



# **The China-US Equity Valuation Gap**

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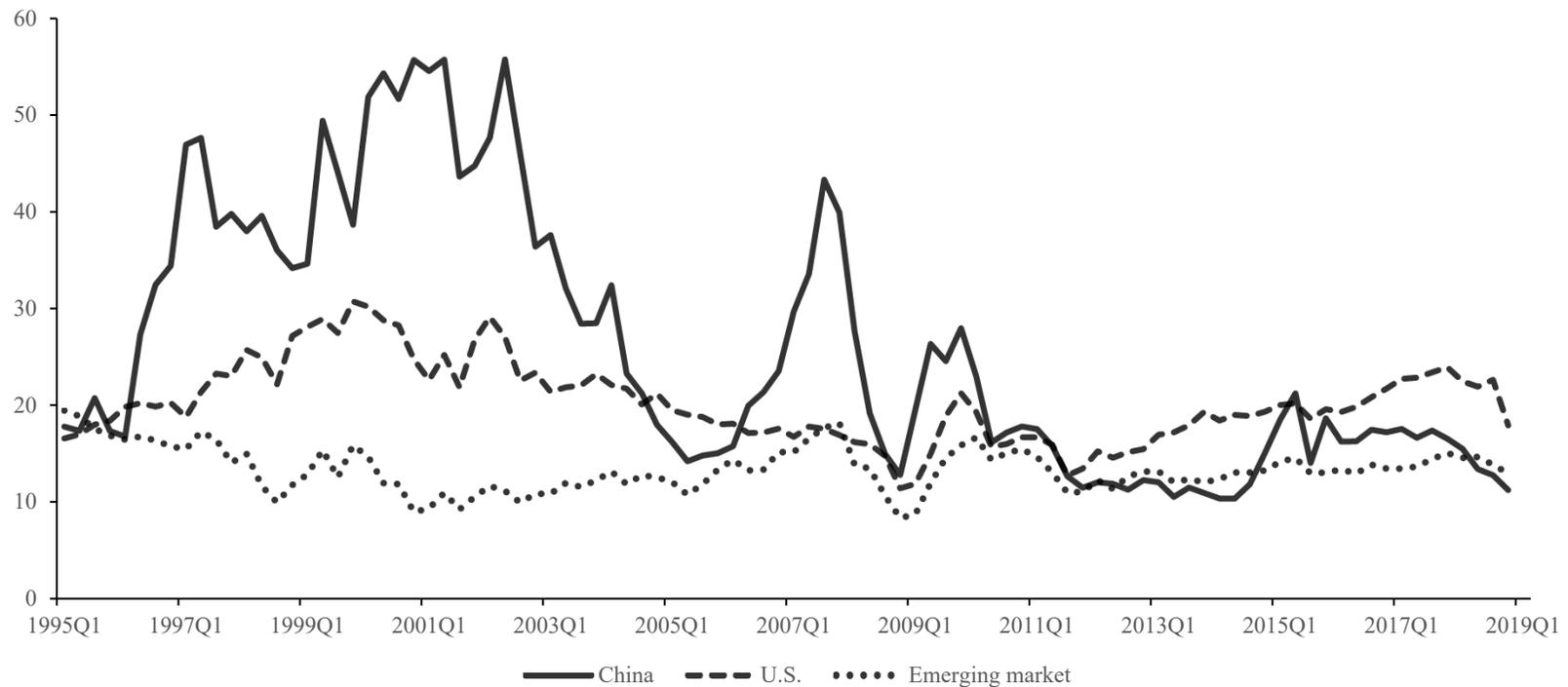
**Discussant: Kalok Chan, CUHK**

**ABFER Annual Conference: Investment Finance**

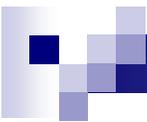
**May 25, 2021**

## MOTIVATION OF THE PAPER

- P/E ratio of China much higher than the U.S before 2009 , but has come down, and is even lower than U.S.

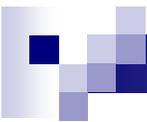


- 3 hypotheses:
  - Changing industry sectors
  - Lower economic growth after 2009
  - Market liberalization



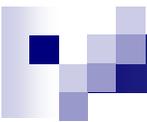
## Methodology

- Study the earnings yield differentials (Valuation Gap) between China and U.S, and explore determinants of the cross-sector and time-series variation of sector portfolios.
  
- Various explanatory variables (market or sector/portfolio level)
  - Growth prospect
    - GDP growth rate, earnings growth expectation, sales growth expectation
  - Market development
    - REGDEV, Zeros, turnover rate, number of public firms, adjusted market development, R-square, Idiosyncratic volatility, industry concentration ratio
  - Financial openness
    - REGOPEN, international accessibility measures (IA1, IA2, IA3), real interest rate differential, overall political rating, quality of institutions, investment profile, AB premium, AH premium
  - Investor base
    - State ownership, institutional ownership, retail ownership, Chinese standardized number of shareholders, turnover rate
  
- Multivariate regressions
  
- Model selection using PcGets
  
- Examine Chinese earnings yields only (market segmentation instead of market integration)



## Results

- Valuation gap between China and U.S. is dominated by the valuation changes within sectors rather than changes in sector structure.
- Multivariate regression :
  - Various measures explain 33% of the total variation in the earnings yield differentials
  - Financial openness variables have the largest explanatory power
  - The key variable is IA2, the market capitalization represented by B, H, and ADR has the highest explanatory power
- Robustness tests (changing betas, market integration assumption)
- Contributions:
  - Analysis of time-series and cross-sectional dynamics of the valuation gap between China and the U.S.
  - Highlight the importance of international accessibility on the valuations in China, although it contradicts the wisdom that higher accessibility should increase the valuation



## Comment: China stock valuation

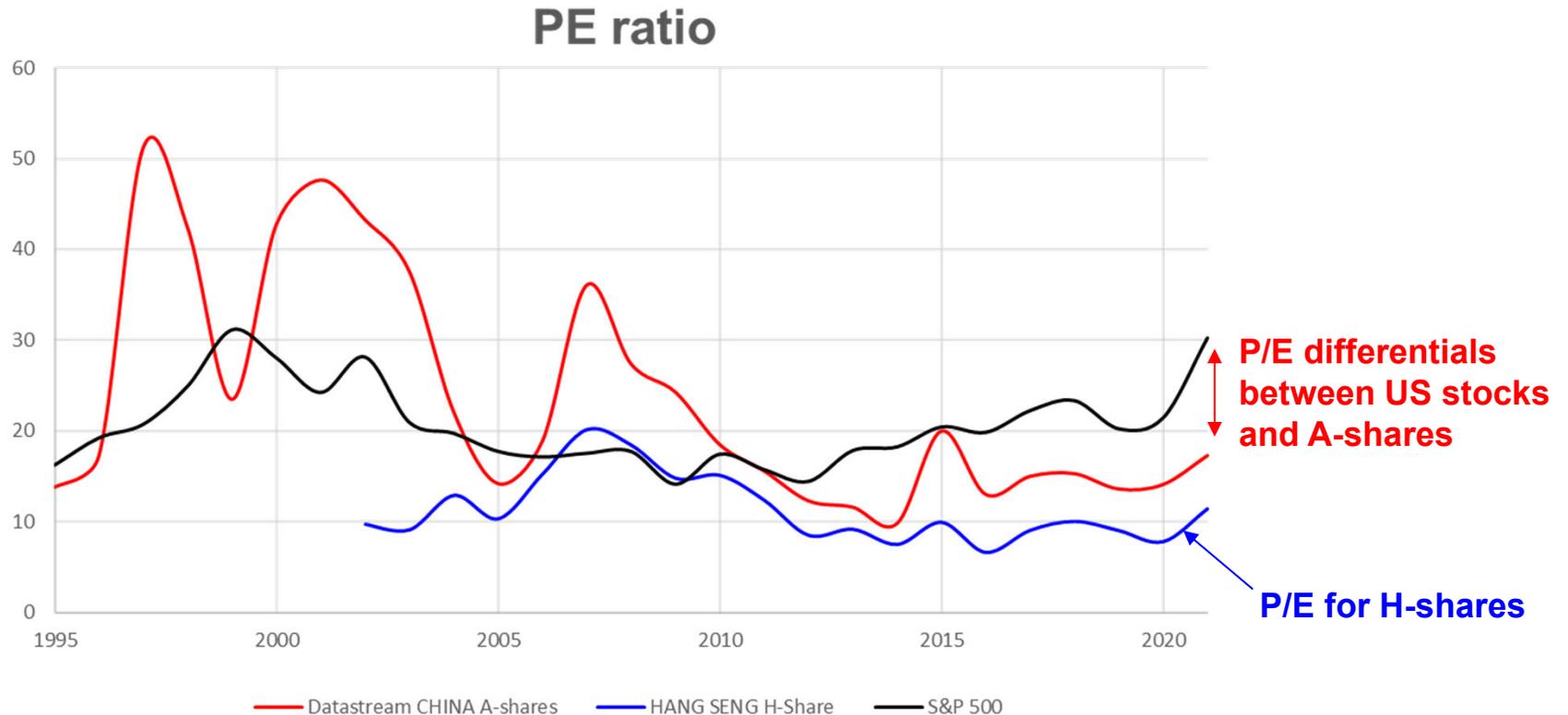
### ■ Why China stock valuation was high before?

- ❑ Dominated by retail investors
- ❑ Lack of alternative investment opportunity
- ❑ Irrationality, speculation, short-term trading
- ❑ Lack of short-sale opportunities

### ■ Why China stock valuation was low now?

- ❑ Tightening monetary policy (relative to the U.S.)
- ❑ Lower growth rate of China economy  
But still higher than the U.S.
- ❑ International accessibility (e.g. Stock Connect Program, A-share inclusion in MSCI)  
But what is the mechanism for the effect on valuation?
- ❑ Availability of short-sale vehicles (e.g. stock index futures).  
But trading volume has been curbed since 2015

## Comment: P/E for H-shares is different from A-shares

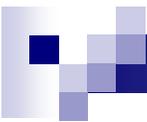


- P/E for H-shares (listed in HK) are generally lower
- P/E differentials between US stocks and A-shares reach the highest now !  
(US historically high)



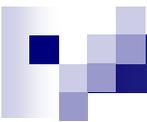
## Comment: Why study China-U.S. Valuation Gap?

- ❑ US and China are the two largest economies
- ❑ Developed market (US) vs Emerging market (China)
- ❑ More Chinese companies listed in the US
- ❑ More US (international) investors investing into the China market



## Comment: Why study China-U.S. Valuation Gap (cont'd)?

- This paper follows Bekaert et. al (2011) that studied the valuation gap among developed/emerging markets, although they study absolute value of valuation gap as a measure of equity market segmentation
  
- Valuation of China stocks using U.S. as a benchmark
  - How integrated/segmented are China and the U.S. market?
  - If the two markets are (almost) perfectly segmented, then not appropriate to study valuation differentials.
  - Assuming that the U.S. valuation is correct.
  
- What do we gain from study valuation gap (under market integration) than China earnings yield (under market segmentation)?
  - The variables are in fact better in explaining China earnings yield than the valuation gap



## Additional comments (I)

- The paper motivates with the reversal of earnings yield differentials after 2009 (a time-series pattern)
  - Might document any significant time-series change of independent variables over the period
  - How much of the explanatory power of independent variables is due to time-series variation rather than due to cross-sectional?
- Some explanatory variables are at country level (e.g. market growth, REGDEV, REGOPEN), and some are at sector/portfolio level (e.g. zeros, International accessibility (IA2))
  - The explanatory power of the country-level measures versus sector-level measures are not comparable.



## Additional comments (II)

- Earnings yield differentials move from negative to positive. Are the market segmentation considered increasing or decreasing?
- Base analysis on individual stocks, rather than industry portfolios, to exploit variation of earnings yield differentials and explanatory variables.
- Financial openness is a major driver in explaining the valuation differentials (or China earnings yield).
  - How much of the explanatory power is due to time-series variation rather than due to cross-sectional?
  - Need to understand more about the puzzling positive, rather than negative, relationship between financial openness (higher foreign ownership) and earnings yield?



**END**