Investment Strategy Note

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China: Year-end Chinese equity market rally to be driven by cheap valuations, policy support and improving sentiment

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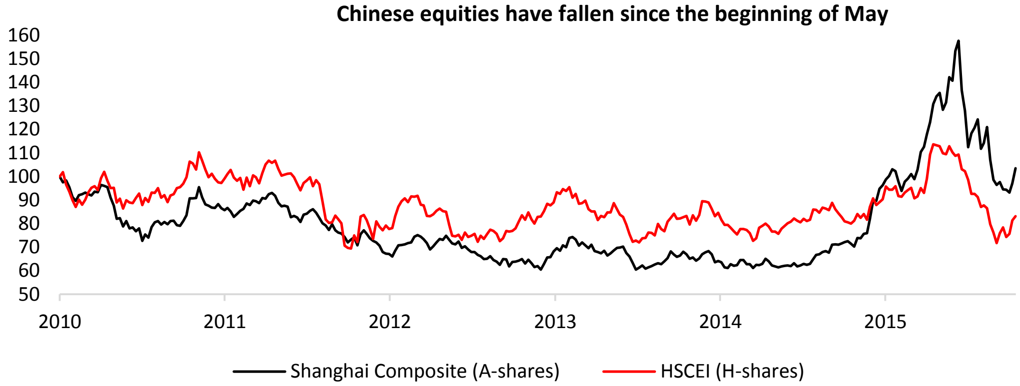
- **Chinese equities have been hurt by worries over the exchange rate mechanism, uncertainty over the timing of the Fed's rate rise as well as a broader EM slowdown**
- **Although we expect economic growth in China to continue to slow, we believe these factors have created a tactical buying opportunity in Chinese equities**
- **China is one of the few large economies with ample policy ammunition, we expect both monetary as well as fiscal easing to take place**
- **In this context, in the very near-term the key policy meeting taking place end of October (the fifth plenum) will be a key event to watch, also for news on further SOE reform**
- **Our call focusses on the H-share market where dual-listed companies trade on 30% lower valuations (vs. A-share) on average and the regulatory environment is more transparent**
- **H-share valuations are extremely cheap around 8x 2015 PE ratio, relative to 17x for the S&P 500 and 16.5x for the Nikkei 225**

Growth is slowing, but not as much as equity markets suggest

The rally in Chinese equities earlier this year ultimately proved unsustainable. Firstly, it was driven mainly by retail investors and secondly by liquidity and margin financing. Add to this fears of a hard-landing and concerns over the exchange rate mechanism and you have a dangerous cocktail. However, now that things have settled down, we see some tactical opportunities in Chinese equities, in particular in the H-shares.

The slowdown of Chinese economic growth to a six-year low of 6.9% most recently is very well documented by market commentators and investors alike. Although we believe a further slowdown in growth is likely as the economy transitions from an investment led growth model to one in which services play a much greater role, we are not expecting an immediate hard landing. Looking at Chinese equity market performance over the past few months suggest that a severe slowdown is priced in, and this is where we believe the opportunity lies.

Chinese equities have fallen since the beginning of May



Source: Bloomberg

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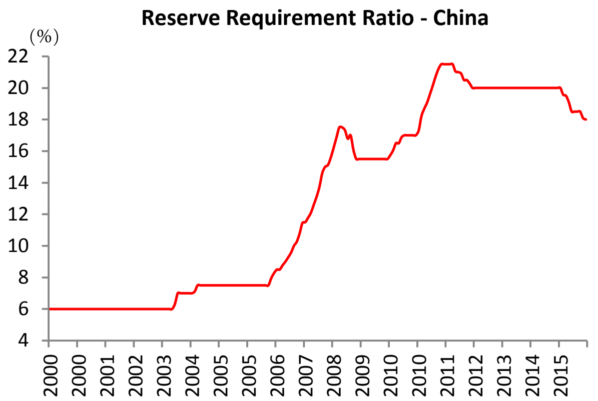
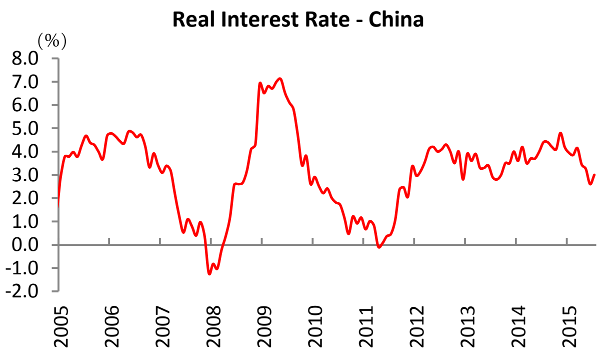
Monetary conditions currently too tight

An important part of our structural call on Chinese equities relates to the view that China is one of the few major economies in the world in which there is scope for significant monetary and fiscal easing, and importantly, we expect this ammunition to be used. On the monetary side, the reserve requirement ratio remains elevated relative to history at 17.5% (it was around 6% in 2000) and is an obvious and popular tool used by policy makers in China to ease financial conditions.



Source: Thomson Reuters

On the policy rate side we have seen a cumulative 140bp in cuts since November last year, but in real terms it has been less due to a rapid fall in inflation. Therefore, real interest rates are only slightly lower than on average in 2014 and higher than in 2013. The current policy rate of 4.6% is also significantly higher than in many major economies. While on the on the fiscal policy side, as in during previous slowdowns in the economy, it is likely that infrastructure investment will be boosted to manage the gradual growth slowdown.



Source: Thomson Reuters

Of course, it should be noted that there are reasons why policy has not been loosened more aggressively already. Put very simply, interest rates in China need to stay high, for example to compel deleveraging by local governments and to prevent excessive capital outflows, but not so high as to undermine growth. This is a fine balancing act which currently we believe is undermining growth, as such, policy makers are likely to act. This month's crucial policy meeting, the Fifth Plenum, to be held during 26-29 October should be closely watched.

Valuations too cheap to ignore

China offers a number of ways to gain exposure to its equity market. Investors are able to choose from the Shanghai Composite and Shenzhen Stock Exchanges (A-shares), to the Hang Seng and HSCEI (H-shares) plus several more. Our call focuses on the latter. H-share valuations are cheaper for dual-listed companies (by around 30% currently) than they are on the A-share markets.

On a price-to-earnings ratio basis, H-shares are currently trading around 8x on 2015 earnings, this is the low end of its recent range and considerably below many Emerging Market peers (India 18.6x, Brazil 12.2x, Indonesia 13.4x, EM average 11.2x). On a price to book ratio basis the current discount is even greater. The MSCI China is trading at historical lows of 1.7x book value, considerably below the 2008 low point.

Our view is tactical, rather than structural

Overall, it is important to stress that we view this call as a short-term tactical opportunity, based on recent equity market weakness, valuations and policy support. Longer-term we believe a much greater degree of clarity surrounding China's growth trajectory, reform and exchange rate dynamics is required in order for Chinese equities, but also broader EM assets to perform sustainably well. This point is likely to be quite far out, and in any case, unlike most Western economies where in recent years policy innovations have marked a clear inflection point, identifying the exact point where Chinese policy makers succeed in managing their growth conundrum is likely to be far less obvious. This is the reason why for the time being our positive call on Chinese equities is tactical rather than fundamental.

Sector wise, we would expect banks and real estate companies to outperform given that they are the most highly geared to the types of monetary and fiscal policy loosing that we envisage.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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