



# Overseas opportunities: Spotlight on China, Europe and Japan

By Dan Delaney, CFA

Global equities ended 2023 on a high note, buoyed by a number of factors during the year. China (finally) reopened, and the impact from large-scale fiscal stimulus in Europe and North America and the associated consumer strength continued. Furthermore, the year presented noteworthy themes: generative artificial intelligence, the expectation of central bank rate cuts in 2024, and the surging popularity of GLP-1 weight loss drugs. As we look ahead to 2024, we consider the “investability” of three overseas regions that are commanding headlines.

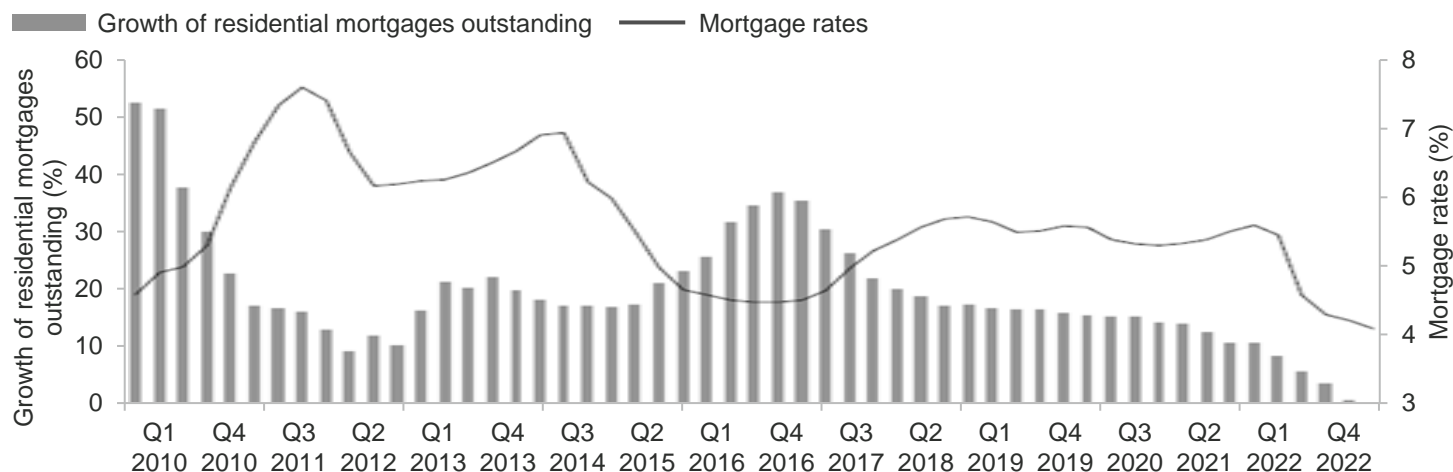
## China skepticism persists

Investors have been uncertain of China as a viable emerging market opportunity, which largely stems from its recent underperformance. As we reflect on 2023, the Chinese market was down approximately 11%—the third year in a row of double-digit negative returns.<sup>1</sup> This underperformance is further complicated by commentary from corporates as well as institutional investors indicating a pullback from China from an investment perspective. So, we ask ourselves what's going on?

The list of concerns in China is long. To highlight a few, aggregate economic growth in China slowed over the last few years, in large part due to a property bubble that is in the process of bursting on an order of magnitude similar to what we experienced in the United States in the late 2000s. As seen in Exhibit 1, the growth in mortgages in the market is slowly drifting toward zero. Despite consistently lower mortgage rates, the market is simply not responding or improving. The property situation is important, as residential real estate is a store of wealth for many Chinese citizens, particularly in the middle and upper classes.

## Exhibit 1: Housing market not responding to lower rates

China – Growth of residential mortgages outstanding and mortgage rates (2010 through Q1 2023)



Source: CEIC, Empirical Research Partners Analysis as of March 31, 2023.

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This situation is further complicated by a piecemeal approach on the part of central and local governments, with only targeted stimulus efforts somewhat tactically placed in various parts of the market, coupled with limited rate cuts. (This is not exactly the big-bath approach that was taken in the West during the late 2000s.) The Chinese property market also faces a difficult regulatory regime, with local governments implementing policies disproportionately across the country, and often complicated by bureaucratic interests superseding market forces.

The property bust has investors worried about the “Japanification” of China. Specifically, after the property bubble bursts, China could experience a similar economic growth profile to what we saw in Japan in the early 1990s, in which a deflationary spiral occurred and subpar economic growth ensued for many years. This would be exacerbated by a demographic profile similar to Japan at that time, with China’s aging populace and low birthrate leading to a shrinking total population.

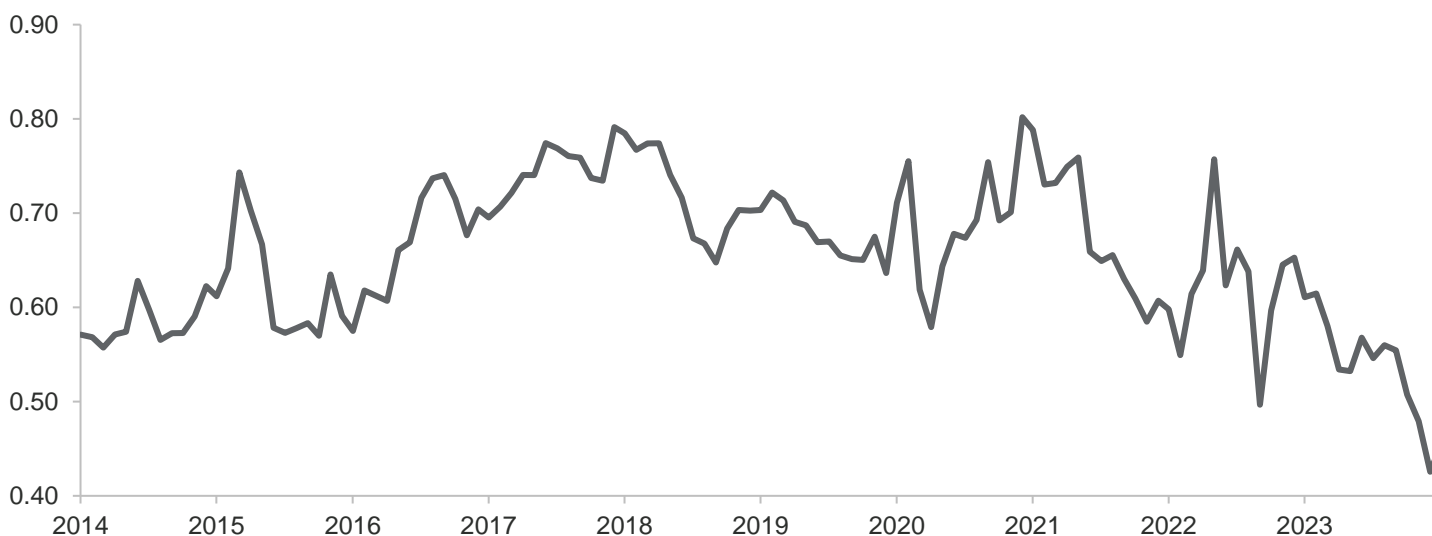
Aside from the property market and overall economic state, there are broader geopolitical considerations for China. Top of mind is the trade situation relative to the US, and the animosity that has built up between the two countries within the last few years. We foresee more of the same in 2024. In a US election year, China becomes a punching bag for both sides of the aisle, and we doubt that rhetoric improves in the short term. Additionally, China-Taiwan relations are constantly in the background as a risk factor, and there will be implications from the recent Taiwanese general election this year that should continue to be monitored.

Despite the negatives, there are reasons for optimism on China from an investment standpoint. Recently, the Bank of China and the central government announced more aggressive stimulus, with additional announcements expected in the coming weeks. Importantly, earlier this year, we saw the government sanction the liquidation of one of the largest property developers, which may kick off the much-needed clearing process of excess inventory in the property market. Local governments are already being given more latitude to relax price floors on homes, incentivizing would-be buyers.

Taking a step back from the short term, investors should be reminded of the sheer size of the Chinese market. Not only is it the second-largest economy in the world, but the Chinese middle class is also larger than the entire population of the United States and has roughly \$3.5 trillion of unspent consumer savings on the sidelines.<sup>2</sup> If that money is deployed and injected into the economy, it could have a rapid effect on economic growth. If you couple that with current valuations at a decade low, as seen in Exhibit 2, a situation presents itself for a fairly rapid turnaround in market performance. As evidenced in the fall of 2022, we saw the Chinese government pull their zero-COVID policy, and the market rallied 60% in a short three-month period. Investors are fickle and can return to the market in short order.

## Exhibit 2: Valuation relative to the US at decade lows

— China P/E NTM relative to S&P 500



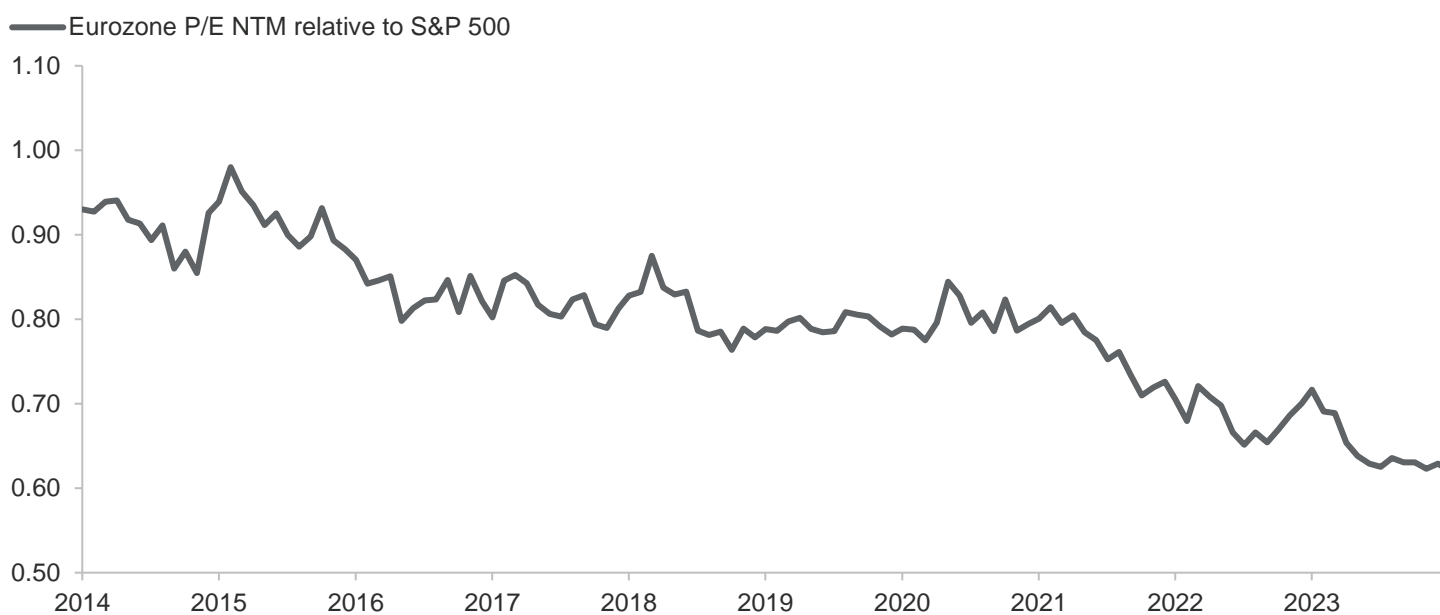
Source: FactSet, iShares MSCI, as of February 21, 2024. P/E = price-to-earnings ratio. NTM = next 12 months.

## Europe and Japan—a tale of two cities

Regarding the developed markets, Europe remains a global laggard, while Japan has reignited investor interest. Growth in Europe continues to be sluggish as the continent suffers from two factors that did not impact the United States to the same degree. First, the conflict in Ukraine and the ensuing energy crisis had a significant impact on economic growth in Europe over the last two years. In fact, some major European countries on an individual country basis are already experiencing recessionary conditions. Second, Europe tends to be a bit overexposed to the Chinese economy relative to the US from an export basis, which also impacted growth.

Similar to China, however, there are glimmers of hope for investors. Looking at Europe from an aggregate perspective, we believe growth in 2024 will be higher than in 2023. (We don't think we can expect the same situation in the US.) As seen in Exhibit 3, valuation is at a multidecade low in Europe, so it's a potent situation in search of a catalyst. A rebound from the recessionary environment and investor interest in more value and cyclical companies could be what ignites better performance in European equities.

### Exhibit 3: European relative undervaluation looks extreme



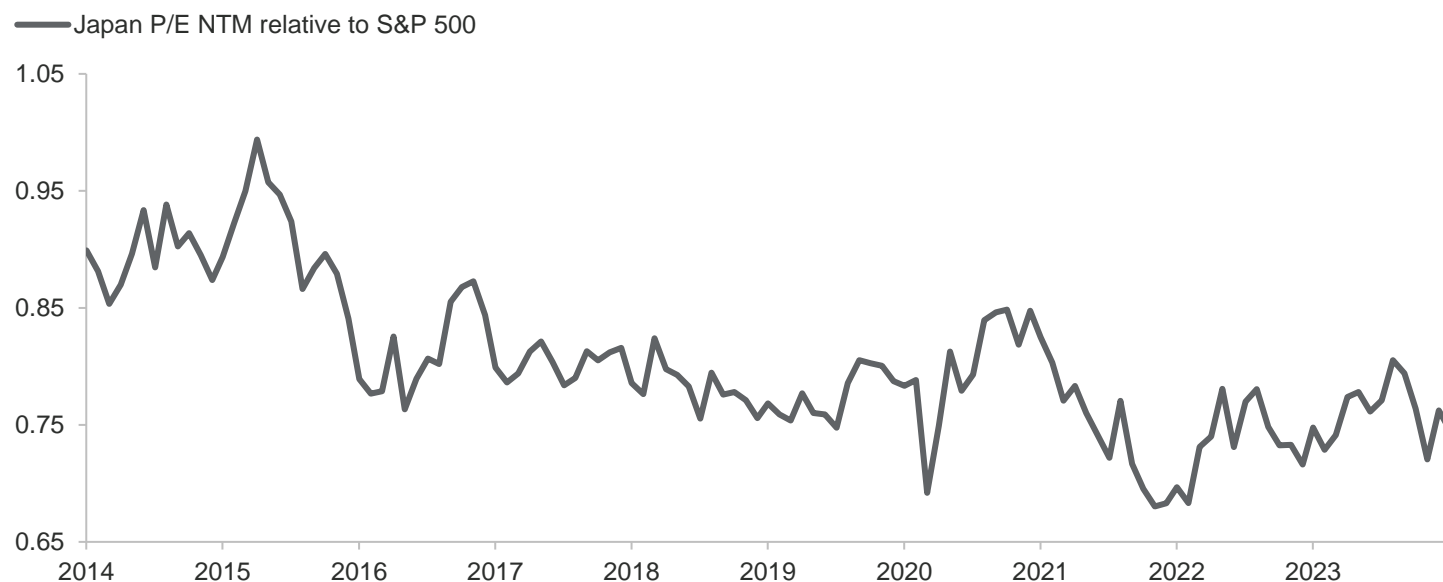
Source: FactSet, iShares MSCI, as of February 21, 2024. P/E = price-to-earnings ratio. NTM = next 12 months.

Unlike Europe, Japanese markets were very strong in 2023, up 29% in local currency terms. There are two major themes that helped propel the massive gains in equities during the year. First, the country's economic profile shifted from deflation to inflation. Japan is reacting favorably to growth for the first time in a long time, and some inflation should allow the Bank of Japan to move away from its negative interest rate policies and institute a more "normal" economic regime.

Second, corporate governance improvements are driving investor attention. Japanese regulators instituted a regulatory regime change that encourages corporates to pursue better returns for their shareholders, address persistently low valuations and simply become more shareholder-friendly. These seem to be taking root, and we believe the positive effects should continue over the intermediate to long term, with more restructuring, higher returns, and increasing buybacks and dividends.

Valuation in Japan, as seen in Exhibit 4, is not as attractive as China and Europe, but it's below its longer-term mean. Additionally, the earnings number in the price-to-earnings (P/E) ratio has room to move higher as these restructuring efforts hold over the next few years.

## Exhibit 4: Japanese valuation in the range



Source: FactSet, iShares MSCI, as of February 21, 2024. P/E = price-to-earnings ratio. NTM = next twelve months.

## Conclusion

Looking forward to the rest of 2024, we expect more discussion on the effects of rate tightening and whether inflationary pressures are in fact behind us. Given weaker economies in Europe and China, there is likely a divergence in central bank policies, which should impact foreign exchange-related returns and market performance. Despite the macroeconomic and geopolitical forces at play in the short and intermediate term, we remain encouraged by extremely attractive valuations in international equities relative to the US. Furthermore, international equities can offer investors diversification benefits and exposure to the three-quarters of the world economy not domiciled in the United States, where much of the potential growth of the next decade is expected.

1. MSCI, December 31, 2023
2. "The Economist," February 6, 2024.

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