To Buy or Not to Buy?

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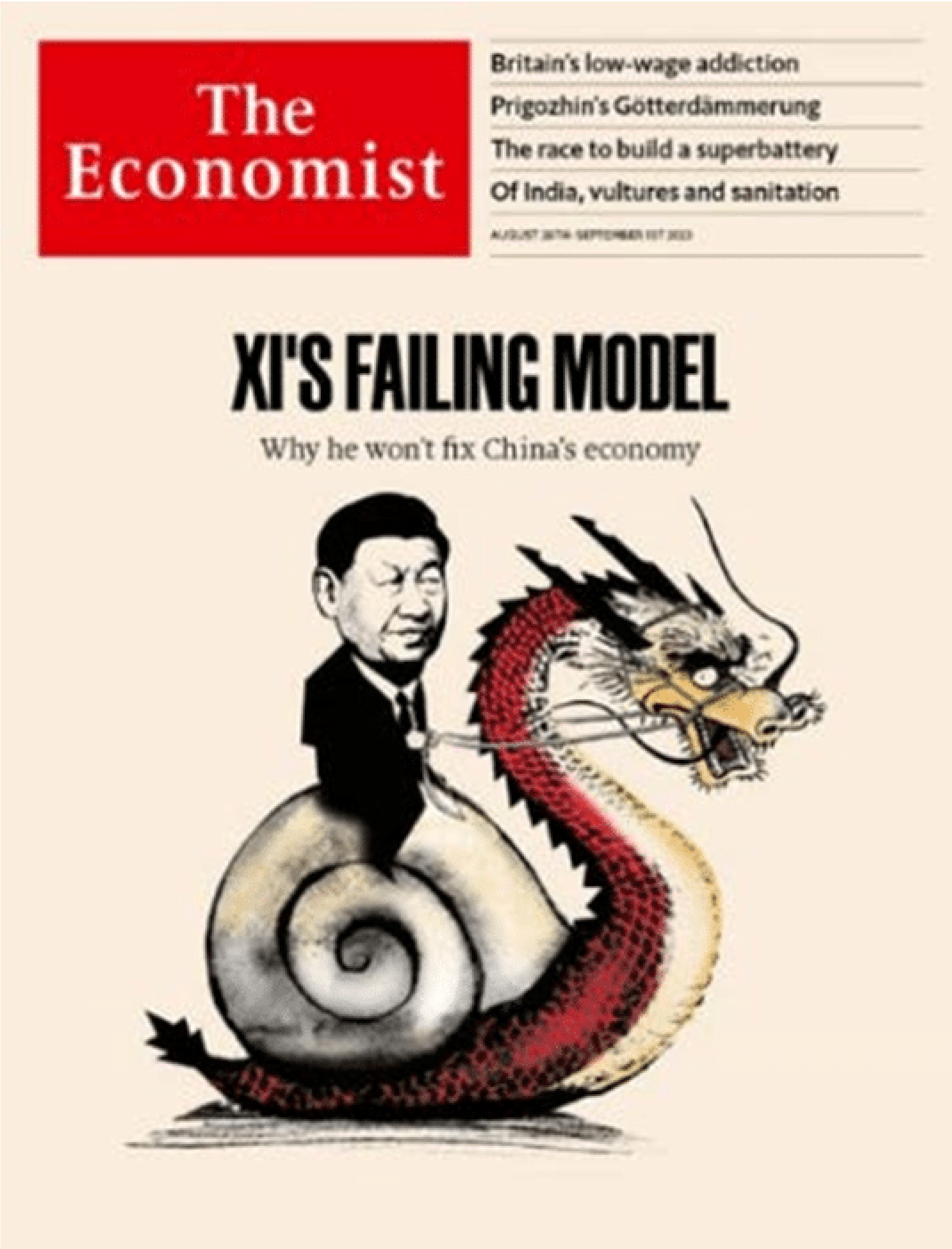
For contrarian investors, which obviously includes yours truly, the most pressing investment question today might be whether Chinese stocks are at a multi-generational buy point. Cover stories such as the ones seen below, especially from *The Economist*, are nearly fail-safe long-term buy signals. However, it's merely being factual to state that China's stock market has performed miserably since early 2021 having been, well, halved.



The Economist

While I think most in the West are aware of China’s recent stock market struggles, many may be unaware of how abysmally its market has performed dating back to 1993. As you can see in the below chart, the MSCI China index is barely positive on an annual return basis even when including dividends. Cumulatively, it is up a mere 24%. This is compared to almost 2200% for the S&P 500 and roughly 600% for non-interest bearing, or dividend-paying, gold.

The fact that this period mostly represented extraordinary Chinese economic growth, until recent years, renders it almost incomprehensible. Similarly, the fact that Apple, Microsoft and Nvidia alone are worth more than the entire Chinese stock market – over nine trillion versus 7.8 trillion – is another jaw-dropper.

Chart of the MSCI (Morgan Stanley China vs the S&P and Gold

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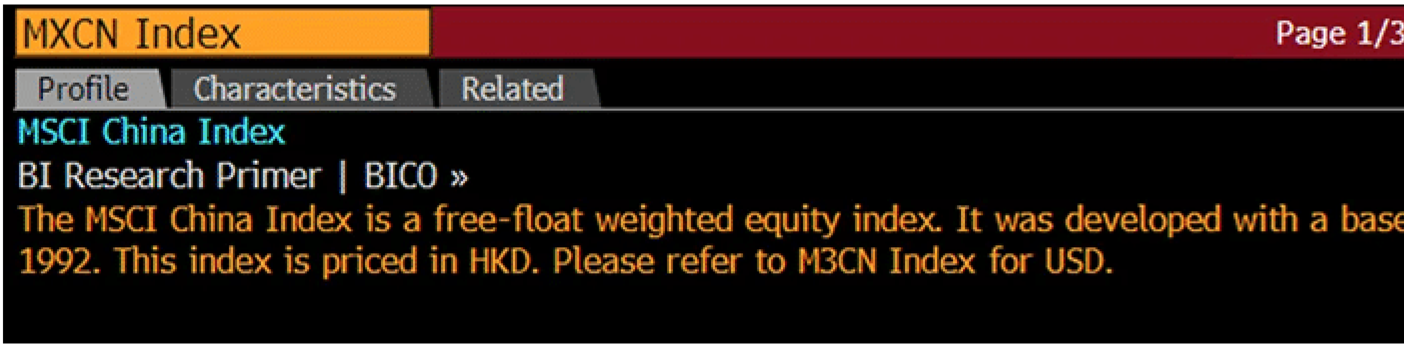
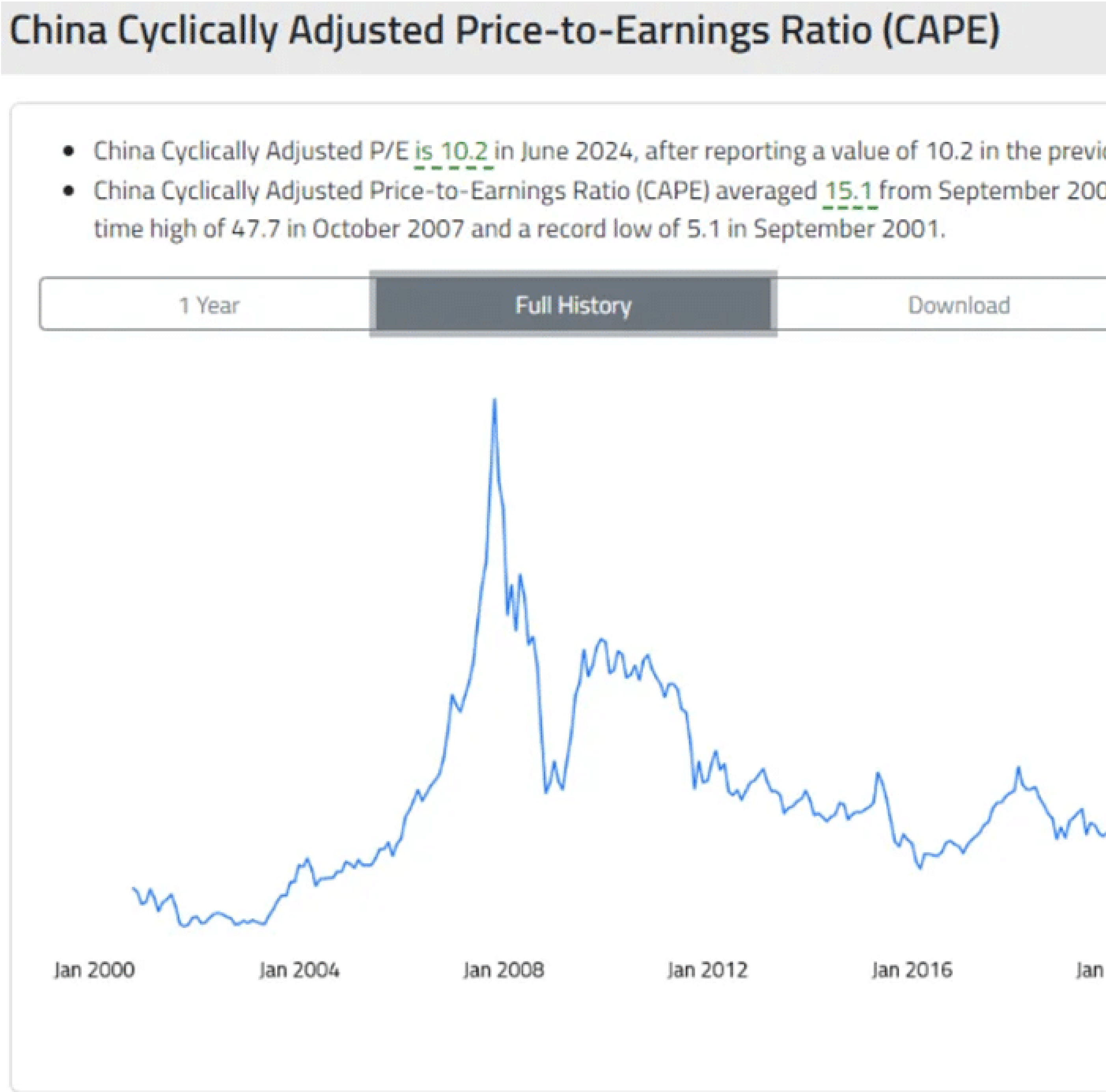


Bloomberg

Underscoring the degree of undervaluation, the Hong Kong Stock exchange, on which many of its strongest companies are listed, hit a Cyclically Adjusted P/E (CAPE) of just 10 earlier this year. That is a level at which major bottoms have occurred for a host of stock markets, including the U.S. in 1974 and 1982.



Additionally, many top Chinese companies are sitting on sizable, cash balances. Backing cash reserves out of their market capitalization makes the valuations even more mouth-watering.

But before an investor can conclude as to whether they wish to commit their capital to Chinese shares, I think we should assess China's strengths, as well as its challenges. In my view, its problems are well-known in the West; thus, I won't spend much time on them.

I do agree that the bursting of its enormous real estate bubble likely heads the list of weaknesses. The rule of law being whatever Xi Jinping says it ranks high as well. The fact that its 1.4 billion strong population is now shrinking deserves mention. Rising tensions with its major Western trading partners, as manifested by proliferating tariffs from some of its best "customers" is seriously problematic. The related fall-off in foreign direct investment (FDI) is yet another negative.

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With that as a preamble, let’s get to the list of China’s strengths and some very brief observations of those. As you will see, they are considerable and in glaring contrast to its bombed-out stock market.

Strength #1: Its vast and hard-working population. While China has recently been slightly eclipsed by India* as the world's most populous nation, the latter’s productivity is no match for that of the Middle Kingdom. As you can see below, China graduates more engineers and STEM students than much of the West combined.

*For added context, “India contributes 31.7% of the total STEM graduates in the world, and has one of the world’s largest STEM job markets.“ -per Business Line, 2022

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Strength #2: Its infrastructure. After two decades of massive spending on potentially productive assets like roads, bridges, airports, high speed trains, etc, China possesses what is the world’s finest and most modern infrastructure. This is an enormous competitive advantage vis-à-vis the rest of the world, despite the reality that some of these projects are the infamous “bridges to nowhere”.

Strength #3: Its graduation out of copycat status. It’s almost undebatable that China’s rapid economic development over the last 30 years, particularly early on, was at least partially due to purloined Western intellectual property (IP). These days, though, there is little doubt that in many high-growth areas, China is now the global pacesetter. Besides EVs and hybrids, China is also currently leading the world in nuclear power plant deployment. As I’ve noted in the past, of the 60-odd large-scale nuclear facilities under construction on Planet Earth, 23 of them are in China. Per prior *Haymakers*, precisely zero are now in the development stage in America. Critically, and I think most ominously, at least for the U.S., China’s atomic power plant construction costs are about one-third of those in the States.

Strength #4: Its boa constrictor-like hold on almost all essential resources for enabling the Great Green Energy Transition (GGET). This includes EV batteries where Chinese companies are way out in front of Western competitors — to the extent there are any, at least of consequence.

Strength #5: Its growing military might. This is another innovation booster. As we saw during WWII, major military buildups have tended in recent history to lead to dramatic technological breakthroughs. Of course, the spoils from those tend to go to the winning side, but it’s likely fair to say innovations slow down when peace breaks out. To quote Orson Welles’ character, the amoral Harry Lime, in the classic post-WWII thriller *The Third Man*: “In Switzerland, they had brotherly love – they had 500 years of democracy and peace, and what did that produce? The cuckoo clock.” Because, among other things Swiss-made, like pharmaceuticals, I love my Rolex; thus, I take some issue with that sweeping statement, but you get the point.

Strength #6: Its embrace of Darwinian capitalism. At least in certain industries, China has encouraged ferocious competition. This is particularly evident in automobiles. There are now over 90 Chinese car companies, most of whom are likely to fail (actually, many already have). This vicious rivalry, and the attendant extreme downward pricing pressure, has allowed China to become the world's largest car exporter, almost overnight. EV share seen especially acute price collapses, to the point where a new model sells for around $10,000 U.S.

In Europe, by contrast, the batteries alone cost around $20,000. It's doubtful they are much cheaper in America. This is why the Biden administration recently slapped a 100% tariff on Chinese EVs, certainly calling into question the USA's commitment to free trade. (This is not to say I don't appreciate the West's motivations in this regard, but it does seem at odds with the spirit of both free trade and the Great Green Energy Transition.) A crucial add-on to this section is that China appears to be following much the same playbook with semiconductors. There may not be a more critical product in the world today than semis.

Strength #7: Its largely effective industrial policy. In contrast to showering trillions of dollars on favored industries in the hope they may actually be able to compete with those in China, as the U.S. does, the Middle Kingdom has managed to create what maybe the planet's most efficient industrial base. This, in turn, has allowed it to post rising trading surpluses, despite the fact that other Asian countries now have, in many cases, lower labor costs.

Here's how Louis-Vincent Gave encapsulated China's ascent up the industrial quality ladder in a recent note:

Meanwhile, a very important development of recent years is how China has suddenly taken over entire eco-systems of its own, whether in EVs, hybrid cars, high speed rail, nuclear power, carbon capture coal plants. China has also moved up the value chaining entertainment (i.e.: TikTok), e-commerce across emerging markets (i.e.: Alibaba), retail (Temu, Schein…). In short, China is now a source of innovation in its own right. This is a new development and a profound change from say, ten years ago.

Again, I realize how suspiciously many in the West view China. As I've written, I share some of those feelings. However, it's my belief it is in the best interest of America and its allies, as well as China's, to deescalate the situation. My fear, though, is that this will be an incendiary subject in the upcoming presidential election, with the two candidates vying for who can come across tougher on China. Again, in my opinion, that's a dangerous game to play… and, especially, overplay.

So, are Chinese stocks a phenomenal buy? Based on valuations and China's remarkable economic progress, that has lifted hundreds of millions of its citizens out of crushing poverty, the answer would seem to be "yes." Yet, given the risks of some kind of military confrontation, even if accidental, I'd suggest replacing the "phenomenal" with "incremental". This might be a situation where it is best to pay the much higher prices détente would produce than to bet too heavily relations are presently as bad as they can get. When it comes to politicians on both sides, their track records are not exactly confidence inspiring.

To end on a positive note, Pippa Malmgren has a high conviction there will be peace in Ukraine soon. She is highlighting the upside risks to global financial markets should we wake up one morning to headlines announcing a Ukrainian truce. If so, Chinese stocks will absolutely explode to the upside, in my opinion. After all, for years, as we've seen, they've done plenty of imploding to the downside. Accordingly, beginning to ease into some of their shares might offer an attractive risk/reward set-up, despite that there are abundant reasons to tread cautiously… make that VERY cautiously.

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