

China's economy was already set to slow in 2020, but strict quarantine measures early in the year brought economic activity to a temporary halt even as they saved countless lives. Assuming the country doesn't get hit with a massive second wave of infection, we think domestic economic activity could continue to strengthen in the coming months.

This should help expectations for corporate earnings growth, which moved lower earlier this year. Since then, most of China's large companies

Key takeaways

- After China's economy ground to a virtual halt earlier this year, most companies have resumed work – which should ease pressure in the global supply chain and help Chinese manufacturers
- Even with the coronavirus outbreak, "onshore" China A-shares have outperformed "offshore" China H-shares this year, and significantly outperformed equities in the US, Europe, Japan and emerging markets
- Given that China A-share companies get almost all their revenues domestically, they are likely to have an advantage over exporters amid a slowing global economy
- With coronavirus causing widespread volatility, it's worth noting that A-shares have had a very low correlation with other major asset classes – including them in a global portfolio helps diversify away some portfolio risk and helps generate a much better risk-return profile

and around two-thirds of its small- to medium-size companies have resumed work, according to China's Ministry of Industry and Information Technology. We expect this will help ease stress in the global supply chain and help Chinese manufacturers, even though the sharp contraction in overseas demand is still expected to slow orders for Chinese exports.

China's success at executing its post-coronavirus recovery plan is one of the main reasons why China A-shares have been resilient compared to risk assets globally. As the accompanying chart shows, China A-shares have fallen this year, but significantly less so than other asset classes.

The future of A-shares depends on global consumers and domestic investors

In our view there are two key – and opposing – influences that will determine the near-term direction of China A-shares:

- Globally, consumers could spend less on Chinese goods. The key risk is the global demand shock if consumers spend less due to the fall-off in economic activity. Although 90% of A-share company revenues are domestic, according to investment group CLSA, China will still feel secondary consequences of the global economy's sudden downturn. This will limit the rate of China's economic recovery.
- Chinese investors could keep buying domestic stocks. On the other hand, liquidity conditions in China remain favourable for equities, in contrast to the rest of the world. The main participants in China A-share markets are onshore private investors. Their investment options are generally limited to domestic equities, the domestic bond market where yields are falling or the property market, where prices are already high. So far, this scenario has been winning, which has helped A-share performance.

We are also optimistic about China's outlook because of its monetary policy. The People's Bank of China (PBoC) has a wider positive interest-rate gap than its counterparts in Europe, Japan and the United States. The PBoC also has a wider buffer between where its policy rate currently stands and the zero lower bound – or even negative territory. These factors bode well for attracting capital inflows and providing stronger support to economic growth.

The long-term case for A-shares remains unchanged

The structural trends supporting A-shares are still in place. For example, the onshore A-share market is large and diversified, with bigger exposure to so-called new economy industries like consumer services, electric vehicles and industrial automation. In addition, global indices continue to raise their A-share weightings even though it is not just foreign investors who are buying A-shares: domestic investors, employees and company management teams have all increased their ownership in the past two years.

Perhaps most importantly, the correlations between China A-shares and other major asset classes is still very low. According to Bloomberg data from 31 January 2020, the correlation of A-shares and world equities was around 0.2 over the past 10 years, while the correlation with US and European equities was even lower. Including China A-shares in a global portfolio helps diversify away some portfolio risk and could help generate a much better risk-return profile.

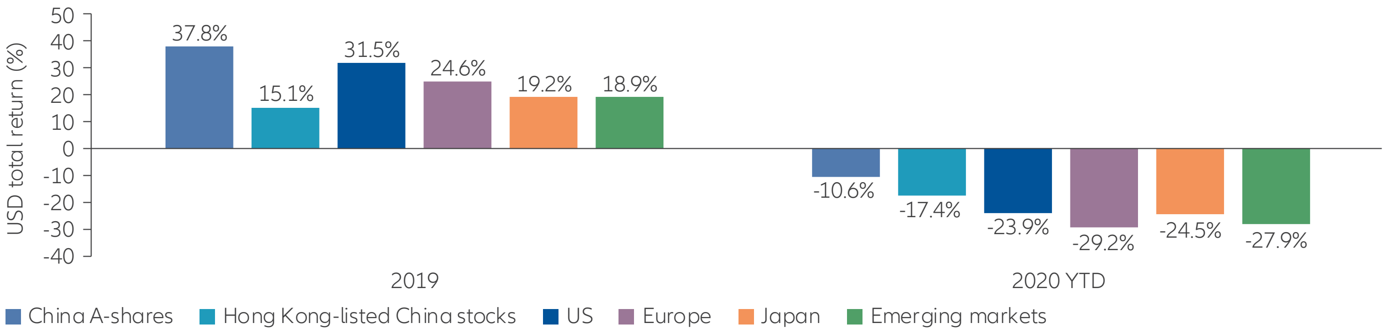
In addition, the relatively under-developed nature of China's capital markets may well be playing to its advantage in the current environment. The forced liquidations seen elsewhere, for example from risk-parity strategies or leveraged quant-driven hedge funds, are not a big influence in China's primarily retail-driven domestic markets.

Considerations for investors

- China's success at fighting the new coronavirus could impart a valuable lesson for investors in other regions. China has shown that the more important indicator of a country's health – both physical and economic – is its ability to contain and combat the virus within its borders, rather than how much monetary and/or fiscal stimulus it plans to enact.
- We expect domestically focused Chinese companies to feel less of an impact from a global slowdown caused by the coronavirus pandemic. China's recovery is likely to be supported by companies that focus on domestic demand, and by public infrastructure investment projects. But use caution when considering Chinese companies that rely more on external trade, such as auto components makers.
- There is a considerable amount of debt in China, and smaller businesses experiencing business disruption may have difficulty accessing funding at this stage. But this is also positive news for the stronger players. Look for small to mid-cap companies that are market leaders in niche market segments, like semiconductors or frozen foods. These are fragmented industries, and gaining market share here while competitors are challenged could lay the groundwork for multiple years of high growth.

China A-shares have been outperforming other major equity markets

Gross return (USD) as at 24 March 2020



Source: Source: Refinitiv Datastream, Allianz Global Investors. Data as at 24 March 2020. Returns are calculated on USD total return basis. Indices used are: MSCI China A Onshore Index, Hang Seng Chinese Enterprises Index, S&P 500 Composite Index, MSCI Europe Index, TOPIX Index, MSCI Emerging Market Index. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

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