Weekly Manager Views – 29 April 2015

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Pacific Equities

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- The most recent game changer for the Chinese equity market has been the announcement by the Chinese securities regulator on 28 March that allowed mutual funds to invest in Hong Kong outside of the remit of going via the qualified domestic investor license programme. That has led to a significant increase in Hong Kong trading volumes and inflows into that market. By way of example, volumes on a strong trading day at the exchange prior to the decision were around USD 10 billion, while we are now consistently seeing over USD 20 billion traded per day, and even at times over USD 30 billion.
- Following the April rally, many investors are now concerned about the outlook for the equity market. However, one should not forget that the Chinese equity market was rangebound over the last five years while major global markets rallied. Looking at the market's current valuation range of 10–12x earnings, and our portfolio on 12x earnings, we are yet to see multiple expansion, despite the latest rally. We now feel there is an opportunity for investors to make up for lost time relative to other markets. Looking at the macro backdrop, GDP growth for China of 6.5–7% this year and a more sustainable 5–6% going forward is lower than it was in the past but it will be good-quality growth, and a re-rating of the market is warranted.
- China has also finally begun to implement structural reforms, which also make us positive on the market. President Xi Jinping is very much in control of the government with no real political opposition, hence he is able to advance his reform agenda. The lack of such reforms was the biggest issue we had with the previous administration under Hu Jintao. Hu Jintao had to deal with many vested interests, which made real reforms difficult to achieve.
- Of course, the market has performed very well year-to-date and we could see a correction, but it remains a stock-pickers' market and we see plenty of opportunities. We remain very encouraged by the value in Hong Kong in particular, and the increased trading volumes will enable us to increase our allocation to small and mid-cap stocks.
- Year-to-date we have made some smaller changes to GAM Star China Equity, in particular cutting the exposure to our long-standing theme of Macau gaming stocks. The Chinese government's anti-corruption campaign has had a more profound effect than we anticipated, with gaming revenues down substantially. The proceeds have been used to fund a position in the Chinese A-share market as well as increasing the allocation to financials. The exposure to A-shares was not a market call, since our approach is centred on stock-picking and we believed that there was still value to be found in that market in stock-specific opportunities.
- The increased allocation to financials was a result of some stock opportunities combined with a more favourable investment backdrop. With high real interest rates, the central bank had plenty of scope to further ease monetary policy, which is exactly what we have seen with cuts in reserve requirement ratios and policy rates. As a consequence of the cuts, we are also seeing a decline in the systemic risk related to the asset quality of banks' loan books. If the economy continues to weaken, then there is still some room for more easing, in our view. Although there are some concerns over interest rate deregulation, which is impacting banks' net interest margins, in the first quarter they have shown they are able to withstand that pressure to some degree. In our view, banks still look cheap at around 7x earnings, which equates to their book value.
- Within the fund, we have maintained our positions in the technology sector, as well as alternative energy and environmental services. The allocation to small and mid-cap stocks has also remained. We suffered a little last year as investors flocked to large caps, but feel there is some good performance to be had from this part of the market. In terms of sector allocation and bottom-up stock-picking, we continue to focus on earnings, investing in companies that have a good business model and strong cash flow. Over the last couple of years, many of these could be found in the technology sector.
- Indeed, the latest reporting season has validated our decision of sticking with our allocation, since it was positive for many of the companies in the portfolio. The majority of them reported good numbers, and as a result other investors repositioned their portfolios accordingly, with our stocks becoming the flavour of the month. Among the holdings in GAM Star China Equity that reported better-than-expected numbers was an online travel agency, whose share price jumped 25% following the earnings announcement.

Emerging Market Fixed Income

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GAM Star Emerging Market Rates

- Flows into emerging market debt continue to benefit from the very low or even negative yields available in developed bond markets. After all, it is pretty much the only asset class that still offers attractive real yields. For example, our long-only local emerging debt product gives an average yield of around 7%. Another indirect positive for us are the inflows into emerging equities, which tend to help currency markets.

- Looking at fundamentals across emerging markets, the picture is a mixed one, with a strong divergence across individual countries. Hence, buying the asset class at an index level may not yield the desired results for investors. Russia, for example, had a very tough year last year on the back of the oil price collapse and the sanctions. Following the sell-off in both bond and currency markets, the country now looks reasonable value and we are exposed there via rouble-denominated bonds. However, we focus on those bonds that settle offshore, as we remain wary of capital controls should the conflict with Ukraine flare up again. Russia was up 14% in March, hence we benefited from that trade. The bottom line with Russia is that it remains very much an oil play. Should the oil price weaken again, this could spell trouble.
- The one large country in the emerging markets that we are really concerned about is Turkey. The country went down the classic path of borrowing too much in foreign currency – money that then went into the property market. We now have a substantial number of property companies that have large amounts of US dollar debt. This makes them vulnerable to any further potential devaluation of the Turkish lira, raising the risk of a vicious cycle.
- As the asset class comprises many commodity exporters, it would clearly benefit from a rally in commodity prices – a scenario that we currently believe is unlikely. This is due to China, which, as a major importer of a number of key commodities, continues to see a slowdown in its economic growth rate. Hence, we are short a number of commodity currencies in GAM Star Emerging Market Rates, including the Brazilian real, Colombian peso, South African rand and Peruvian nuevo sol.
- Meanwhile, we are long the currencies and bonds of countries with better growth prospects, mainly manufacturing and services exporters, which should benefit from stronger growth in Europe and the US. For example, we are long Mexican bonds, and long the Indian rupee, Philippine peso and Polish zloty. In India, we are also seeing improving current account dynamics, while we believe that markets have factored in too many future interest rate cuts.
- Unfortunately, we are not seeing much in terms of domestic growth in emerging markets. We saw some credit-driven growth between 2010 and 2012, but that did not gather any further long-term momentum. However, the notion that emerging markets massively over-extended themselves after the global financial crisis and went into bubble territory is not one that we share. In short, it looks like emerging markets will benefit more from the low interest rate environment in developed markets than from their own internal growth prospects. To give an example of the quite extraordinary consequences of this dynamic, Poland has just issued a three-year Swiss franc-denominated bond with a negative yield of 16 bps. Our view is that the current opportunities in Poland present themselves in the local currency. Poland's credit story is strong, however, the majority of the returns should come from carry, rather than from currency or capital appreciation.