August 2015

News & Views

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CHINESE STOCK MARKET: STILL FERTILE GROUND FOR STOCKPICKERS

By Esther Armstrong, BNY Mellon Investment Management

Following weeks of turbulence in the Chinese stock market, investors may be inclined to shy away from the region, but taking such a blanket approach could lead to missed opportunities.

Exposure to China and Hong Kong equity markets is not something to be afraid of as long as it is a result of selective stockpicking and due diligence, says Newton's Emerging and Asian equity team.

In recent weeks, the stock markets have suffered a sharp correction partly reversing a six-month rally which began in earnest on 22 November after an earlier than expected rate cut from Chinese authorities.

China's Shanghai and Shenzhen markets hit their peak on 12 June after witnessing a price surge of 75% and 111% respectively, according to the Newton team, headed by Rob Marshall-Lee.

"Valuations ultimately became unsustainable and the sharp decline seen in the latter half of June and July was the consequence of this, as concerns around tightening rules on margin credit tipped the balance. The Chinese authorities have responded with increasing intervention in an endeavour to stabilise the markets but these remain significantly above where they were at the beginning of the year. Given the fact underlying profits are still deteriorating, there is arguably further room to fall," the team says.

Selective exposure

Despite this Newton has an overweight to the combined China and Hong Kong region in its core Global Emerging Markets (GEM) growth strategy, although the team stresses the exposure is very specific to sectors and companies where it sees true growth potential – such as consumer, healthcare and internet stocks.

At the other end of the spectrum, Newton believes banks, heavy industry and property sectors are vulnerable as the economy rebalances away from credit intensive investment. "We do not see any value in these companies as profits and revenues are under threat. The banks have insufficient capital and provisioning, so earnings are very likely overstated. Additionally, we believe the need to raise capital and convert debt into equity may have influenced the authorities' efforts to stimulate the equity markets earlier on this year. On the plus side, the H-share market in Hong Kong has been far less frenetic than the domestic Chinese A-share market and so we have been using the sharp July correction to add very selectively to a few holdings, but not in financial sectors."

Marshall-Lee, who is lead portfolio manager on the GEM growth strategy, says the China holdings within the core GEM growth strategy have performed extremely well over recent years underpinned by excellent profit growth and that the return profiles of their Chinese stocks bear little resemblance to the country's equity indices.

This has meant at times, when the Chinese stock market has rallied most strongly, the core GEM growth strategy has lost relative performance but likewise it has held up well during the recent market corrections.

"April was a tougher month for us, relatively speaking, but we have since clawed back all the underperformance and more, helped by stronger ex-China stock performance as well as the reversal of Chinese stocks that we do not own. We continue to find good opportunities in China but only in very specific sectors and companies, many of which are held via US-listed ADRs[1]. We are still not comfortable investing in A-shares yet due to administrative concerns, such as settlement terms," the team says.

So what actually happened?

Simon Cox, managing director and investment strategist, BNY Mellon Investment Management Asia-Pacific, says the dramatic stock market intervention from the authorities in the midst of China's correction could be explained by a degree of panic. "They feared the wrath of millions of domestic retail investors, many of whom had bought shares with borrowed money, as well as a narrower circle of corporate insiders who had pledged shares in their own companies as collateral for loans. They also fretted about the impact on the broader economy, still weakened by a property market slowdown and the indirect exposure of China's more adventurous banks."

The Chinese leadership's attempts to control market forces included blocking the supply of new shares by suspending IPOs. The government also allowed 1,400 firms to halt trading in their shares altogether, Cox explains.

He continues: "For a brutal few days none of these efforts could stop the selling pressure. Too many stocks were overvalued; too many stockholders underwater. The state's intervention was viewed as a chance to get out of the market, not a reason to stay in. Only after the government's agencies and allies began buying shares directly and incautiously did prices stage a partial recovery."

What next?

Cox asks: "Will the stock market collapse ruin the economy? Most economists say no, the losses will not heavily damage consumption spending because equities account for only a modest share of household assets."

Newton's Marshall-Lee says: "The stock market is not the economy and even less so in China and Hong Kong than in most economies, though there are some linkages. Consumer confidence may be impacted at the margin but probably less than you would think as the equity markets are not a major constituent of the savings pool as a whole relative to developed markets."

"A huge raft of stock suspensions across a market usually has the opposite effect to the intended stabilisation. Happily we can use the opportunity to pick up shares in good companies at very attractive prices as they are caught in the cross-fire. However, Chinese banks are certainly not on this wish list. We do not see the A-share rout as the signal for a collapse in the Chinese financial system, as some commentators speculate, though we certainly see the need for far more progress in economic reforms and rebalancing of the economy to a more sustainable footing. This does not preclude attractive growth opportunities in certain equities."

[1] American depositary receipts (ADRs) are stocks that trade in the US but represent a specified number of shares in a foreign corporation. They are bought and sold on American markets like regular stocks and are issued or sponsored by a bank or brokerage in the US. Source: Investopedia.com 27 July 2015

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