beyond*the*headlines

8 January 2016

OUR TAKE ON RECENT CHINESE MARKET VOLATILITY

Chinese A-share markets started 2016 on a volatile note, dropping 7% on the first trading day of the year and again yesterday, triggering a trading halt through a new circuit breaker. Yesterday's fall which affected other markets and currencies was triggered after the People's Bank of China's move to lower the renminbi's (RMB) mid-point rate spooked investors. This has since prompted the Chinese stock exchanges to suspend the circuit breaker mechanism.

It would seem as though China gets negative press every day, but we think these two events may be overhyped. There is no denying that China *is* facing headwinds, as key macroeconomic data indicate, but as long-term investors, we are not unduly concerned about the events. Here's why:

1. In some ways, the market gyrations **should have been expected**, partly fueled by concerns that a six-month ban on share sales by significant shareholders, implemented last July, will expire today. In addition, the **Chinese A-share market is dominated by retail investors (accounting for over 80% of the trades in the A-share market)**, who tend to be short-term and speculative in nature. This likely exacerbated the sell-off.

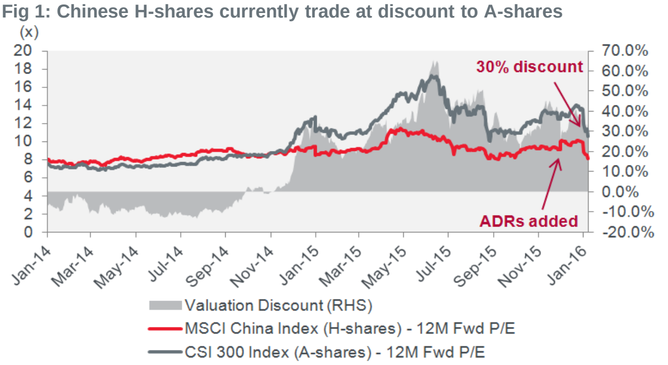
2. In the latest development, the Shanghai and Shenzhen stock exchanges have scrapped the circuit breaker, after realising that the mechanism triggered more fear and panic than the intended stability. It appears **that Chinese authorities are still experimenting with ways to curb market volatility—but they are learning quickly** and are not afraid to throw out or rework new measures that fail.

In addition, the **China Securities Regulatory Commission yesterday issued new guidelines to limit the amount of shares that significant shareholders can sell.** These two moves may inject some calm into the markets and ease speculative selling.

Circuit breakers can be useful in containing panic. However, China's circuit breaker triggers 15-minute trading halts when stocks swing by 5%, and a full-day halt after a 7% fall—**a range that may have been a tad narrow.** In comparison, in the US, a 7%/12% swing effects a 15-minute halt, while a 20% decline stops daily trading.

3. China H-shares remain attractive versus A-shares: The MSCI China Index currently trades at a 12-month forward price-to-earnings (P/E) ratio of 8.1x[1]—back to levels before the 14 American Depositary Receipts (ADRs)[2] were added to the index in end-November. In comparison, the CSI 300 Index is trading at a forward P/E of 10.6x[1].

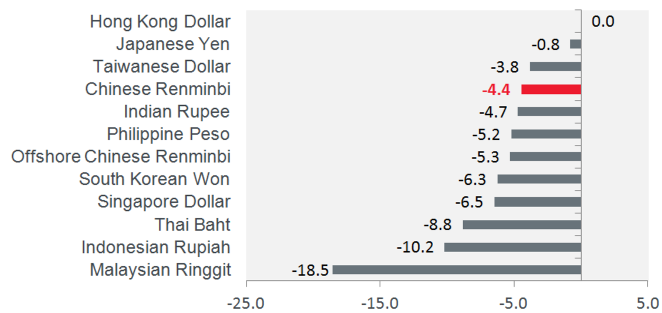
Fig 1: Chinese H-shares currently trade at discount to A-shares



Source: [1]Bloomberg, as of 7 January 2016. [2]18 Chinese stocks were added to the MSCI China Index on the close of trading on November 30, 2015, 14 of which are ADRs, including Alibaba Group Holding, Baidu, Ctrip.com, Netease.com, JD.com and Vipshop Holdings.

4. The **RMB's depreciation in 2015 has been less steep than that of major Asian currencies.** Even with yesterday's fall, it is still among the best-performing currencies in Asia and emerging markets. Also, with China's ongoing capital account liberalisation and gradual shift towards a less managed exchange rate, further RMB devaluation may come as no surprise.

Fig 2: Asian Currencies' Performance in 2015 (%)



Source: Bloomberg, 31 December 2015. Based on spot returns.

5. We believe **structural reforms will continue to progress in 2016 and beyond.** The government has set out to tackle overcapacity and promote manufacturing in China, and has made headway in reforming state-owned enterprises, among others. **Reforms may aid a recovery in cyclicals,** which have underperformed defensives over the past few years. **As China continues to loosen monetary, fiscal and property policies to help boost aggregate demand, China could see a cyclical recovery** from stronger credit creation.

Fig 3: China Cyclicals vs Defensives Price Index (USD)

Source: Credit Suisse, 7 January 2016. Aggregated by MSCI China universe. Rebased on 31 December 2005.

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