



Matthews Asia Perspective

China Equity Markets: Pockets of Opportunities, Fundamental Research Is Key



Andrew Mattock, CFA
Portfolio Manager
Matthews Asia

Following a substantial run-up in 2017, China's stock markets experienced notable volatility in recent quarters. The MSCI China Index was down roughly -9% year to date measured in U.S. dollars as of September 30, 2018, while China's mainland, domestic A-shares were down nearly -20% measured in U.S. dollars for the same period. Valuations among A-shares in particular are reaching the point at which we believe some of the higher-quality stocks within that universe are starting to look more attractive. While sentiment has been weak amid trade concerns and worries about a possible economic slowdown in China, fundamentals remain sound. Larger industrial firms reported 16% earnings growth through August, demonstrating solid footing across even some of the less dynamic segments of the economy. For active managers employing an all-shares approach to investing in China, our current environment provides an array of attractive choices, but caution and due diligence are required.

Where Chinese Equities Trade

A-shares and H-shares represent the largest portion of Chinese equity markets. Here's a brief primer of their definitions.

- ✿ A-shares represent China's onshore, domestic markets, where securities trade on either the Shanghai or Shenzhen stock exchanges. At present, individual foreign investors can typically only gain exposure to the A-share market through a mutual fund or exchange traded fund (ETF).
- ✿ H-shares represent China's offshore, international markets, where securities trade on the Hong Kong Stock Exchange. Individual foreign investors can typically buy individual securities in the H-shares market, as well as invest in the market through a mutual fund or ETF.

At Matthews Asia, many of our portfolios employ an "all-shares" approach to investing in China, which means that we can potentially invest in any markets where Chinese stocks are traded, including the A-share market.

A-Shares: Valuations Look Attractive

Following a steep decline in equity prices onshore, A-share valuations are currently at historic lows relative to H-shares. (See figure 1.) The A-share market, however, may have overcorrected. Current levels of negative investor sentiment don't match what we're seeing in terms of economic activity in China. What's more, the Chinese government added a small measure of fiscal stimulus to the economy on Oct. 1 in the form of tax cuts for China's low wage earners. Sentiment could turn positive should consumer spending remain robust and corporate earnings maintain their current positive trajectory.

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

FIGURE 1. PRICE TO EARNINGS RATIOS OVER PAST TEN YEARS



Source: Bloomberg. Data shown is for 10 years ending September 30, 2018. Stock prices used in price-to-earnings ratios are measured in U.S. dollars.

Opportunities and Risks

The most attractive parts of the A-share market offer access to domestically focused businesses poised to participate in China's rising middle class spending. These consumer-oriented businesses can be found in sectors such as health care, information technology and consumer staples. A-share companies offer the potential for low correlations to global markets, access to a diverse range of industries and good liquidity. Many of these companies were previously unavailable to foreign investors. Today, larger foreign investors, such as mutual funds and institutional investors, can access the A-share marketplace.

The diverse nature of the A-share market creates a large dispersion in quality. For example, we still find many companies within the A-share universe that are still part of an older, transitioning economy connected to the global supply chain. This portion of the market can include everything from auto parts to restaurant supplies and widgets. Businesses that are still part of global supply chains tend to be more susceptible to trade concerns, current account positions and questionable corporate governance standards. In addition, local corporate reporting is often provided in Chinese only. These risks and challenges highlight the importance of local language skills, boots-on-the-ground due diligence and taking a highly selective approach to incorporating A-shares into a China all-shares investment strategy.

Domestic Chinese retail investors represent the lion's share of trading in the A-share market, accounting for much of the volatility this year. Some retail investors may have a shorter time horizon than institutional or professional investors and may be more likely to follow market momentum and headlines in the news. Larger foreign investors are slowly expanding into the A-share market, a trend that we expect will continue as index provider MSCI steadily expands the inclusion of A-shares in its global indices. But the current share of overall trading volumes in A-shares among foreign investors remains low.

Seeking Growth from the Bottom Up

As China continues its shift toward innovation, domestic consumption and services, its A-share market offers investors a chance to take part in the country's attractive long-term growth potential. We believe a dedicated China strategy with the ability to incorporate A-shares into its overall portfolio mix can help long-term investors gain exposure to a broader range of China's growth drivers while managing for volatility. The diversity and continuing evolution of the A-share market adds to its appeal as a way to increasingly complement holdings across the broad universe of Chinese equities.

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