SARANAC PARTNERS

The June Outlook

Market Stance

THE NEW CASE FOR CHINESE EQUITIES

The technology has changed; the capital discipline has not

Commentary

- Global leadership has been established in electric vehicles and solar panels, and other sectors have become less reliant on low-cost labour
- However, even in these newer sectors, the long-established challenge of efficient capital allocation persists
- High rates of investment have led to overcapacity, which in turn constrains profitability

Upshot

- We maintain a market weight in Chinese equities and are sceptical of the arguments for secular outperformance

THE IT CAPEX CYCLE AND ECONOMIC DIVERGENCE

US growth accelerates, Europe decelerates

Commentary

- A significant divergence in growth trends has emerged between the US and Europe, partly reflecting stronger European energy prices but also the importance of the AI boom to US growth
- European economies are experiencing stagflation, while the US appears to be in a cyclical upturn driving stronger price pressures
- In the US, "old" economy sectors such as construction are struggling, as are lower-income consumers

Upshot

- The AI capex upturn has become a central driver of US economic activity, differentiating it from economic performance in other regions

SURGING RETURNS IN IT STOCKS

Market environment

Commentary

- Global equity markets made strong gains in May, but most sectors delivered broadly flat returns. All the broad market gains were attributable to a return of almost 20 per cent in the IT sector
- While IT earnings growth has been robust, price gains in IT shares last month appear detached from earnings revisions
- Analyst estimates of long-term earnings growth for the IT sector have become highly elevated

Upshot

- The AI capital spending cycle is well entrenched, but a higher bar has now been set for it to deliver upside surprises to corporate earnings

MIDDLE EAST TENSIONS AND FINANCIAL MARKETS

Exploring sub-plots in equity markets

Commentary

- Financial markets have been relatively untroubled by Middle East tensions, apparently reflecting a view that the conflict will be short-lived
- However, resolution does not seem imminent, and the risk of oil shortages and significant price increases is rising
- Oil market futures are suggesting that higher energy prices will be sustained into next year, which could deliver a worse inflation outlook than is currently discounted

Upshot

- Saranac has recently increased its exposure to inflation-linked bonds in the US to protect against the inflation risk of an oil price spike

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The Long Read

The updated narrative on the Chinese equity market: new wine in old wine skins?

SNAPSHOT

Persistent Market Underperformance: Chinese equities' returns have systematically lagged those in global markets, and the Chinese market accounts for only a small component of global market capitalisation. Firm economic growth has failed to drive corporate earnings, reflecting sub-optimal capital allocation.

Technological Growth Leadership: a more contemporary narrative for potential Chinese equity outperformance has emerged, based in part on the greater technological sophistication evident across a wide range of sectors.

Profits remain challenged: the technological forefront is genuine, but it is failing to deliver a sustained improvement in Chinese corporate profitability. Even in the 'newer' industries, capital allocation is poor, with high rates of investment leading to overcapacity which constrains profits and productivity growth.

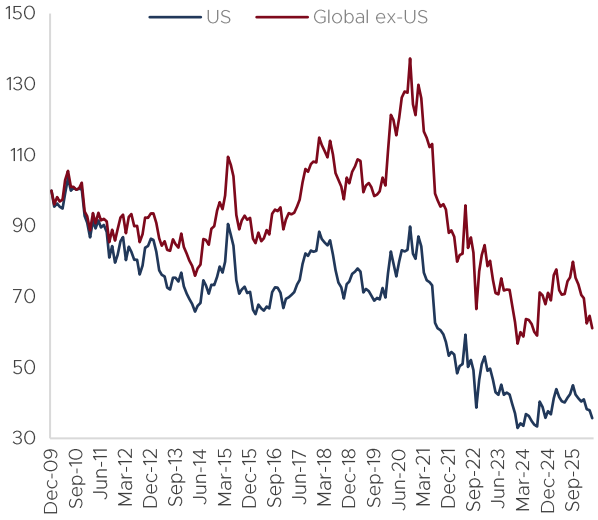
Saranac investment stance: we maintain a market weight in Chinese equities, and hold individual securities when we have confidence that excellent long-term returns can be delivered to equity investors.

1. Long-term relative performance of Chinese equities has been underwhelming

While global equity markets have continued to edge higher this year, concerns nevertheless persist over high concentration levels, extended valuations and optimistic earnings expectations. The search for diversification away from these challenges remains intact. In this context, Chinese equities have resurfaced as a potentially attractive theme. Of course, this is not the first time that this case has been made: over the past decade and more, the Chinese market has often been proclaimed as a potentially diversifying source of high performance.

CHART 1

Performance of Chinese Equities against Global Equities ($), (Dec-09 = 100)



[1]Source: Saranac / Bloomberg

As chart 1 demonstrates, however, the reality is that Chinese equities have systematically underperformed global equities for coming on two decades, both the US and ex-US components. Periods of outperformance have occurred, but these have been proven to be shorter and less pronounced than periods of underperformance.

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The trend in relative performance has been flatter in the past couple of years, but there has been no sustained breakout for the Chinese market. Chinese equities have not therefore been a leading component of global equity portfolios, and at around 2% of quoted global equity market capitalisation, they remain only a small element – indeed, smaller than each of the largest five stocks in the index.[1]

1: The 2% figure includes an adjustment by MSCI, the index provider, which caps the representation of A-shares, reflecting constraints on foreign ownership of the market. In the absence of these constraints, the Chinese equity weight in global indexes would be some 10% points higher.

2. Arguments for the 'old' China

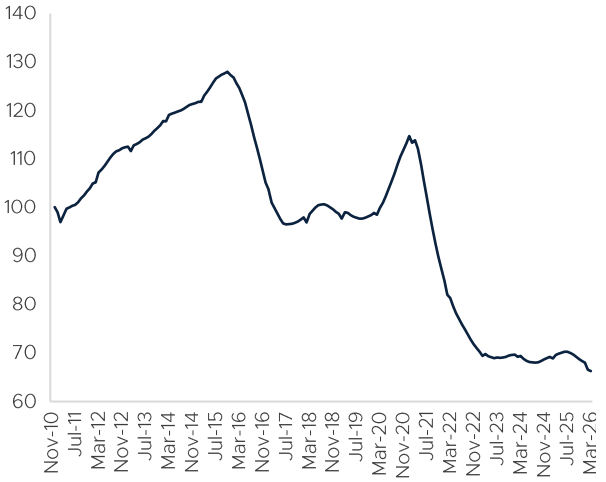
The arguments supporting greater Chinese exposure in the current environment have, however, evolved compared to those prevalent a decade or more ago. Conventional wisdom at that stage was that China's strong relative economic growth would provide a powerful support for the country's equity market performance. This theme has not, however, played out. Firm economic growth compared to other countries and regions was indeed delivered, if by a progressively smaller margin, but it failed to translate into strong earnings growth. The earnings of quoted Chinese companies have persistently and materially lagged those in developed equity markets, as shown in chart 2.

At the heart of this poor profits' performance lies a helpful generalisation: China has been successful at mobilising savings to support investment, but much less successful in ensuring that this capital spending has been efficient, in the sense that it has been allocated to areas which have delivered high returns. This poor capital allocation has been a major constraint on corporate profitability - which is crucial for equity investors.

A good example of this was the substantial property boom of the 2010s and the subsequent bust in 2020. This boom attracted a disproportionate amount of Chinese savings and financial flows into areas with in some cases no economic return, as evidenced by very low occupancy in areas of large-scale construction, and defaults on the associated borrowing. Real estate and linked industries may have accounted for around 30% of the Chinese economy at the peak. The subsequent overhang, in the form of an impaired financial sector and significant excess capacity in the construction sector, remains an impediment to growth even today.

CHART 2

Relative Profits Growth China vs Rest of World (2010 = 100, 12-month average)



[2]Source: Saranac / Bloomberg

3. Arguments for the 'new' China

The contemporary arguments for Chinese equities have, however, evolved from the 'back the economy' framing. They include the claims that the property-related growth impediment is diminishing; that a cyclical upturn in corporate profits is underway (chart 3), which is expected to persist; and that the valuation of Chinese equities remains undemanding (chart 4), both in absolute terms and relative to global equities. However, a further strand to these arguments concerns more structural potential supports.

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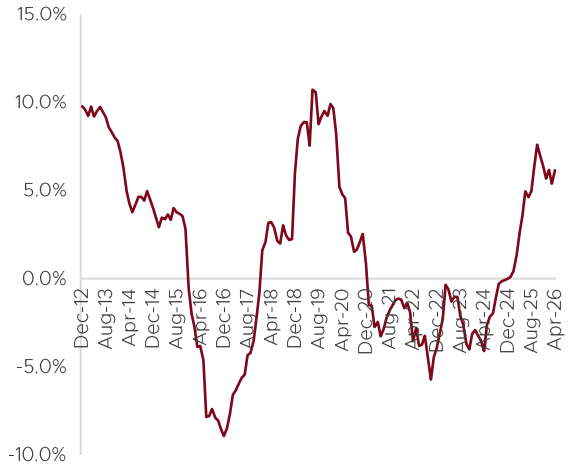
These include geopolitical elements, in particular China's rising status as a global power, which is seen as potentially enhancing equity market returns, for example through access to rare earth metals required in much modern technology.

CHART 3

Chinese Profits Growth (3-year, annualised, after inflation)



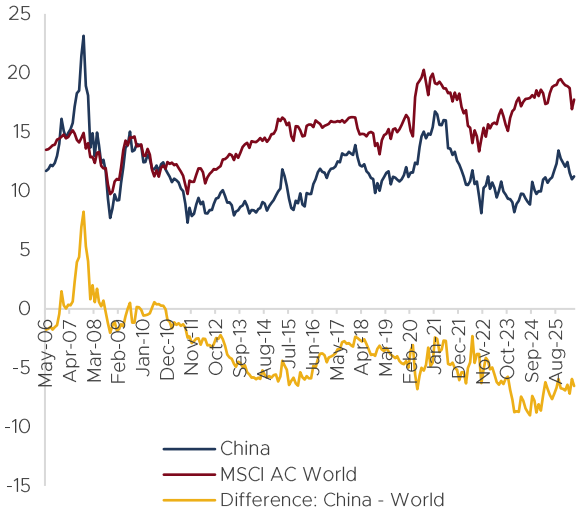
[3]Source: Saranac / Bloomberg

A further bullish position points to the dynamic evolution of China's industrial structure, the result in part of a longstanding government strategy which prioritises the development of an indigenous technological cutting edge. On this view, China is no longer dominated to the same extent by 'old economy' sectors – finance, property and industrial companies with business models based around low-cost labour.

On the contrary, China is seen as emerging as a more sophisticated industrial power, and may still be in the early stages of this process. The Australian Strategic Policy Institute identified global research leadership across forty-four areas of technology. It put China in the lead in thirty-seven of those forty-four, with the other seven all led by the US.

CHART 4

Equity multiples: China and Global Equities



[4]Source: Saranac / Bloomberg

The foundations appear to have been laid for long-term corporate success in other ways as well. For example, twice as many PhDs are now awarded each year in STEM subjects in China as in the US. In the decade up to 2020, China recorded more patent applications than any other economy, suggesting significant payoffs to this increased intellectual resource.

Indeed, there is good evidence of the successful deployment of this intellectual capital across a wide range of sectors. China has absorbed technologies that originated abroad and developed them further. Chinese firms now successfully export products that use predominantly Chinese technologies. Some industries have established significant global market power, and in a few cases dominance of global market share. DeepSeek's low-cost, open-source AI models may be the best-known example of a breakthrough Chinese technology, but it is far from being an isolated example. Others include high-speed trains, nuclear reactors, renewable energy, electric vehicles and high-end consumer electronics.

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4. Critiquing the arguments for 'new' China

i. The bottom-up view

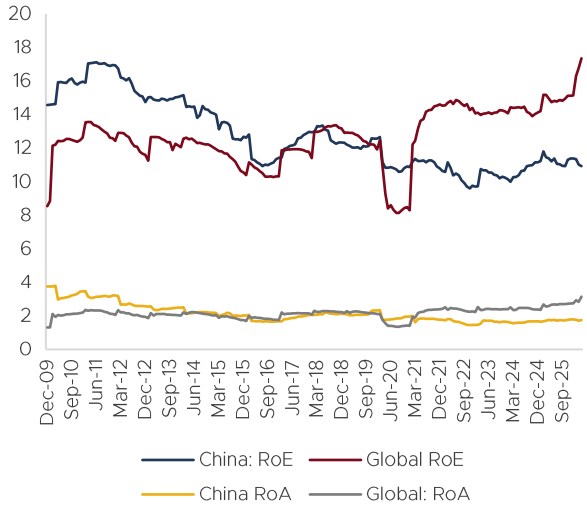
This evidence is indeed impressive, but these advances need to be developed in ways which are beneficial for equity investors, and in particular overseas equity investors, in the Chinese market. Successful long-term investing needs to confront the financial realities which lie beneath the impressive narratives around the pace of technological change in China. What is the evidence that this transition really is shareholder-friendly? In this respect, caution remains appropriate. While a material change in the Chinese industrial structure is underway, these new industries can be represented as new wine in old wine skins. The challenges which have historically limited the growth in corporate profits required for a sustained equity bull market remain intact even in some of the newer industries.

A closer look at these industries suggests a continuation of the previous Chinese theme of economic dynamism being reflected in investment and output growth, but not profits growth. Capital allocation remains sub-optimal, as evidenced by widespread surges in investment in many industries, leading to capacity running well ahead of underlying demand. This undermines pricing power even in the face of significant technological advances.

In the electronic vehicle (EV) and battery sectors, for example, capacity utilisation is only a little over 50%. The capacity surge in both industries has been in part the result of local governments promoting 'new industry' investment through incentives such as free land and subsidised equipment financing. Despite the sector's market power internationally – Chinese EV producers have a global market share of around 60% - returns on assets and equities are very low by international standards, and operating margins are still on average negative. Even the Chinese government has called the price wars and competitive pressures in the EV sector an enormous waste of social resources. A similar picture is evident in the solar panels sector, where an investment boom has led to capacity utilisation rates of only around 50%, despite a market share of the global industry of around 90%. Operating margins have come under material pressure in recent years, and are now on average negative. The consensus expectation is that a return to profitability could take two years, with earnings revisions on average still negative. Investment growth has been cut back, and the sector may be past peak over-supply, but the industry challenges will remain in evidence for some time.

CHART 5

Comparison of Returns on Equities and Assets of Chinese and Global quoted companies



[5]Source: Saranac / Bloomberg

These important examples suggest that Chinese equity returns continue to be held back by a governance system which prioritises output growth and social and political objectives over profits. Returns to shareholders remain further down the agenda. Importantly, companies in the 'newer' industries appear to be encountering the same challenges as the state-owned companies in the 'older' industries. Even where these companies are listed and privately-owned, the state can be a

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significant shareholder, and even where it is not, its influence can be significant, for example through subsidies and financing flows.

Moreover, for all their market share globally, the globally influential solar and electronic vehicle sectors still represent only a small proportion of equity market capitalisation in China, around 3%. The structure of the Chinese market still has an 'old' economy feel, as shown in chart 5. True, the weight of consumer-oriented stocks has dropped back, and the IT weight is higher than at the start of the decade – although it is only just in double digits. Meanwhile, the financials weight still appears significant. More generally, the conventional equity market indexes contain material concentration risk, with the top two stocks accounting for around 25% of market capitalisation.

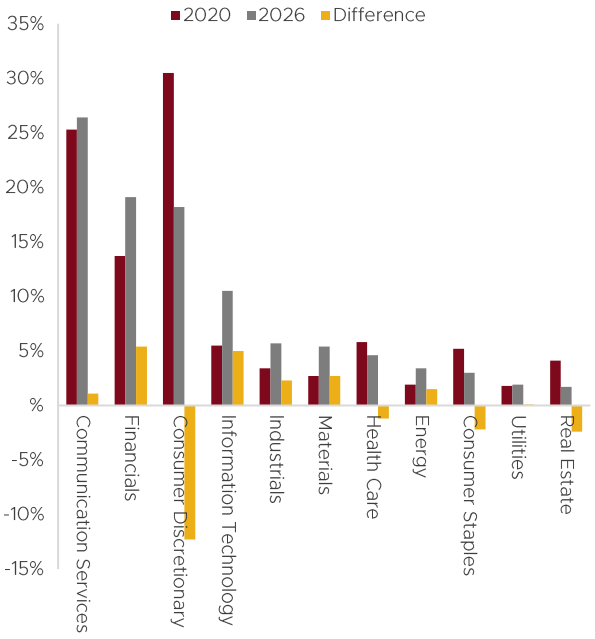
ii. The top-down view

This critique might, of course, miss the point. Particular industries may indeed be unprofitable, but if their output sustains an economy-wide pick up in productivity growth – for example of solar energy leads to a widespread reduction in energy costs - then this might be a price worth paying. So is Chinese productivity growth accelerating? This is a debate whose complexity would delight medieval theologians, with poor data quality hindering a definitive interpretation.

However, a surprising point of convergence is that China's shift towards a more technologically sophisticated industrial structure in the past decade or so has been associated with lower, not higher productivity growth, both in manufacturing and at the whole economy level. A productivity 'miracle' may seem obvious to 'vibes-based' investors whose analysis stops at the impressive technologies rather than the way that they are monetised, but it's not in the statistics or indeed in corporate performance in general. Indeed, for all the positive narratives, Chinese productivity growth appears no better than that in the rest of the world.

CHART 6

Chinese Sector Structure (MSCI index): 2020 and 2026



[6]Source: Saranac / Bloomberg

Importantly, there is no evidence of superior performance relevant to equity investors. Chinese publicly quoted companies' return on equity and on assets have continued to decline, both in absolute terms and relative to other global equity markets (chart 6). Even in the more innovative sectors, such as IT, Chinese companies have continued materially to underperform US firms, in terms of both profits growth and performance. Despite this underperformance, and the apparent low valuation of the broad Chinese equity market, the Chinese IT sector trades on a higher multiple than its US counterpart.

What is driving this underwhelming profitability performance of the Chinese corporate sector in aggregate? How is it that leadership in innovation does not translate into superior economic performance? An optimistic view would be that the

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numbers are wrong, or it is just a question of time before the benign effects become apparent – but these moves can be seen as leaps of faith rather than robust arguments.

Another interpretation would be that a strongly-performing innovative sector in China runs alongside an atrophying 'old economy' sector, as was the case in Japan in the post-1989 bubble period, where macroeconomic weakness co-existed with innovative innovation. However, this interpretation is challenged by the weak profitability even in some of the more dynamic Chinese sectors. The Japanese example suggests caution in another respect. In the 1980s, Japanese technological sophistication was widely ascribed to industrial policy, but hindsight has suggested the opposite: the strategy kept economically inefficient but well-connected firms afloat.

A more damning critique of the Chinese model locates the source of weak profitability in the official industrial growth strategy itself, in particular the use of subsidies which amount to around 5% of GDP. One recent study suggested that these subsidies do boost industries' market share, but at the expense of profits. This is because a disproportionate share of profits goes to less productive firms, and possibly those with better entrenched political connections. These firms' market share may increase, but at the expense of less subsidised firms in the same sector. In addition, subsidies may incentivise firms to produce lower quality patents or investment programmes. Local governments responsible for some of the subsidies have found it preferable to use them to support employment in large and politically well-connected firms, which may also be very inefficient. More generally, higher subsidies have also been associated with a higher level of state intervention, which may have further dampened productivity and profitability.

A recent example of this is the Chinese shipbuilding sector, which now accounts for around 50% of global ship production following a substantial increase in market share. This scale was achieved in part by inducing waves of inefficient entry to the sector, with many high-cost entrants failing, even while the capacity expansion curtailed profits growth for the survive. One estimate is that the subsidies to the sector cost five times the discounted value of the total profits that may be generated by Chinese shipbuilders over the full course of the current century. It is, therefore, of concern, that this subsidy model appears prevalent even for the 'newer' economy sectors, with similar effects – a wave of unprofitable domestic entrants to the sector, which curtails profitability even for the more efficient firms. In this respect it is interesting that DeepSeek's origins were in a hedge fund building AI models for algorithmic trading, and required no government funding. Chinese industrial policy might have resulted in more shipbuilders and fewer DeepSeeks, not an industrial structure fit for purpose in the 21st century.

5. Saranac's strategy towards Chinese equities

Saranac's policy towards Chinese equity investment is not to regard it as a liberation from the potential challenges facing developed equity markets. In multi-asset portfolios, we maintain a market weight in Chinese equities, implemented passively. In stock-specific portfolios, we periodically take positions in individual Chinese equities. Under what circumstances would this exposure increase? Two sets of circumstances are relevant in this context. First, if we can identify Chinese companies capable of delivering long-term sustainable returns for overseas investors. Second, if there is clearer evidence of improved performance across a range of sectors which would warrant higher exposure to the Chinese market in aggregate. In our view, neither of these conditions is relevant at present.

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ABOUT SARANAC PARTNERS

Saranac Partners was founded in 2016 as a private office for investments and more. As an independent firm, we combine the capability of traditional financial institutions with a personalised approach that offers more. We serve a community of individuals and families across the UK, Europe and Middle East with specialisations in strategy, investments and financing.

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We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.

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