Jan 15, 2016

China's Economic & Market Perspective

Market Review for 2015

The real economy still remains weak. Potential macro slowdown could extend into 2016, de-capacity of old economy suggests muted EPS growth. In recent months, economic data have been mixed or temporarily stabilized at a low level, e.g. Dec 2015 industrial production YoY 6.2% vs. Bloomberg survey 5.7%; Dec 2015 Industrial profit YoY at -1.4% vs. Nov -4.6%.

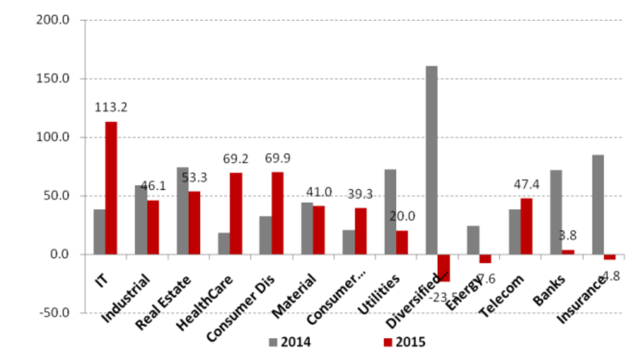
The recent acceleration of RMB weakening is a reflection of still challenging economic fundamentals. It could also be driven by some technical reasons: 1) rising USD demand given individuals' USD 50k annual exchange quota renewal starting from Jan 1, 2016; 2) Possibly, relatively less intervention from the government given the increasing focus on CFETS currency baskets.

Easing liquidity has been well expected by consensus given the 6 interest rate and 4 RRR cuts. Yet the effectiveness via real de-capacity and real reforms matters more in our view, which still needs time to prove.

We still hold a positive view over China's economy as this current administration puts heavy emphasis on the 'Supply-Side' reform and is determined to scale down excess capacities. We believe the long-term well-being of the structure of the economy will benefit from this reform and we remain positive on the market in the long run, despite the headwind in the near term.

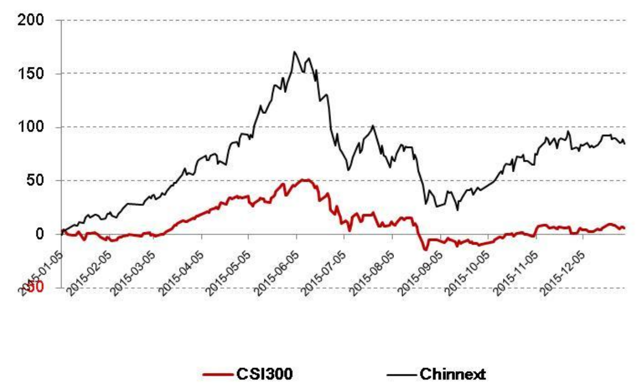
In terms of the market performance of 2015, major indices and most of the sectors have seen increases. The market style is very obvious in a sense that 'the small stock effect'' is very conspicuous. ChiNext and SME rose 84% and 57%, respectively. The Shanghai Composite and CSI300, in which the large-cap stocks constitute the bulk of the indices, have only gained 9.4% and 5.6%, respectively. In terms of sector performance, IT sector led with a 113% rise. Runners-up were consumer discretionary and healthcare, delivering 69% and 62%, respectively. Diversified Financials, Insurance and Energy suffered the worst losses of 23%, 4% and 7%, respectively.

Graph 1: China A-share sector performance (%) in 2015



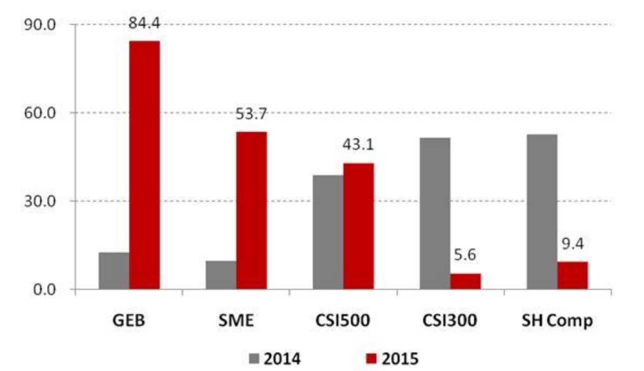
Source: Wind Info, ChinaAMC

Graph 2: Performance of CSI300 and ChiNext in 2015



Source: Wind Info, ChinaAMC

Graph 3: Performance of different indices in 2015



Source: Wind Info, ChinaAMC

Outlook and Investment Strategy for 2016

We have a cautious view on A-share market for 2016 while at the same time we remain positive in achieving our set investment goals. The headwinds are mainly the implementation of IPO registration regime, the lifting of the selling freeze on restricted stocks, pressures of RMB depreciation and GDP growth deceleration.

The new IPO registration regime, which is a US-style mechanism, only requires the IPO companies to register with CSRC instead of going through a lengthy approval process. As a result, the supply of listed names may largely increase, meanwhile valuation and time window of these IPOs will be left for the market to decide. While we are concerned with the new regulation, we are not too pessimistic. CSRC recently clearly stated that the implementation will take time through a gradual process, and the market should not see a big supply shock within a short time. Small cap stocks with lofty valuation may imply high risks, while value stocks will likely to be in better shapes.

For the restricted stocks, the first date for free float is January 8, and this may be part of the reasons for the past two weeks' market volatility. We see this as an ongoing pressure, but we believe such risks can eb contained. In our stock selection, we have been very cautious with names with overhanging large amount of restricted stocks to sell.

In the first week of 2016, RMB fixing rate against USD fell sharply to the lowest level since March 2011. Concerns of economy slowdown and market speculation activities had big impact on the RMB exchange rate. Looking forward, while we think RMB may still have pressure of depreciation, we believe the downside is limited. The weak economy and being "over priced" should cause RMB to remain under depreciation pressure. Meanwhile, being a SDR currency and ambition to be more internationalized means the room of depreciation is deficient. GDP slowdown has been priced in by investors, and the government through "Supply side reform" will help to resolve structural problems. Amid the reforms and the economy transformation, we believe there are plenty of "structural" opportunities to catch.

We will maintain a balanced position and enhance our bottom-up research on high quality stocks to limit the negative effect from the upcoming sell-off wave by major shareholders. Yet at this point, we still favor the upgrade of new consumption, software as a service (SaaS) industry, mobile internet, digital advertising, and high-end manufacturing, while we will increase the weights of value stocks such as banks and consumer names.

To conclude, amid the headwinds of a economy in transforamtion phase, we see challenges ahead, and believe our investment strategies and capabilities will enable us to catch the structural growth opportunities in sectors and companies, thus beat the benchmarks as before.

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