July 29, 2014

Investors Renew their Interest in Chinese Equities

Chinese GDP grows by +7.5% in the second quarter and restores investors' confidence. Chinese equities rebound by +10% in 8 days, but still lag by 40% the S&P500.

Key Points:

- Chinese economic data positively surprises analysts thanks to its strengthening activity
- Quarterly GDP up by +2% and by +8.2% annualized
- Positive equity-market reaction: +10% in 8 days
- Chinese exports are re-invigorating by +7.5%
- Leading economic indicators suggest an accelerating trend for the 2nd half
- Positive evolution of credit lending and liquidity
- Return to an accommodating monetary policy
- Resumption of the yuan's upward trend
- Attractive valuations for Chinese equities: P/E 7.7x compared to US equities (S&P500 14.8x)
- Potential outperformance of Chinese equities

Investors restore confidence and push Chinese equities up

Chinese stocks have long been affected in 2013 and 2014 by the country's growth uncertainties. According to data released on July 16, China's economic growth rebounded to +7.5 percent yoy in the second quarter, and industrial production rose +9.2%, above expectations, and is poised to restore investors' sentiment towards Chinese stocks.

The index of shares reserved for domestic Chinese investors (A-shares), still largely in negative territory since the beginning of the year (-10%), quickly rebounded in just eight days to a positive performance, even if it is still close to zero. They are still well behind the results recorded by B-shares.

Chinese equity indices for foreign investors (B-shares) had already begun a rising phase in May. They also benefit from the renewed general interest and can, consequently, display a +5.7% return since the beginning of the year.

Chinese Equities A and B (2014)

Sources: Bloomberg, BBGI Group SA

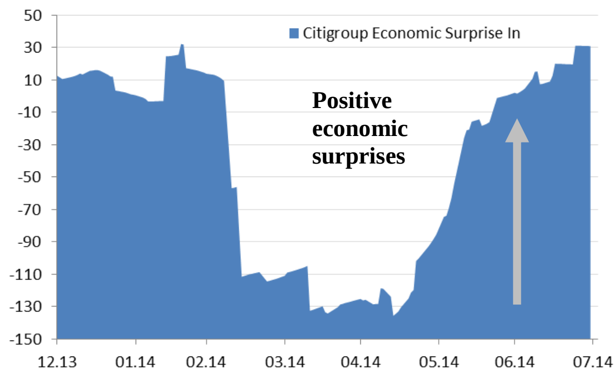
After having long doubted on the ability of the Chinese economy to sustain a +7%/year growth, investors are now forced to acknowledge that the GDP of the second world economy is back to a growth accelerating phase.

On a quarterly basis, the Chinese GDP growth was therefore +2% in the second quarter, a significant improvement compared to the results of the first quarter (+1.5%) and analysts' forecasts (+1.8%).

This result also implies that annualized growth is of +8.2%, which is a significant improvement compared to "only" +6.1% for the first quarter.

The economic surprise indicators for China also clearly show a recovery in momentum. For several weeks, Chinese economic data has positively surprised analysts. The graph below illustrates the sharp disappointment phase that marked the second half of the first quarter and the return of good economic news and positive surprises since June.

Economic Surprise Indicator - China



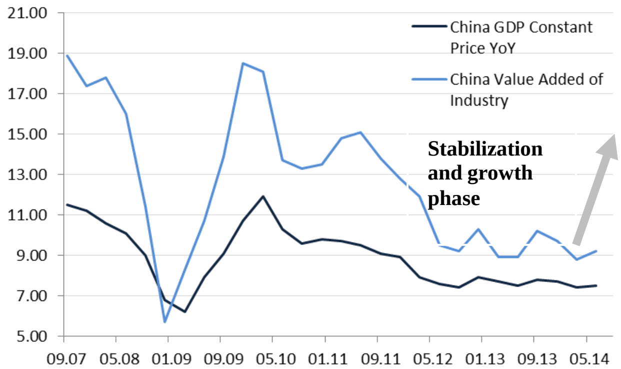
Sources: Bloomberg, Citigroup, BBGI Group SA

The acceleration of the Chinese economy in the second quarter is sustained by the recovery in industrial production, investments and exports.

The graph below puts into historical perspective China's GDP and industrial production growth rate. The Chinese government re-boosted investments in the rail sector, selectively reduced reserve requirements and capital ratios for some lenders and lowered some taxes in order to offset potential negative effects on GDP lower activity in the construction sector and weaker sale property prices.

In June, industrial production stabilized above +9% and surprised analysts. But the Chinese economy still seems to be waiting for global recovery and rising U.S. demand to record higher growth rates.

GDP and Industrial Production - China



Sources: Bloomberg, BBGI Group SA

Change in perception and end of a "hard landing" risk for the Chinese economy

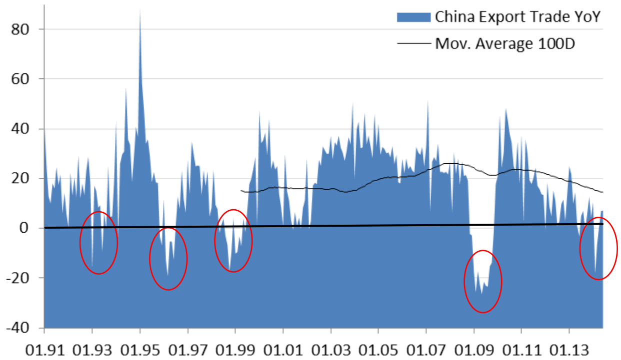
The more skeptics will not change their mind on the reliability of official Chinese data. But for most observers, the recent signs of national economic improvement will most likely result in a revision of growth forecasts.

We should probably observe an upward growth revision of forecasts in the wake of corporate earnings revisions and positive valuations of Chinese companies.

Gross domestic product for the 2nd quarter 2014 benefited from a burst of government stimulus, as fixed asset investment climbed +17.3 percent yoy, just slightly above the +17.2% increase of May. Spending on infrastructure remained strong, as a significant portion of the investment came from the private sector, which was rather an encouraging sign.

Meanwhile the pace of Chinese exports picked up and expanded by +7.2% year-on-year in June. Exports had recorded a significant contraction in February and March, but since then rising international demand contributed to the country's foreign trade.

Chinese Exports - YoY



Sources: Bloomberg, BBGI Group SA

Chinese exports are picking up after having experienced their 5th contraction phase of the past twenty-three years.

We expect a strengthening of this trend and a strong recovery in exports in the coming months, which will accompany the economic recovery in developed countries.

Chinese exports should recover a growing pace, and be closer to +10%, while significantly contributing to GDP.

For the current quarter, the net contribution of exports to GDP growth is thus estimated at 1%: this being the first positive contribution since the 1st quarter 2013.

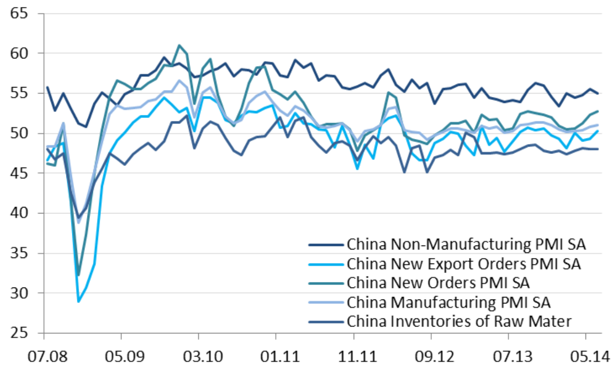
The real estate sector shows no real sign of recovery, as new housing starts plunged by -9.3% in June, this figure being consistent with current estimates of high property inventories. But the home sales by value in June rose by +33% due to significant discounts made by Chinese developers on their stocks.

The full impact of the housing market on GDP growth is of approximately 25%. Moreover, the weakness of the sector could be tempered by the recent easing of home purchases restrictions in major cities and by the will of the People's Bank of China (PBoC) to revive mortgage housing loans. The real estate sector will probably bring little support to GDP growth in 2014, but its negative impact should be significantly reduced.

The leading economic indicators point to improving conditions in the manufacturing sector which is expected to continue in the second half of the year. All advanced indicators in the graph below have seen an increase in recent months.

The overall indicator is again at its highest, but new components recorded a very significant recovery from an internal and external perspective. The recovery in domestic demand seems particularly encouraging, but the leading indicator for exports is also important to confirm the sustainability of the trend observed in recent months.

PMI Advanced Economic Indicator - China



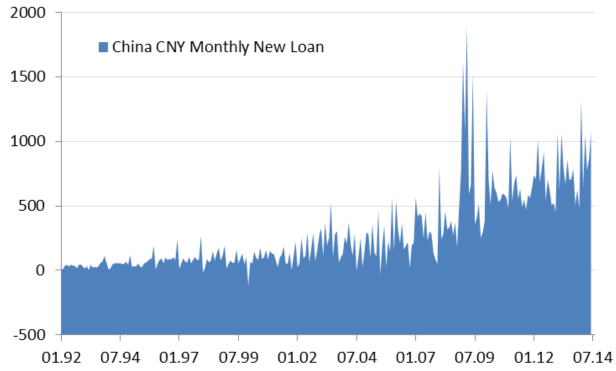
Bloomberg, BBGI Group SA

Advanced PMI indicators give hope of strengthening growth prospects for the second half of the year.

Rebound in credit lending and liquidity in the economy

The credit rebound of the month of June which went from 870 billion yuan to +1,080 billion yuan also surprised observers, beating expectations (1,000 billion RMB). Overall, bank loans have slightly improved in May (+13.9%) and June (+14%) from a year ago. New bank loans are nevertheless high by historical standards, with the exception of the period that directly followed the outbreak of the financial crisis. Overall credit growth accelerated from 15.8% to 16.5% over a year between May and June, reflecting more accommodative monetary conditions.

New Net Monthly Bank Loans - China



Bloomberg, BBGI Group SA

Between 2009 and 2014, net new monthly bank loans grew at a steady 500 to 1,000 billion RMB rate. Bank credit remains the most common form of financing in China.

Overall domestic credit to the private sector has been growing faster since the financial crisis. It accounted for approximately 130% of China's GDP in 2009 and has now reached 206%. It is basically a loan to businesses since households are less indebted. Although we do not have easily accessible information and detailed data, we can suppose that a significant portion of bank lending to businesses is, in fact, headed to the public or semi-public sector. Moreover, the shadow banking system in China, which covers a broad range of financing outside the traditional banking system, has sharply increased while being difficult to measure it (with the exception of fiduciary loans and bank discounts).

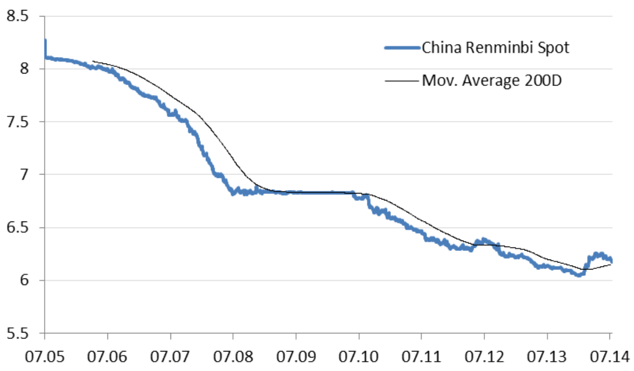
Meanwhile, Chinese government debt, which accounted for only 15% of GDP in 2009, had initially jumped to 42% in 2010 before returning to a 22%-ratio in 2013.

The sharp increase in lending in China is the cause of major concern, especially regarding credit quality and a rising systemic risk. Without discarding this issue, the chances of a major credit event in China in the near future are thin, mainly because of the supervision and control of authorities on most of the financial actors.

China's central bank governor Zhou Xiaochuan can be satisfied, he ensured the liquidity of the country's financial system in June by allowing a +14.7% growth of money supply M2. In China, policy makers are back to an accommodative monetary policy.

China's foreign exchange reserves have hit the extraordinary level of \$3.99 trillion (\$3.95 trillion at the end of March). Despite the seemingly low increase, the forex reserves are still up by +14.2% yoy. Beginning June 2014, following a brief and temporary weakness, the renminbi resumed its upward trend against the US dollar as investors' sentiment improved on equity markets.

Yuan/USD



Sources: Bloomberg, BBGI Group SA

Foreign investment in China fell by -6.7% in June and -1.47% in March. The stabilization phase of the month of June should give way to a bolder recovery of net foreign investment in China in July, which will also support the currency's growth.

Potential outperformance of Chinese equities

Since the outbreak of the financial crisis, U.S. stocks outperformed Chinese equities by +37%. This took place between 2013 and 2014, as consensus was turning more optimistic towards U.S. growth and more uncertain regarding China's economic activity.

MSCI China and S&P500 Index

Sources: Bloomberg, BBGI Group SA

At present, Chinese stocks in terms of price/earnings ratio (P/E) are trading at half the valuation of U.S. equities (P/E ratio of 14.8X). Chinese equities for 2015 are only at 7.7x earnings. Therefore, Chinese equities are attractive and we believe they will benefit from an asset reallocation in the coming months, which could result in +15% to +30% increase.

Conclusion

Chinese GDP growth surprised on the upside and should now support a bull phase in Chinese securities. With a 7.7x earnings for 2015, China is currently trading at 10-year low, which represents a historic opportunity.

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