As China gets back to business, where next for its stock markets?

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China shares staged a massive rally in the wake of a series of announcements pointing to increased government spport for the Chinese economy and its financial markets. But is this the start of a sustained comeback or another short-lived, stimulus-induced bump for China stocks?

Our Markets team is cautiously optimistic about the outlook for Chinese shares but recognise the risks of a pullback. They spent the Golden Week while China was off work considering where next for this rally and think investors need to consider four key issues:

Past pro-growth policy shifts have faded, with the MSCI China Index still below end-2019 levels. The key this time is, not only that policymakers follow through with their promises, but that they step up and prioritise growth if the economy begins to falter again.

In terms of whether shares could go higher from here, we've argued that China's stock market valuations are low due to excessive investor pessimism, particularly for the Hang Seng Index. While relative valuation measures show further gains are possible, downside risks from real estate and geopolitical tensions suggest a more modest 10% increase in the MSCI China Index in the coming months, than anything like a repeat of the 30% rise we've just seen.

On a sectoral basis, Capital Economics believes the tech sectors – which they proxy as consumer discretionary, information technology, and communication services – have the best prospects. While their recent performance has only slightly outpaced the broader market, their valuations have dropped sharply, and they are the only sectors consistently growing earnings per share. Thus, tech stocks stand to benefit most from a continued rally.

Long-term, we're still downbeat on the outlook for Chinese shares. If valuations reach their new equilibrium – wherever that is – the market may stop rising. Sustained growth in earnings per share could extend the rally, but China's listed companies have historically struggled with this. Given the stimulus package's limitations, we remain cautiously optimistic short-term but not beyond that.

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