

Searching for value

With H-shares trading at a discount to A-shares, it might be a good entry point for long-term China investors to build positions

By **KENNETH YEO**

WHILE there is no doubt the Chinese economy is slowing, we believe policymakers have an arsenal of ammunition at their disposal. We have already seen the cutting of the policy rate and reserve ratio rate (RRR) in late August. We expect this monetary easing to continue, and coupled with further fiscal expansion, this will help finance infrastructure investment and support the housing market recovery.

Countering slow growth through buffering domestic demand will be the priority of policymakers, who will do this through monetary easing and fiscal spending rather than attempting to spur external demand by resorting to competitive currency devaluation.

Therefore, we expect the renminbi to become more of a market determinant currency instead of being dictated by policies.

Positive on China

Despite the volatility in equity markets this year, we continue to like China from both a regional and global context. The A-share (onshore Chinese) market rally earlier this year and subsequent strong correction has resulted in a high degree of volatility with effects not just within mainland China, but in Hong Kong and globally.

A great deal of irrational exuberance swept through the A-share market in the first half of 2015 and investors clamoured to take part in the rally by building large leveraged positions through margin financing.

After rallying over 150 per cent in less than a year, when the A-share market turned in late June, many of these investors found their positions underwater. Forced selling ensued as margin calls required positions to be liquidated and the market collapsed.

As at the end of August, the market had fallen over 40 per cent from its peak and at the same time, total margin lending in China fell over 50 per cent as huge amounts of leveraged positions put on at high prices towards the end of the bull rally cleared out of the system.

H-shares over A-shares

We expect near-term volatility to persist in A-shares as the remaining debt is cleared from the system and the market finds its footing. Within this environment, from both a risk and value perspective, we have a strong preference for H-shares in Hong Kong over A-shares in China.

Not only is the Hong Kong market fully liberalised and globally accessible, it is also highly institutionalised and well regulated. Strong governance around company listings allows investors access to timely and transparent information.

Companies are drawn to raising capital in Hong Kong – being a gateway to mainland China – their

confidence buoyed by its resilience to cyclical dislocations and ability to weather market gyrations.

H-shares also trade at a notable discount to their A-share counterparts, despite being effectively the same instrument albeit a different listing location.

Indeed, now may be a good entry point for long-term China investors to build positions.

Good value in bank stocks

Within H-shares we generally like the Chinese financials and have seen a good deal of private client interest in these stocks, particularly the banks.

China banks are trading well below book on what we believe are overblown fears in the market over asset quality amid an economic slowdown.

We believe that even using conservative assumptions around non-performing loan ratios (NPLs), the banks are still very undervalued by the market. At current levels, bank stocks offer good value and strong upside.

Furthermore, they should benefit from additional monetary easing and fiscal spending as well as any potential policy action in the markets as they are very large index component stocks. Also, they pay very healthy dividend yields and can be bought both outright and through various attractively priced structured products.

Liberalising the renminbi

China stunned the world's financial markets by devaluing its currency in August for three consecutive days in a row, triggering fears that its economy is in worse shape than investors believed. With this recent "one-off depreciation", the value of the renminbi dealt a 4 per cent blow to investors.

The move sent fresh shockwaves through global markets, pushing shares sharply lower and sending commodity prices further into reverse as traders feared the move could also ignite a currency war and destabilise the world economy.

However, it is important to note that this downward movement of the renminbi should be seen as a result of liberalisation of its currency management, and not as a deliberate attempt to drive down its value.

Over the last few years, China has been seeking to build on its 2005 reforms in an effort to have the renminbi included in the International Monetary Fund (IMF) basket of special drawing rights (SDR) reserve currencies.

Effectively, while a cheaper renminbi will help Chinese exports by making them less expensive in overseas markets, the IMF has also applauded China's move to make the currency more responsive to market forces. This appears to be a well-coming step should China aim to achieve an effective floating exchange rate within the next two to three years.

With more market information being considered in setting its daily fix, it can be seen as a relaxation of controls, moving the currency a step closer to satisfying the IMF's entry requirements. Significant work is still needed for the renminbi to be considered before its next review in November.

Ultimately this move marks a major step in the international use of the Chinese currency. Greater exchange rate flexibility is important for China as it strives to give market forces a decisive role in the economy and as it integrates rapidly into global financial markets. **W**

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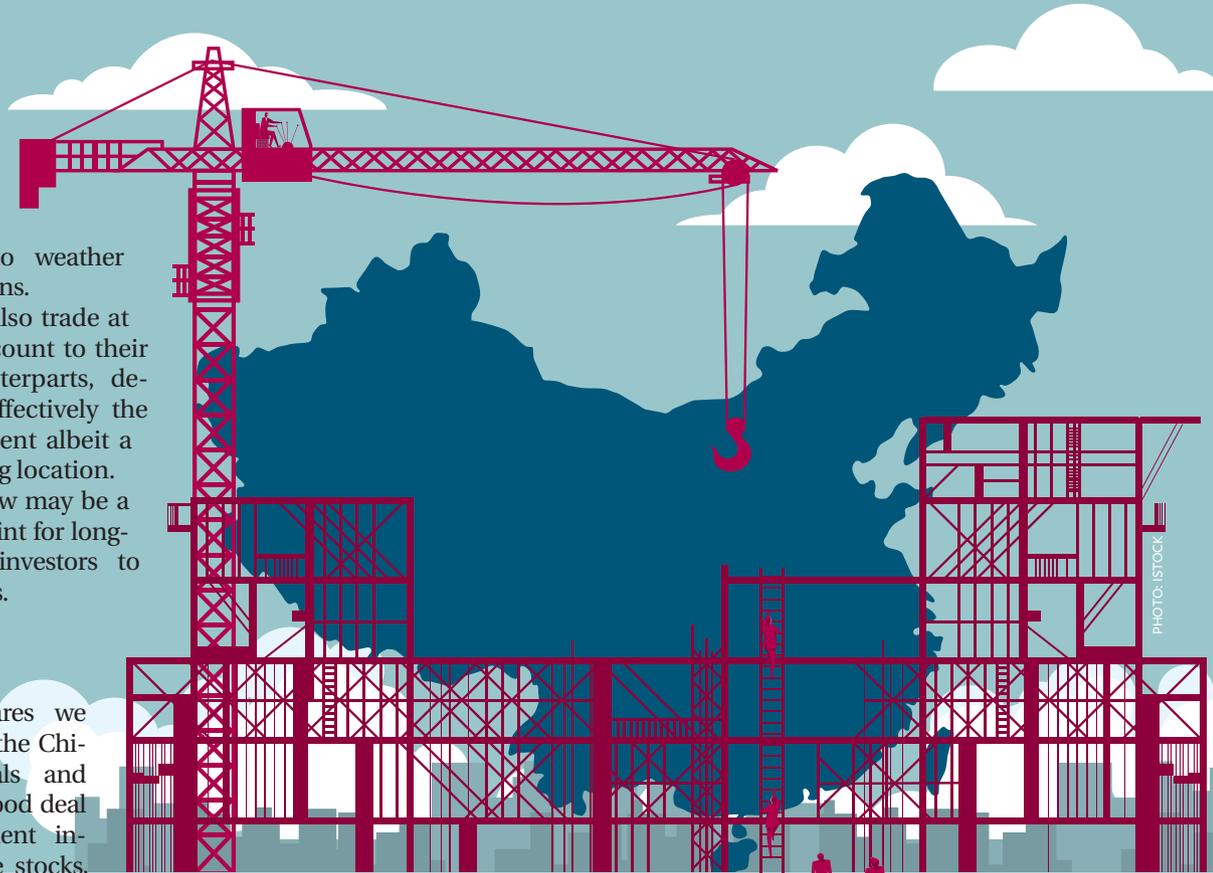


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