

# China overshadows Asian markets

This is not going to be a vintage year for the region's equities, but there are still good opportunities

BY BHASKAR LAXMINARAYAN

**T**HE key development in Asian equities this year has been the surge in Chinese stocks, which even after a correction in June are still up strongly year-to-date. This is in fact a more nuanced phenomenon than most commentary has suggested.

Which China are we talking about? The MSCI China is up by less than 12 per cent year-to-date, down from a peak of 28 per cent – still a strong performance in a regional context, but not as frothy as the smaller exchanges. At its peak the Shenzhen CSI 300 was up by 52 per cent, and the ChiNext by 170 per cent (following corrections in June the year-to-date gains are now down to 10 per cent and 77 per cent respectively).

## Fundamental dichotomy

The surge in some markets does not appear to be supported by fundamentals. First, the economic situation in China is becoming more of a concern. Real GDP (gross domestic product) growth weakened to 7 per cent year-on-year in the first quarter of 2015 from 7.3 per cent in the previous quarter – the slowest rate of growth since the third quarter of 2009.

More recent data suggests that activity remains sluggish. The official manufacturing PMI (Purchasing Managers' Index) was 50.2 in May, barely changed from 50.1 in April, and data for retail sales, capital expenditure and real estate also points to weaker activity.

The economy's slowdown should in fact be viewed as a positive, in as far as it results in a rebalancing to a more sustainable pace of growth. The real concern is that credit intensity has increased significantly – in other words, the additional debt required to keep economic growth at the same level. In short, China is becoming overly indebted, which risks creating problems at some stage.

Bank lending is already around 205 per cent of GDP, which is quite unhealthy by global standards. The authorities tightened controls over bank lending after the credit boom of 2008-09. But non-bank lending by other financial intermediaries has risen and this "shadow banking" system is not effectively monitored by the PBOC (People's Bank of China).

Second, corporate profitability is falling. A comparison with US firms in this context is instructive. US economic growth has also been poor in recent years, but corporate profitability has risen regardless, as companies have cut costs and pursued consolidation. Chinese companies, by contrast, are not making the necessary adjustments to a regime of weaker economic growth. All things being equal, falling profitability ought to mean falling equity prices.

So there is a dichotomy between the surge in many Chinese equities this year and weakening fundamentals –



both economic and corporate. Instead, markets have been driven by liquidity and policy. The PBOC has been cutting interest rates and gradually loosening reserve requirements for banks, but perhaps more significantly, has also been turning a blind eye to margin lending.

As a result, this form of lending has jumped from almost nothing a year ago to around US\$350 billion today – around 4 per cent of total bank lending. Such volumes can really move small indices such as the ChiNext. But this expansion is unlikely to last: The regulators are known to be unhappy about the situation.

Against this background, we expect the sharp correction that began in June to continue in the second half of the year. The slide in June is still far from fully unwinding the over-extension of equity prices. On the Shanghai Composite Index, many stocks are still above their 200-day moving average, suggesting that some momentum is still built in.

There are pockets of opportunity – particularly in new technology companies, health-care and certain service sectors. But as the property and manufacturing-led stage of China's growth comes to an end, we remain wary of companies in those sectors, as well as most financial stocks – the regulators' claim that banks have no serious issues is questionable. Overall, we are neutral on Hong-Kong-listed Chinese equities, and also on

Hong Kong shares, which are closely linked. Prices on the Hong Kong market still seem reasonable, but profits might disappoint.

## Cautious outlook

Most other Asian markets give grounds for caution, on balance – but there are a couple of significant exceptions. We are overweight on India. Although the lack of activity from the new Modi government is worrying, the fiscal deficit has been managed well, which is helping to support the rupee. Indian companies have solid balance sheets and are keen to invest.

Prospects for earnings growth are good, and should play into the stock market, which has been fairly flat year-to-date. Valuations are quite competitive. We like a wide range of sectors in India, including banking, automotive, pharma, manufacturing and services.

Taiwan is extensively integrated into the tech supply chain to the US, so tends to benefit from an improving US economy; and we expect US growth to rebound robustly in the second quarter and for the rest of 2015 after a weak, weather-affected first quarter. Moreover, the quality of the Taiwanese companies in this sector is good: large capitalisations, strong balance sheets and little debt. The Taiwanese market has underperformed year-to-date, rising only slightly, but in light of the supportive US macro outlook we are staying overweight.

Elsewhere we are mostly more wary. We are slightly underweight on South Korea. This is partly because we are concerned about the impact of Mers (Middle East Respiratory Syndrome) – economic activity has been slowing following the outbreak. Korean stocks also look expensive in places, and the electronics heavyweights, such as Samsung, that have played a key role in South Korea's economic success face rising global competition.

We are concerned about the politics in Malaysia and Indonesia, and the Indonesian rupiah also looks particularly vulnerable to Fed rate rises. We are modestly underweight on Singapore, a market that tends to be sensitive to US monetary policy tightening and a strong US dollar. The Philippines is a small bright spot, and we are neutral on Thailand.

This is not going to be a vintage year for Asian equities, especially with China's stock-market surge unwinding, but there are still plenty of good opportunities. **W**

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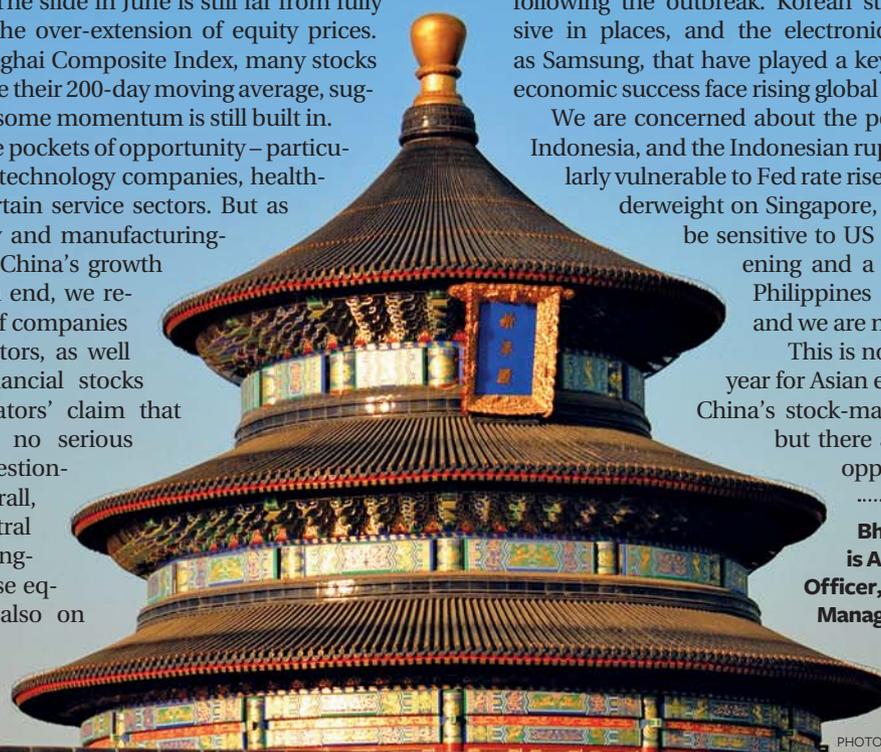


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