CHINA IS FOLLOWING JAPAN'S LEAD ON CAPITAL MARKETS REFORM

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05/21/2024

The last couple months have been busy for stock market Sinologists. The state has announced a series of initiatives that could partially clean up the fraud and market manipulation that tarnishes the market's image.

On April 12, Xinhua reported (my emphasis added):

> *China's State Council has released a guideline on strengthening regulation, forestalling risks and promoting the high-quality development of the capital market.*
>
> *This is the third document on the capital market from the State Council in two decades. The first two were issued in 2004 and 2014, respectively…The guideline demanded strict regulation on the entry into the capital market through securities issuance and listing, urging higher standards for listing on the main boards and the startup board ChiNext.*
>
> *The oversight on issuance and underwriting should be intensified, and illegal activities such as fraudulent issuance should be investigated strictly, it said.*

No doubt China is observing the run in Japan's Nikkei 225, which has surged from the 26,000 area in early 2023 to around 39,000 as I write. China's multi-year stock market charts look like someone turned the Nikkei chart upside down, though the last three months have witnessed a sharp rally across the country.[2]

China's issues are very different from Japan's, so this reform roadmap is going to be new territory.

What held Japanese stocks back for so many years were clog ups such as corporations hoarding mountains of cash on their balance sheets, with the yield on that cash either hovering just above zero or in outright negative territory. Japanese corporations are notorious for having family members on the board of directors, notorious for weird cross shareholdings in companies engaged in disparate industries, notorious for telling agitated shareholders to pound sand.

But none of that compares to China's issues. Ever since things started to fall apart in 2021, many investors have come to associate Chinese stocks with the cancers of fraud, market manipulation, fake financials and corruption.

We have a strategy, the WisdomTree China ex-State-Owned Enterprises Fund (CXSE), that has been rallying recently. It's unclear how much of CXSE's rise from $23.29 (net asset value) on February 2 to the current $30.45 stems from a positive reaction to these governance reforms and how much is predicated on relief that the country's growth scare may not be as sharp as previously believed.

There is always another possibility: this is simply a head fake rally and the reforms are too little, too late.

Nevertheless, there is something that looks particularly promising: China is making a dividend push, much as we witnessed in the reform programs rolled out by Japan and Korea over the last year or so.

One of the things that got the WisdomTree Japan Hedged Equity Fund (DXJ) moving was that country's newfound focus on boosting dividend payout ratios.[1] Figure 1 shows a concept I call the "Shareholder Yield Payout Ratio." Shareholder yield is the dividend yield plus the buyback yield. The payout ratio on it is that figure as a percentage of earnings.

In DXJ, the 2.57% dividend yield is added to the 1.13% being returned in the form of buybacks, netting a shareholder yield of 3.70%.[1] That is 52% of DXJ's earnings, a payout ratio in the general ballpark of the Russell 1000.

In CXSE's case, the situation is materially different. The earnings yield on it is 6.87% but the 1.44% shareholder yield is only one-fifth that size. If earnings simply go sideways in the next 12-24 months, there is little to argue that China couldn't boost its shareholder yield by a matter of percentage points.

The question is whether anything like that will happen.

Figure 1: China Has Room to Hike Dividends and Buybacks

Row	Metric	CXSE	MSCI Japan	DXJ	Russell 1000 (U.S.)	Calculation
A	Dividend Yield	1.63%	2.02%	2.57%	1.37%	
B	Forward P/E	14.6	16.3	14.2	20.8	
C	Earnings Yield	6.87%	6.13%	7.06%	4.80%	1 Divided by B
D	Dividend Payout Ratio	24%	33%	36%	29%	A Divided by C
E	Share Reduction Yield (Buybacks/Dilution)	-0.19%	1.11%	1.13%	0.80%	
F	Shareholder Yield	1.44%	3.13%	3.70%	2.17%	A + E
G	"Shareholder Yield Payout Ratio"	21%	51%	52%	45%	F Divided by C
H	Upside to Equal MSCI Japan	144%				Compare Row G Figures

China Could Boost Dividends and Buybacks by 144% to Equal Japan's "Shareholder Yield Payout Ratio"

Sources: WisdomTree PATH Software, FactSet, as of 4/30/24. SEC 30-day Yield = 1.81% as of 5/14/24. Dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price. Forward P/E is the share price divided by a compilation of analyst estimates for earnings per share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time. Earnings yield is the earnings per share for the most recent 12-month period divided by the current market price per share. The earnings yield (which is the inverse of the PE ratio) shows the percentage of each dollar invested in the stock that was earned by the company. The payout ratio is the percentage of earnings paid to shareholders in dividends. It is calculated as yearly dividends per share over earnings per share. The share reduction yield is the amount by which the share count is reduced divided by the original share count. Shareholder yield is a data point that references the combination of dividend yields and buyback yields. The shareholder yield payout ratio is the shareholder yield as a percentage of earnings.

This material must be proceeded or accompanied by a prospectus. please read the prospectus carefully before investing.

Performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.

For the most recent month-end performance, please click the respective ticker: CXSE, DXJ.

For definitions of terms in the table above, please visit the glossary.

Like Korea, many Chinese companies only pay dividends annually. In a strong stock market like the U.S., "everyone" pays them quarterly. The China Securities Regulatory Commission (CSRC) is pushing for more frequent dividend disbursements, which should come as something of a salve for skittish investors.

S&P Global Market Intelligence agrees with this contention. In January, it published a piece entitled, "Seven Key Dividend Forecasts for 2024."

> *With the CSRC's plan to roll out amended cash dividend distribution guidelines, which was announced in October 2023, we are expecting an increased number of companies to change dividend payout frequency from once per year to twice per year in 2024.*

It's not just mainland China that must turn around to get this bull case moving. Hong Kong has had to face the reality that India is trying to eat its lunch.

Bloomberg

India Tops Hong Kong as World's Fourth-Largest Stock Market

- South Asian nation remains a preferred market for investors
- China's economic struggles have stymied growth in Hong Kong

By Ashutosh Joshi
January 22, 2024 at 7:28 PM CST
Updated on January 23, 2024 at 4:10 AM CST

The fear in Hong Kong is the loss of global financial center status, drip by drip, as the years pass and we roll into the 2030s. There is a feeling that something needs to change now that foreigners are taking a closer look at Indian stocks and as Japan has stopped being a hot potato.

Years ago, one reason to be bullish on China was the creation of the Stock Connect program, which enhanced the ability of mainland Chinese to buy Hong Kong-listed shares, and vice versa.

How to change sentiment in 2024? Enhance Stock Connect, of course.

Figure 2: The April 19 Stock Connect Announcement

HKEX REACHES AGREEMENT WITH SSE AND SZSE TO EXPAND SCOPE OF ELIGIBLE ETFS UNDER STOCK CONNECT

Mutual Market | Market Operations | 19 Apr 2024

Hong Kong Exchanges and Clearing Limited (HKEX) is pleased to announce today (Friday) it has reached an agreement with Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) to expand the scope of eligible exchange-traded funds (ETFs) under Stock Connect.

The eligibility criteria for ETFs for both Northbound and Southbound trading, including the assets under management requirement and the index weighting requirements, will be relaxed to support the continued development of the mutual market access programme. This expansion will further enrich investment options and enable Stock Connect investors to allocate assets in both Hong Kong and Mainland China markets in an efficient and cost-effective way. Further details of the expansion can be found in the circular published by HKEX today.

The three exchanges will work closely on the business and technical preparations for the expansion, which is expected to take effect approximately three months from the date of this announcement.

As the connector between China and the world, HKEX is committed to working closely with the regulators and the Mainland China exchanges to further enhance the pioneering Connect programmes, supporting the long-term sustainable development of the Hong Kong and Mainland capital markets.

Source: HKEX.

Going for the CXSE is still a contrarian venture, even with its 2024 rally having left the lows behind. For the bull case to continue to materialize, be on the lookout for evidence that the country is serious about these reforms and about dividend boosts in particular. That is what worked for Japan and DXJ. If China wants out of this grizzly multi-year bear market, it will have to take its cue from the Japanese.

[1] Dividends are not guaranteed and can fluctuate.

[2] Past performance does not guarantee future results. It is not possible to invest directly in an index.

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Japan's Nikkei : Short for Japan's Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S.

Russell 1000 Index : A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index.