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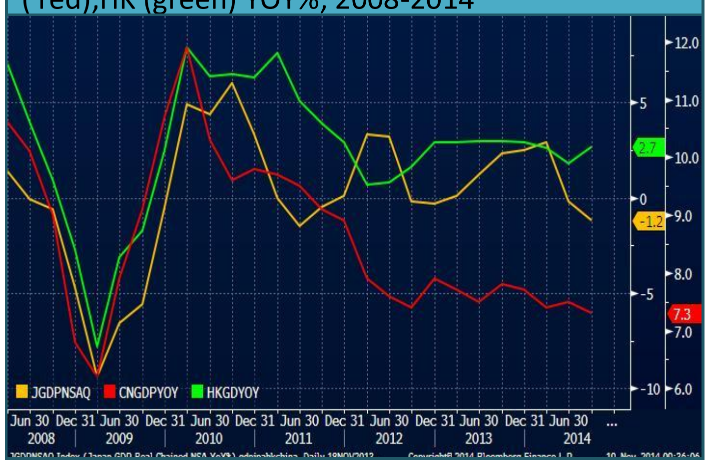
CHINA, HONG KONG AND JAPAN: Trains, trends and disappointments

Summary	Investment Conclusions
The recent macro developments and policy changes in Japan, China and Hong Kong have dominated the news. Unfortunately there is nothing of substance here to create a truly bullish outlook in any of these markets going forward to 2015. Japan's Abenomics experiment lies now totally discredited as it only focused on printing money and using it to expand the fiscal deficit without changing the underlying fundamentals. The linking of the Chinese to the Hong Kong equity markets proved a damp squid. China's slow macro recovery is much more important for its equity outlook, while Hong Kong waits, wide-eyed with terror, the rise in USD rates.	Japan's macro outlook is messier than ever, with more fiscal initiatives and a loose monetary policy, while the economy shrinks and the inevitable fiscal deficit adjustment (higher taxes) is postponed, once again. This is not a supportive equity environment. Chinese equities will benefit in 2015 from the bottoming of the economy and some foreign inflows, spreading some cold cheer to Hong Kong, the latter now awaiting the next move of the Fed, hoping that higher rates will be postponed thus delaying the shock of rising real rates on the inflated Hong Kong property market and on equities.

China and Hong Kong

The **Chinese** economy is decelerating but at a slow pace. The markets seem to be obsessed with differences of growth rates of a few bps, of a GDP growth rate which will be very likely stay at the 7.0% level. (Chart 1). Given that in the past Chinese statistics were, in general, derided as unreliable, if not downright false, worrying whether the economy will grow by 7.3% or 7.1% seems a little academic. So, for example, the widely followed PMI readings were over August to October as follows: The official PMI printed 51.1, 51.1 and 50.8, while the Markit 52.8, 52.5 and 51.7, both over the 50.0 mark and both stable/falling but at a glacial pace. Property prices have been falling, but the PBOC has progressively eased some of the conditions of property financing. The CNY depreciated to mid year and then slowly appreciated again. Fixed Asset Investment has declined while retail sales have also inched down, but also at a slow pace. The relaxation of some of the credit conditions is encouraging, and has had a good impact on the equities markets, which, since June this year, have taken off after years of stagnation. As the data in the Factbox indicate, the valuations of the Shanghai stock market are still some of the cheapest in Asia, but it is a known fact that macro trends and equities have next to zero long term correlation and valuations can be peripheral to global portfolio adjustments.The opening up of the "through train" for the markets of Shanghai and **Hong Kong** was a non-event. On the first day of trade, of the daily quota of USD 1.7 bl funds permitted to move from China to Hong Kong, only USD 0.28 bl moved, while the movement from Hong Kong to Shanghai was stronger with all the daily quota of USD 2.1 bl being taken up. However both markets were down on the day and two days later the situation has not changed (Chart 2)

Chart 1: GDP growth, Japan (yellow),China (red),HK (green) YOY%, 2008-2014



Source: Bloomberg

Japan: No way out

We have been consistent critics of Abenomics and the extremes of the BoJ policies. With two back–to-back quarters of negative GDP growth, Japan is now "officially" in recession with more BoJ easing (predating the 3Q.14 GDP announcements) and more fiscal easing on the way. Bluntly, BoJ will finance the added fiscal deficit, while the forthcoming sales tax hike has been, righty, postponed. The expectation that the central bank buying "second hand" government bonds from banks, while official rates are at zero anyway, will cause the prices of milk and shoes to go up and will force wages up as well has been, at best, naive. The Nikkei rose (Chart 2) but this is not what the BoJ wants, as it wants the end to CPI deflation. As for the Abenomics, they are discredited now as they have had virtually no macro impact and did not introduce any significant, let alone radical, structural reforms of the economy. The JPY has weakened, but this will not trigger deflation as oil prices have also come down dramatically thus easing Japan's energy deficit. The government's reaction has been to call for elections, let the deficit blow out a little more and try more of the same, which has not worked so far. Japan will not face a domestic financial crisis with bigger deficits, as all of the deficit is domestically funded, but will face, eventually, higher interest rates and yields and, perhaps, a much weaker JPY. As Japan is not, on average, an exports driven economy, the weaker JPY may simply encourage more investment both FDI and financial offshore, especially while domestic FI returns stay close to nothing.

FACTBOX: Market valuations: Do they mean anything?

Index	P/E 12 M	P/B 12M
Shanghai	9.26	1.34
Hong Kong	10.27	1.30
Nikkei	19.0	1.68
Mumbai	17.0	2.7
Manila	19.9	2.8

Bloomberg

Mumbai and Manila remain ytd the best performing Asian markets with 33.1% and 21.7% USD returns respectively. Shanghai is up 14.6% ytd, in USD terms, while the HSI has barely moved at 0.5% ytd.

Chart 2 Stock indices: Nikkei (yellow),HSI (blue), SHCOMP (red) 2014

Source: Bloomberg

Different outlooks

So, what does all this tells us for equities in these three economies for 2015? **Japan** is the easiest to deal with as the Nikkei can be driven a little more by liquidity. However, as there is nothing in the immediate future except more deflation, bigger deficits funded by the BoJ and eventually, higher taxes, the panorama does not add up equity positive! For **China** the through train is far more a portfolio adjustment rather than the start of something new, UNLESS the authorities increase the daily and total inflow limits continuously, and for that there is no guarantee while the CNY remains non-convertible in the broad sense. As for **Hong Kong** shares, the absence of any interest from China should not come as a surprise. The predominantly retail-driven Chinese markets (60% of total turnover is accounted for by retail investors) will be indifferent to buying ether Chinese shares in Hong Kong as part of an ever diminishing arbitrage play, or buying Hong Kong shares which are, by now, influenced a great deal by China's macros. The Chinese investors would be interested in buying G20 shares, but the through train is not about this. Hence the HSI is unlikely to see any support especially with higher UST yields looming in 2015... The flattening out of the Chinese economy will support Chinese equities, partially helped by the through-train inflows which will likely peter out soon once the total limit is reached.

Andrew Freris (writing completed 19/11/2014)