Webcast Summary

For Professional Investors Only

Chinese Equities
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Reforms happening at a faster pace than expected

While the slide in China's mainland stock market[1] is dominating headlines, investors should remember that the long-term story for China is one of reform. Actions by the state, despite short-term policy errors such as the one that caused July's market sell-off, reflect China's desire to implement financial and structural reforms to boost long-term growth, and these are occurring at a much faster pace than anyone could have anticipated.

Our views on the A-share market sell-off

- Preceding the sell-off, there had been significant positive newsflow, which combined with a rapid increase in the number of retail investors buying shares with borrowed money pushed the A-share market to new highs.
- This strong A-share rally ended in a dramatic fashion as policy errors triggered selling pressure. Subsequent state intervention to halt the slide in the A-share market was misguided, in our view.
- The market stabilisation measures had the desired effect, but the price is an un-investible market and loss of international investor confidence, undermining the state's own reform plans.
- The wider impact of this correction should be pretty limited - the real economy is likely to be largely immune as the Chinese stock market is only tenuously tied to the economy.
- The Chinese stock market is still at a relatively early stage of its development, with low institutional participation: more than 80% of the market is made up of retail investors. This should change as the market matures and China goes ahead with financial reforms.

Impact beyond the A-share market

- The sell-off extended to the Hong Kong and H-share markets, given the partial closure of the A-share market, however it was not as acute – the premium between A-shares and H-shares is now very wide.
- MSCI China: the sell-off was broad-based but was more severe in the small and mid-cap space given the lower levels of liquidity at this end of the market.
- Valuations: given that the sell-off was more to do with forced liquidations rather than the fundamentals, in our view value has returned to the market, particularly in H shares.

What does China do next?

- In our view, the government should step back and let market forces determine the fair price of a sector and individual stocks. History shows that government-built 'artificial floors' never work over the long-term. In the immediate term this would mean that the A-share market would likely resume falling, but this should not necessarily be viewed in a negative light if this reflects the will of the market.
- At some point the government may want to sell the stakes in the companies it has bought – the IMF has urged China to unwind the measures it has taken.
- Growth remains sluggish. While it is still considerably better than the growth being experienced in developed markets - 2Q GDP came in at 7% - we expect further monetary easing.
- China's monetary policy behaviour remains highly accommodative and policy makers have plenty of 'firepower' at their disposal.
- Real interest rates remains high as recent rate cuts have been offset by the stronger RMB.

The 'Big Picture': China is aiming to rebalance its economy

- Financial liberalisation and capital market reforms are the only way in which China can rebalance its economy away from reliance on external investment in favour of consumer services and domestic demand
- China is keen that the IMF endorses the renminbi as a reserve currency alongside the dollar, euro, yen and pound, and as a result they are taking measures to open up financial markets and develop capital markets. The IMF has said that recent intervention should not hinder its bid to gain reserve status for the currency, saying that the economy is strong enough to withstand the volatility and was cognisant of the very significant reforms the Chinese authorities were implementing.
- If China does indeed want to successfully rebalance its economy, ultimately it will have to let market forces determine the allocation of resources. This goes against the philosophy of China's ruling Communist Party who prefer to have some degree of control over all aspects of the economy. But they do need to recognise that if they do want to increase income per capita, then they will need to have a different economic business model going forward.
- Nevertheless, the pace of reform in the financial system continues at a much faster pace than we could have hoped as China's desire to be a dominant player in the global economy overrides its reservations regarding liberalisation.

[1] Companies that trade on mainland Chinese stock exchanges such as the Shanghai and Shenzhen stock exchanges issue shares known as 'A Shares'. A-shares are generally only available for purchase by mainland citizens; foreign investment is allowed through the Qualified Foreign Institutional Investor (QFII) system