GUEST BLOGGERS

Progress and Improving Sentiment in China

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At the start of the year, sentiment in China's equity market was poor at best, but the worst fears of many investors about its economy haven't materialized. I've invited my colleague Eddie Chow, senior executive vice president and managing director, Templeton Emerging Markets Group, to provide an update on China's market and economy as it stands today. He outlines what has changed over the past few months, and the risks and opportunities we see in China—including a key stock-trading connection that could lure more foreign investors to the mainland market.

China's market, as represented by the MSCI China Index, has recovered from its lows in mid-late February and is now positive year-to-date through September 20.[1] The recovery in Chinese equities is more obvious in the overseas market, mainly stocks listed in Hong Kong (H shares) and those listed in the United States as American Depository Receipts (ADRs). The domestic A-share market in China—local Chinese companies denominated in renminbi and traded primarily between local investors on the Shanghai or Shenzhen stock exchanges—remain relatively weak.

At the beginning of the year, there were fears that as the US interest-rate cycle started to turn upward, capital outflows would lead China's currency to depreciate significantly and would further tighten the liquidity of its already-fragile credit system. Many investors were also uneasy about the government's inconsistency in its various economic policies, such as hard commitments on achieving 6.5% gross domestic product (GDP) growth, not allowing the currency to depreciate, and structural adjustments like capacity closure/deleveraging.

Over the past few months, market sentiment has improved for a few reasons. The Federal Reserve (Fed) has been less inclined to raise interest rates so far this year than had been feared, and the Chinese government has effectively slowed capital outflow and introduced more pragmatic economic policies. It is no longer as staunchly committed to reaching its target of 6.5% GDP growth, it has allowed its currency to embark on a mild weakening trend and has taken more concrete actions to cut capacity in the steel and mining industry. China's macroeconomic numbers remain weak in general, but there are signs in the August reports that China's growth slowdown has begun to stabilize. Fears of a credit blow-up have also subsided as the government introduced nonperforming loan (NPL)-backed asset-backed securities (ABS) for banks to dispose of NPLs, and at the same time, tightened up regulations on banks' activities in wealth management products.

The A-share markets in Shanghai and Shenzhen are dominated by retail investors, and I believe many lost confidence last year when the market sharply declined. It takes time for sentiment to recover. Hong Kong's market is dominated by institutional investors, and in the sell-off at the beginning of this year, the market was overpenalized with valuations reaching levels much lower than those of the Shanghai and Shenzhen domestic markets. As fears subsided, the recovery was therefore stronger in Hong Kong's market. Liquidity is also much better in the market for H shares, and as some developed economies turned to negative interest-rate policies, liquidity stayed relatively tight in the A-share market, driven by capital outflows.

Banking Vulnerability

Some reports this year have stated that China's banking system is vulnerable and at risk due to a reliance on interbank lending. In my view, the level of risk from lending-borrowing activities between large banks and smaller banks in China is not very high. As in many other markets, big banks enjoy scale advantage and would generally be stronger in their deposit franchise. It is generally more cost-effective for smaller banks to borrow from big banks in the interbank market. This would be unlikely to develop into a systemic risk if everyone follows the regulatory requirements and truly reflects the risks of their activities on their balance sheets. From my perspective, the real issue is that some mid-size and small banks may be hiding their loans to high-risk customers through swap arrangements with other banks. Such arrangements are shown on their balance sheets as lower-risk financial assets held under repurchase or resale agreements with other banks. The purpose is to make those high-risk loans consume less capital so the banks can do more business (or in other words, assume more risks) without the need to put up more capital. That situation can become a systemic risk. In the event of a wide-scale default among those high-risk customers, we would expect some degree of a credit crunch in the banking system, and other healthy borrowers would also likely be affected.

A New Stock Connection

The recent approval of the Shenzhen-Hong Kong Stock Connect program facilitates foreign and domestic trading between China's local market and Hong Kong—and to us, this means China's A-share market is further opened up. As they have with Shanghai-listed shares, foreign investors will be able buy Shenzhen-listed stocks directly. This greatly expands the number of stocks available to foreign investors and there are also more private companies in Shenzhen than in Shanghai, which we view as positive. For China's domestic A-share market, higher participation from foreign investors, especially institutional investors, is a positive development as it may potentially provide greater breadth in the near term and, longer term, can help drive the push for better corporate governance, a better regulatory framework and stricter enforcement.

Monetary Policy Action—or Inaction

The Chinese government has refrained from introducing stronger monetary measures at this stage, acknowledging that monetary policy is not the most effective tool to support the economy. Economists have pointed out that the contribution of credit to GDP growth has been rapidly declining. Much of the credits created are taken up by inefficient state-owned-enterprises in the legacy, old-economy industrial sector. In addition, the government would like to control an already-high debt situation. There are certainly some sectors that may benefit from government's focus on boosting certain infrastructure projects. For example, the government has planned to have more city rail systems. From an investment standpoint, this would be good news for some of the rail-system manufacturers.

Meanwhile the US Fed seems to be on a tightening course, as opposed to many other central banks that are still in easing mode. In general, a rise in US interest rates would be negative for China's market because when the interest-rate gap widens between the countries, money will likely flow out of China and drain the liquidity or money supply in the system, which is detrimental to economic growth. However, I believe with the current US tightening cycle, the market won't react with as much volatility as perhaps it did in the past, as the market has factored in a US interest-rate hike, and in the past few months, many Chinese companies were able to close their foreign debt exposure. Also, with the European Central Bank and Bank of Japan continuing to maintain negative interest-rate policies, I believe investment flows to emerging markets should be able to remain positive.

Investment Themes: Technology and Consumer Products

In terms of potential investment opportunities we're looking at in China, we are focused on the Internet and technology sector as we found that many companies can enjoy strong structural growth as the economy shifts toward more online transactions, shopping and services. We also like select consumer-oriented companies, especially in the automobile sector and in sportswear. We look for opportunities in select industries (for example, packaging paper) that have gone through a consolidation, industries where barriers to entry have increased and where the competitive environment has become more benign.

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All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

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1. Source: The MSCI China Index captures large- and mid-cap representation across China H shares, B shares, Red chips and P chips. With 149 constituents, the index covers about 84% of this China equity universe. Indexes are unmanaged, and one cannot directly invest in an index. They do not reflect any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

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