Chinese equities

# Growth, debt and liquidity promise to capture the spotlight

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**Key takeaways**

- We expect China's policymakers to focus their efforts on near-term growth stability, with reforms taking a secondary role for now.
- Looking ahead, we expect growth to be stable and resilient, with consumption being the major contributor.
- China's debt problem will linger on, but we see no imminent risk to an economic blowout.

Looking ahead in 2017, the Invesco Equity Investment Team in Asia believes the focus of attention for the Chinese economy and equity markets will be on growth, debt and liquidity. We expect China's policymakers to focus their efforts on near-term growth stability, with reforms taking a secondary role for now. Consumption is expected to continue to be the growth driver. China's debt problem will linger on, but we see no imminent risk to an economic blowout. We are seeing a shift in loan activity from corporations to consumers, which we see as a positive development for the economy. Looking at liquidity, the existing Shanghai-Hong Kong Stock Connect and the recently launched Shenzhen-Hong Kong Stock Connect will continue to enhance market accessibility from both north- and southbound channels. In particular, we believe that global investors in offshore Chinese equities should benefit from the strong liquidity in the southbound route. In this piece, we will elaborate our views on these three topics.

**Growth: Stable and resilient, driven by consumption**

China's policymakers have two main objectives: maintaining decent economic growth and pursuing structural reforms. In 2017, we expect China will put greater emphasis on maintaining growth, with less priority on structural adjustments for now – such as reforms and debt reduction – given that growth is still the most important element for China's long-term stability.

We believe the government will enhance growth through targeted infrastructure spending, offsetting the slowdown in private investments. We also expect the government to remain generally accommodative in the property sector, given the significance of this sector to overall gross domestic product (GDP) growth. That said, property measures will be differentiated across the country – with selective tightening in cities that are perceived to be overheating, and supportive polices in less affluent and overbuilt cities.

Looking ahead, we expect growth to be stable and resilient, with consumption being the major contributor. We expect retail sales in China to maintain an annual growth rate of about 10%,[1] supported by resilient wage growth. Disposable income per capita for the urban population grew in the range of 8% to 13% year-on-year[2] over the past year, and we expect this trend to continue. Also, we believe the consumption sector should continue to benefit from the rising demand in services. Ranging from hospitality, retail, financial services, health care, education and information technology services, the services sector should be a key source of growth looking ahead, in our view.

**Debt: No imminent risk, but it will take time to resolve**

We will continue to monitor China's debt condition closely. The overall debt is now 255% of GDP, compared to 150% 10 years ago.[3] The surge was driven by excess gearing, or leverage, following the aggressive stimulus program in 2008. While we acknowledge that the overall gearing level is high, we do not believe there is an imminent risk of a short-term crisis, based on three reasons:

- China's debt is mostly locally funded. This eliminates currency mismatches and systematic risks that could potentially be linked to foreign debts.
- Government and household debt remains low. Total government debt currently stands at about 45%. We estimate central government debt to be less than 20% of GDP – a comfortable level compared to major developed economies. Household-debt-to-GDP remains low at 40%, much lower than the 70% to 90% levels recorded in major economies.[4]
- The government has the balance sheet strength from the "asset side" to support the troubled-corporate industries through its vast holdings in quality assets, its ownership in listed companies and its flexibility to gear up if needed. We estimate state-owned enterprises (SOEs) represent around 50% of total A-shares and have a combined market cap of around RMB25 trillion (about US$3.7 trillion).

One positive development in the banking sector is the increasing penetration in household loans and the slowdown in corporate lending. Similar to the deleveraging process in an economy, rising consumer credit demand can help spur the economy while allowing time for troubled corporates to undergo restructuring and deleveraging. Also, household loans, particularly mortgages (backed with a house as collateral), have lower default risk than that of the

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corporates, and thus are considered better-quality loans. Over time, the banking sector's loan book quality should gradually improve as the consumer loans rise, in our view.

**Strong liquidity and market support for offshore Chinese equities**

The Shanghai-Hong Kong Stock Connect program[5] has opened up accessibility between onshore and offshore Chinese equity markets, without the need for QDII/QFII/RQFII[6] quotas. The commencement of the Shenzhen-Hong Kong Stock Connect will complete the system, and both programs will allow two-way investments between onshore and offshore markets covering the majority of stocks listed on the Shanghai, Shenzhen and Hong Kong exchanges. In our view, this is an innovative approach that promotes higher market accessibility between the two markets but without losing control over capital flows.

The potential benefit for global investors from the increase in market accessibility via the Stock Connects is twofold:

- First, global investors in offshore Chinese equities should benefit from the abundant liquidity in the southbound route, which should also support the market. In the past weeks, more than 50% of the southbound daily quota was used, and close to 20%[7] of Hong Kong daily turnover was reached at peaks. In particular, the liquidity was attributed to the mainland flows, where mainland China investors' accounts increased from 11% to 22% over the three years ending Dec. 31, 2015.[8] Looking ahead, the expectation for renminbi weakness, generally cheaper relative valuations in H-shares[9] compared to A-shares, and higher dividend yields may be reasons for mainland investors to consider diversifying their exposure into offshore Chinese equities.
- Second, global investors can take advantage of the easy access to the onshore A-shares market via the northbound route. Both Shanghai and Shenzhen Connects will collectively cover 92% of the MSCI A-shares index by stocks or 97% by market cap.[10] This is a significant development. Without the restrictive QFII quotas or reliance on A-share ETFs, investors can now have direct access to the onshore markets to invest in specific A-share stocks.

**Conclusion**

In 2017, growth, debt and liquidity will be in the spotlight for the Chinese economy and markets. While we closely monitor the macro developments in China, our focus is on stock-specific fundamentals. As active, bottom-up investors, we adopt a selective approach to investing in companies with sustainable leadership and competitive advantages. Companies we select for our portfolios share a number of common, qualitative features — superior business models, competitive products or services, solid corporate governance with clear ownership structures, as well as transparency and corporate access.

1 Sources: CLSA, NBS, August 2016
2 Sources: CLSA, NBS, August 2016; quarterly year-over-year growth rate
3 Sources: Bank for International Settlements and Invesco, September 2016. Data as at first-quarter 2016
4 Source: JPMorgan, September 2016
5 Launched in November 2014, the Shanghai-Hong Kong Stock Connect is a securities trading and clearing links program that allows both international and domestic investors to make cross-border stock purchases between the Shanghai and Hong Kong stock markets.
6 QDII stands for Qualified Domestic Institutional Investor. This scheme permits registered Chinese financial institutions to invest a limited quota of funds in foreign financial assets, including offshore-listed Chinese equities. On the other hand, global investors can access China A-shares through the QFII (Qualified Foreign Institutional Investor) and RQFII (RMB Qualified Foreign Institutional Investor) schemes. However these schemes are available only to institutional investors who can fulfill capital and asset size requirements. Detailed submissions and pre-approvals are needed for the mentioned schemes.
7 Sources: Goldman Sachs Research, HKEX, Invesco, as at September 2016
8 From 2012 to 2015. Source: HK Stock Exchange Factbook 2015
9 "H-shares" refers to mainland Chinese companies listed on Hong Kong Stock Exchange. As at Nov 1, 2016, H-shares are trading at a discount to A-shares for the dual-listed Chinese companies.
10 Source: MSCI, FactSet Research Systems, Inc., Bloomberg L.P., Invesco, as at September 2016