We see a disconnect between valuations and financial performance in China, creating intriguing opportunities for disciplined value investors, despite the macroeconomic headwinds and geopolitical tensions.

Nearly every major equity market is up substantially from the 2020 pandemic sell-off, with China being the notable exception. Chinese equities are hovering near their zero-COVID lockdown valuations of two years ago, which we believe does not reflect many of the companies' fundamentals. This essay explores the opportunities and risks we are observing in Chinese stocks today.

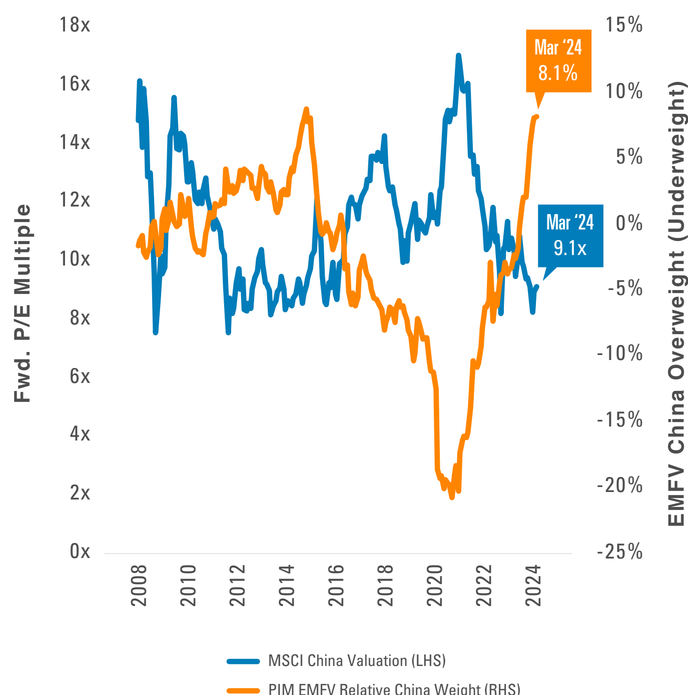
THE OPPORTUNITY IN CHINA VALUE

We see a clear, fundamental disconnect between Chinese asset valuations and financial performance. Put simply, investors have extrapolated the nation's current macroeconomic headwinds and geopolitical uncertainty into the future, ascribing little-to-no probability of conditions and policies improving.

Chinese stocks have been characterized as "uninvestable" by many, as evidenced by a 46% market decline since the end of 2020, with the vast majority of MSCI China constituents in the red since then. As valuation multiples have collapsed over the past few years, it should not be surprising to see disciplined value investors, like us, intensifying our research efforts in this region (Exhibit 1). We see these significant and broad declines as opportunities to begin intensive, fundamental, company-level research, seeking to identify strong franchises unduly punished by sweeping reactions to temporary issues or macroeconomic and geopolitical fears (see the Highlighted Holding and Global Research Review sections for specific examples). We have thus selectively increased our Chinese exposure in our Emerging Markets portfolios to 33.2% today (the MSCI weighting is 25.1%; down from 40.7% when COVID began), up from 22.4% in 4Q20 (we combine China and Hong Kong exposures when considering risk in that region, as we believe they share common macroeconomic and geopolitical risks).

Exhibit 1: The Opportunity in China Value

China's PE Near Generational Low



Source: FactSet, Pzena analysis
**Pzena Emerging Markets Focused Value Composite estimate; includes both China and Hong Kong. MSCI China valuation uses NTM P/E. Data from January 1, 2008 – March 31, 2024.*

Valuation's positive impact on long-term returns has been well-documented, and our research has also shown that steep performance declines in emerging market countries often sow the seeds for significant future alpha generation (4Q21 Newsletter Commentary).

Incessant negative headlines have caused selloffs in many outstanding franchises, despite these companies displaying solid financial performance. This circumstance has resulted in a large subset of Chinese value stocks offering financial metrics comparable to EM peers at far less demanding valuations (Exhibit 2).

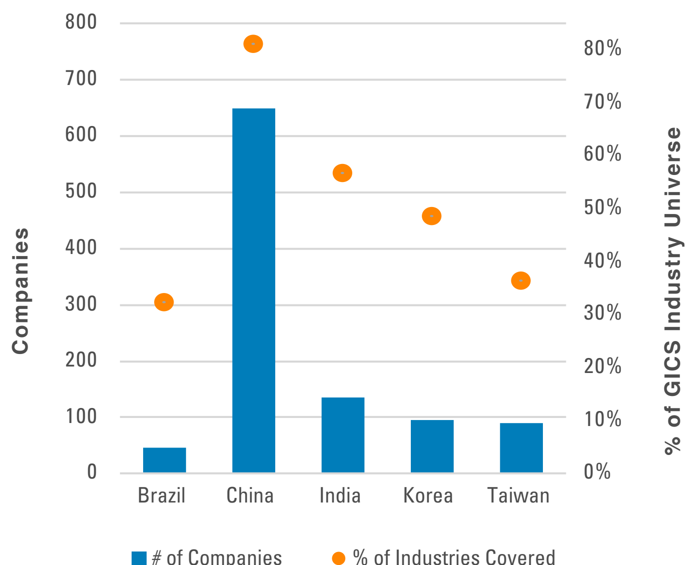
Exhibit 2: Similar Fundamentals at Different Valuations
Emerging Markets Key Financial Data Cheapest Quintile vs. Market

	Historical Return on Equity	Historical Revenue Growth	Price to		
			Earnings	Sales	Book Value
Cheapest Quintile (Q1)	**16%**	**14%**	**8.6x**	**1.3x**	**1.2x**
Q1 China	14%	17%	6.5x	0.9x	0.8x
Q1 ex-China	16%	12%	11.3x	1.9x	2.0x
Market	**13%**	**15%**	**12.4x**	**1.4x**	**1.6x**

Source: FactSet, Pzena analysis
Cheapest quintile basket of stocks based on Pzena's price-to-normalized earnings estimates.
P/E and P/S ratios are calculated using consensus FY1 estimates.
Return on equity and revenue growth average calculated over trailing 10-year period.
Market is the largest ~1,500 stocks in non-developed markets ranked by market capitalization.
Data as of March 31, 2024. Does not represent any specific Pzena product or service.

The opportunity set in China is also significantly larger and more diverse than in any other developing country, with more than 600 stocks spanning 60 industries (Exhibit 3).

Exhibit 3: MSCI EM by Geography



Source: FactSet, Pzena analysis
MSCI EM Index data as of March 31, 2024

WHY IS CHINA SO CHEAP?

Every value opportunity is born from some controversy, which is what makes a stock cheap in the first place. Chinese stocks have the additional burden of the country in which they are domiciled.

While we are bottom-up stock pickers, we always assess the impact of the long-term macroeconomic environment on the companies in which we invest. Additionally, we assign higher discount rates to EM-domiciled companies, including China, compared to developed market peers, for whom macroeconomic and geopolitical risks are less material.

China is confronting obstacles it has never faced before. In our view, and from the perspective of investors, China's issues are mainly two-fold: 1) decelerating GDP growth, highlighted by weakness in the crucial property sector and exacerbated by unfavorable demographic trends and counterproductive government policies, and 2) geopolitical uncertainty—namely, trade wars and persistent friction between Beijing and Washington, and in the extreme case, the possibility of an outright conflict with Taiwan.

China's property market malaise stems from decades of debt-fueled overexpansion, followed by an abrupt government-directed deleveraging campaign. China is unique, in that roughly 70% of household wealth is tied up in property, while the sector accounts for more than a fifth of economic output[1], well above global peers. As consumers observe their net worth plummeting, they are likely to spend less on discretionary items, with effects that could ripple through the economy.

Worsening demographics, in the form of a declining and aging population, are also causing investor angst. With rapid population growth no longer a catalyst for economic expansion, the Chinese government must boost labor productivity to keep the economy steaming ahead.

1. Goldman Sachs https://www.goldmansachs.com/intelligence/podcasts/episodes/11-28-23-ho-shan-wang-f/transcript-final.pdf

Perhaps the most unpredictable China investment risk involves geopolitics. China's President Xi has been explicit in his goal of "reunifying" Taiwan with Beijing. Additionally, trade tensions remain elevated, as China looks to procure advanced technology it cannot produce itself to boost its defense capabilities. Meanwhile, it is flooding Western countries with government-subsidized exports, like cheap electric vehicles, drawing the ire of US and European officials. Furthermore, the prospect of a second Trump presidency increases the uncertainty around another trade war with China.

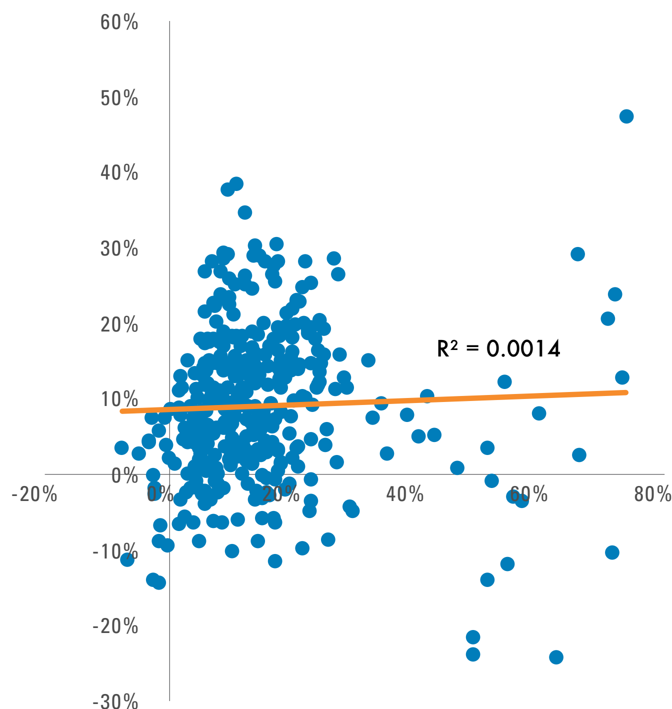
THE UPSHOT

As value investors, we look at issues through a long-term lens to assess whether they are likely to be temporary in nature and have a reasonable probability of abating. For China, we believe these macroeconomic risks should neither be disregarded nor marginalized, but it is also important to contextualize today's situation. China is still one of the fastest growing economies in the world, exhibiting real GDP growth of over 30% from 2020—nearly 20 percentage points above the US[2]. China remains a predominantly supply-driven economy, and, on that front, activity is objectively positive, with 15 consecutive quarters of year-over-year industrial production growth, powering the country's $3T export machine[3]. Investors are understandably more concerned about the consumption side of China's economy, but even retail sales have continued to grow as unemployment remains relatively low, and consumers pull back on home purchases, supporting spending elsewhere.

Despite investors' fixation on China's moderating economic output, the reality is that a country's GDP growth on its own has never proven to be a reliable indicator of the future path of equities (Exhibit 4).

Exhibit 4: GDP Growth Has Historically Been an Unreliable Indicator for Equity Performance

G7 Countries + China 5-Year Real GDP Growth (x-axis) vs. 5-Year Return (y-axis)



Source: World Bank, MSCI, Sanford C. Bernstein & Co., Pzena analysis
Chart displays all five-year data points available since 1960 for Canada, France, Germany, Italy, Japan, UK, US, and China combined. Five-year returns are annualized. All data was analyzed annually and in local currencies as of December 31, 2022.

South Korea provides a great example of the lack of correlation between economic growth and stock market performance. In the decade before 2010, Korea entered a period of decelerating GDP growth, from +11.5% in 1999 to barely above water 10 years later[4]. Korean stocks nonetheless returned +13% per annum, whereas US stocks gained just over 1% per year (excluding the Global Financial Crisis' negative impact on US market performance)[5]. The principal reason for this extreme performance differential, we believe, was valuation. In December 1999, US stocks were trading at an average of 5.6x book value versus 1.7x for Korean stocks[6].

China's troubled property sector also does not resemble the GFC-era housing crisis in the US,

2. FactSet (CY20–CY23)
3. FactSet as of EoY 2023

4. FactSet; YoY real GDP Growth (1999–2009)
5. FactSet; MSCI USA vs. MSCI Korea, total return in local currency from Dec. 1999–Dec. 2007
6. Bloomberg; MSCI USA vs. MSCI Korea

mainly because Chinese homeowners are not in remotely as precarious of financial shape as US subprime borrowers were in 2008. In fact, property owners have been rapidly deleveraging over the past few years, mitigating the prospect of a consumer default wave that collapses the nation's banking sector.

China's population may be in decline, but its labor productivity remains well below that of developed market peers, leaving a massive runway for improvement and aligning with President Xi's goal of moving up the manufacturing complexity curve.

On the geopolitical front, both the timing and manner of Taiwan's "reunification" remains unclear. Russia's military ineffectiveness in Ukraine and NATO's cohesiveness certainly weighs on any decision that would include hostility. Most importantly, China's dependence on, and its importance to world trade, makes its calculus for "reunification" far different than Russia's. China is the leading trading partner for 120 countries, and its exports represent more than 20% of its GDP. The pandemic years and the associated supply chain problems highlighted the reliance of China's trading partners on its massive manufacturing base.

While the prospect of conflict in the Taiwan Strait clearly weighs heavily and uniquely on Chinese stocks, we believe investors are overlooking the potential impact on global stocks, should it come to fruition. TSMC—the world's largest chip manufacturer—potentially being forced to shut down due to a Chinese invasion, for example, would surely be disastrous for market darling NVIDIA, which counts TSMC as its single largest supplier. And yet, there is seemingly no discount applied to NVDA shares for this possibility. We have chosen to add Chinese-domiciled stocks to our portfolios, which, we believe, are now priced at a discount, considering the geopolitical risk. This risk has always existed but is only now being reflected in share prices.

CONCLUSION

While China's equity market has faced significant challenges and uncertainties, the current landscape offers intriguing opportunities for disciplined value investors. Despite the macroeconomic headwinds and geopolitical tensions, the deeply discounted valuations of select Chinese stocks present a compelling starting point for potential alpha generation. By carefully assessing the underlying fundamentals of individual companies and considering the broader economic context, investors can uncover hidden gems amid the market turmoil.

As history has shown with other country-specific opportunities, the starting point of cheap valuation is the most reliable determinant of long-term equity performance, in our view. Therefore, while acknowledging the risks, it is imperative to recognize the potential rewards from selectively investing in strong Chinese franchises trading at cheap valuations.

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