# China/Hong Kong update

## Monthly commentary

August 2015

### Market overview & outlook

- Fragile sentiment led to another roller-coaster month for Chinese equities, with A-shares bearing the brunt of the volatility. Initially, panic selling set in, as margin traders unwound positions. Confidence was restored somewhat after Beijing's spate of stop-gap measures, including liquidity support, A-share suspensions and a market stabilisation fund. However, the sell-off resumed as worse-than-expected PMI data deepened concerns about the faltering mainland economy. This was despite better-than-expected GDP growth of 7% in the second quarter. Broader anxiety over Greece and US monetary policy normalisation also persisted through July.
- At the time of writing, China's central bank unexpectedly devalued the yuan, leading to a sharp fall in the offshore Chinese currency. The authorities said the aggressive cut in its reference rate by 1.9% was a one-off adjustment and meant to help position the yuan towards more market-driven movements. Many mainland companies have increased their US-dollar borrowings in recent years because of low US interest rates and hopes that the yuan will strengthen against the US dollar. A sharp depreciation of the yuan would leave many of these companies, especially those that have not hedged their US-dollar loan exposures, in a fix, given that their revenues are still denominated in the yuan.
- Earlier in July, many Chinese companies voluntarily suspended trading to shield their stocks from further losses amid the market volatility. At one point, more than 1,000 stocks were frozen, with the majority in Shenzhen. By the end of the month, about 300 companies remained suspended. Among our holdings, **Hangzhou Hikvision** (held in the China and A-share funds) remains suspended. We are in contact with its management and continue to monitor developments at the company.
- Beijing attempted to shift investor focus to more promising themes, such as state-owned enterprise (SOE) reforms. The National Development and Reform Commission announced 13 projects, including transport and water conservation facilities as well as public services, using the public-private partnership model.
- On a positive note, IMF managing director Christine Lagarde indicated that the recent stockmarket turbulence would not influence the decision on whether to include the yuan in the special drawing rights basket, the IMF's unit of money.
- The aggressive adjustment of the yuan fixing has stunned markets, which assumed that Beijing was more inclined to use monetary policy easing and government spending to support the economy. The move effectively kills two birds with one stone – achieving currency depreciation, hence improving export competitiveness, and foreign exchange reform. While it could set off a regional currency war, the move reflects Beijing's growing concerns over the faltering economy. Stabilising jittery stockmarkets and growth appears its top priority for now.

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## Model portfolio news

In July, we added to China Conch Venture, Fuyao Glass, Kerry Logistics and Tong Ren Tang Technologies, as their valuations appeared attractive following recent price weakness. We took some profits from China Merchants Bank and China Vanke, given their resilience over the month.

*Note:*
*Any changes refer to those of our model portfolio, which is the basis for actual portfolios we manage that have similar investment objectives. However, there might be minor variations, so the comments may not apply to all portfolios.*

## Corporate news

Among our holdings, **ASM Pacific Technology**'s second-quarter profits missed market forecasts. Its management was also cautious about the second half, owing to slower growth in orders. **Dairy Farm** disappointed, as cost pressures and intensifying competition, particularly in Indonesia and Malaysia, eroded margins. Nonetheless, it maintained its dividend rate. Dairy Farm's new associate, Yonghui Superstores, posted solid earnings, driven by sales growth that surpassed the industry average and new stores.

Meanwhile, the UK will introduce an 8% surcharge on domestic banks from next January. In return, it will reduce the bank levy from 0.21% to 0.1% in 2021; by then, the levy will apply only to UK profits instead of global earnings, which seems like good news for our holdings, **HSBC** and **Standard Chartered**.

**Swire Properties** and HKR International launched "HKRI Taikoo Hui", their joint venture in Shanghai, which is set to be a landmark development in the prime Jingan district. Swire also embarked on its second Shanghai venture, partnering Shanghai Newbund Industrial Development to build a retail complex in Pudong.

We hold the companies highlighted.

## Focus: A tale of two SOEs

Headline: Peer comparison across key ratios in the first half of 2015 (%)

| | Net interest margin | Deposit growth | Loan growth | Net profit growth | Non-performing loans ratio | Return on equity |
|---|---|---|---|---|---|---|
| Agricultural Bank of China | 2.84 | 6.50 | 6.30 | 0.40 | 1.73 | 20.60 |
| Bank of China | 2.20 | 6.40 | 6.50 | 0.10 | 1.39 | 16.50 |
| **China Construction Bank** | **2.67** | **6.30** | **5.20** | **1.10** | **1.41** | **20.80** |
| **Industrial & Commercial Bank of China** | **2.63** | **3.30** | **5.30** | **0.30** | **1.34** | **19.50** |
| Bank of Communications | 2.25 | 6.70 | 5.70 | 0.10 | 1.38 | 15.40 |
| China Merchants Bank | 2.84 | 2.30 | 7.90 | 8.00 | 1.36 | 20.40 |
| China Minsheng Banking Corp | 2.36 | 2.80 | 6.70 | 0.60 | 1.33 | 20.50 |

Source: Companies, CLSA, 9 August 2015

We initiated positions in China Construction Bank and Industrial & Commercial Bank of China for the A-share fund in July. The two banks boast solid financials and progressive management. While both are willing to boost profitability, they are also sensible in not overpaying to attract deposits and in growing non-interest income. The government remains their biggest shareholder, but management gave us the impression of wanting to run their businesses independently. Over the long run, we expect the financial sector to benefit from efforts to restructure the economy from investment- and export-led growth to a more sustainable one focused on services and domestic demand. Both banks are well-placed for such an environment.

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