Oct 15, 2015

China's Economic & Market Perspective

Fundamentals

The earlier reading of the data shows that the economics still face tremendous downward pressure for the 3rd quarter. Driven by the accelerated growths in the service and financial sectors, the GDP reading for the second quarter is 7.0%, slightly above market expectation. However, with respect to manufacturing, fixed asset investment growth fell to 9.7%, which indicates that the inhibition of excess capacity has not been alleviated. Real estate demand is indeed improving while the destocking is still in process. According to an economic policy related statement made by the Political Bureau. In July, the policy easing is unlikely to expand, and as a result the policy curve tends to be flat over the next few months. Currently, due to the steady increase of pork price, investors are concerned about CPI rise that might restrict the room for further monetary policy easing.

In the early of July, the A-share market has experienced an unprecedented collapse due to the negative feedback loop triggered by deleverage process. Most of small cap stocks saw their liquidity dry up, and some of which daily turnover decreased by more than 90%. The investors were panic. This situation has never happened in the last 20 years of A-share history. Even back to the financial crisis, the liquidity was still there even if the market went down significantly. Chinese government began to bolster the market by launching some support policies. China Securities Financial Limited, a company formed by CSRC, has stepped in markets and bought blue-chip stocks and index ETFs to stabilize the market since June 27. Chinese authority also made several announcements indicating that it will closely monitor the index futures market and crack down those who disrupt the market by speculating with index futures. The market began to stabilize in the second half of July.

While market has stabilized in the early August, it soon was dragged into another round of downfall caused by the disturbance in exchange rate market. In 11th August, PBoC announced an adjustment for the pricing mechanism of the RMB fixing. Such sudden change triggered a significant depreciation of the RMB against the U.S. dollar which dropped by 4.5% approximately within 3 days, and it also caused sharp decline in equity market. To counter the capital outflow and also to inject more liquidity, PBoC announced that another round of interest rate cut and RRR cut on August 26th. As a result, the market has witnessed another round of policy easing and began to stabilize at the end of the August.

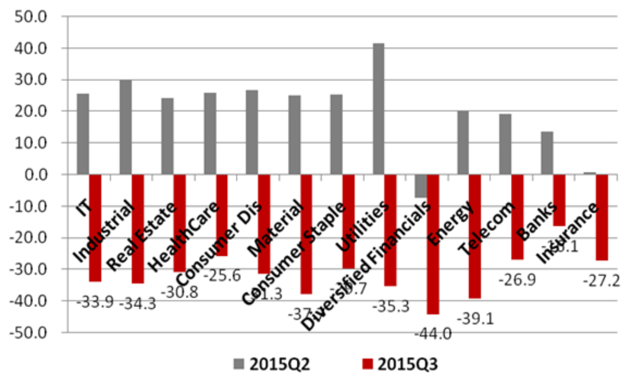
In September, the markets began to differentiate. Spurred by several positive news including the achievement of Sino-US cooperation achieved during President Xi's official trip to US and some thematic opportunities, such as new energy vehicles and information technology and information security start to gain attraction, many small-mid cap stocks began to rise and ChinNext index soared nearly 17% in less than two weeks.

Market

In terms of the market performance in3rd quarter, **all indices and sectors have seen over 25% losses. Shanghai Composite and CSI 300 have shown drops of 28%.** The small-medium cap stocks have also suffered loss as SME and GEB indexes declined by 26.4% and 27.4% respectively.

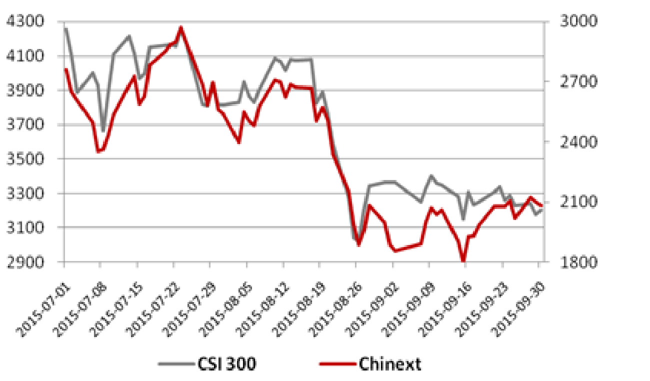
As for the sector performance, no sectors seem to be immune to the losses. Except for Banks, a defensive sector with a 16% quarterly drop, all sectors report declines of more than 25%, Diversified financials and energy are the two worst-performing sectors recorded drops with 44% and 39%.

Graph 1: China A share sector performance (%) in Q3



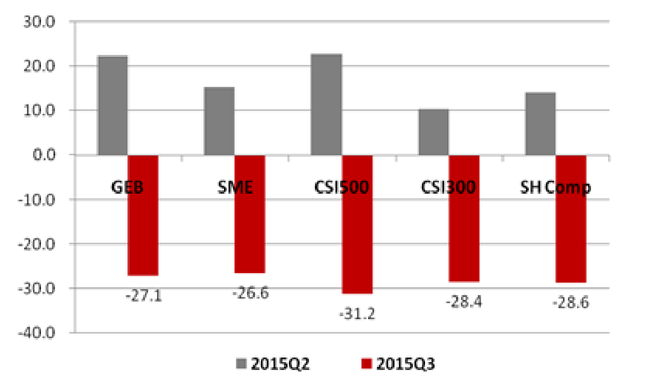
Source: Wind Info, ChinaAMC

Graph 2: Performance of Shanghai Index and Chinext in Q3.



Source: Wind Info, ChinaAMC

Graph 2: Performance of different in Q3.



Source: Wind Info, ChinaAMC

Outlook

We believe the economy may remain weak in the fourth quarter. There is a lack of positive changes from economy indicators like Purchasing Managers' Indices (PMI), Producer Price Index (PPI) and electricity generated, although the government has carried out more policies to stimulate the economy. In September, the CaiXin China manufacturing PMI hit a six-and-a-half-year low of 47, below the key 50-level for seven consecutive months. China's PPI fell by 5.9%, compared with an expected 5.5% drop, and remained negative for over the past three years. The US Federal Reserve postponed the rate hike. With less devaluation pressure, RMB is expected to stay firm in the next few months. Yet, there is still an expectation that RMB will slightly depreciate at around 3-5% in 2016. Commodity prices remain low, especially energy and precious metals. Therefore, commodity-exporting countries, such as Canada and Australia, may experience slower growths over the next three years. In the A-share market, investors' equity exposure are low (hedge fund <20% and mutual fund <70%) due to the pessimistic expectations on economy and earnings growth of companies. The clean-up of shadow margin financing accounts is coming to an end and the margin balance is under control. As the trading volume shrinks, the market will be stabilized. With the economy slowing down, we believe there's still room for loosening monetary policies, such as Required Reserve Ratio (RRR) cut and interest rate cut.

In September, A-share market is traded in a low range and the trading volume shrinked after the sell-off triggered by a second round of deleveraging in August. The oversold information technology stocks and ChiNext stocks rebounded strongly this month. Thematic sectors such as information security, new energy vehicles and Shanghai Disneyland-related stocks are been actively traded. Deleveraging and regulating of shadow margin financing is coming to an end and have limited negative impacts. Delay of the rate hike relieves the pressure on RMB devaluation and as a result the capital outflow decelerates. Considering the limited allocation choice, equity market is still attractive.

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