A tale of two sharemarkets

Dominic McCormick | Select Asset Management | 06 May 2014

Investing always feels more comfortable when you are going with the flow, with what is currently working. Yet that is not the way to make significant money or even preserve capital over the long term. That requires a contrarian bent, the willingness to "buy in gloom and sell in boom" - however hard that tends to be.

In recent years, the US equity market has been one of the best performers globally, increasingly becoming the "only game in town" as other markets lag. The S&P 500 has returned a total 190% (in local currency) since bottoming after the GFC in March 2009 and is currently trading at record highs. Most investors remain bullish on the US equity market and it is automatically heavily weighted in most portfolios (representing almost 55% of the MSCI World Index).

Meanwhile, the sharemarket of the economy that, within a decade or so, is likely to eclipse the US as the world's largest economy - China - has performed extremely poorly. The Shanghai Composite of A and B shares has returned -40% since a sharp, post-GFC rally in July 2009 and has lost around two thirds of its value since its record peak in 2007. Chinese equities are hated, distrusted and barely owned by global investors.

Of course, there are structural as well as investor preference reasons why many investors hold so little in China, at least in relation to the Chinese A shares which are currently only open to foreign investors with allocated QFII (Qualified Foreign Institutional Investor) licences. Chinese shares are also currently excluded from the MSCI World Indices. Along with these issues, there are ongoing concerns about transparency and corruption, despite pledges by the current leadership to make major changes in these areas. The China A share market is slowly being opened up to more foreign investment and this will continue. In any case, other avenues to Chinese shares such as Hong Kong-listed H shares have also generally performed very poorly through this period.

For many investors, the current narrative around the respective markets is all that matters and reinforces their current preference for US equities and rejection of Chinese shares. This narrative focuses on the continued US economic recovery (despite near zero growth in the March 2014 quarter), the quality of US management, and the strong global market position of many major US companies. Meanwhile, the dominant narrative around China is concern around a severe slowdown or hard landing, the risks around its shadow banking system/high debt and, as noted above, corruption and poor transparency in many Chinese companies.

I am not suggesting there are not some valid truths in these narratives. But investing is about much more than following current, usually backward-looking stories. Indeed, this can be a very dangerous way to invest. Well known narratives are likely to be already fully reflected in market prices. Thus, while there is no doubt that these narratives have played a significant part in motivating investors and pushing market prices to current levels, they will likely provide limited guidance on where things go from here.

Indeed, while the current trends could continue further, there is a growing risk that the US is setting up to disappoint over-optimistic and complacent investors. Meanwhile, China could well positively surprise increasingly pessimistic and disinterested investors. Often, the true dangers reside where investors are most comfortable going and the best opportunities are where investors fear to tread.

It therefore makes sense to step back and try and make a more objective assessment of these respective markets from a range of fundamental and technical perspectives. For clarity, I will refer to the China A (CSI 300) and the US S&P500 Index, although in both cases these are not fully representative of the sharemarket opportunities in each country. Still, I think they will get the main points across.

Figure 1: Fundamental and technical characteristics of China & US equity markets

	China (A shares)	US (S&P500)
Valuation	Trailing PE – 9.5 Price to Book – 1.3 Est 2014 PE – 8 (lowest in decades)	Trailing PE – 17 (on record margins) Price to Book – 2.6 Prospective 2014 PE – 16
Macro	Economy slowing but GDP growth of 7.5% still expected. Company earnings expected to grow 15% in 2014.	GDP Growth of 2.75% expected in 2014 (despite near zero for Q1). Earnings expected to grow at around 8%.
Sentiment	Extremely negative. China risks the major concern of global investors in surveys	Most surveys bullish/complacent. High insider/professional selling.
Flows/investor positioning	Continued fund outflows for Chinese Funds/ETFs. Most active managers underweight.	Strong mutual fund/ETF inflows/low mutual fund cash levels. Margin debt at record $466B in February (2.7% of GDP).
Length of bull/bear market	Bear market for almost 5 years (since July 2009) or 7 years if back to 2007 peak.	Bull market for 5 years (longer than average).
Technical/price movement	Market bouncing around multi-year lows on investor disinterest, tight trading ranges.	Markets making slightly higher record highs but upside momentum fading. Investors' eagerness to buy dips has recently prevented "healthy" corrections.

Source: Select Asset Management

Most investors fail to understand that bull markets generally end in good economic times when investors, consumers and business feel optimistic. Bear markets bottom in periods of absolute or relative economic weakness and major concerns. This is a point that most economists, obsessed with understanding and describing where the economy currently is, just don't seem to get.

But, perhaps the more important point to consider from the above comparison is that starting valuation matters - a lot. PEs of below 10 and Price-to-Book ratios a little over 1 provide a much greater margin of safety than valuations close to twice that level. Numerous studies show that the best returns are achieved when starting valuations are cheap, while equities usually struggle to outperform cash when purchased at the upper valuation ranges.

Indeed, bull and bear markets are heavily driven by changing valuations in addition to underlying earnings. In the US, PE ratios have moved from around 10 to 18 since early 2009. In China, they have moved from over 20 to below 10. Eventually, this cycle reverses.

In addition, from a sentiment perspective, many of the above indicators should lead you to be very cautious on US stocks and bullish long-term on Chinese stocks. A range of factors suggest excessive bullishness on the US and excessive bearishness on China. For example, in the April Merrill Lynch Investor Survey, a China hard landing was the largest concern by far for global investors. On the other hand, Edward Chancellor of GMO recently wrote about a composite sentiment indicator GMO has developed that uses 20 sentiment measures for the US sharemarket. It showed "exuberance" now is higher than at any other period in the last 60 years except the years around the Tech bubble.

Predicting the future course of markets is difficult. But on an objective analysis of the above factors, the US sharemarket shows characteristics of a tiring bull market in the process of topping out, while the Chinese market shows all the marks of an extended bear market close to a bottom. Only time and hindsight will tell whether such an assessment proves correct.

It is clearly difficult for investors to reduce or exit strongly performing and expensive assets, and step into poorly performing and cheap assets. The problem is compounded because topping and bottoming processes can take months or even years, so assessment of the above factors may provide little guidance on short-term market direction. Clearly, Chinese equities can easily go lower and US equities higher, perhaps significantly so, in the near term. However, the assessment above provides some key guidance on the long-term relative risks and opportunities.

Some investors may accept the case for increased holdings of Chinese equities, but argue that they already have enough indirect Chinese exposure through:

- Their exposure to locally listed resource companies such as BHP and RIO and other local businesses benefiting from China (mainly commodity) demand; and,
- Exposure to global companies (many US listed) that receive significant levels of revenue from China (and other emerging economies).

The first argument is increasingly flawed as future Chinese growth will be focused on the growing domestic consumer demand for goods and services rather than demand for resources for infrastructure. While the second argument has some validity, there is likely to be a growing range of opportunities that can only be accessed by Chinese-based and listed companies. In addition, some of the US-listed global brand companies benefiting from this demand are already very expensive and potentially priced to deliver poor returns for new investors. Having said this, there is an increasing tendency of some Chinese companies (especially internet related) to also list on US markets although many global investors tend to avoid these shares due to concerns over broader transparency and quality risks discussed above.

It was interesting that well-known UK global fund manager, Anthony Bolton, who ran the Fidelity China Special Situations Fund until retiring recently, wrote that while "the worst companies in China are a great deal worse than their counterparts in the West... the best Chinese companies are the equals of their rivals in the developed world". This suggests that an active stock selection approach is necessary.

Having said this, there are also upcoming developments that may alter the demand and flows relating to Chinese stocks in the future. In June this year, Index provider MSCI will make some decisions about the potential inclusion of China A shares in its emerging market indices, to be effective from May 2015. If they go ahead, initial inclusions are likely to be small but these will grow and would, over time, create enormous passive demand for China A shares. Many active managers are likely to pre-empt this move although a number recently rallied against this move as "unfair" since not everyone has large and easy access to A share quotas via QFII arrangements. However, this licencing regime will almost certainly be dramatically loosened, if not abandoned, in coming years.

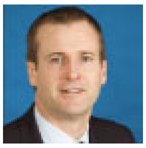
There is also the diversification benefit of including Chinese stocks in portfolios. A recent paper, "The Real Value of China's Stock Market" by Carpenter Lu Whitelaw (2014) highlighted that unlike most equity markets that have become quite correlated with the US, Chinese shares still offer significant diversification benefits. Some of this relates to the current restrictions on overseas investors participating and this factor can be expected to reduce over time as China's capital markets are loosened up. However, this decline in diversification benefit is likely to be quite gradual, particularly given the two markets' divergent paths in recent years, and their very different current positioning as discussed above.

Recently, there has been increasing discussion as to whether the US market or parts of it are in a bubble. However, it is not necessary for the US market to be in a fully-fledged bubble for it to provide poor returns in the future. Indeed, the recent dumbing down of the bubble/no bubble argument is potentially providing false comfort to complacent US-focused investors. For example, the main argument currently being used to demonstrate that the US sharemarket cannot be in a bubble is that valuations are not as expensive as they were at the peak of the Tech boom in 2000. However, it is silly to use the very point in time when US valuations were at their most expensive ever over almost two centuries of history as the appropriate benchmark for defining a bubble. This is like saying Stalin was a good bloke because he was not as bad as Hitler. It totally misses the point that valuations on a range of longer term measures such as the Schiller PE are already at levels above where other major bear markets have commenced through history (e.g. 1929, 1973, 2007).

One way to try and gain perspective on the relative long term merits of Chinese and US shares is to ignore the short-term issues and current narratives and try and assess what the key factors will look like 10 to 15 years from now. How big will the Chinese economy and sharemarket be versus the US? Will the Chinese continue down the path of reform and liberalisation? Which economy/companies will have had the strongest GDP/earnings growth over that period? What respective market valuation will be placed on these (and importantly what impact will this change in valuation have had on the intervening returns)? None of these can be predicted with precision, but obtaining some sense of the absolute and relative path of these factors for China and the US is realistic. In my view, sensible answers to these questions encourage a significant leaning towards the Chinese equity market, rather than the US.

Of course, other less predictable issues such as major geopolitical changes or periodic financial crises could be important for the path of returns over this period. But they are likely to be less important for the actual return outcome over the full 10 to 15 year period.

Looked at this way, long-term investors with global portfolios dominated by US shares and with next to nothing in China should be feeling uncomfortable. However, if history is any guide, only after US shares are well into their next bear market and China shares are well into a new bull market will most investors become sufficiently uncomfortable to act and change their portfolio mix. No one said contrary investing was meant to be easy.



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