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CHINA NEEDS TO STICK TO ITS RESOLUTIONS ON REFORM AND REDUCTION IN CAPACITY IF IT IS TO ACHIEVE ITS ULTIMATE GOAL OF PROMOTING A NEW TYPE OF GROWTH, ARGUES DIAMOND LEE, MANAGER OF THE OLD MUTUAL CHINA EQUITY FUND

Chinese New Year is typically a time for age-old traditions and celebrations. In addition to the giving out of hongbao – red envelopes filled with money to bring good luck and ward off evil spirits – Chinese people are treated to lavish fireworks displays the length and breadth of the country’s many provinces.

Having witnessed fireworks of their own in recent months, the analogy won’t be totally lost on investors. Year-to-date China’s Shanghai Composite index of domestic ‘A’ shares has fallen by over 20%, with the Hang Seng China Enterprises index of foreign-owned ‘H’ shares falling only marginally less.

Several factors have combined to undermine confidence. Most recent are the mishandled attempts by the Chinese authorities to ‘devalue’ the renminbi in an attempt to halt its continued rise against the US dollar. Yet the issue is not so much one of renminbi weakness as US dollar strength. Since the middle of 2014 the greenback has risen by 16% on a trade weighted basis. By contrast, sterling has fallen by 15% and the euro by 20% compared with an 8% fall for the renminbi. Despite minimal devaluation, China’s share of the US import market has actually grown, so all the talk of China not being competitive is not terribly convincing, in my view.

Then there are the lingering fears over how successfully China is managing its growth transition, away from an economy dependent on exports and manufacturing (essentially the State Owned Enterprises that make up ‘old’ China) to one of bolstering domestic demand through the promotion of China’s ‘new’ industries.

Whether or not China will achieve growth rates of 6.9%, the lowest since 1990, or even less for 2016 is something of a red herring. Slower growth is to be expected. But the market has been too bearish on Chinese consumption, in my view. December data showed airline passenger traffic grew at 14%, while the Caixin Services Purchasing Manager Index survey for January came in at 52.4, a six-month high, versus December’s 50.2. Anything above the number 50 signals expansion.

But supply side reform is still key. The need to reduce the vast amounts of overcapacity in China’s old industries such as steel, coal and shipbuilding is ongoing. In the UK, recent steel closures both at Redcar and Port Talbot have been blamed on the flood of cheap imports from China. But little has been made of the fact that in December alone, China actually reduced its steel-making capacity by 6%. Premier Li Keqiang has also indicated that efforts to reduce overproduction and overcapacity are being strengthened in the iron and coal industries over the next three years.

In terms of stocks and sectors I believe there are some really interesting companies opening up in light of ongoing market volatility, many of which can be found in the IT sector. Structurally these companies are in the right place. China has a large internet sector, very different from that of the American business model, but it’s a sector which is attracting much talent and a great deal of research and development spend. Examples of companies I like include Tencent, Alibaba and Ctrip.

Other sectors I favour at the moment include healthcare, on the back of the government’s drive to upgrade the quality of providers, and China Biologic Products in particular, as well as higher value added manufacturing areas, particularly in the field of electronics technology. That’s not to say that there aren’t opportunities amongst China’s ‘old’ industries – many of China’s cement companies are trading at below replacement cost.

At the time of writing the price/book value of the MSCI China index currently trades on 1.2x – lows not seen since the SARS crisis of 2003 and the Global Financial Crisis. We may not yet have witnessed the absolute low for the year, and poor data may act as the catalyst for a further leg down, but I’m happy watching and waiting, ready to buy when valuations start to signal almost panic-selling proportions.

1 Source: Citi as at February 2016.
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