Investors eye a good year

Even analysts cautious over China stocks' recent retreat see compelling opportunities in the market in 2018

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Until mid-November, the Chinese stock market had been rising steadily this year. But the roughly 4 percent retreat in less than a month since then, dubbed a "correction" by market mavens, rattled some investors nevertheless. Their main worry: Is the equity market in the world's second-largest economy running out of steam?

At least some sections of the market believe such concerns are not completely unfounded. Investors tended to book profits this month in certain large-cap stocks that appeared to be expensive, having surged of late.

The ongoing deleveraging efforts by the government to rein in runaway corporate debt, coupled with resolute regulatory crackdown on risky financing, sparked worries about potential liquidity constraints.

In addition, the drastic US tax cuts and expected interest rate hikes by the Federal Reserve could also exert greater pressure on asset prices in emerging markets, including China, some analysts said.

Cautious optimism

Given this set of factors, any profit-taking by way of year-end pruning of holdings of A shares would appear justified, they said.

But a step back here would help offer a longer term perspective, the big-picture view, if you will. And that overview seems to suggest there is no dire need for anyone to press the panic button.

The general consensus among equity analysts, international investors and asset managers is that the new year would not see any Chinese marketocalypse, to coin a word. A cautiously optimistic approach is all that is needed, they aver.

That is because some blue-chip stocks surged this year. For instance, shares of liquor giant China Kweichow Moutai soared as much as 150 percent this year until the recent price fall. But, overall, the A-share market still looks healthier than it was in the summer of 2015, which saw a dramatic rout, said Chen Jiahe, chief strategist at Cinda Securities.

"There has been less price distortion in the market," Chen said. "When small-cap stocks become much more expensive than the big blue chips, you begin to worry about bubbles. But this year, the market has been led by the good performance of large-cap stocks with solid fundamentals, allowing rational value-investors to make money.

"The speculative mood has also weakened because of the tighter regulation to curb risky investment as well as less enthusiasm from mom-and-pop investors."

Investor sentiment received a boost from the Dec 18-20 Central Economic Work Conference's attention in Beijing to curbing financial risks, setting the tone for the country's economic policies in 2018.

Looking into next year and beyond, analysts said the resilience of the Chinese economy, the earnings prospects of Chinese companies, and the government's ability to manage growth deceleration and credit risks will mean the country will continue to offer opportunities for investors.

"When we talk about the China opportunity, first and foremost we are interested in how the Chinese economy develops. We really care about whether China succeeds in having this moderate growth path and a change of economic composition toward more consumption," said Rick Lacaille, global chief investment officer at State Street Global Advisors.

In the investment firm's view, the markets are overstating debt fears and underestimating China's growth prospects, which may provide a window in 2018 for investors to gain long-term strategic exposure.

Gao Ting, head of China strategy at UBS Securities, said in a research note that the recent market pullback will likely be short-lived, noting that earnings growth estimates for 2018, and the current market valuations, suggest further upside for both onshore and offshore Chinese equities.

The fact that the Chinese stock market is evolving toward a more mature market and becoming more integrated with the global markets is also making Chinese equities more appealing to international investors.

Market players welcomed the beginning of a shift in emphasis toward shareholder returns, the institutionalization of the market, and signs of change in China's dividend culture.

Meanwhile, the stock connect programs that gave overseas investors greater access to the Chinese mainland shares, and the expectation of inclusion of the A shares in the MSCI emerging markets index next year, will likely fuel more positive sentiment.

"As the ownership of Chinese assets becomes more globalized, the positive aspect of that is that volatility may be lower," said Lacaille.

Ning Jing, portfolio manager at Fidelity International, saw investment opportunities in China's structural changes.

"The emphasis will be on 'quality over quantity' of economic activity in China. We are likely to see a renewed thrust on reforms across State-owned enterprises, as well as in energy pricing and pro-environmental policies," Ning said in a report.

"I continue to focus on opportunities arising from the long-term structural changes that are under way in China. At the sector level, I have noteworthy exposure to energy, materials and financial stocks."

Swiss bank Credit Suisse anticipates an approximate 10 percent return on the Chinese equity market in 2018, mainly driven by corporate earnings gains and steady growth of the services sector.

Potential for volatility

While China may continue to offer compelling investment opportunities in 2018, some analysts are more cautious about potential volatility in the market, highlighting that investors should watch out for tighter liquidity conditions in the new year.

Hong Hao, chief strategist at BOCOM International, expects the A-share market to be tepid in 2018 with bouts of brief volatility due to changes in liquidity conditions.

"Shadow banking growth is curtailed, and the new regulations are targeted at the stock of off-balance-sheet leverage that has been accumulating with increasing layers of complexity to evade regulatory supervision and capital requirements in the past few years," he said.

Hong believed that investment opportunities will likely emerge in smaller-cap stocks that have underperformed this year.

"Large-caps have run hard in 2017 and their relative outperformance is approaching (an) extreme (end)," he said.

"The rotation from large-caps back to small-caps will zigzag before the trend becomes apparent for most. Some large-caps will continue to perform, but it's unlikely that the strength will be ubiquitous."

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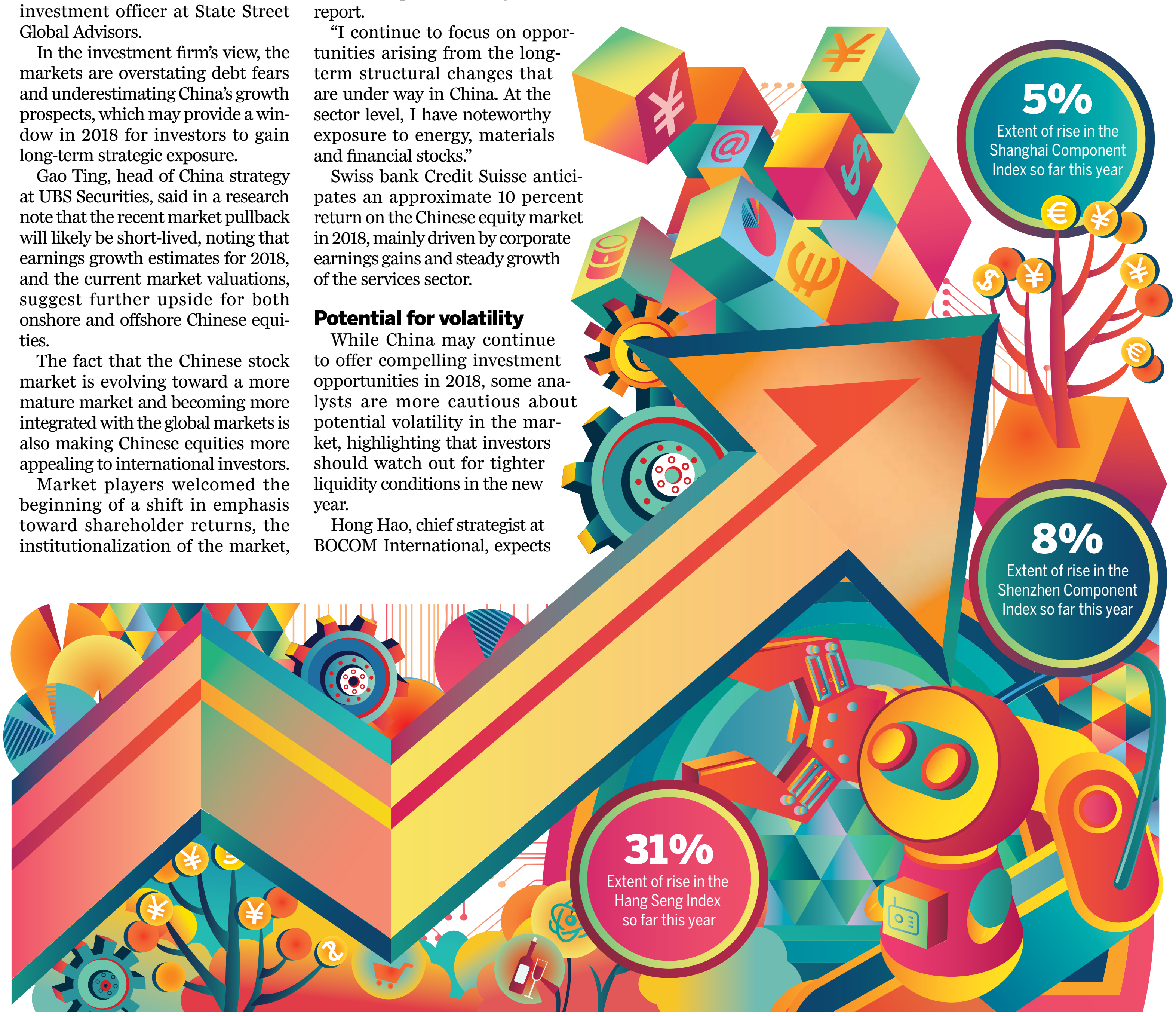
Chief strategist, BOCOM International



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