PRIVATE BANKING INSIGHTS
Market Update

April 29, 2015

Webster Private Bank®
LIVING UP TO YOU™

Yves Cochez
Senior Vice President
Chief Investment Strategist

SLOWING ECONOMY, SOARING STOCK PRICES

It seems like nearly every day, one can read or hear apocalyptic comments about the Chinese economy. For the bears, the second largest economy in the world is slowing down at an alarming pace and excessive debt levels will soon become so unmanageable that a crisis of epic proportions will unravel and have disastrous consequences for the global economy and financial markets.

Despite this doomsday scenario, Chinese domestic equities (A-shares) are up a staggering 40% so far this year (and 125% from their lows in 2014). We have been advising our clients to overweight China (and more generally emerging Asia) in their portfolios for quite some time already and, despite these hefty gains, we remain upbeat going forward.

These explosive gains have caught the legion of bears completely off guard (and probably also surprised even the most bullish investors). The economic picture in China does not seem to have brightened to an extent that would justify such a dramatic improvement in investors' sentiment.

It is well known however that economic growth has little impact on equity prices in the short term. It is also true that in the long run (besides the fact that we are all dead), economic growth is what matters for corporate profits and households' income. From that perspective, it is obvious that Chinese equities were trading at a substantial discount to economic fundamentals a few months back, reflecting a significant level of pessimism among investors. In their short history, A-shares have had a tendency to go through some very powerful boom-bust cycles but in the end, stock prices are driven by economic growth and corporate profits. Since 1992, Chinese domestic shares are up a whopping 1,200%. As impressive as this performance looks, it still trails the growth in nominal GDP by a significant margin. Hence, the starting point for the current rally (as in the mid-90s and back in 2003) was one of clear undervaluation and extreme pessimism, most likely as a consequence of the shift in economic policies and a growing emphasis on the quality (instead of the quantity) of economic growth.

FIRST A LITTLE SPARK, NEXT A FLICKERING FLAME, THEN A MIGHTY BLAZE

Reversion to the mean is a very powerful concept in financial markets. When markets have been out of sync with underlying fundamentals for several years, a little spark can unleash a sharp mean revision rally. With the benefit of hindsight, we believe the following factors have acted as the sparks that have ignited the current mighty blaze.

Policy easing was most likely the key driver. As evidenced by the most recent manufacturing PMI, the overall economic picture remains weak and more counter cyclical measures are therefore needed. The latest 100bps cut in the reserve requirement ratio (RRR) suggests that the Central Bank (PBoC) is becoming more aggressive in its efforts to ease liquidity conditions in the banking sector (50bps cuts have usually been the norm). We view these easing measures as a normalization process from an excessively restrictive starting point. The self-imposed drag on growth (with a particular focus on the shadow banking and the housing sector) is progressively being lifted. Monetary easing will also help soften the near term growth headwind from economic reforms. Indeed, the pace of reform (particularly in the financial sector) has accelerated in recent months. These measures improve the long-term outlook for Chinese assets but they have also contributed to weaker growth in the near term. The most recent easing of both monetary and fiscal conditions sends a clear signal to the market that policymakers will not tolerate a too sharp growth slowdown as the price to pay for fixing the economy's structural issues. The reduced uncertainty with regards to near-term economic performance has allowed equity valuation levels to expand from depressed levels.

While investors perceived the reform agenda as a headwind for short-term growth, another, probably even darker cloud, has been hanging over Chinese equities for quite a while. Fears of a financial crash due to the rapid increase in overall debt levels have played an important role in the severe de-rating of Chinese stocks since 2010. On that front, the recently announced debt swap program should be seen as a major step in easing investors' concerns that a significant hard landing will inevitably occur at some stage. The debt swap will for the first time allow local governments to issue bonds (RMB 1 trillion as a first wave) in order to pay back loans obtained through various investment vehicles. This program is significant for the following reasons:

- The debt swap reclassifies local government debt accumulated through various investment vehicles (previously reported as corporate loans) as fiscal liabilities. While this reclassification does not change the overall leverage ratio of the economy, it will change investors' perceptions towards the true level of corporate leverage (making the recent increase much less alarming). Following this reclassification, total government debt would still stand at a relatively low level of 53% of GDP.
- For the banking sector, the swap will act as a form of credit easing. As banks will be able to swap their existing loans for local government bonds, this will free up a decent amount of lending capacity through a reduction in their risk-weighted assets (local government bonds carry a 20% risk weighting versus 100% for the current outstanding loans). The swap will also improve the overall asset quality of banks' balance sheets and reduce their risk profile. At the overall economy level, the swap will help ease concerns of ongoing crowding out of the private sector as local governments have in recent years eaten up a large share of bank credit origination.
- The debt swap should also be seen as the beginning of the Chinese municipal bond market. Not only will it help drive further fiscal reforms, but it will also play an important role in the internationalization of the RMB as it will increase the size of the Chinese government bond market and provide a recipient for foreign RMB demand.

WE REMAIN BULLISH ON CHINESE EQUITIES, PARTICULARLY H-SHARES

Despite regulatory changes on short-selling and leverage, Chinese stocks have continued to soar, buoyed by liquidity easing measures. Given the extent of the rally in the domestic market (A-shares), we continue to recommend investments in the investable universe (H-shares). Indeed, the MSCI China index has significantly trailed the Shanghai stock index over the past 12 months – up only 45% vs. 120%. The domestic market benefited from a combination of a rapid increase in public participation (a surge in new brokerage accounts – driven by measures to cool off the housing market which traditionally soaks up domestic savings) and the introduction of the Hong Kong-Shanghai Connect aimed at boosting cross-border portfolio investments. Given the large valuation gap in favor of H-shares and the acceleration in the pace of reforms to liberalize China's capital account, Chinese investors will find the Hong Kong market increasingly attractive.

Irrespective of the relative attractiveness of H-shares compared to A-shares, we expect further gains in both markets:

1. Valuations are still far from excessive for the domestic market. H-shares are still trading at a large discount compared to global markets and relative to their own history.
2. Policy easing (monetary, liquidity, fiscal and housing sector) will continue and lead to a further expansion of valuation multiples. Chinese stocks usually come under pressure when strong economic growth leads to a shift towards policy tightening. Despite some signs of economic stabilization, it is way too early to alter the current accommodative policy stance.
3. As growth recovers and reforms are implemented, tail risks or black swans (fears of a financial/debt crisis), will increasingly be priced away, allowing a further reduction in the equity risk premium.

FOR MORE INFORMATION CONTACT YOUR WEBSTER PRIVATE BANK PORTFOLIO MANAGER OR EMAIL US AT PBINFO@WEBSTERBANK.COM.