China's A-shares Look Increasingly Attractive

Current headwinds providing opportunity for long-term investors.

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KEY INSIGHTS

- China's A-share market offers potentially attractive value as trade war concerns and slowing economic growth have weighed heavily on sentiment.
- It's not just valuations that are attractive: Fundamentals remain robust with demographics and household income providing a potentially better backdrop.
- The most interesting areas are within cyclical and trade-related sectors, where we are currently witnessing trough valuations.

China's A-shares are trading at near-historic lows for an economy that is still growing faster than most places around the world. Indiscriminate stock selling by local investors on the back of trade tensions with the U.S. have left China's A-share market looking attractive.

Despite trade tensions and a slowing economy, there is a positive case to be made for China's A-share market aside from valuations. Household income continues to grow 10% year-on-year and the government continues to hike minimum wages. Furthermore, due to demographics, there is a shortage of skilled blue-collar workers. Importantly, the income growth of the average household matters much more to corporate earnings than the GDP of the overall economy.

Low Valuations Bring Opportunities in Cyclical Sectors

The most interesting opportunities are in cyclical and trade-related sectors that have fallen sharply, and for which earnings expectations and valuations are very low:

- **China autos**—Automobile sales were down sharply in the second half of 2018, with negativity on these stocks as bad as it has ever been and valuations at their lowest point. However, it is important to bear in mind that auto penetration in China is still low compared with other countries in the rest of the Asia-Pacific region, indicating that the structural story remains intact. The industry has temporarily shifted from structural to cyclical growth, and potential policy easing may provide additional support to the sector.

> "After recent falls, there are some stocks trading at near-historic lows.
>
> — **Eric Moffett**
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1%

Current proposed trade tariffs would represent less than 1% of GDP growth.

- **China property**—Inventory levels are low and affordability outside the top few cities is very good, offering opportunities for high-quality property companies to gain market share. Property is an important engine of growth for the economy and has been quiet for a few years now. With government policymakers already easing policy in the sector, there are opportunities to be had.

- **Trade-related companies**—While the outlook for trade with the United States is muddy, the U.S. accounts for less than 20% of China's exports. We are mindful that net exports are not a big driver of economic growth in China, but export-related industries remain important employers. Given the depressed valuations that A-shares are trading at, we are of the view that much of the bad news has largely been priced in.

Encouragingly, an aggregation of all the proposed trade tariffs still represents less than 1% of GDP, and China's economy is still growing at around 6% annually. It's also important to bear in mind that the Chinese renminbi has depreciated by around 5% over the last year, which helps to offset the negative effects of trade tariffs. Importantly, we believe high-quality companies that can compound earnings in different cycles and through macroeconomic ups and downs can continue to perform well.

WHAT WE'RE WATCHING NEXT

A key factor to watch is China's unemployment rate, which remains low at under 4% as of the end of 2018. Back in 2009, there was a sharp uptick in Chinese companies telling their workers not to come back to the factories after Chinese New Year which alarmed government officials. Policymakers will be laser-focused on whether unemployment may become a problem in the months ahead given exporters' contribution to the labor market. So far we are not seeing a shift in employment figures but are carefully watching these for any sign of reversal.

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