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China A: Resilience in the eye of the storm

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The China A market is up more than 25% year to date in USD terms despite the ongoing US-China trade dispute. While China's economic outlook is likely to be clouded in the near term, the rising representation of China A stocks in the MSCI indices continues to be a positive structural factor that longer-term investors cannot ignore.

It is no secret that the US-China trade conflict has weighed on the Chinese economy. The latest macro indicators in July were a sobering read. The Purchasing Managers Index for new orders as well as new export orders stayed below 50 while property and infrastructure investments moderated. Weak auto numbers weighed on retail sales and worryingly, the unemployment rate has ticked up (5.3%). The NBS Manufacturing Purchasing Manager's Index dipped to 49.5 in August, staying below 50 for the fourth consecutive month.

A closer look reveals that the impact on exports is not as bad as feared, for now. In fact, net exports contributed positively to GDP growth in the first two quarters of 2019, helped by an uplift in exports to ASEAN even as exports to the US fell. The 7%[1] depreciation of the renminbi against the USD since February has also helped exports at the margin. Meanwhile, imports fell on the back of weak domestic demand.

SURPRISING RESILIENCE

The China A market has been resilient despite the headline noise. The CSI 300 Index is up 28.9% year to date in USD terms[2], beating the MSCI Asia ex Japan's 6.8% gain. See Fig. 1. Interestingly, northbound flows have rebounded since June (See Fig. 2). Clearly, the China A market is holding up better relative to the March – December 2018 period where it fell 26.3%.

QUALITY OVER GROWTH

While the Chinese authorities have eased on both the monetary and fiscal fronts to support the economy, it is noteworthy that they remain focused on promoting quality growth. While the People's Bank of China (PBoC) has cut the Reserve Requirement Ratio and encouraged bank lending

Fig. 1. China A market more resilient to trade conflict in 2019[3]

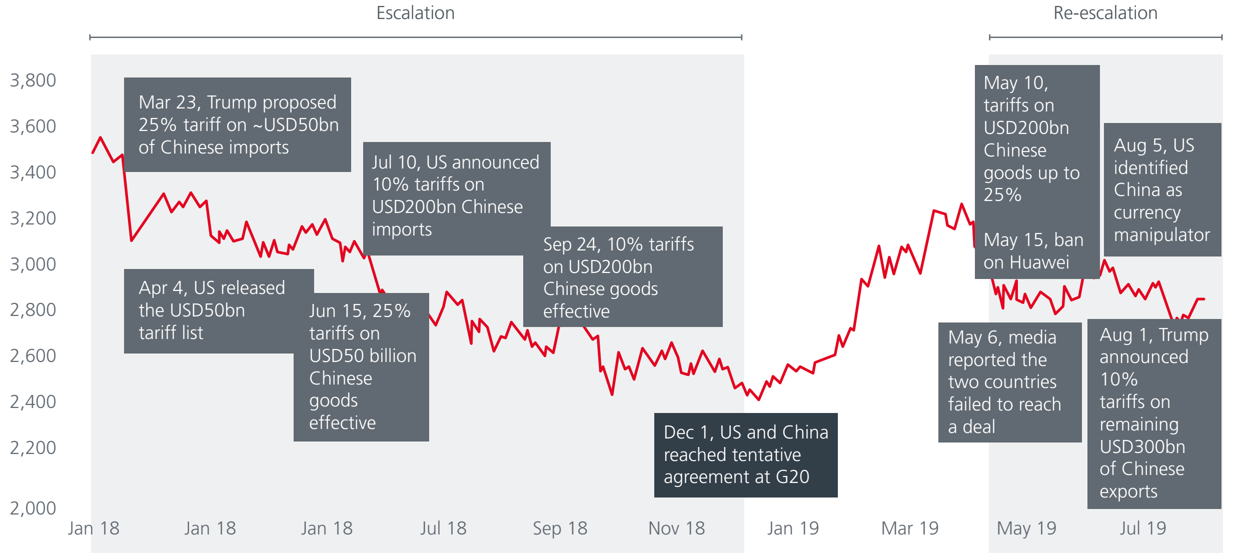
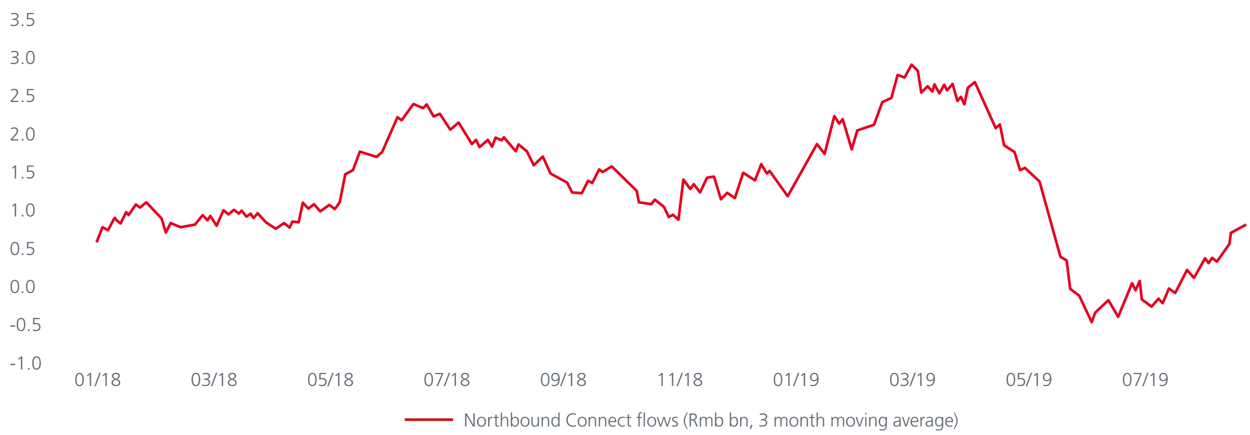


Fig. 2 . China A northbound flows rebound[4]



to small and medium sized companies, the central bank has not let up on shadow banking activities. Meanwhile, the trade tensions have not distracted the central bank from accelerating its interest rate reforms. The People's Bank of China set the MLF (an open market operation tool) rate as the new policy rate in August to replace the previous benchmark lending rate. Longer term, the ability to establish their own loan pricing models should enhance the banks' risk management capabilities going forward.

On the fiscal front, the Chinese authorities have also cut taxes and fees to stimulate the economy. The local governments accelerated their bond issuance this year to fund qualified infrastructure projects including shanty-town redevelopment, as well as highway and railway construction. By June 2019, local governments' total net bond issuance reached RMB2.1765 trillion, accounting for 70.7% of the annual quota. That said, there are no plans for a massive investment stimulus similar to what was rolled out post the Global Financial Crisis.

The government is also unlikely to ease property restrictions substantially given explicit statements from the politburo that "the government will not use real estate as a short-term means of stimulating the economy".

A LONGER-TERM PERSPECTIVE

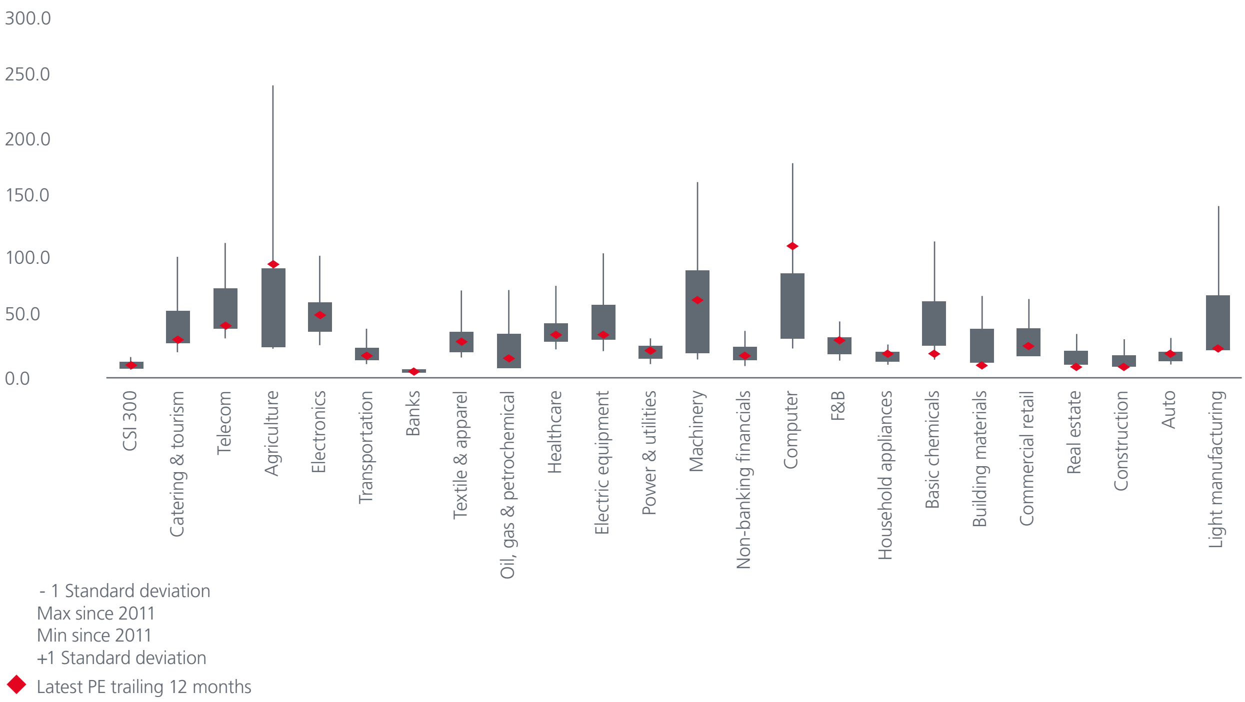
In the near term, until we get greater clarity on the trade front, the Chinese economy is likely to remain soft. Greater stabilisation efforts to support domestic demand and alleviate external pressures will probably be forthcoming should the economy decelerate too quickly. Earnings visibility is also expected to remain low. Meanwhile valuations are not demanding at the aggregate level, especially when considering that the risk-free rate is low and may get even lower. Policy support is also intensifying. The CSI 300's 12-month forward price to earnings ratio is currently trading close to its lower bound, around one standard deviation below its long-term historical average.

For now, our investment team in China is focusing on sectors that have domestic drivers or may benefit from policy support. They are also favouring sectors/stocks that have sufficient valuation buffers given the ongoing uncertainty. These currently include the health care and consumer discretionary sectors as well as selected sub-sectors within the TMT (Technology-Media-Telecoms) sector. See Fig. 3.

Investors, however, may not want to forget the positive structural drivers for the A share market. In March this year, MSCI agreed to increase the inclusion factor of A-shares in the MSCI China and MSCI Emerging Market indices to 20% in a three-step process in May, August and November, each time increasing the representation of Chinese large-cap stocks by 5%.

The latest move in August brings the weighting of China A shares in the MSCI China and MSCI Emerging Market indices to 7.8% and 2.5% respectively and can potentially lead to around USD22.7 billion of incremental capital to the market[6]. In our view, the demand for China A shares from global asset managers will continue to increase over the coming years, helping to underpin the market over the longer term.

Fig. 3 . Sector valuations vary[5]



Sources: [1]As of 10 September 2019. Bloomberg. [2]As of 10 September 2019. Bloomberg. [3]Wind. Eastspring Investments. August 2019. [4]Wind. Eastspring Investments. August 2019. [5]Wind. Eastspring Investments. August 2019. [6]China International Capital Corporation Limited.

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