

# Fund Manager Perspective

May 2016

In the first half of April, the A-share market extended the rebound seen in March. By mid-April, the market saw a large decline after going through a consolidation phase. After downside risk quickly faded, the market stabilized in late April, trading in a narrow range. For the month, the Shanghai Composite Index fell 2.18%, the Shenzhen Component Index dropped 3.00%, the SZSE SME Price Index sank 3.61%, and the ChiNext Price Index tumbled 4.45%.

Benefiting from the notion of the supply-side reform, stronger-than-expected PMI and a credit surge, cyclical sectors including mining and coal as well as some traditional manufacturing sectors fared better in April; and some growth sectors that had seen active trading earlier pulled back on the back of weaker-than-expected financial results. Overall, value stocks outperformed growth names.

The market stabilized in late April, consolidating in a narrow range amid thin volume, which reflected a gradual decline in risks tied to the fundamentals and downbeat investor sentiment. Fundamentals are likely to remain neutral in May, though investor sentiment may be restored to some extent.

The official CFLP manufacturing PMI came in at 50.1 in April, standing above the boom-or-bust threshold for the second month, though the reading was weaker than expected. Thanks to policy efforts aimed at steadying growth and supply-side reform measures, market demand has picked up, though it is still too early to tell whether the economy is undergoing broad-based improvement. Meanwhile, as the side effects of the renewed massive stimulus measures have been apparent, the authorities may ratchet down such efforts along with increasing signs of stabilization across the economy. The new economy represented by the ChiNext is set to be where the economic transition is headed, though the current valuation of the NASDAQ-style board remains at moderately high levels from a historical perspective. Strong growth is still needed to justify valuations of ChiNext names and earnings may continue to pose a drag on their share prices.

Long-term yields have fallen of late, reflecting easing expectations for inflation, which bodes well for the stock market. The Federal Reserve's cautious stance towards its next interest rate hike, coupled with disappointing corporate earnings, has led to a weaker U.S. dollar. As such, the downside risk of the RMB's exchange rate has receded to some degree, creating a better external environment for the A-shares.

On the market front, investors' confidence has been gradually improving as top policymakers vowed "to maintain the healthy development of the stock market and protect investors' interests" at a recent Politburo meeting, which helps stabilize market sentiment. The negative spread of stock index futures relative to the benchmark stock index has narrowed, indicating that investors' confidence in the futures market has been gradually on the mend. But the overall market confidence is still fragile, which means that the impact of any negative event could be easily amplified. Therefore, it is still advisable to keep an eye on how fluctuations in commodity prices and changes in credit spreads would influence the stock market.

The bottom line is that the fundamentals will remain under heavy pressures in the longer term, though risk factors have faded to varying degrees, and the market sentiment has been improving, though it will still take time to build confidence in the longer-term prospects of the stock market. The risk of a sharp decline is low in May when the market is more likely to see a modest gain. Nonetheless, investors need to remain vigilant as any surge in futures prices could affect capital flows and trigger a regulatory clampdown.