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2010: A year in China

Laura Luo, Chinese Equities Fund Manager, looks ahead to 2010



- The extraordinary turnaround in the Chinese economy and rapid asset price appreciation have prompted fears about monetary tightening, which is likely to weigh on market sentiment in 2010
- Although near-term liquidity appears to have peaked, we do not envisage a sharp reversal of the government's pro-growth strategy
- Given the headwinds facing the global economy, and the rebalancing of the Chinese economy towards private consumption, we remain focused on good quality domestic companies with solid and visible earnings growth.

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Fears about the possibility of global economic depression were dramatically displaced in 2009, with China leading the rebound. This can be accredited to the Chinese authorities, which reacted quickly to the downturn by injecting liquidity into the system through aggressive interest rate cuts and increasing lending and fiscal spending. However, this was perhaps done with too much vigour, as the extraordinary turnaround in the Chinese economy is now raising concerns about budding asset bubbles and inflation, leading to talk about when the authorities will unwind such ultra-loose monetary policies. While this is probably somewhat premature, we believe that this delicate balance to keep economic growth on a sustainable path is likely to dominate the direction of Chinese equities in 2010, creating periods of increased volatility on any indication of monetary tightening (for example, restricting credit, raising banks' reserve requirement ratio and increasing interest rates).

Market caught between strong macro data and liquidity concerns

Chinese equities experienced significant volatility in 2009, with the domestic A-shares market bearing the brunt of the sharp movements. This is likely to continue into 2010 as uncertainties remain. However, what appears certain is that the markets will wax and wane between strong macro data on the one hand, and liquidity concerns on the other. As we approach 2010, we think economic momentum – on both a macro level and in terms of earnings results – will remain strong, supported by the government's massive lending and investment programme, as well as the low statistical base in Q4 2008 and Q1 2009. However, the pace of growth in government spending is likely to slow in 2010.

Monetary policy should stay accommodative. In contrast to the West, where banks are still reluctant to lend, Beijing merely had to send out directives to gear up the banking system – with a whopping RMB 10 trillion (USD 1.47 trillion) of new loans expected to be issued over the course of 2009. However, this frantic pace of bank lending is unlikely to be repeated over 2010; both we, and the market, are predicting that new loan issuance will fall to around RMB 7 to 8 trillion (USD 1.03 to 1.17 trillion). Still, hardly a trifle amount! This extraordinary surge in activity has also prompted concerns about the formation of new bad loans, as well as future asset bubbles, with many banks being warned by the authorities to rein in excessive lending, and to ensure that new loans are being channeled into the real economy. While this is positive for economic growth, it could constrain further upside in the equity and property markets.

We believe that this tug of war between tightening and liquidity will be key to the direction of Chinese equities in 2010, with the markets very sensitive to any policy talk or any indication of monetary tightening. This will act as an overhang on markets, driven by fears that the potential withdrawal of economic support will undermine the recovery. While the government



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will need to start looking at exit strategies at some point, it is still difficult to pinpoint when this will occur. That said, we believe that one of the key focuses in 2010 will be on inflation, and rises there could put pressure on the government to start raising interests in the second half of the year.

Pro-growth policy continues, but the balance to shift towards the consumer

Although near-term liquidity appears to have peaked, we think the government will continue to fine tune policy, so a sharp policy reversal in its pro-growth strategy is unlikely, unless there is a much stronger export recovery. While exports are rebounding, they are still well below their pre-crisis level, and we do not anticipate them returning to those sorts of levels anytime soon, as developed economies still need to work through a severe and drawn out de-leveraging process.

Infrastructure investment and exports have long been the key engines of economic growth; however, the government is now attempting to rebalance the economy towards private consumption. In the past year, Beijing has introduced a series of measures to encourage households to spend more, which has had some success. Domestic consumption has held up surprisingly well in the downturn, with pockets of strength seen in the sales of both home appliances and cars. We think this rebalancing of the economy towards more consumer-led growth is likely to continue, supported by increasing urbanisation, growing disposable incomes and the expansion of the social security net (such as spending in healthcare, pensions and education), which should lead to a better quality of growth for the Chinese economy.

Domestic companies with visible and solid earnings growth should fare better

Given our less sanguine view about the global economy in 2010, we continue to take a more defensive stance, focusing on good quality domestic names, which offer better valuations and visible and solid earnings growth. In particular, we are committed to identifying opportunities in those sectors that will benefit from increased infrastructure and consumer spending trends, as well as those stocks exposed to the pick up in the property market. On the other hand, we continue to avoid many cyclical stocks, which appear excessively valued, and which are the most exposed to global demand trends.

At the time of writing, the overall market is now trading at slightly above historical average valuations, and we believe some investors have unrealistically optimistic expectations on some stocks. On that basis, we think it is important to pick wisely – particularly in China, where overinvestment will continue to lead to poor returns in many industries. Therefore, it is imperative to remain disciplined in our investment approach and stay focused on the long-term winners. While this could mean having to forego some short-term gains, our strategy should reward investors over the longer term as strong underlying fundamentals – such as strong management teams, good transparency and solid balance sheets and earnings – rather than momentum, drive performance.