China: Preparing for a Turnaround in Coming Quarters

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In recent weeks, stock markets in Asia have attempted to find a bottom as investors begin to price-in the probability of additional interest rate reductions from the People's Bank of China (PBoC) at upcoming monetary policy meetings. The benchmark Shanghai Composite Index (SHCOMP) is currently trading at its monthly highs but, from a regional perspective, some attractive opportunities still exist with the SHCOMP showing declines of 11 percent from the 2012 highs that were posted on March 2nd.

Thus far, rate cuts from the PBoC have done little to inspire markets, with the SHCOMP currently valued at 9.7 times projected earnings, significantly below the 17.5 average that has been seen since 2006.

But investor activity is suggesting that a bottom could be near after widespread speculation has suggested that the latest Chinese economic data will force the PBoC to stimulate growth activity by easing monetary conditions even further at their next policy meetings.

Economic Data Seen Having Counter-Intuitive Effect

Looking at the Chinese macro data, market bias began to shift once second quarter GDP figures showed a rise of 7.6 percent (on a yearly basis), which was a sharp drop from the 8.1 percent increase that was seen previously and the sixth consecutive quarterly decline in national growth. In addition to this, Industrial Production and Retail Sales figures showed slowing momentum for the month of June, indicating that global factors are having an impact on all major aspects of the Chinese economy. "One needs to be realistic about the long-term growth prospects of China and the rest of Asia," says Khiem Do, Head of Asian Multi-Asset Investments at Baring Asset Management in Hong Kong. "It would be unrealistic for anyone to believe or expect that the Chinese economy can continue to grow at a rate above 9%. The next 5-10 years' GDP growth of China is more likely to be in the range of 6.5-8.5%."

Surprisingly, however, the latest weakness in economic data (and in Chinese corporate earnings) has actually turned out to be a positive for stock prices. Recent trends are showing that investors have started to buy-in at lower levels, anticipating that government stimulus moves aimed at boosting economic growth will lead to a positive reversal in investor sentiment. Clearly investors have begun looking for undervalued stocks and sectors in order to build

new positions into the end of the year: "Currently, the cheapest stocks and sectors are those which are global trade sensitive, or related to global financials," explains Do who also manages The Asia Pacific Fund. "We are looking for potentially positive catalysts and to take advantage of stocks that are currently undervalued."

Potential Policy Strategies

Determining the strength of the coming moves in Chinese and Asian stock prices will depend heavily on course of action that the PBoC decides to implement. Since we have already seen direct cuts in interest rates this year, there is an increasing possibility that we will see a policy strategy that is directed more toward reductions in the Reserve Ratio Requirement (RRR) for private banks and a greater focus on encouragement in corporate lending.

Evidence of central bank policy easing is already becoming visible, as bank lending has so far showed substantial increases in July with China's four largest banks completing new loans equal to 50 billion Yuan (roughly doubling the figures seen in the first half of June). Most industry analysts are expecting these trends to continue given that China has a great deal of room to make monetary policy more accomodative and to increase fiscal spending in support of economic growth. "The PBoC's cuts in interest rates and the RRR have helped stabilize the offshore-listed Chinese equity market after its significant fall seen during the past 15 months," explains Do. "This monetary easing is likely to assist the private sector in accessing bank lending and supporting first-time property buyers in China."

Effects of Previous Rate Cuts

Last year's inflationary problems in China are now seen as being under control by most of the commonly used measures (currently at the lowest levels since the summer of 2010), and this has allowed the PBoC to change directions in its rate cycle during the year. Interest rates were lowered by 31 basis points at the PBoC's latest policy meeting and with consumer inflation seeing a sharp drop in June (rising only 2.2% after the 3% rise seen in May), there continues to be scope for additional rate cuts. Success in previous policy moves can be seen in the strength of China's trade surplus, so policymakers are likely to build on this in order to improve national growth figures as a whole.

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Previously, widespread market concerns came mostly from risks of a possible "hard landing" and the potentially negative effects that this would have on global growth prospects for the remainder of the year. But as interest rate cuts filter into economic data, these concerns will continue to dissipate as China is

able to resume its position as a key driver of global growth. Long term demographic trends in Asia largely remain as a supportive factor: "The balance sheets of Asian governments are relatively healthy, and this is also seen in China's banking systems, household and corporate balance sheets," Do says. "Continuing modernization and urbanization trends will allow China to meet most of its funding needs through internal economic measures."

Thus far, the primary evidence of improvement can be seen in the Trade Balance (where both imports and exports hit new records last month) and industrial output numbers which signal that the previous downtrend in manufacturing is coming to an end. Retail Sales growth is still seen at a healthy 13.8%, and all of these figures suggest that recessionary conditions in many European countries are having only a limited impact on Chinese factory activity. It also suggests that since a quickly growing percentage of GDP is generated by domestic consumer spending, China will be less heavily impacted by external financial shocks going forward.

Changes in Leadership

In addition to lower consumer pricing pressures, analyst opinions arguing for additional economic stimulus are being supported by the fact that Chinese officials generally attempt to keep growth at healthy levels before major changes in leadership. Since the next presidential regime change is scheduled for later this year, we are likely to see renewed waves of government spending in infrastructure and increased business investments in factory projects. Investment levels are likely to remain high until the new leadership is in place at the beginning of 2013, so the latest rally in Asian stock markets looks set to continue in the coming quarters.

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Identifying Investment Opportunities in Asia

Given the strong probability that stock prices are likely to remain supported in Asia throughout the remainder of the year, medium to long term investors will be looking for find opportunities to capitalize on the positive momentum. Three choices that stand out can be seen in the Asia Pacific Fund (APB), the Greater China Fund (GCH), and the Aberdeen Asia-Pacific Income Fund (FAX). All of these closed-end funds offer a diversified collection of stocks that are actively managed and well-positioned for the market trends that are likely to be seen into the close of this year and since each fund is focused on investing in different areas of the economy, we will take a look at the benefits of each so that investors can choose the most appropriate investment option.

The Asia Pacific Fund

The Asia Pacific Fund had a strong month in June, with the Fund's NAV showing gains and outperforming its benchmark index. Most of these gains came from stock selection rather than sector focus, as the Fund was not heavily exposed to Utility and Telecom companies (the best performing sectors in June). With the Fund looking to take a protective stance to shield against the long-term macro concerns in Europe, the US and China, the Fund looks to invest in quality assets and to invest in companies that are unlikely to show vulnerability in corporate earnings results for the second half of the year.

With earnings downgrades

in coming months becoming increasingly likely in some sectors (such as Industrial and Raw Materials), the Fund is defensively positioned to benefit from new policy developments in Europe and China, which will likely encourage consumer activity in export markets and keep stock prices supported.

The Greater China Fund

As Chinese stocks closed higher for the month of June, areas of weakness were still seen in some sectors. But exposure in the Greater China Fund to Health Care, Energy and Consumer Staples helped to balance the losses that came from holdings in the Materials sector. The Fund's strong monthly performance was also aided by profits that were taken on property investments that had reached valuation targets.

Some of the latest additions to the Fund have included investment banks, as the sector has seen significant drops in valuations, and the focus remains in fixed asset investment companies (such as railway construction companies and building materials producers). Companies in the consumer sector are expected to see strong earnings performances relative to their counterparts, as the sector is likely to benefit from stable demand and the pro-consumption policies that are being implemented by the Chinese government.

In the current market environment, there are companies in these sector areas that have experienced valuation pullbacks in recent months yet are still positioned to deliver sustainable growth into the end of the year. The risk of a "hard landing" in China has decreased with the Chinese government's plans to launch another sizable round of Fixed Asset Investment (FIA), and this will likely ease some of the market concerns for the Asian region as a whole. Valuations for Chinese equities are now seen at a trough in their historical ranges as investors have priced-in global uncertainties and pessimistic GDP forecasts, and the Greater China Fund is now using excess cash reserves to build positions in companies with good growth prospects and strong balance sheets that are likely to bring sustainable returns over the longer term.

The Aberdeen Asia-Pacific Income Fund

With risk aversion and volatility reaching elevated levels during the month of May most of the market's attention was clearly centered on the deterioration in global market data, uncertainty surrounding Greece's position in the Eurozone, and significant stresses being place in the banking system in Spain. Economic weakness was displayed in Asian stock values as it became

more evident that stagnation in both Europe and the U.S. Would weigh on external demand for Asian exports. In addition to this, elevated inflation levels (despite declines in oil and other commodities) made it more difficult for central banks to enact measures to stimulate growth.

But sentiment recovered in June as financial markets expressed optimism after structural developments in Europe were viewed with credibility. Loans of up to €100 billion (roughly US$121.8 billion) were set aside for Spain's banks and a pro-bailout government was elected in Greece, helping stock markets in these areas to reverse off of their lows for the year. These events came along with China's first interest rate decrease since 2008 and reductions in the one-year lending/deposit rates (which was a positive surprise for stock markets).

With these factors in mind, the Aberdeen Asia-Pacific Income Fund is positioning its exposure levels to account for the potential effects of additional interest rate cuts and reduced restrictions on lending by commercial banks, as policymakers continue to stimulate stalling credit growth and boost the sluggish economy. While potential risks still exist (lackluster demand from Europe and the US) it remains clear that China as the flexibility to enact further easing measures, given the weak inflation forecasts and solid fiscal positioning.

Onward...

Given that the major macro risks in Asian and global equity markets are expected to continue to be sourced in Europe and the US and asset performance in Asian markets will continue to be dictated by the direction of the region's global counterparts. But with recent policy moves by the PBoC (and other major Asian central banks) to loosen credit access and stimulate domestic growth, markets have started to reverse this year's downtrend. Additional policy measures by the PBoC will likely ensure that Asian markets have seen their lows for the year and such funds as The Asia Pacific Fund, The Greater China Fund and the Aberdeen Asia-Pacific Income Fund have begun to position portfolio allocations to reflect these changes.

While each of these funds maintains a defensive stance for the short-term, these positions are gradually being adjusted to reflect the long-term view that Asian equity markets will resume their previous uptrends once the European debt crisis is properly resolved, and Western economies fall back into their natural economic growth profiles.

With most analysts suggesting that this is likely to be seen in the next twelve months, Chinese markets (and Asian markets as a whole) are set for a positive performance in the coming quarters. "At the end of the day, the implementation of credible policies in Europe and the US in fixing debt and growth problems will ultimately give investors in Asia a greater level of confidence," explains Do. "Once this is seen, markets will gain assurance that the global trade between China/Asia and the rest of the world can grow at a healthy rate once again." ■