



The China-US Equity Valuation Gap

Bekaert, Ke, and Zhang

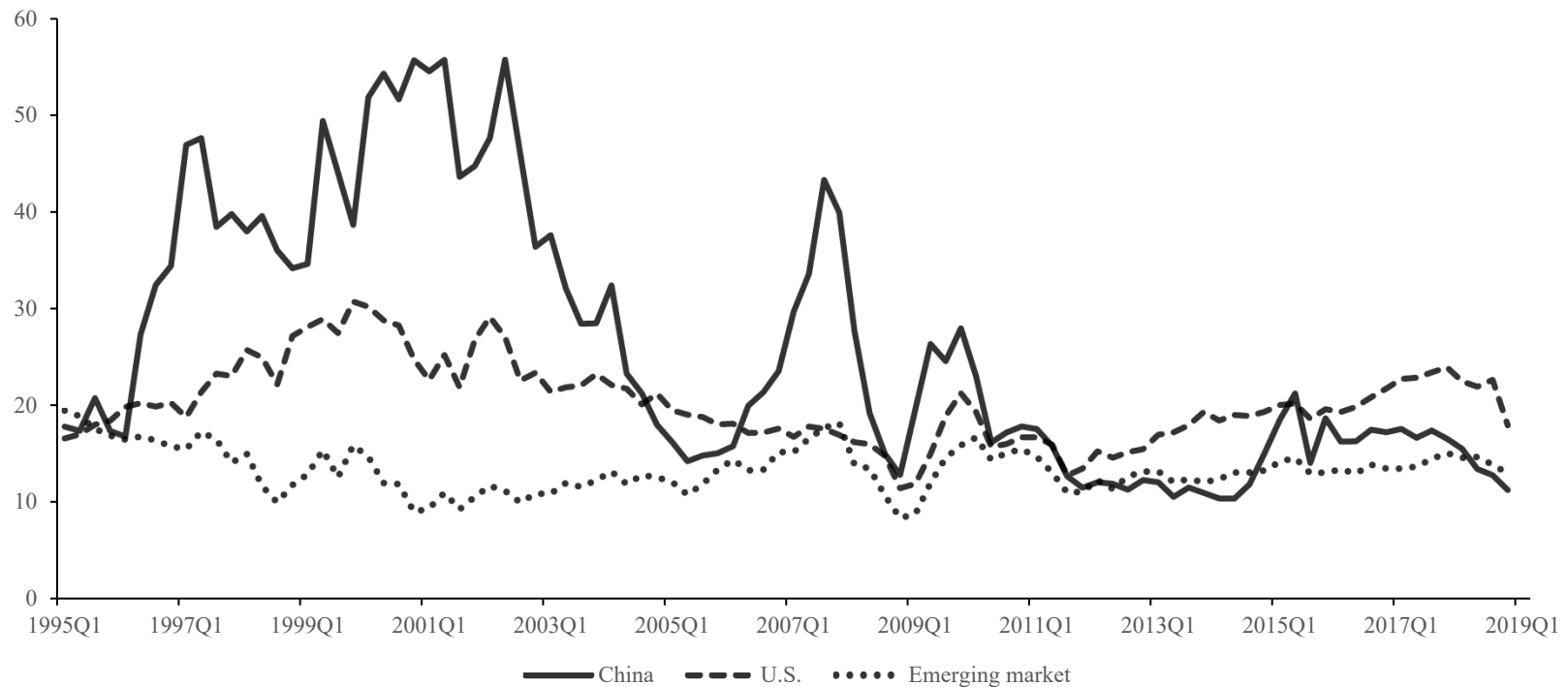
Discussant: Kalok Chan, CUHK

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

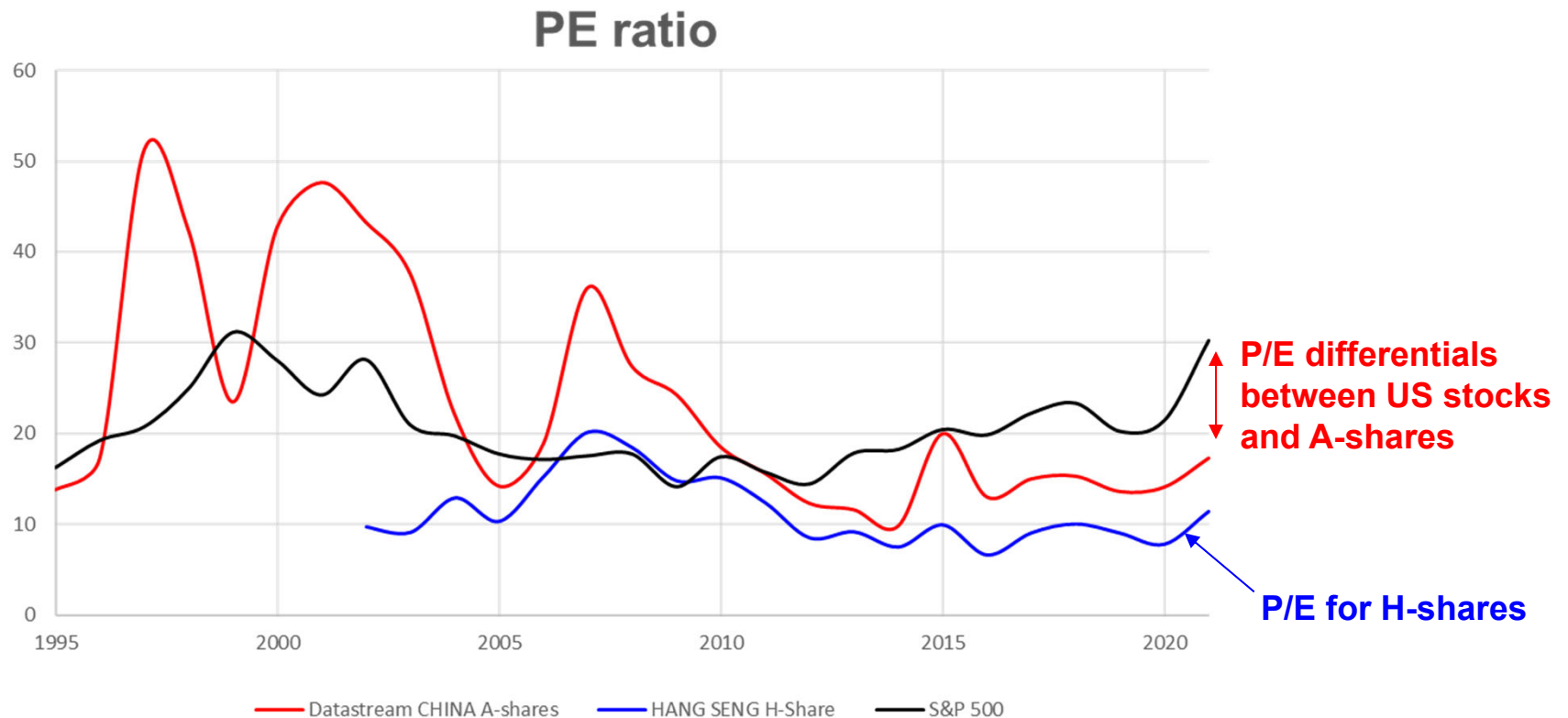
■ Why China stock valuation was high before?

- ❑ 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