Q4 2017 China Macro Outlook

Economic data in China which has improved in recent months, suggests a resilient economy despite some moderation in investment activity. Rising commodity and factory prices over the past year amidst capacity rationalisation have enhanced industrial enterprises' pricing power. Hence, corporate earnings have improved significantly this year in 2017. China's positive earnings revisions year-to-date has outpaced global and most other emerging markets.

Economic reform and rebalancing

China is now gearing up for its 19th Party Congress this October to formalise the leadership transition. Following this, there will be the Central Economic Work Conference in November where the execution of economic reform and rebalancing will likely feature as one of the key focus topics. The Chinese economy is on a path towards sustainable long term growth, as policymakers have made tangible steps to rebalance towards a more consumer and services driven economy.

Reforming state giants

One major component of Chinese reform encompasses state owned enterprises (SOEs) which control a substantial part of China's total assets and economy. Many of these giants regulate vital economic inputs from energy to financial transactions, and lag the private sector in terms of performance, operational efficiency and profitability. SOEs have much room to catch up with the private sector on these metrics. Many of the reforms will involve divesting non-performing assets, lowering debt burdens, improving performance incentives for management and accelerating productivity. For instance, supply side reforms that target over-capacity in heavy industries have already gained traction and resulted in improving profits.

New economy

Meanwhile, rebalancing aims to shift toward consumption to drive growth, and reduce reliance on fixed asset investments as the key economic growth engine. Another objective is to redistribute the national debt burden away from corporates to the government and household. This rebalancing should kick off a virtuous cycle of more sustainable economic growth going forward as follows.

- Economy: Debt redistribution away from corporates to households to encourage higher levels of consumer expenditure
- Consumption: Stronger consumption stimulates the economy and creates more jobs in cities
- Population: Jobs will need to be filled up, with the supply coming from an expanded urban labour force that will raise the demand for infrastructure

Sectors such as information technology, consumer discretionary and healthcare are termed to be part of the 'new economy' and now comprise over half (50.8%) of the market, compared to just 11.7% at the end of 2010. In contrast, the 'old economy' sectors which were reliant on fixed asset investment including energy, industrials and materials comprise less than half (49.2%) of the market, down from 88.3% at the end of 2010. This means the market is generally less sensitive to investment slowdowns.

One Belt One Road

While China recalibrates its economy domestically, an ambitious plan to expand China's reach and growth frontiers is underway. The 'One Belt One Road' initiative is expected to channel Chinese investment into infrastructure projects that will facilitate connectivity from the Middle East, Central Asia and Europe. This will generate immense downstream impact for China's infrastructure and material companies as they embark on reviving roads, railways, and ports along areas that once dotted the ancient Silk Road. 'One Belt One Road' should help China utilise its excess capacity in materials and machinery as well as improve trade linkages.

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UOBAM equities outlook on China

Across all the Greater China markets, good investment opportunities exist with improving returns on equity (ROE) and upward revisions in corporate earnings across most sectors. Corporate financial health across a range of industries has been improving over the past 2 years which could lead to improving non-performing loan (NPL) ratios in the banking system. This has been a perennial concern which led to China's de-rating over the past few years till now. China market's valuations are still attractive relative to the region and global markets. Together with the supportive fundamental backdrop of stable macroeconomic growth and strong corporate earnings, we believe the market's recent outperformance should continue.

Why invest in China equities?

The changes in the stock market structure reflect the accelerating progress in China's economic rebalancing. This should improve corporate profitability and financial health and create longer term sustainable growth. China will soon become the largest consumer market in the world with a booming middle class. This will have significant spillover benefits for Hong Kong, which is a gateway to the mainland with an established rule of law. The special administrative region is also the largest renminbi clearing centre which facilitates investment and trade linkages with the mainland, and is a favoured office and residential investment destination for the Chinese.

Meanwhile, Macau is a thriving holiday and gaming destination and will continue to benefit further from new gaming and tourism developments as well as better infrastructure linkages with the mainland. Taiwan is Asia's leading technology hardware designer and manufacturer. Taiwanese companies, many of which have significant operations in the mainland, are well positioned to ride the wave of global digitization and artificial intelligence revolution, mutually benefitting both Taiwan and China.

The Greater China region should continue to deliver above average economic growth and performance, underpinned by the emergence of China as a global economic superpower in the years ahead.

UOBAM fixed income outlook on China

This period of economic transition presents both opportunities and pitfalls. Although many Chinese corporates were seen leveraging up in the previous years, their business remain supported by continual healthy consumption demand. The recent measures from authorities to curb leverage are positive for China in the medium term. In these times, credit analysis and selection remain paramount when it comes to investing in Chinese bonds.

Why invest in China bonds?

- China is the world's third largest debt market and is a large part of the Asia Credit universe, providing yield enhancement versus other bonds that are similarly rated
- Ongoing measures from Chinese policymakers to relax control and encourage inflows means growing opportunities for foreign investment in bond markets
- Greater issuer mix with diversity of sector and issuers expanding for investor choice
- Increased corporate disclosure and transparency as more companies head for initial public offering (IPO) listings.

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