# Talking Points

## Despite China's market volatity, no change to our structural view

**8 January 2016**

**Market recap**

Along with global markets, offshore Chinese equities (MSCI China Index) were shaken up by developments in mainland China, losing -8.8% in the first four trading days of the year. The mainland China A-shares (CSI 300 index) corrected -13% in the same period.

**Circuit breaker and its prompt suspension**

The recent market volatility could be explained by a few reasons. The new circuit breaking mechanism being triggered was the most apparent one, where trading was halted for the entire day after a +/-7% move in the CSI300 index. During the first week of January[1], a-7% move triggered the circuit breaker twice.

In our view, the circuit breaker mechanism was not introduced at the right time – as global markets were already volatile after the Fed's rate hike in December. This is an example of 'unintended consequence' of Chinese government action. As with many young markets with a large retail presence (over 85%), A-shares markets are often more driven by sentiment than underlying fundamentals. Together with the painful experience from China A-share market volatility during the summer of 2015, mainland investors panicked with the aim to sell their stock holdings before getting trapped -- when the circuit breaker was triggered. Subsequently, the suspension of the circuit breaker took place on 7January 2016, and was in our view, a prompt and appropriate decision. It is evident the Chinese government is still learning from experiences how to best build a more stable, healthier stock market going forward.

**Renminbi depreciation – more reflective of market forces**

Another contributor to the market volatility was increased concern on the pace of renminbi (RMB) depreciation. The RMB already lost -1.5% versus the US dollar since the beginning of the year as of 7 January. Since the inclusion of RMB into its basket of Special Drawing Rights (SDR) currencies on 30 Nov 2015, the Chinese government allowed the currency to depreciate more rapidly. Yet, the Chinese government may have further room for improvement on the execution where it may have underestimated the market reaction to the move. In any case, we believe the depreciation of RMB makes sense given the intention is to liberalize the currency to better reflect market forces going forward.

**No change to our structural views on China**

In our view, it is sensible to see market volatility from time to time, as China is rebalancing its economy to a 'new normal' and more sustainable long-term growth. Rather than focusing on short-term market developments, we believe in taking a long-term approach to investing in China. The transition will take time, leading to bumpy rides at times. That said, despite the recent market volatility, there is essentially no change to our structural views on China. Looking ahead, we believe China is heading in the right direction while seesawing between growth and reform. China's transition will unfold with a greater role for consumption, with further structural reforms being carried out in parallel.

**H-shares in a better position**

With the equity market trading in mainland bourses mainly made up of retail investors, who can be very momentum driven, it is not surprising to see volatile market swings for China A-shares. In contrast, offshore Chinese equities are less volatile given the higher percentage of institutional and international investors who seek to tap into Chinese equities via H-shares. In our view, H-shares are much better positioned than A-shares with more attractive valuations (10x 12 month forward PE) and a more diversified investor base. In terms of our investment strategy, through bottom-up stock selection, we continue to seek companies with industry leadership and competitive advantages. In fact, we would see periods of market volatility as presenting great opportunities to accumulate quality stocks at even more attractive valuations.

[1] January 4 and 7, 2016

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