20 February 2018

China and HK equities: Solid fundamentals remain intact

Markets in China and Hong Kong have experienced volatility in early February, but rollercoaster markets leave investors still on edge. In this investment note, Kai Kong Chay, Senior Portfolio Manager, Greater China Equities, believes that despite the market movements, the fundamentals underpinning China and Hong Kong equity markets are sound. From an economic perspective, Chinese growth remains robust, inflation is muted, and China runs a trade surplus. From a market perspective, earnings continue to enjoy upward revisions, while valuations remain comparatively attractive compared to developed equity markets.

From time to time, equity markets remind investors what volatility can be like. Following a roughly 50% rally for Chinese and Hong Kong equities in 2017[1] and also a strong month in January 2018, it is sensible to take a breather and keep investors' expectations in check.

Fundamentals remain intact: economic and market perspective

As a pulse check, when revisiting China's fundamentals, we do not find any evidence of economic deterioration in fundamentals. Instead, China's economic growth continues to be strong with solid GDP growth, foreign reserves of US$3.1 trillion and a trade surplus. In particular, Chinese and Hong Kong equities are supported by the strong inflows of mainland money, while Chinese and Hong Kong equities are a beneficiary of increased equity allocation from wealth management and overseas institutions.

In terms of corporates, we continue to see upward earnings revisions with the latest 2018 earnings per share (EPS) growth estimate for MSCI China of 21.6% (EPS growth estimate was 15.3% as of end of 2017)[2]. Valuations remains compelling at around 14 times to earnings, a more reasonable level when compared to developed equity markets (e.g. US is around 19 times to earnings).[2] More importantly, the continued southbound flow to China and HK equities year-to-date has continued to drive liquidity (see Figure 1).

[1] Bloomberg, MSCI China Index, total returns in US dollar, as of 31 December 2017.
[2] Goldman Sachs Research, Factset, IBES, MSCI, Worldscope, as of 4 Feb 2018, in Hong Kong dollars.

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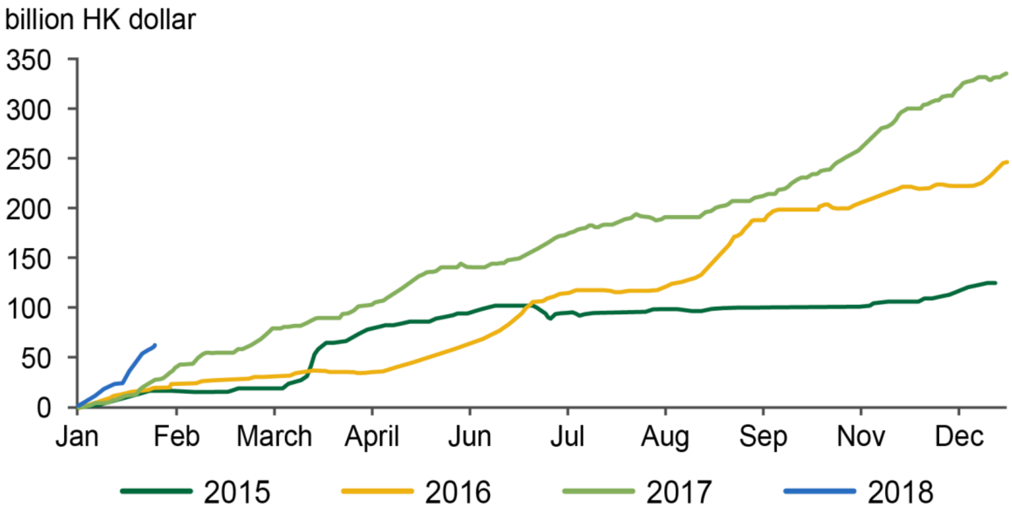
Figure 1: Southbound flow continues to drive liquidity[3]



Outlook

We believe that when the dust settles and sentiment improves, investors will refocus on the strong economic and corporate fundamentals that China has. Meanwhile, amid the volatility, we believe high quality names should find stronger price support. We are selectively adding more to the structural growth yet under-owned sectors that are trading at reasonable valuations, such as selected consumer related names. Indeed, moderate inflation is a positive sign that consumers are ready to spend.

We also hold on to other long-term themes such as research and development, consumption upgrade and policies related companies that can benefit over the long run.

[3] CEIC, Citi Research, as at 5 February 2018

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