
China Equity Strategies Review- Third Quarter 2013

Market over view

As we expected in the second quarter review, the equity market momentum started to turn positive as the inventory situation started to improve and enhancing free cash flow situation (less manufacturing capex); the financial system risk concerns were reduced and very importantly, as the valuation on stocks were getting more attractive. Both A and H shares markets have had a strong performance during the third quarter.

The economy was stabilizing in third quarter; we are closely monitoring the sustainability. PMI improved sequentially to 51.1 in Sept from 51 in Aug (50.1 in June to 50.3 in July). Industrial profit also showed the similar trend and grew by 10.4% yoy in Aug (9.7% yoy in July and 8.9% yoy in June). Machinery utilization growth turned positive in third quarter. Corporate earnings improved with total earnings of overseas-listed Chinese companies grew 13% yoy in first half, up from 2% in 2012 as a whole. Total earnings of A share companies grew 11.4% in first half (up from 5% in 2012). We expect the momentum to continue in Q3, which will be verified soon after Q3 results announce in Oct. Most importantly, decreasing capex helped free cash flow of companies to stabilize.

Portfolio positioning

We did not invest in the banking sector in second quarter due to our concerns on their balance sheet quality and potential risks on the off balance sheet liabilities. The sector was one of the worst performers during first half of the year. However, after the sector price has been largely corrected, we believe the valuation has factored in most of the negatives and concerns. In July, we gradually accumulated banks that are better managed and could possibly be the long term winner during the financial reforms.

Healthcare sector underperformed during the quarter caused by the anti-bribery campaign which would temporarily slow down the topline growth and anticipated drug price cut which would further squeeze out margin. In long term, we still keep bullish on healthcare sector, and the current pressure on share price gave us opportunity to accumulate high quality healthcare names with strong R&D capabilities and new product pipeline in promising sub-segment.

Our view remains intact on the Chinese economy having structural issues after high growth in the past 20 plus years. Low end manufacturing is facing multi-dimension squeeze. The capital misallocation and duration mismatch of financial assets are causing explosive growth of off balance sheet items and “the state advances and private companies retreat”. Reform is needed in the area of taxation, rural land, finance system, administration and income redistribution. We foresee plenty of opportunities emerging in quality life, smart world, high efficiency and green China. As a result, the fund is over weighted in consumer, transportation (logistics related), information technology, selective industrials (environmental protection, telecom equipment, agriculture machinery, railway machinery and automation) and health care; we still less like the financials, properties, energy and materials. The short coming of this portfolio lies in the risk that monopoly sectors such as energy, telecom services and banks outperform in the near future. However, we believe that in a one to three year time window, the stronger bet lies in the midcap companies outperforming the index by a bigger margin.

Chinese Economy out look

The economy has shown signs of stabilizing during third quarter; the improvement we have seen in PMI, industrial profit growth, the inventory levels in many industries, machinery utilization ratio are positive indications to tell that the worst is over in the near term. The activates including decreasing in capex that helps free cash flow improvement, active M&A, distressed assets auctions, tightening liquidity are all positives in helping the economy to build a bottom. We are closely monitoring the sustainability of these positive signs.

Our investment themes are the same. We stay with quality companies with attractive valuations.

The State Council has approved Shanghai Free Trade Zone, which we view as version 2.0 Economy free trade zone. This is a pilot program for future economic and social reform, which is fairly important and essential for China to go through economy structural changes successfully. Like any other reforms, this may not be a very smooth one either. Although the new China leadership is confronting lots of challenges to establish and execute this new pilot program, we see it as long term positive.