Nikko Asset Management

MARKET COMMENTARY

7 July 2015

China: Now and Tomorrow

Reforms have been a key element of the Chinese leadership and we foresee a continuation of policies aimed at eradicating state inefficiencies and corruption; liberalise and prepare capital markets for more competition; address labour mobility and encourage urbanisation, to name a few.

Nikko AM Asia views the recent market corrections in Chinese equities, particularly in the onshore markets as healthy given the sharp advance on account of a frenzied retail market intoxicated by relatively cheap margin financing.

While reforms act as short term speed bumps, the medium and longer term prospects for China are much brighter as we expect Chinese companies to generate higher returns for shareholders particularly in new economy companies and selected old fashioned bricks and mortar.

Market Situation

Reforms at this stage of the economy will understandably compound slowing investments and domestic consumption with the latter arguably hurt by widespread anti-corruption measures. In that respect the People's Bank of China (PBOC) has been easing monetary policies with 4 interest rate reductions in the last 9 months and an equal measure of lowering banks' reserve requirements.

Recent market movements in China's onshore markets have raised questions on the sustainability of its fledging bull market. Since the anticipation of the Shanghai-HK Connect program that will allow foreigners to buy directly into Shanghai listed stocks plus successive easing by the PBOC, the onshore markets have rallied approximately 150% from 3Q 2014 to their highs in June 2015.

Source: Bloomberg as of 7 July 2015

These powerful rallies contrast with the more modest rise of Chinese companies listed outside of China, primarily in HK. The MSCI China and HSCEI indices rose approximately 40% to their highs in April/May this year.

Source: Bloomberg as of 7 July 2015

Subsequent corrections in both onshore and offshore Chinese markets have been severe with gains for the onshore markets culled to a "mere" +85% while the MSCI China and HSCEI indices gain for the last 12 months is down to about 18%.

The volatility of the markets underscores the policy dilemma faced by the authorities. Attempts to cool the market with more IPOs and moral suasion were initially overwhelmed by the surge in accounts opened and margin financing which rose sharply in 2H 2014.

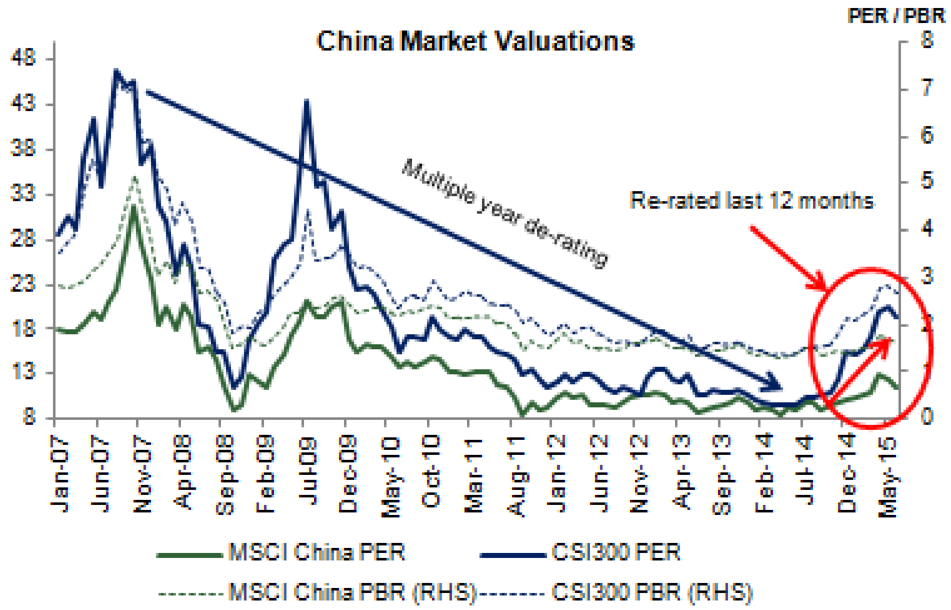
Source: Goldman Sachs Research as of 2 July 2015

The extent of declines engendered by the prevalence of margin loans have suddenly become a problem for authorities now accused of not doing enough to support the markets. A rush of measures including a temporary ban on IPOs and the setting up of a Rmb120bn stability fund proved insufficient to halt the vicious cycle of forced selling resulting in lower prices and more forced selling. The sharp declines in the onshore Chinese markets eventually had a negative impact on the neighbouring HK bourse as prices began to slide in sympathy. The Greece saga merely heightened a souring of investors' sentiment.

The sharp rise and fall of Chinese equities is reminiscent of the 2006/07 rise and fall in 2008. However, it is instructive to note that the economy in 2006/07 was peaking at a growth rate of 11-12% with inflation rising rapidly from under 1% in early 2006 to peak at 8% in 1Q 2008. Monetary policy was on a tightening mode. China raised reserve requirements from 9% in 2009 to 22.5% by 2013 (Source:Bloomberg, July 2015). During that same period the world was introduced to "QE" as championed by the US, Japan and later by Europe.

The situation couldn't be more different today. Growth has gradually slowed to 7% and inflation has declined from over 6% in 2011 to 1.2% at the end of May 2015 (Source:Bloomberg, July 2015). The PBOC has cut interest rates 4 times since November 2014 and is still one of the few countries in the world with positive real interest rates. Reserve requirements have been cut thrice this year alone albeit to a still lofty 18.5%.

Stock valuations in both the onshore and offshore Chinese equity markets have been de-rated severely from 2007 to 2013. Current valuations remain reasonable by historical measures after the strong advance and subsequent correction. The CSI 300 Index (A proxy for Shanghai and Shenzhen listings) is trading at an average of 15x current year earnings. Meanwhile, Chinese equities listed primarily in HK are trading at an average of 10.5x current year earnings.



Source: Bloomberg 3 July 2015

Conclusion

The China related equity markets suffered a sharp correction in recent weeks after a very strong run over the past year. During times of this type of volatility, it is crucial to take a medium to long term view. Economic growth in China will continue to slow and the authorities will continue to ease monetary policy and implement reforms. This is actually a very favourable environment for the stock market. Our view remains that we are in the early stages of a longer term bull market in China. With this recent volatility, we are taking the opportunity to switch our portfolio around, enabling us to buy some high quality Chinese companies at much more favourable valuations. While near term news flow may not be overwhelmingly positive, policy tools at the disposal of the Chinese government remain a powerful driver for the equity market in particular the inevitable opening of the country's capital markets.

The world's 2nd largest economy with the 2nd largest stock market cannot be ignored for long by serious investors.

Important Notice

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