China A-shares: Market rallies on stimulus measures[1]

With Chinese equity markets approaching multi-year highs, Kai Kong Chay, Senior Portfolio Manager for Greater China Equities with Manulife Asset Management shares his views on the recent market rally and the outlook for 2015.

China recently surpassed Japan as the second-largest equity market by value with a total market capitalisation of over US$4.5 trillion. Meanwhile, daily turnover on the Shanghai and Shenzhen exchanges exceeded RMB1 trillion (US$162 billion) for the first time on 5 December 2014, more than five times the average daily turnover during the past three years. In the year to date, the CSI 300 Index has returned 30.40% and has surged 13.23% in the last two weeks alone while the MSCI China has returned 5.30% in the same period, thereby lagging behind onshore indices. This most recent market rally, which commenced in mid-July, can be attributed to a number of measures.

Stimulus measures draw domestic liquidity to A-shares

With GDP growth falling to a five-year low of 7.3% in the third quarter of 2014, the People's Bank of China (PBoC) loosened monetary policy by cutting interest rates for the first time since 2012. The one-year lending rate was lowered by 40 basis points to 5.60%, while the one-year deposit rate was lowered by 25 basis points to 2.75% (see Investment Note – *China interest rate cut boosts market sentiment*). In addition, the PBoC injected about US$126 billion in liquidity into the market via a "medium-term lending facility". This follows attempts over the past year to boost economic growth via more targeted measures that have included increased fiscal spending in areas such as railway transportation and urban renewal and selective monetary policy loosening to boost financing for certain provinces and sectors.

Against this backdrop, increased regulatory scrutiny on high-yield investment products and a downturn in the property market have left local investors looking at other investment options. At the same time, the November 2014 launch of the Shanghai-Hong Kong Stock Connect also increased foreign interest in Chinese shares. This has not translated into higher inflows, with northbound flows slowing significantly since launch, although it remains a conduit for potentially higher demand going forward.

According to Kai Kong Chay, Senior Portfolio Manager for Greater China Equities with Manulife Asset Management, the recent rally has not been based so much on economic fundamentals as it has been driven by inflows from retail investors on the back of expectations of a looser monetary stance by the government. Leverage provided by brokers to retail investors has also increased, with A-shares bought on margin having increased to over RMB800 billion in the past three months from approximately RMB500 billion as of July.

Chay explained, "Historically retail investors have invested in wealth management products on the basis that they provided a 'risk-free' return due to the widespread perception of government backing for these products. However, some of these products have now defaulted and investors are looking for new investment avenues. Looser monetary policy and a cut in interest rates, combined with the fact that brokers are now offering increased leverage to trade shares, has meant that retail investors are now coming back to equity markets in larger numbers.

"Retail investors believe a combination of slowing economic growth, domestic industrial overcapacity and an overvalued currency is likely to see the government to embark on looser monetary policy going forward. With the expectation of a policy shift, retail investors are increasingly been drawn into the equity market and this

[1] All data sourced from Bloomberg as at 10 December 2014.

has been reflected in a significant increase in new stock trading account openings, which are occurring at the fastest rate since 2011."

Caution ahead

However, Chay urges caution in the current market environment as the sharp rally is largely attributable to retail investors and a large portion of these funds are going into bank, insurance and brokerage shares, allocation that is not necessarily driven by fundamentals. Leverage is also playing an important role in this rally and the risk is that at some point, it is likely to reverse and therefore may not be sustainable.

"We do not share this herd mentality and believe that over the long term an understanding of the macro environment must be complemented by a strong bottom-up investment analysis approach in order to identify quality companies with growth opportunities.

"We are positive on certain sectors that have real economic support and that are likely to benefit from the asymmetric interest rate cut, such as the property sector. Property sales started to recover in October and November and the first quarter of 2015 is likely to see more activity as Chinese banks will have more room to issue loans in the beginning of the year.

"In addition, the Chinese government is expected to focus on reforming SOEs and enacting agricultural land reform in 2015. As such, we are positive on selective utility stocks and continue to seek opportunities among Chinese companies with strong management teams, compelling business models and solid and transparent financial foundations that are geared to structural growth drivers in China. We also remain constructive on healthcare and environmental protection technology."