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China Economics and Equity Strategy | Asia Pacific

What Is the Fiscal Policy Expectation? How to Position?

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We expect a Rmb2trn initial fiscal package, likely to be positively received by onshore investors. Index valuations have reached their 5-year averages as internet and ChiNext lag. Minor tactical upside is possible, but watch for volatility spikes in case of external changes and A-share market overheating.

We put the current rally into context and identify investment opportunities by answering the following questions:

Q1 – What is the market expectation for the fiscal package? We expect the announcement of a Rmb2trn fiscal package soon (possibly with the first batch to be unveiled at an Oct 8 NDRC press conference), which could include support for local government financing, infrastructure capex, a modest consumption boost, and/or bank recapitalization. Based on our marketing feedback, the size and timing of the stimulus will likely be viewed positively by onshore investors, as it reaffirms Beijing's commitment to reflation with more concerted policy efforts, albeit using the time-tested trial-and-error approach.

Q2 – Where are we vs. China's equity market valuation history? Valuations for major market indices have all largely hit or surpassed 2023's post-Covid reopening peak; similar observations can be seen vs. the 5-year average level. At the sub-index level, ChiNext and the China internet space are still significantly lagging the rally, trading at 27-37% discounts to 2023's peak and the 5-year average. Starboard is the exception, trading at a premium vs. 2023's peak (+21%) and the 5-year average (8%).

Q3 – Where are we vs. previous rallies? We identify five rallies over the last 10 years (Exhibit 1 - Exhibit 4). We observe that:

- On average a rally (MSCI China as benchmark) lasted 231 days with average upside of 65.6% and a valuation re-rating of 55.6%;
- However, the duration and magnitude of each rally show a declining trend, as China's macro slowdown dragged down sentiment and positioning;
- The current rally lags the historical average in both duration and magnitude. However, it has beaten the Feb - May 2024 recovery rally on both measures.

Q4 – How to position / risks to monitor? The tactical rally is likely to continue. Another 12% or more near-term upside could be driven by a valuation re-rating to narrow the gap with EM. Rising demand in diversification and benchmarking could drive more inflows and upside. We see large-cap internet and broad consumption names as well positioned should swift fiscal policy measures come through and macro signs improve, given attractive valuations and high liquidity. We advise monitoring for market volatility spikes due to potential external factors such as geopolitical moves and/or a global liquidity shift, A-share market overheating, etc.

What is the market expectation for fiscal policy?

Size of initial fiscal package likely to be modest at Rmb2trn…Market speculation on an imminent fiscal stimulus package has increased. We expect a Rmb2trn fiscal package to be announced soon. The NDRC press conference on Oct 8 may announce the first batch, followed by the Ministry of Finance in the next few weeks. The key focus will be on support for local government financing and the recapitalization of six major commercial banks, but there may also be a modest boost to consumption and/or social benefits.

…but it could be positively received by onshore investors: Some foreign investors may view a Rmb2trn fiscal package as underwhelming, with insufficient support for economic rebalancing. That said, onshore investors might view this as positive, as the size and timing of the initial stimulus would reaffirm Beijing's reflation commitment with more concerted policy efforts. It is also in line with Beijing's time-tested trial-and-error approach, particularly as policymakers are shifting to adopting new measures to address demand weakness and local government debt.

More meaningful fiscal support for housing and social welfare spending is needed: Investors we talk to agree that for decisive reflation, more central government leveraging up is needed to support housing inventory digestion and social welfare reforms – a key to boosting consumption by reducing precautionary savings and negative wealth effects. In our view, the optimal stimulus size should be Rmb10trn over a two-year horizon, which could effectively lift the GDP deflator back to a healthy level of 2-2.5% in 2025-26. That said, given Beijing's trial-and-error approach, the initial stimulus size will likely remain modest over the next 1-2 years. A “whatever it takes” moment could be triggered by a rapid decline in our Social Dynamics Indicator (see China Musings: Addressing Your Top Questions on China Stimulus, Sep 29, 2024).

Where are we in the rally vs. history?

Question 1 – Where are we vs. China's equity market valuation history

Key observations:

- Valuations for major market indices have all largely hit or surpassed 2023's post-Covid reopening peak;
- Similar observations can be seen vs. 5-year averages;
- At the sub-index level, ChiNext board and the China internet space still significantly lag, trading at 27-37% discounts to 2023's peak and the 5-year average;
- Starboard is the exception, trading at a premium vs. 2023's peak (+21%) and the 5-year average (8%).

Exhibit 1: Major index valuation vs. history

Index	MSCI China	Hang Seng Index	Hang Seng Tech Index	CSI 300	Shanghai Composite	ChiNext	Internet Composite Index	Starboard	MSCI EM	MSCI APxJ
Current valuation (12-mon fwd P/E)	11.4	10.4	21.2	13.4	13.3	26.6	16.3	55.1	12.8	15.2
Peak valuation (Dec 22 - Feb 23)	11.7	10.5	43.5	12.3	12.6	36.2	24.0	45.4	12.5	14.6
Premium / Discount v.s. peak	-2.7%	-1.1%	-51.4%	8.7%	6.0%	-26.5%	-32.1%	21.3%	2.5%	3.9%
Avg valuation in past 5 years	11.7	10.3	32.0	12.4	12.2	37.5	25.7	51.0	12.5	15.0
Premium / Discount v.s. 5 years avg	-2.4%	0.8%	-33.9%	7.4%	9.7%	-28.9%	-36.6%	8.1%	1.9%	1.0%
Standard deviation	2.4	1.8	11.1	1.6	1.3	12.2	9.0	14.3	1.4	2.3
Premium/Discount vs. 5-yr avg (in stdev)	-0.1x	0.0x	-1.0x	0.6x	0.9x	-0.9x	-1.0x	0.3x	0.2x	0.1x

Source: Datastream, BBG, Morgan Stanley Research. Data as of Oct 3, 2024

More detailed read-through: As indicated in Exhibit 1 , the three major components of the China equity space – the onshore A-share market, the Hong Kong market, and the major ADR indices (CSI 300, Hang Seng Index and MSCI China) are trading at forward P/Es of 10-13x (as of Oct 3, 2024), up 13.1%, 12.6%, and 14.8%, respectively, vs. one week ago (Sep 26, 2024). The current valuation level is comparable to the prior peak at the end of 2022 / beginning of 2023 (with CSI 300, HSI and MSCI China trading at 12.3x, 10.5x and 11.7x), while MSCI China's valuation is still 38% below its all-time peak in Feb 2021.

From the perspective of 5-year averages, MSCI China is trading 2.4% below, while the Hang Seng Index and CSI 300 were 0.8% and 7.4% above the 5-year averages (as of Oct 3). Tech indices have been trading much higher versus broad indices, with the Hang Seng Tech, ChiNext Internet Composite Index and Starboard trading at forward P/Es of 21.2x, 26.6x, 16.3x, and 55.1x, while most of them (except for Starboard) are trading at 1 standard deviation below and around -30% discount vs. the 5-year average (Exhibit 1).

MSCI China and Hang Seng Index are now 2.7% and 1.1% below prior peak valuations in Dec 2022 to Feb 2023, while the CSI 300 and Shanghai Composite are 8.7% and 6.0% above their peaks for that period, respectively.

Question 2 – Where are we vs. previous rallies?

Key observations:

- Across the five previous rallies we have identified, on average they (MSCI China as benchmark) have lasted 231 days, with average upside of 65.6% and a valuation re-rating of 55.6% (the average would be 233 days, upside of 36.4% and a valuation re-rating of 36.5% for the Hang Seng Index and 224 days, 53.5% and 47.3% for

Shanghai Composite).

- However, the duration and magnitude of each rally show a declining trend, as China's macro slowdown has taken the driver's seat, dragging down sentiment and positioning;
- The current rally so far lags the historical average in both duration and magnitude. However, it has beaten the Feb-May 2024 recovery rally on both measures.

**Please scroll down for a quick recap of the five previous rallies we have identified.*

Exhibit 2: MSCI China bull market table

MSCI China bull market table							
Start Date	End Date	Trough Date	# of days lasted (in trading days)	Index level return in USD%	Valuation rerating in %	# of days taken to fall to the next trough	Index level decline in USD% from peak to trough
5/7/2014	4/27/2015	9/3/2015	254	48.6%	50.3%	94	-33.9%
2/12/2016	1/26/2018	10/29/2018	511	111.6%	70.0%	197	-33.1%
3/19/2020	2/17/2021	3/15/2022	240	86.5%	87.1%	280	-54.8%
10/31/2022	1/27/2023	1/19/2024	65	59.7%	47.4%	256	-33.4%
1/29/2024	5/22/2024	8/5/2024	83	21.6%	23.1%	54	-13.2%
Historical 5 rallies average			231	65.6%	55.6%	176.2	-33.7%
9/23/2024	10/3/2024	N/A	9	27.1%	26.2%	N/A	N/A

Source: Datastream, Bloomberg, Morgan Stanley Research. Data as of Oct 3, 2024

Exhibit 3: Hang Seng Index bull market table

Hang Seng Index bull market table							
Start Date	End Date	Trough Date	# of days lasted (in trading days)	Index level return in USD%	Valuation rerating in %	# of days taken to fall to the next trough	Index level decline in USD% from peak to trough
5/7/2014	5/4/2015	9/9/2015	259	29.3%	31.7%	93	-21.3%
2/11/2016	1/31/2018	10/24/2018	515	76.7%	53.8%	191	-23.4%
3/30/2020	2/17/2021	10/20/2021	233	34.2%	63.2%	176	-16.2%
11/7/2022	2/10/2023	1/18/2024	70	27.7%	19.7%	245	-27.1%
2/6/2024	6/4/2024	8/21/2024	86	14.4%	14.1%	57	-5.5%
Historical 5 rallies average			233	36.4%	36.5%	152.4	-18.7%
9/23/2024	10/3/2024	N/A	9	21.5%	20.3%	N/A	N/A

Source: Datastream, Bloomberg, Morgan Stanley Research. Data as of Oct 3, 2024

Exhibit 4: Shanghai Composite bull market table

Shanghai Composite bull market table							
Start Date	End Date	Trough Date	# of days lasted (in trading days)	Index level return in USD%	Valuation rerating in %	# of days taken to fall to the next trough	Index level decline in USD% from peak to trough
7/22/2014	6/12/2015	8/25/2015	234	148.7%	148.8%	53	-44.4%
5/13/2016	1/26/2018	12/26/2018	446	29.8%	23.2%	239	-35.5%
3/23/2020	2/18/2021	4/25/2022	239	52.0%	21.9%	308	-21.3%
10/31/2022	4/21/2023	1/17/2024	125	20.9%	31.3%	194	-17.8%
2/5/2024	5/21/2024	9/18/2024	77	16.2%	11.0%	87	-12.2%
Historical 5 rallies average			224	53.5%	47.3%	176.2	-26.3%
9/23/2024	10/3/2024	N/A	9	22.1%	21.3%	N/A	N/A

Source: Datastream, Bloomberg, Morgan Stanley Research. Data as of Oct 3, 2024

History recap: Five China equity market rallies in the last ten years

1) May/July 2014 - Apr/May/June 2015, the biggest A-share market rally in the past 10 years. A series of policy announcements had preceded the kickoff of this cycle, including a) the announcement from Premier Li Keqiang that the Stock Connect program would be launched (April 10, 2014), b) followed by the proposed plan to extend the margin transaction timeline to 18 months (July 22, 2014), and c) the launch of Shanghai / Shenzhen – Hong Kong Stock Connect (Nov 17 and Dec 5, 2014), among others. This was the biggest A-share market rally recorded over the last 10 years, measured by trough-to-peak index moves, with the Shanghai Composite Index up 149% in US$ terms (Exhibit 4).

The rally eventually stopped rather abruptly due to: 1) concerns about over-leverage built up in the equity market through margin financing (including from OTC channels), which had led to a targeted crackdown; and 2) more importantly, macro fundamentals were still under pressure with overcapacity in old economy sectors, PPI deflation persisting, soaring debt-to-GDP levels, and declining ROE. See our report explaining the bull cycle rationale.

For MSCI China and Hang Seng, both had gone through a bull cycle within largely the same time frame, but on a much smaller scale (48.6% up for MSCI China and 29.3% up for Hang Seng, Exhibit 2 , Exhibit 3). This is because: 1) many of the liquidity relaxation measures (margin financing, brokerage account opening relaxation etc.) were A-share specific; 2) A-share market didn't get included into MSCI China until 2018; and 3) even MSCI China was still dominated by cyclical and SOE companies at the time as ADRs weren't included until late 2016.

2) Feb/May 2016 - Jan 2018, the longest rally backed by structural reforms and fundamental improvement, and the biggest one for the offshore space (Hang Seng, MSCI China). The next biggest Chinese stock rally occurred from Feb 2016 to Jan 2018. We see the following as major drivers behind this rally: a) macro and consumption recovery as well as a real estate up cycle; b) successful supply side reform which had cut down excess capacity, de-leveraged and improved ROE significantly for the Old Economy sectors (energy, industrials, materials); and c) major equity market-friendly events and supply side supportive policies. These included Shenzhen/HK Southbound flows kicking in, MSCI including Chinese ADRs (largely Chinese large-cap internet companies) into global indices from late 2016, as well as MSCI's announcement that A shares were to be included in its EM indices in two phases. This is the largest rally over the past 10 years for the offshore indices - MSCI China and Hang Seng, which rose by ~112% and 77%, respectively. This rally ended as a result of: a) policy tightening as well as shadow banking and trust product clean-up; b) US/China trade tensions kicking off; and c) profit-taking after the fulfillment/ execution of several major index inclusion/ rebalancing events.

3) Mar 2020 - Feb 2021 with the biggest valuation re-rating for the offshore market. The next nearly-one-year rally occurred from early 2020 to early 2021 during the Covid period. Main drivers behind this rally included: a) the Chinese government's forceful anti-Covid measures during the initial phase, a stance taken much earlier than rest of the world; b) rapid penetration of platform economies including e-commerce, online education, and others; and c) easing at a global level which helped with market liquidity and risk sentiment - the Fed rate cut and 2 trillion USD stimulus plans (the FOMC delivered two huge rate cuts at unscheduled emergency meetings in March 2020, returning the federal funds target rate range of zero to 0.25%), and QFII/RQFII rule relaxation. Eventually, the market entered a persistent downward trend on the back of a) policy tightening and rising yield; b) proactive effort to deflate the housing bubble, starting from "three red line" announcement; and c) regulatory tightening across multiple sectors including gaming, education, and healthcare.

4) Oct/Nov 2022 - Jan/Feb/Apr 2023 – the post-Covid reopening rally. The fourth rally lasted for shorter period starting from late 2022, with Covid relaxation, guidelines and reopening on Nov 11, 2022, beating market expectation. Investors were excited at the macro growth potential, but ended up disappointed from 2Q2023 with signs of slowdown across major macro data prints and further deterioration of housing deflation.

5) Jan/Feb 2024 - May/June 2024 – the National Team rescue. The latest rally in early 2024 lasted just three months and had two legs: a) in Feb-Apr, market sentiment somewhat stabilized and then rose gradually, primarily caused by a step-up of government market rescue measures and some early signs of macro stabilization; and b) more importantly, external global factors had helped to drive the rally to a different level with global geopolitical tension rising, and some heightened volatility in the US and Japan markets. The rally lost momentum as the global market returned to normal, while China's temporary signs of macro stabilization once again proved to be transitory and short-lived.

How to position from here & risks to monitor

We believe there will be three legs to this latest rally, and the low-hanging fruit has already been picked:

- Leg 1: In the near term, technically ~15% upside based on the relending program's borrowing cost at 2.25% vs. the CSI 300's dividend yield of 2.6% at the start of the rally. **This has already been priced in by now.**

- Leg 2: Up to 12% upside implied by re-rating opportunity. Still ongoing. Global investors are becoming more willing to give Chinese equities a higher valuation on the hope that China will combat debt-deflation. We look at the post Covid reopening valuation peak as a reference point, where MSCI China traded as high as 12x forward P/E, compared with the index's current valuation of around 11.4x. Alternatively, during that period, MSCI China's valuation discount to MSCI EM had collapsed to a low single digit. MSCI China now trades at a 12% discount vs. MSCI EM. A repeat of history in terms of the relative valuation gap convergence with the EM market would imply a further valuation re-rating opportunity of similar scale.

Additional upside for this leg could be driven by asset allocation diversification and benchmarking. China's index weight in MSCI EM has climbed from 24% to over 29% in only one month. Given rising global uncertainty on the macro, geopolitical, and cyclical fronts, we see an increasing chance of rising allocations to China, with an independent and separate cycle to the rest of the world. **We advise closely monitoring the following on the external fronts**: Fed rate cut pace (our US economists continue to expect two more 25bps cuts this year), US election dynamics, and the global geopolitical environment.

- **Leg 3: Earnings growth needs to catch up.** For the current rally to go further, investors will need to see more concrete evidence of China breaking out of its debt-deflation loop (which the Feb-May 2024 rally failed to do). For that to happen we would likely need to see the following:

- Fiscal policy follow-through by the late Oct NPC standing committee meeting, with a commitment to fiscal spending expansion targeting consumption stimulus and local government projects. The Oct 8 NDRC press conference will be the first event to watch;

- More details regarding the PBOC equity purchase programs with regular and transparent communication;

- More signals of accelerated excess housing inventory clearing through: 1) improved housing sales; and 2) more forceful implementation of the government-sponsored housing inventory relending program;

- Further fiscal policy affirmation by CEWC (Central Economic Work Conference) in Dec 2024;

- Corporate earnings growth bottoming out by 1Q/2Q25.

How to position: As each of these milestones is reached, beneficiaries of the rally will likely shift towards reflationary related and higher beta stocks. We see the large cap internet space and broad consumption as being well positioned given their still attractive valuation, large cap nature and high liquidity, as well as their exposure to reflation. As a secondary derivative, as corporate capex picks up and investment activities start to reaccelerate, stocks exposed to industrials and materials, as well as IT related spending could also benefit. We also closely monitor any major rollout of social welfare benefits, for example, a major refunding of medical insurance coverage could particularly benefit healthcare companies.

Risks to watch:

- Market getting overheated? Our last reading of A-share sentiment index before the National Day holiday suggested that the absolute level is still well within the normal range, however the pace of the jump (doubling in one week before and after the PBOC and Politburo announcements) has never been seen, and could trigger our sentiment reading to approach an overheated threshold level soon. Meanwhile, the risk of an A-share frenzy bears watching as prolonged stock-selling restrictions (e.g. IPOs, shareholder selling) might set the stage for a potential boom-and-bust cycle.

- Has government policy follow-through under-delivered? We would like to see certain milestones as laid out above to be reached in a timely fashion. However, there seems to be some gap between what's needed as a stimulus package (Rmb10trn, in our view) and what's likely to be delivered (Rmb2-3trn each year for two years).

- External factors include geopolitical uncertainties, the US Fed rate cut path, and US elections, as well as other external events that cannot be predicted.

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(as of September 30, 2024)

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Underweight/Sell	588	16%	81	11%	14%	238	14%
Total	3,740		771			1687	

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