China/Hong Kong update

Monthly commentary

April 2016

Market overview & outlook

- A steadier yuan and signs of a stabilising mainland economy buoyed A shares, which led gains in China and Hong Kong. Investors harboured hopes of further policy easing after Beijing cut lenders' reserve requirement ratio. Risk appetite was also whetted by dovish comments from the US Federal Reserve. All this offset weak earnings from several mainland companies, while Standard & Poor's downgraded China's credit rating outlook.
- Premier Li Keqiang struck a confident tone at the close of the National People's Congress. He stated that the country would achieve its economic targets, given ample policy tools to stimulate growth, while reiterating the need to push ahead with reforms.
- Meanwhile, inflation was higher than expected, likely due to a temporary spike in food prices during a cold winter, while sluggish exports proved a further concern, amid signs of a global slowdown.
- Mainland manufacturing data improved for the first time since last July, owing to a pick-up in construction activity and recovery in industrial profits. In Hong Kong, however, retail sales slumped the most since 2001, dragged down by China's slowdown and its impact on mainland tourist arrivals.
- We expect mainland markets to remain volatile over the short term. While recent data appear to signal increasing stability, overcapacity persists in the industrial and materials sectors. On a more positive note, improvements in the latest services PMI data highlight resilience in that sector, as well as the economy's continuing structural transformation. At a broader level, significant external headwinds prevail in the form of volatile oil prices, unintended consequences of negative interest rates as well as weak global growth. Against such a backdrop, we expect the operating environment to remain challenging for companies, which are likely to continue to keep an eye on costs and attempt to consolidate to protect margins as sales and revenue growth are expected to remain lacklustre.
- While the A-share market has corrected from last year's speculative mania and valuations appear more reasonable now, we are concerned that the market remains vulnerable to heavy retail punting. That is why we see more value in the Hong Kong market and favour accessing China via Hong Kong-listed companies, with better standards of accounting and transparency. That said, we have identified some mainland-listed companies that are backed by relatively robust fundamentals and well-incentivised management; these companies can be found in our A-share fund.

Aberdeen

Model portfolio news

There were no major portfolio changes in March.

Corporate news

The results of most of our holdings across sectors reflected the weak macroeconomic conditions.

In the consumer sector, **Fuyao Glass** delivered robust earnings, underscoring its resilience and dominant market share. The company increased its dividend payout. **Li & Fung** posted better-than-expected core operating profits, although revenues were soft as deflationary pressures outweighed higher trading volumes and declining freight rates. However, the company's lower net gains led to a dividend cut. **Giordano**'s full-year gains were flat. Our A-share holdings **Midea** and **Tsingtao Brewery** faced contrasting fortunes. Midea was supported by its more diversified portfolio, whereas Tsingtao's margins were hurt by higher marketing expenses.

As for our energy holdings, **PetroChina** bore the brunt of the drop in oil prices, as it booked a 25 billion yuan write-down for its upstream business. The company will cut upstream-related capital expenditure this year and expects a 5% reduction in annual crude output, the first in 17 years. Meanwhile, **China Oilfield Services** (COSL), held in the A-share fund, announced the cancellation of two rig contracts by Norway's Statoil. This was not surprising, given cuts in capital expenditure across the industry. COSL's domestic operations remain cash-generative and profitable, cushioning the decline in its international business.

In the financial sector, **China Vanke** posted decent results, aided by stable margins. Separately, it signed a preliminary accord with Shenzhen Metro Group to acquire the group's property projects, mostly above metro stations. These purchases will be funded via new share issues. **Swire Pacific** increased its dividend despite mixed results. Its aviation arm (Cathay Pacific) performed well owing to lower fuel costs, and its property unit (**Swire Properties**) saw higher profits, as improvements in its China portfolio offset slower growth in Hong Kong. The property subsidiary also raised its dividend.

The results of lenders **Industrial & Commercial Bank of China**, **China Construction Bank** and **China Merchants Bank** met expectations. Asset quality and rising non-performing loans (NPLs) remain an industry-wide concern; we are keeping an eye on how the banks manage risks and their exposure to beleaguered industries, particularly those facing overcapacity. Both ICBC and CCB cut their dividend pay-outs to preserve capital. **Dah Sing Bank**'s significantly lower deposit costs outweighed an increase in NPL provisions. Its higher earnings led to a stronger capital position, allowing the bank to raise its dividend pay-out. **Hong Kong Exchanges & Clearing**'s results met our expectations, driven by higher turnover and contributions from the London Metal Exchange.

Meanwhile, **China Life Insurance** will raise its stake in Guangfa Bank, buying shares from Citigroup and IBM Credit. Separately, China Life's new business value, which gauges the profitability of new life insurance policies sold, saw sturdy progress in the second half of last year. We are monitoring the insurer's broadened exposure to non-standard assets, which is in line with recent industry trends to compensate for the low interest rate environment.

Our health-care holdings proved defensive. **CSPC Pharmaceuticals** reported solid fourth-quarter net gains, on the back of growth in its innovative drug division. The company raised its dividend; nevertheless, its larger net cash balance will allow it to invest in research & development. Among our A-share positions, **China Resources Sanjiu** was buoyed by its prescription drug business and diversified strategy, while **Beijing Tongrentang** reported good volume and price increases.

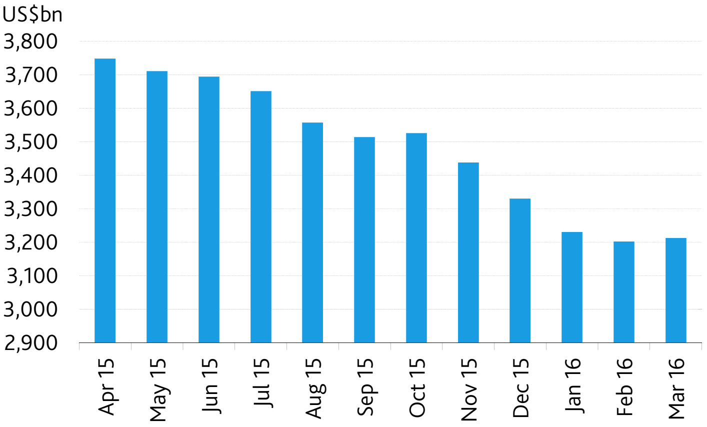
In the industrials segment, **Jardine Strategic**'s results were hampered by lower margins from subsidiaries Astra International and **Dairy Farm**. The latter gained market share across most businesses but faced rising rental and labour costs. These losses were mitigated by smaller divisions, including Jardine Pacific and Jardine Cycle & Carriage. **Pacific Basin**'s shipping losses were within expectations, given the tough operating environment. Encouragingly, its balance sheet strengthened with a reduction in net debt. **Hong Kong Aircraft & Engineering**'s performance was hampered by losses at its US subsidiary, which overshadowed healthy business flows in Hong Kong. **Shanghai International Ports Group**'s container throughput rose year-on-year, offsetting a decline in its dry bulk business. On the other hand, **MTR Corp**'s recurring profits were underpinned by better transport revenues and higher rental income from duty-free shops at its stations. It also received approval for an additional HK$19.6 billion to fund an express rail link to Guangzhou, removing significant uncertainty and meaning that a special dividend will be paid in two tranches over the next two years. **Kerry Logistics** was lifted by stable demand for its services, with management proposing higher dividends.

Elsewhere, **Yingde Gases**' full-year core profits improved despite sluggish conditions in the steel industry. However, net earnings fell as a result of higher finance costs. Amid faltering cement demand, **Anhui Conch**'s income declined, as expected, but it continued to outperform its peers, given its tight leash on costs. **Huaxin Cement**'s strong cash flows mitigated the fall in profits.

China Mobile missed expectations, as tower-leasing expenses and asset write-offs hurt profit margins. Encouragingly, the telco delivered impressive growth in mobile data revenues, driven by migration to 4G services and strength in users' monthly data traffic.

Focus: Turning a corner?

China's forex reserves: riding on the yuan's recovery



Source: Bloomberg, 8 April 2016

China's foreign exchange reserves rose marginally in March, bucking the trend in recent months. This reversal comes amid a strengthening renminbi, as Fed chairman Yellen's more dovish stance has resulted in US dollar weakness. It also reflects Beijing's latest efforts to reassure investors that it has the means to support the renminbi, mitigating capital outflows. Steadying reserves will allow the central bank more room for policy manoeuvre, such as interest rate cuts to bolster the economy. We expect the renminbi to continue to depreciate gradually, with the government still leaning towards currency liberalisation. However, the transition is tough in the current environment. Slowing economic growth means that renminbi demand is soft, while the volatility of a fully market-driven renminbi could be too much for Beijing to bear for now. Hence, we think policymakers are likely to keep the currency relatively stable.

We hold the companies highlighted.

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