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Tightening fears give rise to China 'buy' opportunities

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Although the Chinese market rallied by about 60 per cent in 2009, it lagged behind the stronger performances of the other big emerging markets such as Brazil (121 per cent), Russia (100 per cent) and India (101 per cent).

As such, the Chinese market offers further upside potential and could catch up with the gains of the other markets this year. Trading at about 13.5 times forecast 2010 earnings, projected to grow by about 20 per cent, the valuation of H shares (Chinese companies listed in Hong Kong) or red chips (Chinese companies incorporated outside the mainland but listed in Hong Kong) remains attractive.

This valuation is supported by China's robust economic recovery in 2009. Third-quarter gross domestic product grew 8.9 per cent from a year earlier while exports rebounded by a much stronger-than-expected 17.7 per cent in December after 13 months of decline, providing a solid backdrop for ongoing strong performance of the Chinese economy. We forecast at least 8 per cent GDP growth in 2010.

Consumption is likely to be the main theme again in 2010. The government has extended some stimulus measures, such as the reduction on tax for vehicles with engines of 1.6 litres or less. Beijing has also extended the 10 per cent subsidy on the scheme to trade in old appliances for new in both rural and urban areas. We believe that these schemes will continue to drive robust growth in domestic consumption. Last year, China achieved roughly 15 per cent retail sales growth and we think this will continue this year.

We also believe that export-related sectors will continue to be strong in 2010. After weathering a tough year in 2009, manufacturers that have survived have become leaner and gained market share from those that have closed, and therefore should improve their margins in 2010.

In terms of infrastructure spending, the government will maintain the size of existing projects but will scale back new ones to adjust investment as economic recovery has been stronger than expected.

China's record Rmb9,210bn ($1,349bn) in lending in the first 11 months of 2009 and the Rmb4,000bn stimulus package drove an economic rebound following the global financial crisis. With exports returning to positive territory in December following a fall of about 16 per cent in 2009, we think it is logical for Beijing to reduce gradually the amount of stimulus to pre-empt the risk of overheating and were not surprised when, on January 12, the government raised the banks' reserve requirement ratio (RRR) by 0.5 per cent to 16 per cent. As China is recovering much faster than anticipated, the latest adjustment in the RRR signalled that authorities are confident to start the process of fine tuning stimulus measures.

Steps are also being taken to reform and develop China's capital markets, which have grown tremendously over the past 10 years. The launch of stock index futures, margin financing and short selling of mainland-listed A shares which had been delayed by about three years due to market volatility and system trials, has now been approved. This will give investors more trading tools and flexibility by allowing long-short, event-driven and other forms of market-neutral strategies. The introduction of the short-selling mechanism will pave the way for the smooth launch of index futures and other equity derivatives such as warrants and options.

The first stock index futures, based on China's CSI 300 index, which tracks the 300 biggest stocks traded in Shanghai and Shenzhen, could begin trading in three months following the completion of preparations, such as structure, pricing and margin requirements. Short-selling and index futures are intended initially to help institutional investors better manage their portfolios rather than for retail participation due to the relatively high risk of these instruments. According to the initial rules, the minimum investment requirement has been set at a relatively high level of Rmb500,000.

Over the longer term, we could see a gradual narrowing in the premium of A shares over H shares as qualified domestic institutional investors (QDII), domestic institutional investors authorised by the government to invest in overseas capital markets under the foreign exchange control system, may begin to short sell A shares and go long H shares. A shares are trading at a premium of about 37 per cent over H shares. In October 2009, the State Administration for Foreign Exchange (Safe) resumed approval of QDII quotas after a 17-month moratorium. The approval of more QDII quotas should drive market liquidity and help reduce the valuation gap between A and H shares.

The stock market's initial reaction to the increase in the RRR was negative as investors feared a start to interest rate hikes. We believe, however, that this is an opportunity to buy quality stocks on weakness.

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