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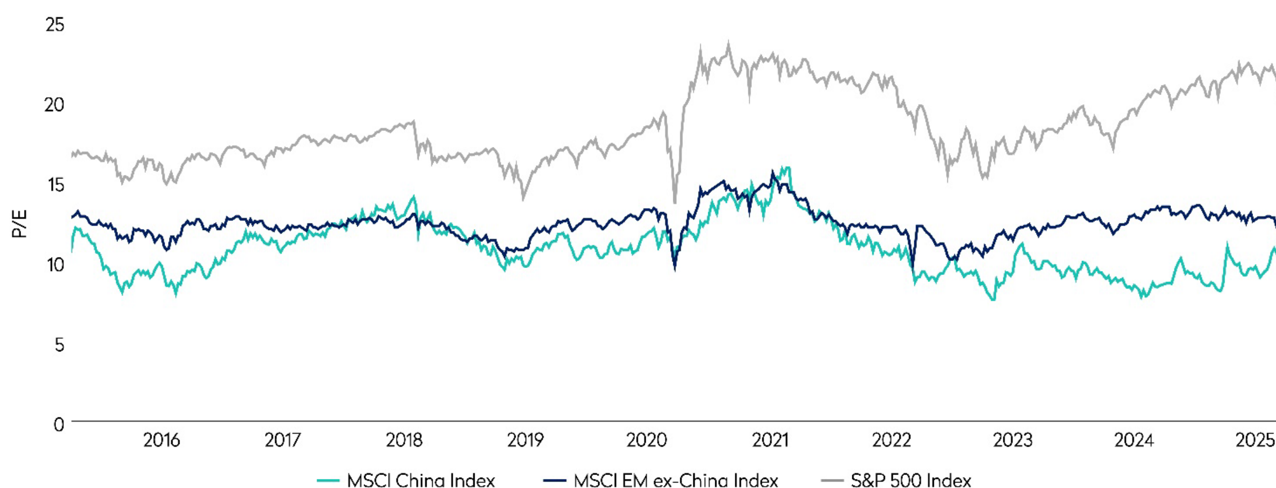
China vs. US Exceptionalism

Q1 2025 saw Emerging Markets (EM) rise 3% in a volatile quarter dominated by geopolitical concerns and trade tariff headlines. Amongst large markets, China was the standout performer, rising 15%. China's performance was in sharp contrast to the US market with the S&P 500 down 5% but was coming off lows over the past 3 years. What has accounted for the divergence and shift in investor sentiment between the world's two largest economies?

Heading into the year, global investors broadly expected a continuation of U.S. exceptionalism. The country had delivered strong nominal GDP growth, was home to companies at the forefront of the new wave of AI innovation, and business sentiment was buoyed by optimism surrounding a potential second Trump term, which many believed would further boost economic growth. As a result, the S&P 500 traded at 22x next-twelve-month (NTM) price-to-earnings — a level well above both its historical average and that of most other markets (chart 1)

Chart 1: Price to Next 12 Months Earnings



Source: Factset Estimates

As the quarter progressed, doubts emerged around the sustainability of the factors supporting elevated valuations. The Trump administration's policy stance, especially regarding tariffs and government spending cuts raised concerns on the impact of such unpredictable policies to the U.S.'s economic performance. Meanwhile, China's Deep Seek rose to prominence in the AI space, challenging the narrative that the U.S. would maintain its dominance in innovation. Despite the S&P 500's poor performance in the quarter, U.S. equities still trade at a substantial premium to both EM and global markets.

In stark contrast, Chinese markets began the year mired in the same challenges that have plagued them for the past three years: persistent weakness in the property sector, subdued inflation, and fragile macroeconomic momentum. Against this backdrop, business and consumer confidence remained weak. There was a prevailing fear that companies would continue to compete destructively on price rather than innovation, in a

deflationary environment offering little in the way of nominal growth. Unsurprisingly, the MSCI China index was trading at just 10x NTM PE — a discount to its own history, and to the broader EM ex-China universe at 13x.

However, much of this pessimism began to reverse over the quarter as investors reassessed China's potential. Deep Seek's breakthrough in large language models (LLMs) renewed confidence in corporate China's ability to innovate, despite the constraints imposed by U.S. chip sanctions. This breakthrough triggered a wave of domestic adoption, and revitalized capital investment by major players such as Alibaba and Tencent, as new monetization avenues emerged.

On the policy front, the Chinese government continued to implement countercyclical macroeconomic measures. Since Q3 2024, authorities have rolled out a series of pro-growth initiatives, most notably a multi-trillion renminbi local government debt swap and a broad easing of property purchase restrictions in higher-tier cities. This quarter built on that momentum, highlighted by the introduction of a comprehensive 30-point stimulus package aimed at boosting weak domestic consumption. Key measures include financial incentives for childbearing, the extension of trade-in programs for consumer durables, and enhanced social welfare support for migrant workers. These initiatives represent a meaningful shift away from the traditional reliance on fixed asset and infrastructure-led investment, signaling a more targeted approach toward stimulating demand-side growth.

To improve business sentiment, President Xi Jinping hosted a high-profile private business symposium, which notably included Jack Ma, founder of Alibaba. In response to this renewed policy focus, as well as the monetary and fiscal stimulus announced last year, some early signs of recovery began to emerge — with an uptick in consumer sentiment and indications of an inflection in property prices in select cities.

Of course, the outlook for China is not without risks. The current U.S. administration has just announced reciprocal tariffs for most of its trading partners, including traditional allies. This is a global macro-economic shock that China's export economy is not immune to. However, unlike many other major economies, China's experience during the first Trump administration spurred structural changes in its trade relationships. (see Chart 2) Since the previous trade war, China has reduced its dependence on the U.S. and its allies, and cultivated new trading partnerships, particularly with other EM countries. Further, the Chinese government has acknowledged the external risks and appears prepared to deploy further countercyclical measures should tensions escalate.

Chart 2: US Share of China's Exports

Source: Asia Times

In Q1, before the tariff announcement, China's equity market responded positively led by large Hong Kong-listed tech companies. The rise in China equities in the quarter helped narrowed its discount relative to history, with the MSCI China index now trading at 12x NTM PE, roughly in line with its 10-year median. Nevertheless, China still trades at a discount relative to both the EM universe and the U.S. Looking ahead, it's important to note that this improved backdrop has yet to translate into widespread earnings upgrades, with current 2025 earnings growth forecasted 7.8% (FactSet consensus). It is also important to acknowledge the persistent risks, in addition to the new tariff regime — chief among them, the perception of China as an adversary by the U.S., and uncertainties surrounding the effectiveness and execution of government policies going forward. That said, we remain confident in the overall direction of travel, and see valuation as well as income to be key underpinnings for many stocks in China

One particularly encouraging trend is the growing focus on shareholder returns and return on equity (ROE), particularly amongst companies with net cash balance sheets. Private companies are beginning to follow the lead of state-owned enterprises (SOEs) in increasing capital returns to shareholders. Within the China piece of the Mondrian portfolio, approximately 80% of companies have increased either dividend pay-out ratios or share buy backs for fiscal year 2024 with capital return to shareholders averaging 60% of net income.

The Mondrian EM strategy has benefited from China's resurgence, through an overweight positioning to China at the beginning of the quarter. As technology and select consumer names rallied, we took the opportunity to take profits in key outperformers, including Alibaba, Tencent, Tingyi, and Yum China. We redeployed capital into lagging, more defensively oriented names within China, such as Guangdong Investment, a water utility, and Beijing–Shanghai High-Speed Railway, both of which offer attractive risk adjusted return profiles.

Amongst emerging markets, China has the deepest investment universe and so even as some areas have outperformed, there remains abundant opportunities for stock picking. Additionally, for EM investors, China's renewed confidence in its technological and industrial base — set against the backdrop of a slowly recovering domestic macroeconomic cycle — offers a compelling diversification opportunity, particularly as the narrative of U.S. exceptionalism continues to come under pressure. This is further reinforced by attractive bottom-up valuations and the ongoing improvement in shareholder returns.

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