MARKET INSIGHTS

INVESTING IN CHINA OPPORTUNITIES AMID HEADWINDS

MARCH 2016

China's recently-concluded National People's Congress (NPC), during which it unveiled its 13th Five-Year Plan (FYP) for 2016-2020, threw up few surprises. The government revised downwards its GDP growth target, raised its fiscal deficit target, plans to address industrial overcapacity and stuck to state-owned enterprise (SOE) reforms. These are among the issues that have been weighing on the world's second-largest economy.

Indeed, this year's NPC session took on particular significance as it coincided with a time when China is maneuvering multiple headwinds. Beijing's rising political and economic clout also means its policies will likely have spillover effects on the rest of the world.

A few questions remain, though. First, is the negative news flow surrounding China's economic slowdown, burgeoning debt and supply gluts overblown? We generally think so, even as we acknowledge the issues China faces. Second, is enough being done, or can be done, to alleviate the pressure points? We believe that while the government's policies are positive, much hinges on their successful delivery. In this article, we highlight key areas of concern, as well as possible growth drivers.

ECONOMIC GROWTH

Premier Li Keqiang set the GDP growth target at 6.5%-7% for the next five years, for the first time adopting a range rather than a hard target. The rate is in line with the government's longer-term aim of doubling GDP between 2010 and 2020 to achieve a "moderately prosperous society" in time for the Chinese Communist Party's 100th anniversary. But the new target also implies the authorities are accepting faltering growth, which may also help allay doubts over official GDP numbers many believe are inflated. In addition, a range gives the government more flexibility to meet its target.

Fig.1. NPC's macro targets

	2016 target	2015 actual	2015 target
GDP growth	6.5%-7%	6.9%	7%
CPI inflation	3%	1.4%	3%
M2 growth	13%	12%	12%
New urban jobs (million)	10	13.1	10
Fixed asset investment	10.5%	10%	15%
Fiscal deficit % GDP	3%	2.4%	2.3%
Foreign trade	No target	-8%	6%

Source: National Bureau of Statistics of China, Commerzbank AG, as at March 2016.

While China's slower economic growth has mostly received negative press, we think the normalisation is not surprising, given its size and rising maturity. A comparison with other large and developed countries provides some perspective: During the mid-1970s, Japan, US, Germany and UK recorded inflation-adjusted GDP per capita of USD7,6001, similar to China's current GDP per capita[1]. These countries only grew their economies by an average of 2.9% over the next 20 years. If China manages a 6% GDP growth rate per annum over the next five years, it will still stand out as one of the world's fastest-growing economies.

The government expects further monetary and fiscal easing to support economic growth. At the same time, its higher fiscal deficit target of 3% of GDP this year (from 2015's actual 2.4%) points to more targeted spending. Sectors expected to receive a spending boost include infrastructure, agricultural modernisation, clean energy, "One Belt, One Road" and construction of city clusters in the northern areas of Beijing, Tianjin and Hebei. Within infrastructure, for instance, there are plans to expand high-speed railways to 30,000 kilometers by 2020, from 19,000 km last year, and build 50 new civilian airports.

Government policies, coupled with an expected rise in wages and consumption, could be powerful drivers of economic growth. This is especially so as China aims to transition from an investment- to a consumption-led economy. So far, progress on that has been encouraging; in 4Q2015, consumption accounted for 67% of real GDP growth, an increase from 51% in 4Q2014[2].

REFORMS: OUT WITH THE OLD, IN WITH THE NEW

"Supply side reforms" was a heavily-touted phrase at the annual parliament meeting, essentially referring to the government's commitment to tackle oversupply in outdated industries, while developing innovative ones. Prior to the NPC, China's human resources and social security minister had said the country expects 1.8 million job cuts in the coal and steel industries, without giving a specific timeframe. But a new RMB100 billion (USD15 billion) fund the government intends to set up provides an indication of the timeline: The money will be used over two years to resettle workers from restructured industries.

There are also plans to weed out "zombie" companies, firms that have shut down some operations but keep staff on payrolls to avoid backlashes. China has roughly 350 listed "zombie" companies with financial leverage of at least 100%, and return on equity of less than 5%[3].

Dealing with overcapacity and inefficient SOEs looks rosy in theory, but may be tough to execute. If not handled carefully, it may lead to social and political repercussions, distractions the government can ill-afford. But if successful, production cuts and industry consolidation should help stabilise resource prices, redirect funds and manpower to sunshine industries and raise SOEs' efficiency. This may in turn spur profitability and economic growth. This is precisely why the State-owned Assets Supervision and Administration Council (SASAC), formed in March 2003 to help SOEs develop more rapidly, also needs to reduce its influence and give SOEs more leeway to progress further.

Shutting down coal mines and companies in other heavily-polluting industries also ties in closely with a stronger push for clean, renewable energy. This is a priority on the government's agenda. It intends to cut the country's coal consumption to 60% of total primary energy consumption by 2020, from 66% in 2014. There are also plans for central and regional authorities to add charging points to accommodate five million electric vehicles by 2020.

China is also making innovation the bedrock of its economic development, targeting to raise research and development (R&D) spending to 2.5% of GDP by 2020, from 2.0% in 2014. In this regard, the government will introduce tax breaks and funding for high-tech and R&D industries. This is especially important for China to play catch-up to other Asian countries. For example, Japan and South Korea spend 3%-3.5% of their GDP on R&D.

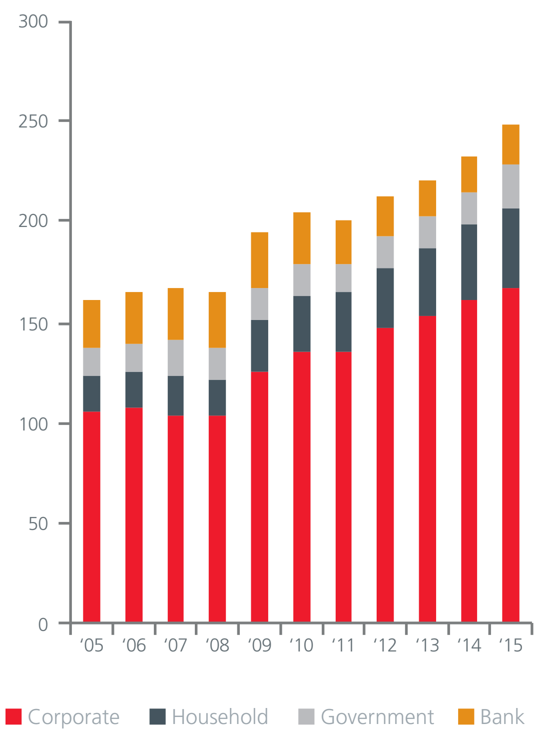
[1]Goldman Sachs, as at February 2016. [2]Datastream, as at 10 March 2016. [3]Bloomberg, as at March 2016.

DELEVERAGING ON HOLD?

While the reforms mentioned above are laudable, it appears that policymakers are in no rush to tackle China's debt overhang, even if they have taken some steps to address it. In the 13th FYP, the government set total social financing growth at 13%, up from actual 12.4% growth last year, suggesting a further increase, rather than an unwinding, of leverage. Also, a registration-based system for A-share initial public offerings has also been placed on the back burner, which limits equity financing, an alternative to debt financing, for Chinese corporates.

This has raised questions about the size and urgency of the issue. China's total debt as a percentage of GDP has risen consecutively over the past four years to nearly 250% in 2015, as corporates and regional governments borrowed to fuel spending.

Fig.2. China's debt as percentage of GDP (%)



Source: Bloomberg, as at 31 December 2015.

Chinese banks' non-performing loans (NPLs) raised investor concerns in February this year after market speculators said Chinese bank losses could exceed 400% of US banking losses during the subprime crisis. Official data put banks' NPL ratio at 1.7% as at December 2015, but many believe that number is closer to 8%. Given that the banks' total credit exposure stands at RMB122 trillion[4], an 8% NPL ratio suggests that the banks could incur potential losses of up to RMB10 trillion (USD1.5 trillion), which is still significantly below market estimates of USD3.5 trillion.

Importantly, Chinese banks remain profitable. Net interest margin at commercial banks stood at 2.54% as of December 2015, still healthy despite having fallen over the past few years amid looser monetary policy. This provides a buffer for banks to absorb bad debt.

Still, the authorities last year launched a debt-for-bond swap programme to lighten local governments' load. First introduced in March 2015, the scheme was doubled to RMB2 trillion in early June. It allows debt issued by LGFVs to be exchanged for lower interest rate bonds. The People's Bank of China is also now preparing regulations to allow commercial lenders to exchange companies' NPLs for stakes in the firms, aimed at reducing banks' NPL ratios. But the government has stopped short of bank recapitalisation, which looks to be the last resort.

HONG KONG AND MACAU TO PLAY BIGGER ROLES

A key development worth watching is Hong Kong's and Macau's expected contribution to the Chinese economy. Beijing pledged support for Hong Kong over the next five years to consolidate the latter's position in international finance, shipping and trade. This includes supporting mainland enterprises to set up regional headquarters in Hong Kong, and continue to promote Hong Kong as an offshore renminbi centre. It also proposed to add Hong Kong and Macau to nine southern mainland provinces to create a larger Greater Pearl River Delta zone.

[4]China International Capital Corporation (CICC), as at February 2016.

While such moves may be politically-motivated, greater synergies among Hong Kong, Macau and the mainland generally bode well for various industries, including finance.

Importantly, the Shenzhen-Hong Kong Stock Connect will likely be launched in the second half of this year. While volumes through the pilot Shanghai-Hong Kong Stock Connect scheme has not been particularly stellar, brokers hope the Shenzhen scheme will boost market sentiment, given that Shenzhen has more small- and medium-sized A-share stocks that retail investors like. It would also allow investors to access the nation's technology and high-growth shares.

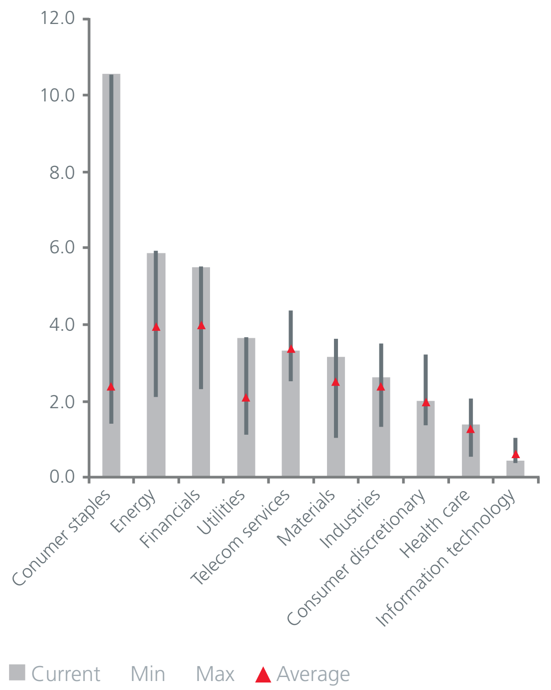
Under the Shanghai-Hong Kong Stock Connect, c.38% of northbound (Hong Kong investors buying Chinese A-shares) quota has been used up since the scheme's launch in late 2014, with net purchases at USD16.1 billion[5]. Meanwhile, 50% of southbound quota has been used, with investors buying USD21.6 billion worth of Hong Kong stocks.

EQUITY MARKETS REMAIN ATTRACTIVE

Against the backdrop of continued structural reforms and new policies, Chinese equities remain attractive. In particular, H-shares are trading at lower valuations than A-shares, and far below their own long-term averages. From a 12-month forward price-to-earnings ratio standpoint, the MSCI China Index (which represents H-shares) trades at a 19% discount to the CSI300 Index (which represents A-shares)[6]. The valuation gap is even greater on a 12-month forward price-to-book (P/B) ratio basis, with H-shares having a 29% discount to A-shares[6].

In addition, two indicators point to corporate strength, dividend yields and share buybacks. The MSCI China Index continues to offer solid dividend yields, even after the first tranche of American Depositary Receipts, mostly comprising IT stocks which have lower dividend yields, were added to the benchmark in late November last year.

Fig.3. MSCI China index's dividend yield by sector (%)



Source: Eastspring Investments, Bloomberg, as at 29 February 2016. Numbers shown represents current dividend yield.

Meanwhile, share buybacks by Hong Kong companies have also been on the rise. On the Hong Kong stock exchange, buybacks reached a four-year high (among Hong Kong and Chinese stocks) last year. In the past, buybacks have preceded stock market rallies, so this is likely positive for equities.

Eastspring's China equity strategy stands to benefit from China's reform story and eventual cyclical recovery. Our strategy is currently overweight in financials and consumer staples[7]. As long-term investors, we are not excessively worried about short-term market noise and fluctuations, even as we keep an eye on them. In fact, such situations may throw up valuation opportunities for us to exploit. With our bottom-up investment process, we continue to search for attractively-priced companies trading below their intrinsic values.

[5]Citigroup, as at 28 February 2016. [6]Bloomberg, as at 11 March 2016. [7]As at 29 February 2016.

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