China equities: Is the rally sustainable?

JP Morgan Asset Management | 29 April 2015 |

The People's Bank of China's surprise rate cut in November 2014 and investor expectations of further easing measures have triggered a strong rally in China equities - in particular, the domestic A-share markets, with the CSI 300 Index rising 84% since 21 November 2014. H-shares have been laggards so far, with the MSCI China Index up 33%.

However, as written in our 2Q edition of Quarterly Perspectives, we had expected to see some catch-up in performance of the Hong Kong-listed H-share laggards in the near term, given their much cheaper valuations compared to A-shares. The current sharper-than-expected rally in H-shares (+17% in three weeks) began after the extended Easter and Chinese Ching Ming holidays in Hong Kong in early April. It was mainly triggered by the announcement around the end of March that onshore mutual funds have been given permission to buy Hong Kong-listed shares through the Shanghai-Hong Kong Stock Connect program without the need of a QDII license.

A SIGNAL TO CLOSE THE VALUATION GAPS BETWEEN A-SHARES AND H-SHARES

Conveniently, the China Securities Regulatory Commission relaxed the restrictions on cross-border buying of Hong Kong shares just as the A-share market hit a seven-year high on the back of very bullish investor sentiment. As shown in Figure 1, the euphoric sentiment is illustrated by the number of weekly new investment accounts in the A-share market, which jumped to 1,670,000 at the end of March, versus a historical average of 240,000.

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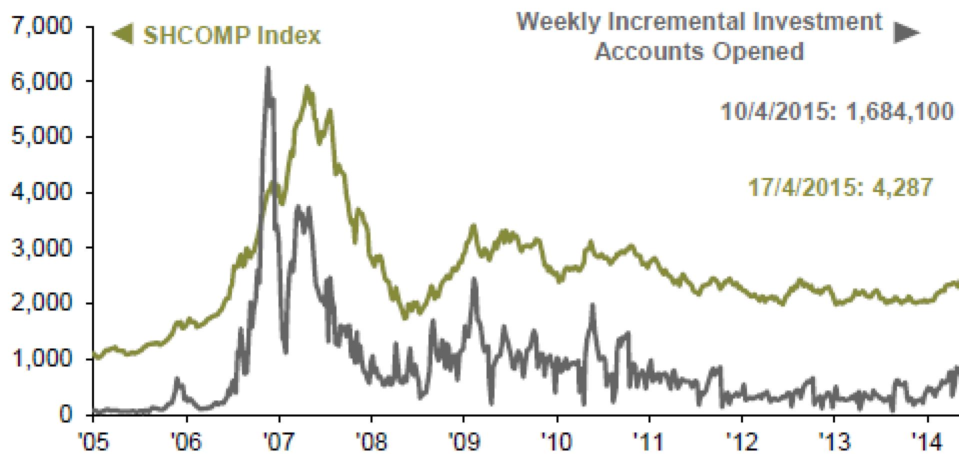
Figure 1: Number of weekly new investment accounts in the A-share market soared in recent weeks



Sources: Bloomberg, CICC, J.P. Morgan Asset Management "Guide to the Markets – Asia 2Q 2015, page 40." Data reflect most recently available as of 17/4/15.

Therefore, the green light for Mainland mutual funds to use Stock Connect can be seen as a signal that the central government wants domestic investors to shift their focus from expensive A-shares to cheaper H-shares, which were trading at an almost 30% discount for dual-listed companies around the end of March.

The recent outperformance has certainly reignited positive sentiment among Hong Kong domestic and overseas investors. Furthermore, China accounts for the largest country weightings of 22% and 24% in the MSCI AC Asia Pacific ex-Japan Index and MSCI EM Index, respectively. Many of the benchmark-focused institutional investors, who have been underweight China, are now being forced to chase H-shares to make up the performance.

HOW SUSTAINABLE IS THE RALLY?

Given the massive increase in both A-share and H-share markets, we will not be surprised to see some consolidation in the near term. However, we believe there are several possible key drivers for the rally to continue in the medium term:

1. Weak economic data – The macroeconomic data continues to be disappointing. Poor data will increase expectations for both greater monetary and fiscal easing.
2. Further reform announcements – Some senior officials hinted early this year that there will be key announcements on state-owned enterprise (SOE) reform this year.

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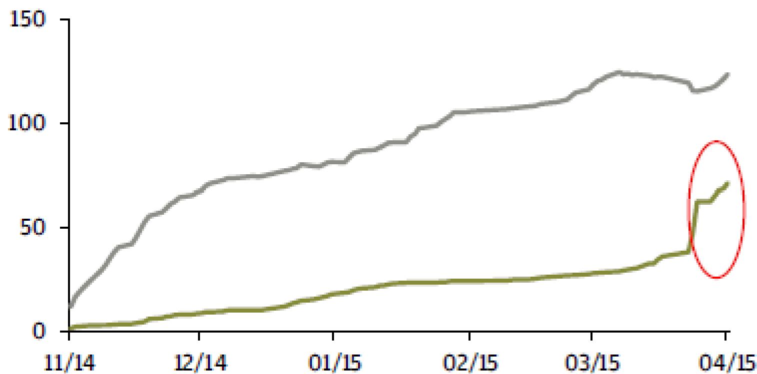
As SOEs account for around 60% 80% of the A-share and H-share indices, any key reform news should be a catalyst for a re-rating in SOEs.

3. Expectations on further inflows – For the A-share market, the launch of Shanghai-Hong Kong Stock Connect in November 2014 has brought the largely domestically driven China A-share market to the global arena. Growing expectations of Shenzhen-Hong Kong Stock Connect, or even the Shanghai-Taiwan Stock Connect, as well as future inclusion of A-shares in global equity benchmark indices are likely to continue to attract inflows. For the H-share market, as Figure 2 illustrates, investors are now expecting to see an increase in the southbound quota soon. The total amount of assets that can be invested in equities by onshore mutual funds is around RMB2 trillion (USD340 billion), where the current southbound quota represents just 12% of this amount. This implies huge potential inflows to the Hong Kong share market. Furthermore, as stated by People's Bank of China governor, Zhou Xiaochuan two weeks ago, Beijing has pledged to largely complete capital account liberalisation by end of this year. Encouraging fund flows to outside of China is one of the important steps towards liberalisation. The Hong Kong stock market is very likely to be one of the key beneficiaries.

Figure 2: SH-HK connect southbound quota expected to increase soon
SH-HK connect quota utilization (aggregate)
RMB billion)



Source: Bloomberg, J.P. Morgan Asset Management "Guide to the Markets – Asia 2Q 2015, page 40." Data reflect most recently available as of 17/4/15.

4. Bullish retail investor sentiment in A-share market: Optimism in the A-share market, which is largely dominated by onshore individual investors, could continue to drive up the market. Nevertheless, the announcement of allowing onshore mutual funds to invest in Hong Kong shares via Stock Connect as well as recent regulatory changes on leverage and short selling seem to suggest that the central government has been

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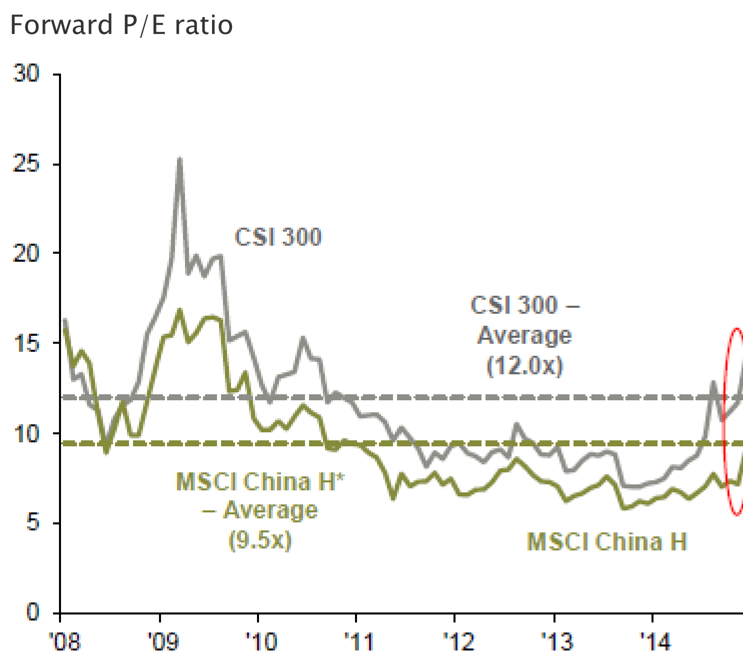
trying to calm down the current euphoria sentiment. We believe some healthy corrections in the A-share market are needed for the uptrend to sustain longer.

5. Relatively cheaper valuations for H-shares: The catch-up in H-shares or Hong Kong shares is expected to keep going as their valuations are still cheaper than their A-share counterparts. Figure 3 shows that the MSCI China H Index is still trading below its long-term average.

Figure 3: H index is still trading at discount despite recent rally

Forward P/E ratio

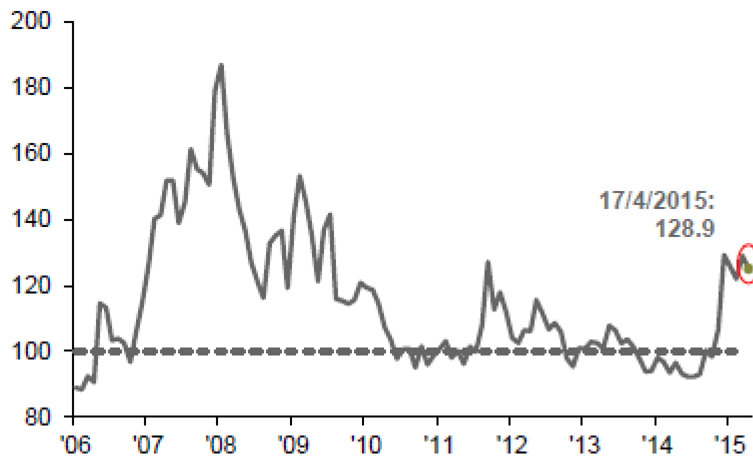


Sources: Bloomberg, J.P. Morgan Asset Management "Guide to the Markets - Asia 2Q 2015, page 40." Data reflect most recently available as of 17/4/15.

Also, Figure 4 shows that as A-shares on average are still trading on a 20%+ premium to their H-share peers, the A/H arbitrage theme on closing the valuation gaps between A- and H-dual-listed companies is expected to continue.

Figure 4: Valuation gaps are expected to close further

HANG SENG China A-H Premium index



Sources: Bloomberg, J.P. Morgan Asset Management "Guide to the Markets - Asia 2Q 2015, page 40." Data reflect most recently available as of 17/4/15.

Lastly, what could make the rally sustainable in the long run? We believe that the markets need to see some evidence of significant improvement in economic fundamentals and corporate earnings, as well as realisation of reform dividends. Otherwise, this is likely to be a rally that only runs for the short term.

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