China Equity

Mind the gap

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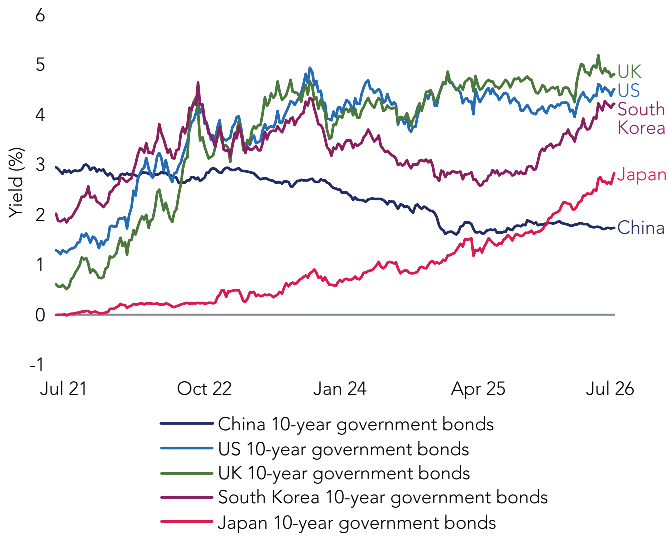
For investors looking at China, there can be a gap between perception and reality.

The country's macroeconomic backdrop is strong, as evidenced by the credit market. The yield on the 10-year Chinese government bond stands at 1.7% – compared to 4.5% on the 10-year US Treasury (see Figure 1).

Figure 1: 10-year bond yields



Source: Bloomberg, as at 20 May 2026. **Past performance is not a reliable indicator of future performance.**

The country's debt-to-GDP ratio is low[1] relative to other large economies and household savings are high. Unlike much of the developed world, inflation is under control (1.2% in May[2]).

China has high levels of energy self-sufficiency – supported by large coal reserves and its huge renewables sector – which have insulated it from the economic fallout from the Iran war. As a global leader in green energy and electric vehicles (EVs), it stands to benefit from the surge in demand.

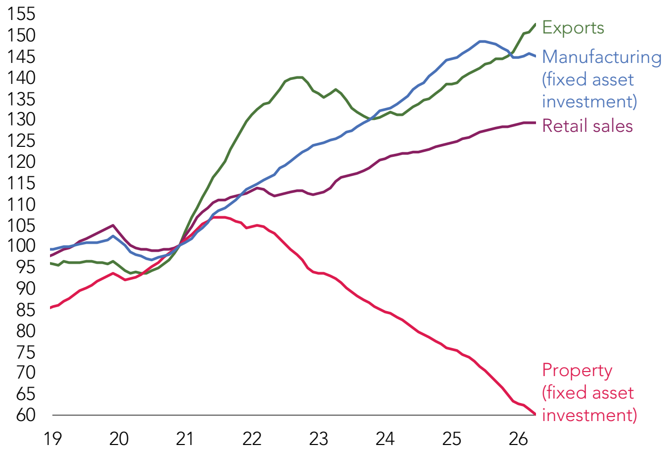
AI cutting edge

The Beijing government is pushing ahead with its ambitious overhaul of the country's economy, moving away from its reliance on low-end manufacturing – and property-led growth – and towards higher-value industries such as technology and advanced manufacturing. Export growth is strong and its trade surplus is growing.

Figure 2: China's economy is undergoing an overhaul

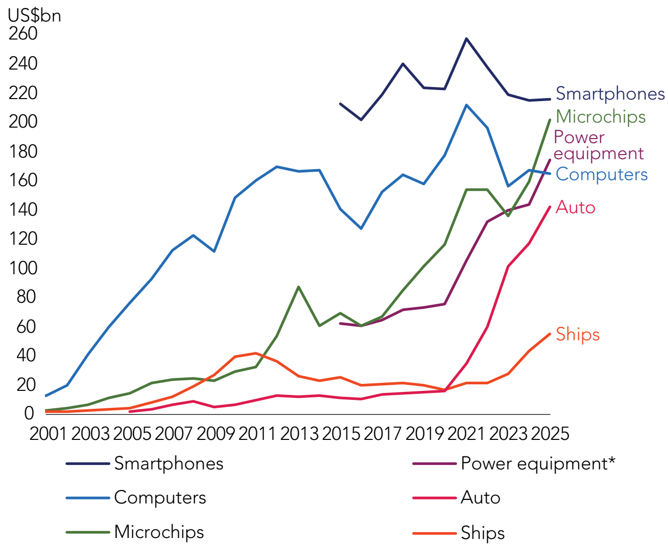
Exports and industry lead while property lags, as the economy shifts to higher-value growth

Two-speed growth



Source: China Customs, WIND, Macquarie Macro Strategy as at April 2026.
12 month rolling sum, December 2020 = 100.

Figure 3: China's leading export products



*Power equipment = battery + transformer + wire & cable + switch + generator set

Source: China Customs, WIND, Macquarie Macro Strategy as at April 2026.

1 Country List Government Debt to GDP

2 China inflation stabilises in May as energy costs ease - Latest News

China is now at the forefront of the global artificial intelligence (AI) boom. The AI supply chain is centred around north Asia, and Taiwan and South Korea are leaders in logic chips and memory, but the bulk of AI data centre-related infrastructure is manufactured in China, including the racks, power supply, energy storage, cooling systems and optical networking.

China has made great progress in building its own semiconductor industry and the gap with other countries is narrowing. China's integrated circuit (IC) exports reached US$201.9bn in 2025, representing year-on-year (YoY) growth of 26.8%, and that figure grew to US$103.5bn in the first four months of this year (an 83.7% YoY increase[3]).

In AI software, China is second only to the US.[4] Its strongest advantage is cost competitiveness: some Chinese models can deliver around 70-80% of the performance of leading global AI models, but at less than 10% of the cost.[5]

Unsurprisingly, Chinese software companies are among the fastest growing in the world. Many leading open-source AI models originate in China and the country's whole AI ecosystem is developing rapidly and with increasing self-sufficiency. Increasingly we are seeing Chinese AI models using Chinese chips manufactured by Chinese foundries.

The property drag

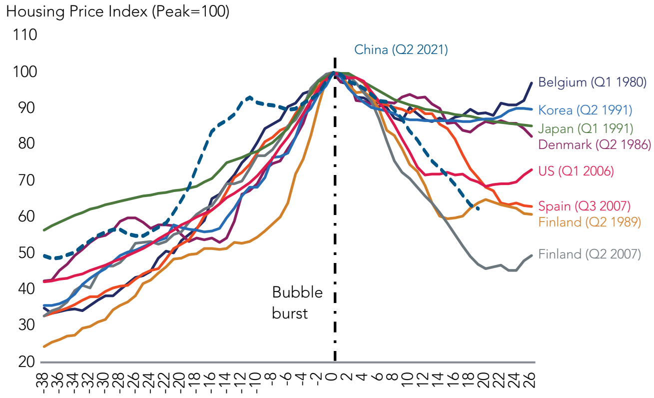
The most persistent domestic tailwind is the impact of the property crisis five years ago.

Residential property prices peaked in Q3 2021[6] and since then real estate – and property-related sectors – have become a much smaller part of the overall economy. But the property crisis continues to impair household, corporate, and local government balance sheets. The relentless focus on de-leveraging has undermined consumer confidence and contributed to a deflationary backdrop. It's a vicious cycle.

Since the peak, property investment has almost halved, dragging down fixed-asset investment – spending on buildings, infrastructure and machinery – as well as jobs and growth. New housing starts, meanwhile, have plummeted by 70–75%, and peak-to-trough national price drops are estimated between 20–40%.[7]

Figure 4: Property sector may have turned corner

How China's property crisis compares with other property bubble bursts around the world in recent decades

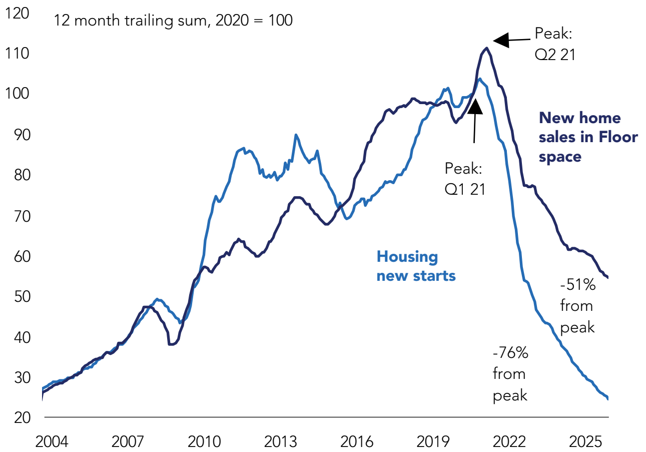


Quarters before/after housing bubble burst
Dates in brackets represent when housing price peaked

In China, the housing cycle shows early signs of bottoming, as supply adjusts and prices stabilise in select areas

Source: BIS, Bingshan, Morgan Stanley Research, as at April 2026. *Japan: Land prices in urban areas

Figure 5: Housing new starts have fallen sharply



Source: Macquarie, as at April 2026. Japan: Land prices in urban areas.

However, plenty of evidence suggests the sector has turned a corner. The overhang of housing stock is beginning to ease, helped by the collapse in new-build activity and government purchases of selected inventory for social housing.

This can be seen in Hong Kong, where residential prices have risen by more than 10% since bottoming in H1 2025.[8] Another example of this rebound can be found in the pleasant coastal city of Huizhou which is 23 minutes from Shenzhen and 50 minutes from Hong Kong by high-speed rail.

[3] China General Administration of Customs (GACC)
[4] Which countries are leading in AI? | Stanford HAI
[5] ai_index_report_2026.pdf
[6] Real Residential Property Prices for China (QCNR628BIS) | FRED | St. Louis Fed
[7] China's Property Rebalancing: The Long Road to a New Development Model | Asia Society
[8] The Case for Hong Kong Real Estate | J.P. Morgan Private Bank Asia

A one-bedroom apartment in Huizhou with a sea view can rent for as little as US$130 a month. If you consider that average graduate pay in China is about US$952 a month,[9] this represents a bargain. The reason is that the city has an oversupply of new-build apartments in comparison with the size of the local population. However, evidence suggests this imbalance is easing. Huizhou is attracting thousands of young people – many working remotely – who are attracted by the city's low-cost quality of life. The value gap has become too wide to ignore.

It is one of several signs that China's property downturn may be past its worst. Supply and demand are starting to rebalance, while prices and rents are finding a floor in parts of the country.

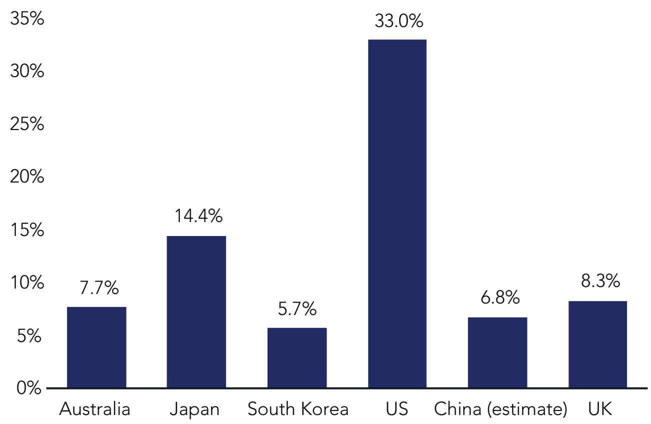
Equities disconnect

One impact of China's sluggish property market is that it has encouraged households to look at other investment options. The domestic equity market represents a small proportion of Chinese households' assets, and we expect it to grow in appeal.

The dividend yield on the Hang Seng Index typically averages 3–4%;[10] providing a meaningful advantage over Chinese household bank deposit saving rates (about 1–1.5%)[11]

Figure 6: Household balance sheets support increased domestic equity exposure

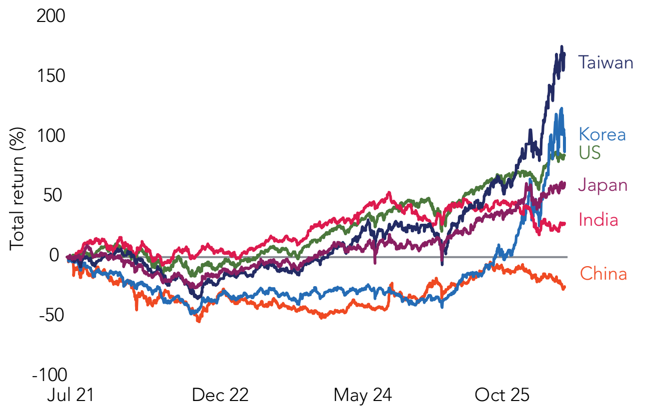
Stocks as percentage of household assets



Source: ANBS, COJ, BOJ, BOK, FRD, ONS, Wind, CEIC, Jefferies. Latest available as at May 2026.

Several factors are behind the underperformance of China's stock market YTD. But we believe the most pressing is that it has been crowded out by the momentum-led tech trade focused on South Korea and Taiwan.

Figure 7: China's equity market lags peers



Source: Bloomberg, total returns in US$ as at 20 May 2026. Taiwan: Taiwan Stock Exchange Weighted Index. US: S&P 500 Index. India: NSE Nifty 50 Index. South Korea: Korea Stock Exchange KOPSI Index. China: MSCI China Index. Japan: Tokyo Stock Exchange Tokyo Stock Price Index TOPIX. **Past performance is not a reliable indicator of future performance**

As outlined earlier, China has benefited from the global AI boom, but the impact has been uneven. Earnings have risen sharply among companies in the global AI supply chain, yet the sector is not large enough to lift overall index earnings.

Large-cap companies face a tough earnings backdrop. The Beijing government's consumption stimulus introduced last year has set a high bar for revenue growth, while hefty investments in AI have added to near-term cost pressures.

Near-term earnings growth remains subdued, and in a market dominated by short-term capital, conviction has been slow to rebuild. Yet none of this negates the longer-term transition underway.

China's shift away from property toward technology, advanced manufacturing, renewables and automation remains intact. It is now firmly established as the world's number two player in AI, and is a leader in green energy and robotics.

In markets increasingly driven by short-term flows, patient capital focused on fundamentals may need to wait, but it is often rewarded for doing so.

There remains a disconnect between China's economy – GDP grew 5% in Q1 2026 – supported by globally competitive companies, and the sweeping discounts still available in the country's equity market. But this disconnect offers tremendous stock-picking opportunities for vigilant bargain hunters.

[9] Retiring on 300,000 RMB: China's youth flee big cities for smaller towns | ThinkChina
[10] Hong Kong-Hang Seng Index-Dividend Yield | Series | MacroMicro
[11] Deposit interest rate (%) - China | Data

The value chasm

The tech boom has created a massive valuation gap.

While global capital has chased AI hardware in Taipei and Seoul, China's domestic value plays have been largely left out of the party.

In light of persistent investor caution towards China, investors need to distinguish between areas where scepticism is justified and those where it has gone too far – and what characteristics to look for to ensure downside risks are properly priced.

In our opinion, there are three types of Chinese AI companies.

One: Global AI supply chain

The first group is companies that are on the global AI supply chain and have enjoyed rapid revenue growth and margin expansion. Earnings momentum is solid, but the price-to-earnings ratio (P/E) is on par – or even higher – than equivalent global peers.

As an example, we invested in Foxconn Industrial Internet, a top AI data centre rack manufacturer, when it was trading at 7x P/E in 2022 but exited last year when it re-rated to 30x P/E.[12]

The company deserved its re-rating. Only a handful of companies can manufacture AI racks because the process is highly complex. However, it is hard to justify paying 20-30x P/E for Foxconn when semiconductor giant TSMC (Taiwan Semiconductor Manufacturing Company) only trades at 24x P/E.[13]

Two: China-centric AI

The second group is China-centric AI companies, which have limited earnings support. These are groups that have not yet found a way to generate sufficient returns from the extensive investments in AI. However, we believe that over time some of them have the potential to become very successful.

The global market for Chinese AI models – which can deliver 70-80% of the performance at less than 10% of the cost[14] – is growing, and the gap between China and the US is narrowing.

Such investment opportunities hold out the prospect of high returns but remain high risk. An approach investors may choose to take is to buy a basket of companies; the return could be justified if just one becomes a winner in the AI race.

Three: AI optionality

The final group offers AI optionality that the market has not yet priced in. These companies are still being valued on their legacy businesses – and in some cases de-rated because AI spending is dragging on near-term profits.

Baidu, for example, is still viewed as a search engine company with half of its market value in net cash, even though half of its core revenue is now AI-related. Fellow tech giant, Tencent, meanwhile, has been de-rated to 13x P/E because the market has written off its AI capabilities, even though the company is still delivering in its core business and has a great track record.

Our view

It is this last group that we believe offers the most attractive risk-reward opportunities, while a cautious position could work for the second group. We are, however, less enthusiastic about the first group because they have already re-rated significantly and earnings upside from here is limited.

We expect global AI capital expenditure (capex) growth to slow from 2027, while supply-chain margins are already elevated. For now, investors are fixated on the risks of microchip shortages. But shortages tend to be solved. When the cycle turns, the greater risk may be excess capacity.

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[12] Bloomberg as at May 2026
[13] Ibid.
[14] ai_index_report_2026.pdf

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