Insight

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# Investing in China: Opportunities and challenges

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*Editor's note: The Asian Listed Equities team at Macquarie Asset Management have been managing Asian equities on the ground in Hong Kong since 2008. For more insights from the team on China, India, and other Asian markets, please look for its commentary in the 2016 Investment Outlooks section of the website, appearing this month.*

As investors seek to understand the impact of the Chinese economy and its stock market on markets globally, it's worth keeping in mind that China is a very different economy compared to those in which many investors are accustomed to investing. Three areas in which China shows unique attributes include the structure of its "share markets," its monetary policy toolbox, and its currency.

## Two markets: A-shares and H-shares

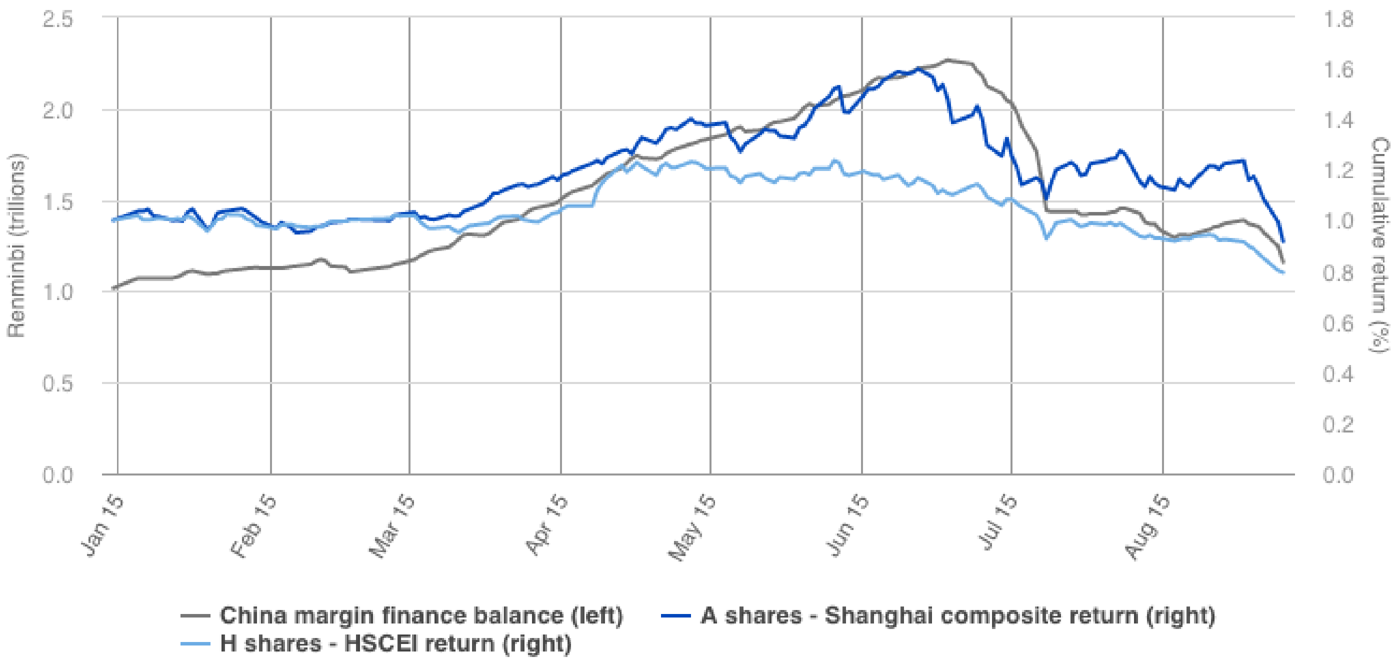
Let's look first at the Chinese market, which made headlines this year due to its volatility as it underwent a challenging summer followed by a more recent recovery. It is important to distinguish between the Chinese A-shares market and H-shares market. The A-shares market was notably more volatile than the H-shares market during 2015. At first, the A-shares market was up 59.7% on the year as of June 12, 2015, but it grabbed global investors' attention as it fell by 42.9% from its peak through Aug. 27, 2015.

The Chinese A-shares market turnover is dominated by local investors, trading in shares on the mainland-China stock exchanges located in Shenzhen and Shanghai. The market is essentially fuelled by these individual local investors, who account for 73% of the average daily turnover.

These local investors have had easy access to margin loans which further added to the recent period of volatility. China's A-shares market has been on something of a history-making journey. However, we believe that it can be argued that China's A-shares market is more reflective of the nature of its investor base than the state of the Chinese economy.

Notably, international institutional investors generally invest via H-shares and do not invest in the China A-shares market, as its access is more tightly controlled. The H-shares market, which consists of Chinese companies listed on the Hong Kong Stock Exchange, is available to all investors and not subjected to the same capital controls. For the same 2015 peak and trough periods mentioned earlier, the H-shares market was up 14.7% year-to-date in June and then fell 30.9%.

## A-shares vs. H-shares




Source: Bloomberg.

## A commitment to easing

What drives equity markets in China? Simply put: liquidity. “QE China Style” has just begun, and we expect monetary policies to remain loose. It is the People’s Bank of China’s (PBOC’s) guidance to keep real yields low in order to stabilize growth and support the economy with liquidity.

When it comes to the Chinese economy, some international investors may be finding that they have more questions than answers as they analyze China more closely. We have long believed that China’s gross domestic product (GDP) growth will slow steadily. We also expect the drivers of China’s growth to change, with consumption-led GDP growth holding up and investment-led GDP growth slowing. This change is supported by the recent manufacturing Purchasing Managers Index (PMI) in October, which slowed to 49.8 while the services PMI held steady at 53.1.

With China’s growth rate clearly slowing, however, a key question for many investors has become: What will China do in the face of slowing economic growth? With its most recent rate cut of 25 basis points and reserve requirement rate cut of 50 basis points, the PBOC has confirmed our view that China will continue its monetary easing policies. (One basis point equals a hundredth of a percentage point.)

We note that China has a significant monetary policy toolbox at its disposal — which it is likely to use to help stabilize growth. We believe the market has underestimated the amount of liquidity to come from the PBOC. The most recent rate cuts added approximately 680 billion renminbi of liquidity to the market.

Since November 2014, China has cut interest rates six times (a total of 150 basis points) and the reserve requirement rate five times (a total of 250 basis points). We expect significant liquidity to be injected in coming months to keep cost of funding and rates low. Finally, the recent renminbi depreciation will help some export industries but is too small to have a major impact on the overall economy. We believe the depreciation was to support domestic liquidity easing.

## Our outlook on China

Overall, we are cautiously optimistic on the China story, but we do stress that China is a unique and evolving economy. As investors, we are focused on investing in Chinese companies that benefit from domestic demand and structural growth. We tend to prefer companies that generate the majority of their revenue domestically in Asia, avoiding exporters and state-owned enterprises. We also tend to invest in companies that we believe offer some notable growth themes.

In general, we think old-economy sectors like banking, energy, metals and mining, materials, and property will continue to slow in a scenario of overall benign economic growth. But we believe that new-economy sectors like insurance, healthcare, consumers, and alternative energy could be more resilient and generate above-GDP growth with government support. In addition, we're optimistic that deleveraging at the corporate level will continue to take place, as overcapacity serves to reduce capital expenditure in many parts of the economy.

All of this bears close watching over time, given China's macro dynamics. Our team continues to be focused on performing rigorous fundamental company analysis, seeking to uncover opportunity in attractively priced shares of favorable growth companies that exhibit a strong corporate governance focus.



### IMPORTANT RISK CONSIDERATIONS



The Shanghai Stock Exchange Composite Index tracks the daily price performance of all A-shares listed on the Shanghai Stock Exchange.

The Hang Seng China Enterprises Index is a free-float capitalization-weighted index comprised of H-shares listed on the Hong Kong Stock Exchange and included in the Hang Seng Mainland Composite Index.