Fund Manager Perspective

December 2017

Stock Market

The year of 2017 recorded a domestic stock market rarely seen in history. In the whole year, the CSI 300 index soared by 22% while the growth enterprise board tumbled by 11%. The increases of the stock prices were exactly proportional to the market capitalization. The whole market saw 20% of the stocks rise and the other 80% fall. Such a differentiation in the market trends was rare in history. How should we understand and interpret the unusual situation? We are now trying to make an explanation from the perspectives of the basis formed in the past, the evolution at present and the prospects for the future.

First of all, the starting valuation of the large and small-cap stocks showed large differences. In 2015, the themes such as growth, the internet and merger and acquisition recorded extremely outstanding performance, resulting in the high valuation of the small-cap stocks represented by the growth stocks as well as the largest difference between them and the large-cap stocks represented by blue-chip stocks in valuation. In such a context, the A shares experienced a stock market crash, and almost all the real and fake growth stocks recorded huge drops, with the trend still underway.

Secondly, the reality is that the economy has picked up, the RMB exchange rates have rebounded and the successful 19th CPC National Congress has continued to enhance the market confidence. With the economy bottoming out, the blue-chip stocks have quickly recovered from the stock market disaster, forming the continuous uptrend starting from the low-valuation dividend yields almost higher than the risk-free return rates. The stabilizing RMB exchange rate and the successful 19th CPC National Congress have strengthened the market confidence. The market is gaining the upward momentum.

Thirdly, in the future the, A shares will be included into the MSCI index. In mid-2017, it was confirmed that the A shares would be incorporated into the MSCI index, and the specific time would be May 2018, when a 5% weight will be calculated with the weight expected to reach 20% in the future. It will be an actual driving force to continuously push up the foreign investments in the A shares. The driving force will continue to exist in the next three to five years. The earlier participation in China's stock market, the sooner profiting from it.

Bond Market

December saw the yields rise generally, as the short-term bonds went up significantly due to the tightening money supply and the long-term bonds were relatively stable, with the trend of the flattening yield curves more prominent. In terms of the return on the large-class assets, the bond market index increased by 0.16% last month. From the perspective of the inter-bank products of key terms, the credit bonds of about three years recorded the best performance in valuation.

In December, the money supply was very tight in general, but also showed the "structural differentiation", which means that the overall inter-bank liquidity was relatively stable on the whole, compared with the extremely strained liquidity in the exchange market, while the cross-year capital was in extremely short supply in contrast to the relatively stable funds within the month. I personally believe that the former reflected the stratification of the liquidity between the banking and non-banking sectors, and the further stratification of the liquidity mainly resulted from the following two factors. First of all, the overall liquidity of the banks was not relaxed, reflected by the continuously falling excess reserves rate. At the end of the third quarter, the overall excess reserves rate of the banks was only 1.3%, at a historical low level, which remarkably reduced the capacity of the banking system for withstanding the impacts on the liquidity, and made the banking system much more dependent on the injections of the central bank at the same time. Therefore, with the central bank suspending the open market operations continuously at the end of the year, the expectation of the banks for the liquidity inevitably tended to be cautious, thus leading to the banks further reducing the lending to other institutions. The decreasing funds obtained by the non-banking institutions from the banks would increase the demand of the exchange market for financing, thus rapidly pushing up the prices of the exchange funds; secondly, the intensifying restriction on the regulatory indicators for banks also exacerbated the stratification of the liquidity. At the end of 2017, the large and medium-sized banks were required to reach 90% in LCR assessment, an increase of 10% over the end of 2016, which would make the banks less ready in net lending. In addition, as in contrast to the inter-bank lending, the lending of the banks to the non-bank institutions is included in the general credit, the restraint of the MPA assessment at the end of the year would further reduce the banks' readiness to lend to the non-bank institutions, intensifying the stratification of the liquidity. With regard to the significantly tighter cross-year funds than the funds within the month, it was related to the banks' tradition of "absorbing deposits at the end of the year" on the one hand, and the restriction of the regulatory indicators on the other. Since the issuance of the new rules for liquidity, not only have the banks above the size of RMB200 billion been in the face of the intensified LCR assessment, but also the banks below the size of RMB200 billion have been under the restraint of the quality liquidity adequacy ratio. From the perspective of numerator, in order to ensure the adequacy of the liquid assets, the banks would reduce the net lending of the funds, thus leading to the scarcity of cross-year funds. From the angle of denominator, in order to control the scale of the net outflow of funds in the next 30 days, the banks would increase the borrowing of the funds of more than one month, thus continuously pushing up the SHIBORs of more than 3 months. To sum up, there were two reasons for the liquidity shortage at the end of December, including the relatively low excess reserves rate and the pressure of the regulatory indicators at the end of the year.

In 2018, whether the market liquidity can be improved depends to a large extent on whether the above two constraints can be mitigated. In terms of the excess reserves rate, in early 2018 the central bank may have two measures to alleviate the problems caused by its too low level. The first is to implement targeted reserve requirement ratio (RRR) cut for the inclusive finance, which is expected to release a long-term liquidity of about RMB300 billion with the time likely to be in mid-January, based on the completion of related data reporting by the banks; the second is the temporary RRR arrangements during the Spring Festival, which is expected to unleash a temporary liquidity of about RMB1.5 trillion, with the time possibly in early February, based on the tradition of cash withdrawal happening two weeks ahead of the Spring Festival; therefore, the too low excess reserves rates of the banks are expected to be eased in the near future. With the regulatory indicators highly characterized by the point of time, once the year-end assessment is finished, the restriction effect will be significantly reduced. In general, the liquidity environment for the market is expected to see a certain degree of improvement in the next period of time.

In the aspect of the fundamentals, the December PMI data showed that the manufacturing expansion was still significant, with the month-on-month PPI going up as expected, but it is noteworthy that the profit growth of industrial enterprises recorded a more significant decline in November, with the monthly growth rate falling to 14.9%, the lowest in nearly seven months, representing a sharp drop from 25.1% registered in the previous month. The phenomenon means that the year-on-year downward trend of the PPI has begun to have a negative impact on corporate profit growth. In November, the PPI increased by 5.8% from the same period of previous year, down by 1.1 percentage points from the October figure. According to the estimates of the statistics bureau, the price changes dragged down the profit growth by nearly 13.8 percentage points. Considering the carryover effect, in December the year-on-year PPI continued to decline to around 4.8% as expected, which means that the burden of the price factor on the profit growth will continue. Looking forward, we believe that with the overall carryover effect of the PPI downgrading in 2018, the certainty of the slowdown in profit growth of industrial enterprises will be gradually increased. In addition, besides the price factor, the decline in sales volume is also a major drag on profit growth. Under the pressure of a series of restrictions on production for environmental protection, the scale of output at the enterprises has also contracted, demonstrated by the sharp decline in the growth of the main businesses in November. In the upcoming period, the output contraction is expected to coincide with the price drop on a year-on-year basis, driving a slowdown in nominal growth.