WHAT I LEARNED THIS WEEK

Excerpt from August 31, 2017

4 China deserves a “stability premium” for its strong leadership. A buy signal for China’s stock brokers?

Last Friday, the **Shanghai Composite Index** (SHCOMP Index, CNY 3,361) closed above the critical 3,300 level for the first time since the index’s major crash in January 2016, when it lost 23% of its value in a single month. Moreover, the **Hang Seng China Enterprises Index** (HSCEI Index, 11,295) closed last Friday at its highest level since August 2015, while our favorite value-style/large-cap index, **the Shanghai Stock Exchange SSE 50 A Share Index** (SSE50 Index, CNY 2,715) closed at its highest level in 25 months. Finally, the broad-based **Shanghai Shenzhen CSI 300 Index** (SHSZ300, CNY 3,822) closed at its highest level since December 2015, and two trading days later, the Chinese yuan broke above the 6.60 (yuan per USD) level to close at 6.5968, a 14-month high.

In *WILTW* November 12, 2015, as we prepared our readers to take profits on Chinese shares, we saw the potential for a long-lasting bull market to emerge from the intensifying uncertainty of that period. We wrote then, as follows: “**When global investors come to the realization that China will be one of the few places capable of generating 6%-plus growth rates, global capital is likely to concentrate in China, driving-up prices of Chinese equities. This could very well set the stage for an epic bull market, eventually capable of exceeding the SHCOMP’s all-time high of 6,124 in late 2007.** We will be watching for an opportunity to re-enter Chinese stocks in a major way over the coming 12 to 18 months. Please stay tuned…”

Since we turned bullish on the Chinese economy a year ago, in *WILTW* August 18, 2016, **it is now time to turn bullish on the broader Chinese equity market, because a rising tide will lift all boats.** The Chinese equity-market backdrop is much more favorable now than it was at yearend 2015, for the following reasons:

- China's GDP grew 6.9% year-over-year during the first half of 2017, and **if current trends hold throughout the second half, it would mark the first full-year acceleration in GDP growth since 2010.** Moreover, the structure of Chinese economy is now much more balanced than a few years ago: **Domestic consumption contributed 63.4% to overall GDP growth during the first half of 2017, the highest level we can recall,** while the service sector drove 59.1% of overall GDP growth.

- Industrial profits have been rising along with strengthening demand for materials, implying that **the largest industrial companies are now in better financial shape than they were a few quarters ago**. Meanwhile, inflation has remained at comfortable levels, indicating little impetus for monetary authorities to tighten policy, at least for now.

  Stephen Roach, former Chairman of Morgan Stanley Asia and senior fellow at Yale University's Jackson Institute of Global Affairs, recently wrote a column for *Project Syndicate*, which we excerpt, as follows:

  "The latest bout of pessimism over the Chinese economy has focused on the twin headwinds of deleveraging and a related tightening of the property market–in essence, a Japanese-like stagnation. Once more, the Western lens is out of focus. Like Japan, China is a high-saving economy that owes its mounting debt largely to itself. Yet, if anything, China has more of a cushion than Japan to avoid sustainability problems…China's national savings is likely to hit 45% of GDP in 2017, well above Japan's 28% saving rate. **Just as Japan, with its gross government debt at 239% of GDP, has been able to sidestep a sovereign debt crisis, China, with its far larger saving cushion and much smaller sovereign debt burden (49% of GDP), is in much better shape to avoid such an implosion.**"

- **Foreign exchange reserves reached $3.08 trillion at the end of July, up $24 billion from June and the sixth-consecutive monthly gain**. As we noted in *WILTW* August 3, 2017, private fixed-asset investment (FAI) has begun to accelerate, rising 7.2% year-over-year in the first half, compared to 3.2% year-over-year growth in 1H2016. Furthermore, the inventory of unsold new homes in the 80 largest cities fell to 402 million square meters at the end of July, **the lowest level in four years.**

- Retail sales growth registered 10.4% year-over-year during this year's first half, more than triple the rate of retail sales growth in the U.S. during that time. According to Andy Rothman, an investment strategist at Matthews Asia: "[W]hile spending by Chinese consumers was equal to only 22% of U.S. retail sales a decade ago, it was equal to 87% of American consumer spending last year and is likely to surpass U.S. retail spending by the end of the decade."

- **August's Purchasing Managers Index (PMI) was just reported at 51.7, 0.3 higher than July's reading of 51.4.** This is one more indication that the Chinese economic expansion that began in 2H2016 remains on course.

Politically speaking, **China's leadership is much more unified now after President Xi's first five-year term**, during which he fought a major battle against corruption within the communist party, the government, and the army. It appears that President Xi was able to obtain endorsements from most groups within the Communist Party apparatus in advance of the 19th Party Congress, to be held in Beijing this autumn, enabling him to further consolidate power.

In a world where most political leaders are beholden to populist themes, and U.S. withdrawal has given way to a multi-polar world, having strong leadership and a clear national strategy is more important than ever, and thus deserves a valuation premium. However, Chinese stocks remain attractively-valued, with average P/E ratios of 12x for the SSE 50 Index and 15x for CSI 300 Index—far from bubble territory.

Over the past year, we have recommend dozens of cyclical Chinese SOEs, as well as the best-managed major Chinese banks, and most of them have rewarded investors very well. **If momentum in Chinese stocks continues to improve, as we believe, investors will likely direct their attention to the country's major stock brokers, whose share prices tend to be highly sensitive to market sentiment.**

Case in point: this past Monday, following the SHCOMP's Friday breakout, most brokerage stocks saw their daily trading volume expand five-fold from their average daily levels. Given the volatile swings in trading volume, **the best strategy to employ with these shares is to wait patiently for market corrections to buy or build positions.** Our favorite Chinese brokerage companies include:

- **CITIC Securities** (600030 CH, CNY 18.23; 6030 HK, HKD 17.36), which carries an annual dividend yield of 1.9%;

- **Haitong Securities** (600837 CH, CNY 15.29; 6837 HK, HKD 13.12), which carries an annual dividend yield of 1.5%; and

- **Guotai Junan Securities** (601211 CH, CNY 21.58; 2611 HK, HKD 17.10), which carries an annual dividend yield of 1.8%.

The overseas listed subsidiaries of these large Chinese brokers are also well positioned to benefit from the bull market in Hong Kong and its spillover effect on the mainland Chinese markets, due to the stock exchange "connect programs" established between the Hong Kong and mainland exchanges over the past two years. These include:

- **Haitong International Securities** (665 HK, HKD 4.61), which carries an annual yield of 3.9%; and

- **Guotai Junan International** (1788 HK, HKD 2.60), which carries an annual yield of 3.5%.