China International
Fund Management

MARKET INSIGHTS

Voice of the Bund

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Client Portfolio Manager

Recent publication:

- IPO Reopens: Sprint before a Marathon - 2014/02
- A Year of Reform – 2014/01
- The End of the Blue? – 2013/12
- Reform 2.0 – 2013/11

Market Review

- Contrary to past "spring rallies" helped by abundant liquidity and little earnings pressure, CSI300 fell by 7.88% in 1Q 2014. CSI 300 was affected by lower than expected economic data, RMB depreciation and credit risk concerns. Market was further dampened by little new funds flowing into the equity market.
- **While quality growth stocks delivered outstanding performance last year, thematic and conceptual growth stocks garnered traction: online education, electrical vehicles, online travel agencies saw funds inflow YTD. As a result, software, technology and machinery were the winners for Q1, posting returns of 18.8%, 13.18% and 10.82% respectively.**
- **Mining, agriculture, and household appliance were the laggers, down by 12.79%, 11.48% and 11.96% respectively.**
- Unexpected weak growth in Q1 with a slowdown in manufacturing, retail sales and investment posted a question for the central government: how to achieve a balance between stability and transformation? On the positive side, favorable government policies were introduced such as preferred stocks, which are expected to support large caps in the short term and six measures to support the capital market. Previous restriction on financing for properties was lifted; some cities may selectively relax the home price restriction in order to support the local property market.
- Beijing-Tianjin-Hebei integration discussion has been initiated to relocate less important industries and diffuse population from Beijing to neighboring cities, to alleviate pollution and overcrowding problem, and boost competitiveness of the surrounding regions. This government action helped performance of the regional properties and related stocks.
- Economic slowdown and sufficient liquidity resulted in the bond market rally and yield curves steepened in 1Q.

Chaori debt default

- **On March 4th, Shanghai Chaori Solar Energy announced its inability to meet interest payments on its debt, marking China's first onshore corporate bond default. Unlike the local government debt crisis in 2011, we believe the impact of Chaori default is limited as the market had already priced in this event.** In the medium to long term, differentiation between credit loans will continue to diverge, pushing the debt market to further maturity. What investors should really focus on is the LDK MTN1 and Huarui 01 bond that are due with principle repayment at the end of this year. Default on principle has far more adverse impact on an issuer as it will damage its reputation and trigger redemption.

- Chaori default may trigger correction in the low grade corporate bonds. Low grade government bonds may experience some correction as a rippling effect, albeit with a much smaller magnitude. After a big rally last month, junk bonds have much time and room for correction from a technical standpoint. Some junk bonds may be under valuation pressure in the long term. Meanwhile, individual bonds without default risk will stand out as investment opportunities.

- We don't think this event will positively impact long duration bonds and local government financing vehicle. The former is driven by economic fundamentals and inflation, which have not seen any deterioration. Moreover, with continued supply and limited liquidity, high grade corporate bonds and local government financing vehicles are unlikely to continue their rally from Q1. We recommend investors to take a cautious position by reducing the duration of their portfolio and lowering leverage till the correctional period ends.

China's retirement communities

■China is experiencing a rapidly aging population. Senior citizens are expected to account for 1/3 of the population by 2050. Currently the retirement communities exist in permanent housing and temporary housing models. The former is mainly home-based service communities and house-for-pension schemes whereas the latter is vocational homes and resorts. The retirement community industry chain is made of the housing providers, consumers and capital providers, involving parties including the government, insurance companies, real estate developers, care providers and senior citizens. The government acts as an oversight body, regulating and guiding capital flow into the industry while the care taker, insurance companies and real estate developers develop retirement communities. Currently the profit is relatively low.

■As population aging accelerates in China, there is a lot of growth potential for retirement communities**. Currently, retirement communities do not have a defined profit model - cash flow for rental homes is inconsistent and after sales maintenance inadequate. A more defined profit model will act as a stimulant to retirement community growth.** We will continue to focus on supporting government policies as well as formation and innovation in the profit model.

Market outlook

- **Recent effort in stabilizing the economy,** such as SOE reforms, introduction of preferred stocks, government spending on railways, tax relief for small businesses, increasing financing to build low-income housing, restriction lifted for house purchase and MSCI's proposal to include China A shares in its index **have increased investors' appetite for blue chips. We expect the trend to continue as the economic growth is expected to moderate for March and detailed policies may be laid out to achieve 7.5% growth target for 2014.** In addition, IPO resumption will increase pressure to ChiNext and SME stocks. The key event to watch is the State Council's meeting in mid-Apr after the release of Mar economic data.
- **However, this appetite for the blue chips might be short-lived as the stimulus package will be a small one while interest-sensitive properties and banks stocks will be depressed by the elevated funding costs.** Moreover, as the economic transformation is expected to be the long term trend, the return on blue chips could be limited. In addition, massive trust loans are due in May-Jun, the credit risk concerns may negatively impact the broad market again.
- **The popular conceptual stocks for Q1 will face earnings test in Q2.** While the return boosted by speculation on themes could benefit investors in the short term, we believe alpha source exists in long term growth and fundamental earnings. The quality growth stocks valuations have dropped to attractive levels (low 20x) that the sell off could come to an end. With catalysts such as release of new products (iPhone 6, new drugs approval etc) and improving expectation of earning growth, these stocks should attract funds back.
- **On the one hand we remain cautious on growth stocks in the short term given pressures from the IPO resumption, credit risk concerns and downward earnings revision. On the other hand, we maintain our conviction in the following sectors in the long term: healthcare, oil and gas equipments, electrical vehicles, green energy, consumer electronics, and internet revived traditional industries.**
- **For the bonds we favor quality as credit concerns might widen the spreads**. The economy is likely to improve and the coupon will be the main source of return. We will closely monitor the monetary policy as it will not be certain.

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