China’s stock market was a roller coaster in 2012, and those investors with a weak stomach for unpredictability probably found the ride unpleasant. It's true that by many measures last year’s weak market performance in China’s A share market was disappointing, but in a market of this size the story isn’t all good or all bad, so unlike the market masses, I remain confident about China’s prospects and continue to search for long-term investment opportunities in China. As the late Sir John Templeton famously said, “The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.”

For instance, from my team's value perspective, China's local equity market appears relatively cheap at the moment with the Shanghai A shares average price/earnings ratio at 12 times, as of mid-January 2013.1 Equity valuations overall are currently not much above their 2008 lows, although we believe earnings downgrades may have peaked.

Retail Investors Swing the Market

In the early part of the past decade, China’s local equity market charted a bullish course. The Shanghai Composite Index (of A and B shares listed on the Shanghai Stock Exchange) rose from about 1,000 in 2005 to above 6,000 in October 2007. It then crashed, taking many local investors with it. The market was then able to regain some lost ground, but in December 2012, it fell back to a four-year low, and the index stood just above 2,300 as of mid-January. Retail (individual) investor participation accounts for about 80% of the Shanghai and Shenzhen A share markets. That being the case, retail investor sentiment is a driving force behind market fluctuations. (For more information on the different equity markets in China, read my previous post, “The ABCs of China's Share Markets.”)

The Power of Policy

Sentiment toward China’s local market seems to have improved a bit recently. Guo Shuqing, chairman of the China Securities Regulatory Commission, seemed to aid the market in early 2013 as he suggested a possible expansion of foreign participation in China’s local equity markets. China’s local stock markets are subject to tight capital controls, making them largely inaccessible to foreign investors. A more open, transparent and equitable playing field would be a welcome development.

In the past, though, policy measures have largely been the catalyst for a surge in Chinese stocks. More than 90% of the population reads the same news reports, so major policy announcements and reform programs can trigger large emotional market reactions. I believe Chinese investors will probably start moving into the market in greater numbers as they see reform policies implemented at the local level. Overseas investors in the B-Share and Hong Kong H and Red Chip markets seem to have been more easily moved, since money has been pouring into emerging markets equity products. Global inflows into emerging markets funds surpassed US$50 billion in 2012.1 We have thus seen overseas listed Chinese stocks generally outperform the local Chinese (A-share) equity market last year. Of course, past performance is not indicative of future results.

Upwardly Mobile

It’s our expectation that, as disposable income increases for China’s middle class, more personal assets could be funneled into savings and investments. Many consumers in China have been benefitting from annual increases in wages of 20% or more. In addition, urbanization is continuing apace, with the government devoting more resources to infrastructure and subsidized housing as well as extending social security, education and health benefits to new migrants to the cities.

Challenges of China’s New Leaders

It looks like a new generation of Communist leaders is steering the country toward continued potential for growth and dramatic reform. Xi Jinping and Li Keqiang will officially take over the reins as China’s next president and premier in March 2013. They both face a time of big changes and challenges, including some intense political rivalries. Mr. Xi and the
incoming leaders will have to contend with the continuing influence of party elders. The retired and standing committee members will likely want a say in major decisions.

Mr. Xi represents a generation of heirs to the revolution who now need to prove that they have the integrity to lead the nation without corruption and abuse, and move China toward greater openness in both the economic and political spheres. An anti-corruption campaign recently went into full swing, and it seems likely that in some regions, government officials will be required to declare their asset holdings within the next one to two years. Mr. Xi has made his position clear; at the Party Congress in November he said bluntly: “We have every reason to be proud — proud, but not complacent… Inside the party, there are many problems that need be addressed, especially the problems among party members and officials of corruption and taking bribes, being out of touch with the people, undue emphasis on formalities and bureaucracy, and other issues.”

Mr. Xi seems to be laying out a strong reform program with specific timetables and goals versus the piecemeal approach of “crossing the river by feeling the stones” which former party leader Deng Xiaoping had advocated decades ago.

The new leaders also aim to increase efficiency of decision making. The implementation of China’s 12th Five-Year Plan (released in 2011) should also encourage businesses, calling for a rebalancing of China’s economic growth toward domestic consumption and reforming the financial and social welfare systems. The new leaders should have lots of leeway on interest rates to help fuel the economy. Between 2010 and 2011, interest rates in China increased five times and are now at a 6% lending rate. This means that the leadership has a lot of room to reduce rates if they need to stimulate the economy, since most major nations around the world have much lower rates.

While many investors often see volatility as a bad thing, there’s one thing it does bring—opportunity. This year is likely to bring some challenges for China, and volatility too. But as we see it today, my team and I think the outlook for China’s stock market under its new leaders looks bright, and plan to go along for the ride.

1. Source: Bloomberg LLC.
2. Source: EPFR Global.

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