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Author profile

Haiyan Li-Labbé joined Carmignac Gestion in 2011 as the head analyst focusing on the greater China market. Prior to joining the group, Li-Labbé was a fund manager and head of Asian projects at OFI Asset Management in Paris. She has also held several roles at Société Générale, covering the Asian and European convertible bond markets.

China's global stock market plays catch up

Haiyan Li-Labbé, greater China analyst at Carmignac Gestion, highlights the many drivers that could eradicate the differences in price between local and overseas-listed Chinese companies in 2015

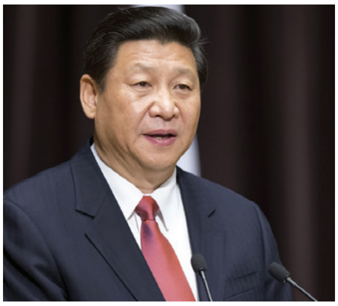
After a six-year bear market, the Shanghai Stock Exchange Composite (SHCOMP) index registered a performance of 53% in 2014, the best global performer of the year. Global investors remained sceptical by maintaining low weightings on Chinese equities, with overseas-listed Chinese stocks, represented by the Hang Seng China Enterprises index (HSCEI), only returning 11%.

Several reasons could explain the local market's impressive rally in 2014. Firstly, valuations within the SHCOMP index were attractive, trading at 7x 2015 price-to-earnings before the rally, and Chinese banks were trading at 0.7x book value.

Secondly, equity holdings by Chinese households were low, around 3% of their total assets. Amid a weakening property market and increasing risk of other alternative financial investments, such as trust products, retail investors begun to switch their investments in favour of the local equity market.

Thirdly, China's reform programme and the launch of the Shanghai-Hong Kong Stock Connect in November boosted confidence among investors last year.

Finally, the rate cut by the People's Bank of China in November was a strong trigger that sent signals of a potential credit easing cycle.



The clamping down on corruption will continue throughout president Xi's mandate. The government needs to stabilise economic growth and accelerate reforms such as urbanisation, SOE and healthcare

Difference between A/H shares: Hang Seng China A/H premium index

Date: 2 January 2007 - 20 January 2015. Source: Bloomberg

Catch-up opportunity

Local Chinese equities are trading at 12x 2015 P/E, slightly higher than the five-year average, while HSCEI is trading at 8x 2015 P/E only.

Based on the fact further credit easing is likely, plus the attractive valuations and acceleration of reforms, the picture remains positive on overseas-listed Chinese stocks, and there is an opportunity for the HSCEI index to catch up to the SHCOMP.

A good indicator is the A/H share premium index, which is trading at nearly 30%, up from a few months ago (see chart). There are more than 100 dual-listed Chinese stocks in the Chinese local market and Hong Kong. Due to access to the local market being restricted and a lack of arbitrage channels, the same companies are not trading at the same price, which in financial theory is unheard of.

The price differential will gradually disappear with the increasing eligibility of local and overseas-listed Chinese stocks.

Growth quality

On the local Chinese market, there are attractive long-term investment opportunities in various areas: home appliances, pharmaceuticals, environmental protection, clean energy car makers and consumer products (see boxes on next page).

On the economic side, the government is expected to set 7% as the official growth target for 2015, although investors

4m Number of extra passengers likely at Shanghai International Airport per year

should not pay too much attention to the official growth rate, as this has been inflated over the past few years.

In this case, growth quality is much more important than growth rate. China is likely to deliver much lower growth, but higher growth quality, with higher cost efficiency of state-owned enterprises (SOE) and a higher return on invested capital thanks to SOE reforms.

Deflation risk

China is also expected to continue its credit easing in order to decrease the cost of the real economy, and as it continues to face an increasing deflation risk. CPI was trending at around 1% in January, with its Producer Price index in negative territory.

The central bank's benchmark one-year loan rate was cut to 5.6% in November. More rate cuts are likely at the central bank, one of which will be in the first quarter of 2015, but a credit injection kind of stimulus similar to the ¥4trn in 2008 is unlikely.

The current Chinese government looks poised to better manage expenditures than the previous Hu/ Wen regime.

Although China still needs to expand its railway and subway networks, the incremental demand of commodities is limited.

Anti-corruption measures

Keeping an eye on politics in China is key for any global investor. Xi Jinping, the Chinese president, has in effect consolidated his position since his ascension to power in 2013, and has since announced several reforms, including a bold and sweeping anti-corruption campaign and a new law to punish corrupt members of the Communist Party.

This is fundamental to restore the party's legitimacy as headlines reporting the arrest of high-level officials are likely to continue.

Though anti-corruption reforms will not be a significant focus, the daily work of clamping down on corruption will continue throughout president Xi's mandate. The government needs to stabilise economic growth and accelerate reforms such as urbanisation, SOE, and healthcare.

Finally, the success of the Shanghai-Hong Kong Stock Connect and the inclusion of local Chinese stocks by MSCI indices will both be important events that will open up opportunities in the Chinese investment universe this year.

Take two: Local outperformers

Zhengzhou Yutong Bus

Zhengzhou Yutong Bus is the largest bus manufacturer in the world in terms of sales volume, with 12% market share globally, and 30% market share in China. The Chinese government has allocated funding to replace old school and city buses with more eco-friendly transportation. Yutong should benefit from these positive regulatory developments for 'clean vehicles' as it owns 37% of the market share for hybrid and electric buses in the country.

Shanghai International Airport

Shanghai International Airport operates Pudong Airport, the major international and national aviation hub. This airport is ranked 22 globally in terms of traffic, thanks to its strategic location (in Shanghai's Free Trade Zone). It should also benefit from the opening of Disney Shanghai (at the end of this year), a park which should be twice the size of Disney Japan, and three times that of Disney Hong Kong. It is expected to attract between 15 and 20 million visitors per year, which should lead to an increase of four million passengers per year through SHIA. This airport is among one of the fastest-growing airports in the world, and passenger traffic is expected to double by 2021. The company also profits from an attractive valuation and 25% net cash.