

## Market Insights

### 2014 China investment outlook - room for re-rating

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The Chinese equity market experienced a bumpy ride in 2013, with the market lagging the performance of developed markets by more than 20%<sup>1</sup>. Such a wide performance gap can partly be attributed to uncertainties around the political transition, as well as macroeconomic concerns, which kept investors on the sidelines. However, with policy priorities now clearly on reforms, and macro stability providing a positive backdrop, we believe Chinese equities, as an under-owned asset class, offer room for market re-rating as we celebrate the Year of Horse.

#### China reforms - a year of action

The comprehensive reform package decided at the Third Plenum in November 2013 covers socioeconomic, financial, fiscal, land and Hukou (household registration) and state-owned enterprise (SOE) reforms. 2014 will be a crucial year to translate these structural reform plans into action. In fact, the Chinese government is willing to tolerate slower growth to accelerate reform as a higher priority. While still aiming to maintain gross domestic product (GDP) growth at around 7-7.5%, with emphasis on quality rather than on quantity, the government has sufficient tools to defend lower growth, if needed.

In the first year of reform implementation, we expect to see a modest market re-rating, driven by the optimism and expectations of the structural reforms. It is, however, important to note that reforms are unlikely to post any near-term positive impact as these will take a number of years for their economic implications to materialize and prove their effectiveness. In any case, with reform initiatives continuing to be rolled out, the theme of reforms will be one of the main drivers for 2014 equity performance.

We have already seen swift follow-through on various reform items by different ministries in just over the month's time after the Third Plenum. The Central Economic Work Conferences, which just concluded in mid-December 2013, underscored the commitment to reforms such as transforming migrant workers into urban citizens. In the near term, we continue to expect more details on various reform fronts to emerge.

#### Revitalizing SOEs to enhance shareholder returns

Amongst all the reforms announced, the reform on SOEs came under the spotlight as it represents a shift in the government mindset to address the deep-seated structural problem of SOE inefficiency. This is not easy to implement as there are many stakeholders involved. However, we have already seen concrete steps taken after the Third Plenum as Shanghai recently launched SOE reform guidance with the aim of separating government from directly running the SOE.

The pilot program in Shanghai is encouraging as it provides an important framework as to how the central government would like to shape the structure of SOEs. The ownership of SOEs will be transferred to state-owned asset management companies which focus on investment returns rather than intervening in daily operations. The government will also give a clear vision of breeding globally competitive SOEs in the long run. We consider that this plan with a market-based tilt is a strong structural positive to the Chinese equity market which is currently dominated by SOEs, because it opens up more stock opportunities, with attractive investment propositions, for investors over the long term.

However, we also recognize this reform will take time (up to years) to bear fruit and there will be winners and losers in the reform process. We also expect the opening up of industries like finance, energy, electricity, railway, telecom, resource exploration, public utilities to more private enterprise participation will add to the competitiveness of these sectors.

#### Consumption - a multi-year growth story

The consumption story is a multi-year investment theme that will continue and we believe the rise of mass consumption will be a long-term secular trend, supported by favorable demographics, a rising middle class, as well as broad government policy direction. Also, the aging population and the rise in chronic conditions could boost demand for healthcare over the long term.

<sup>1</sup> Source: Invesco, Factset. In 2013, MSCI China delivered a return of +4.0% while MSCI World delivered a return of +27.4% in USD, total returns.

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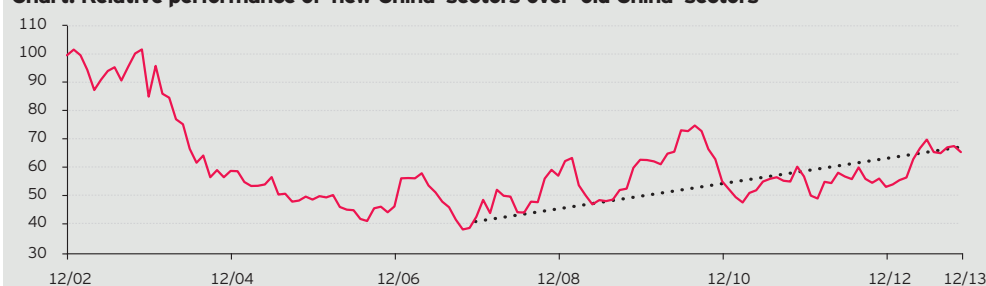
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China is on the course of rebalancing its economy from investment/manufacturing-led towards being household consumption-driven, and the recent reforms decided at the Third Plenum could unleash structural consumption demand. For example, land and Hukou reforms could increase the wealth of farmers and accelerate urbanization. Also, the increase in urban population at an expected rate of 33 million per year (compared to 18.7 million per annum in 2001-12)<sup>2</sup> will unlock consumption power in second and third-tier cities. Other reforms such as relaxation of the “one-child” policy could also add to long-term consumption demand.

#### “New economy” outshines

In 2014, we believe that “new economy” sectors will outshine the traditional “old economy” sectors. The term “new economy” sectors refers to those that stand out as secular growth stories and are likely to benefit from the new trends in China, such as a greater role in the Chinese economy, the rise of mass consumption and an increasing awareness for environmental protection. “Old economy” stocks tend to be associated with those vast investments by the government such as in heavy industries and are relatively more prone to the risk of overcapacity. In the course of the Great Rebalancing of the economy, we believe the earnings growth of “new economy” stocks is likely to be more resilient as they are relatively independent to macro cyclicalities. The market resilience in the “new China” sectors is also reflected by the sectors outperformance against “old China” by 70% since late 2007 (Chart).

**Chart: Relative performance of ‘new China’ sectors over ‘old China’ sectors**



Source: RIMES, Morgan Stanley Research, 18 December 2013.

#### Stock selection is key

Picking stock winners is now more important than ever. Using the year of 2013 as a reference, we have seen a wide dispersion among different sector returns, with information technology (IT) and energy sectors returning 80.4% and -13.9%, respectively<sup>3</sup>. We believe being selective and focusing on the differentials in stock fundamentals will be the key to outperformance. From a bottom-up perspective, looking ahead, we will tend to avoid inefficient SOEs which are currently protected by monopolistic/oligopolistic policy barriers, particularly those without competitive business niches or strong management capabilities. Further, we expect Macau gaming names, food & beverages, automobiles, healthcare & consumer services to be beneficiaries of the surge in demand. We currently are looking for interesting “new economy” stock opportunities in IT (especially software services and internet names) as well as green energy.

In our view, the growth potential of China makes it one of the most attractive markets from a risk-reward perspective among emerging market plays. MSCI China's forward 12-month price-to-earnings ratio (PER) is just 9x<sup>4</sup>, which is even lower than the pre-global financial crisis valuation. While market may still be affected by external concerns, with most of the downside risks of growth deceleration priced in, the increasing certainties on the political and macroeconomic fronts give investors the assurance to come back to this under-owned asset class in search for quality growth.

<sup>2</sup> Source: UBS Investment Research estimates, 19 November 2013.

<sup>3</sup> Source: Invesco, Factset, 2013 MSCI China sector performance in USD terms.

<sup>4</sup> Source: Invesco, I/B/E/S, Factset, as at 31 December 2013.