

Premium China Funds Management—Investment Insight
Views on recent China market developments

February
2016

Dear Investors,

Amidst the market volatilities seen in the month of January and the increasing fear of a China hard landing, we would like to share with you our investment team's view on the recent market developments and thoughts on topics such as currency and economic growth.

Moderating growth but not a hard landing

The current panic selling shows fears over a hard landing in China, as well as doubts that the country has to depreciate the renminbi to boost growth. We think the extreme pessimism is overdone. It is true that China's economy has weakened substantially and we continue to see fatigues in the "old economy" sectors, but there are also increasing signs that activities may have started to stabilise.

Besides, new economic indicators such as movie box office, the number of airline passengers, auto sales and 4G mobile subscriptions all pointed to an expanding "new economy" in China last year, and the contribution of real tertiary output to China's economic growth has increased to close to 60% in the first nine months of 2015. As the government pushes ahead with the necessary reforms, the "old economy" sectors will continue to drag on China's growth, and this is perhaps the price to pay for a more sustainable economy in the long term. The structural rebalancing will be a multi-year process and more bumps are expected along the way. We will continue to be very careful with our stock picking in this transitional period.

CNY weakened against USD but the trade-weighted index largely stable

We believe the recent adjustment of the renminbi is more about the dollar strength than the renminbi weakness. China needs relative currency stability to avoid financial panic and maintain confidence in its policy, and it is not in its interest to substantially devalue the trade-weighted exchange rate, although the renminbi may become increasingly decoupled against the USD. Allowing the renminbi to fall against the dollar helps pave the way for further monetary easing by the central bank, and this has nothing to do with a big competitive devaluation to boost exports as China's export growth has actually been holding up better than some Asian countries which have devalued their currencies.

Policy easing expected to step up

We believe stimulus spending will continue to support the Chinese economy - monetary policy is expected to stay accommodative in 2016 and the central government is anticipated to step up fiscal effort to stabilise the economy. While the room for further rate cuts decreases, most monetary easing in 2016 may come from cuts in the reserve requirement ratio. It will be a policy priority to maintain the momentum of government spending, and the unofficial fiscal deficit can also increase given restrictions on bond issues by local government financing vehicles have been lifted and official local government bond issues are rising.

Premium China Funds Management—Investment Insight
Views on recent China market developments

February
2016

Offshore Chinese stocks offer attractive values

Valuations of Chinese stocks in offshore markets, e.g. H-shares in Hong Kong, have returned to a very compelling level. It is worthy to note that these stocks listed in an international free market dominated by institutional and professional investors are at a 40% discount to the policy-driven A-share market. In 2015, H-shares (as represented by the Hang Seng China Enterprises Index) slumped 16.8%, dragging its valuation to the same level as the trough during the 2008 Global Financial Crisis. After the recent corrections, we believe prices have already reflected the negative repercussions of the reforms, and the fragilities in the Chinese economy are largely factored in. As a deep value investor, this is the time for us to actively look for opportunities.

Portfolio implications

One impact of the volatility we saw for the whole of January was that the H-share market (offshore Chinese equities market) corrected severely on the back of liquidity/capital outflows stemming from negative sentiment. This is where a significant proportion of our holdings reside. The companies with the strongest fundamentals (blue chip H-shares) which we hold were the hardest hit. Valuations are now at historical lows with H-shares trading at approximately 6x forward P/E and 1x P/B.

As deep value investors, we maintain our high conviction in the companies that we hold and have little reason to be concerned at this point in time. At the same time, the margin of safety has increased. The key question that we ask ourselves is—if we previously built up holdings in a company based on price and attractive metrics, is there a logical reason to sell down at this point if underlying fundamentals remain the same? We say no.

Given the volatility however, our portfolios have been raising cash targeting 10% since the middle of January in order to be more cautious while waiting for better opportunities. Looking ahead, global stock markets are still full of headwinds and valuation traps abound—this is where active asset management comes into play. While China's economic outlook remains challenging this year, our flexible investment approach empowers us to excel among peers during uptrends, and to stay defensive when the market loses ground.

If you have any questions or would like further information on our portfolios, please don't hesitate to contact us on (02) 9211 3888. We thank you for your ongoing support of our strategies over the last decade, especially through volatile times such as now.

Simon Wu
Executive Chairman /
Chief Investment Strategist

Jonathan Wu
Associate Director /
Head of Distribution and Operations

Think Asia
Think Premium™