INSIGHTS

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China, India or Chindia?

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Often viewed as rivals, China and India in fact complement each other. China produces the goods while India provides the services. Together they cater to the full range of the industrialized world's outsourcing requirements. These complementarities are evident elsewhere. India's younger population offers consumer makers a market for all kinds of basic goods as opposed to China's ageing but wealthier society's growing penchant for luxury items.

China and India are two of the world's fastest expanding economies. Concerns over slowing growth in China have receded after recent data showed that the country's economic recovery was gaining traction. Although growth is expected to ease over the medium term as the economy shifts away from an investment-and-export-led model to one that is driven more by consumption, it will remain strong compared with the world average. In 2013, China is forecast to grow by 8.1% versus the global average of 2.6%[1].

Just as attractive is India's 2013 growth forecast of 6.5%[1]. Strong domestic consumption and demographic advantage will continue to underpin the country's growth potential. Announcement of key reforms and liberalisation of certain sectors by the government last year has also improved sentiment.

With reasonable valuations and strong long term growth potential of both markets, investing in either is an attractive proposition. Yet to focus on one market alone risks overlooking the most compelling facet, its complementarity. Picking global winners from complementary industries in China and India, we believe is an optimal way to tap this huge potential.

1. Why should an investor buy a combined China – India fund? Why not buy individual China and India funds?

China and India have built winners in different industries where we are able to extract the different strengths in both countries under one single portfolio.

One example is within the technology sector. China has become big players within the e-commerce and online advertising space while many Indian IT companies are established global IT outsourcing partners. Both countries have winners in different part of the technology sector's food-chain.

The same can be seen for the pharmaceutical and resources sectors. India has developed a cluster of world class listed generic drug companies, whilst China has solid medical device companies. On the flip side, India has limited offerings within the resources sector while we can find good opportunities in, say coal mining within China.

Our “two countries, one portfolio” China-India fund can harness the strength and opportunities in both countries by picking stocks that are best in class within both markets.

2. Since last May, the Indian market has risen 25%[2] and since last September the China market has risen some 27%[2]. Are these rallies “the big ones” or is each market merely clawing back previous over discounting?

Back in May, India’s market valuation on a 12 months forward price to earnings (P/E)[3] ratio was 12.5x, while China was trading at 8.8x in September. As these levels were over one standard deviation lower than its historical averages, valuations were very attractive for both markets. So it was not surprising to see reasonable returns from that starting point.

Despite these rallies, valuations today still look inexpensive. China’s P/E[3] is currently around 10.3x and India’s 14.3x which are still around one standard deviation lower than their historical averages thus still providing a sufficient margin of safety.

3. The outlook for India and Indian companies seems to be improving. What triggered the improvement?

Investors have generally viewed the Indian government’s effort to trim the fiscal deficit as well as reform the economy in a positive light, showing that the government can make difficult decisions if need be. Successful reforms can help start the investment cycle in 2013.

We have also become far more optimistic about the government’s reform pledge after our recent one on one meeting with India’s Finance Minister.

Some of the Indian companies will benefit should the reforms push through.

4. Few people today are expressing fears of a residential property bubble or a rise in NPLs should local governments renege on their debt servicing in China. Can we forget about these issues?

Non performing loans from local government loans remain a concern in the medium term, but we think that the banking sector has discounted some of these issues. Chinese banks are currently trading at around

7x P/E[4] and 1.1x price to book (P/B)[4] compared to its historical ratios of 12x P/E and 2x P/B for the sector.

Whilst there are pockets of bubbly residential prices, affordability has generally improved with rising incomes and broadly stable prices in 2012.

5. Another rising concern is the falling profitability of Chinese companies. Are these concerns justified? If not, are Chinese stocks as attractive as they appear? Is the current rally based on fool hardiness?

We do not think so. Firstly, expectations now seem reasonable. Previously, the market was too optimistic not only on GDP growth but also on company earnings growth. The disappointments combined with higher starting point on valuation resulted in the underperformance of Chinese equities in 2010, 2011 and for much of 2012.

Some sectors and companies with excess capacity (an unintended consequence of stimulus measures implemented in response to Global Financial Crisis) will continue to face pressures on profitability.

Going forward, we observe that consensus expects 2013 earnings per share growth to be around 10%[5] for MSCI China which is a more sensible starting point than previous years.

Secondly, valuation still provides support. 2013 consensus P/E[3] is around 10.5x while consensus P/B[3] is around 1.5x. Both are around 1 standard deviation below historical levels (historical average is 13x earnings & 2.2x book over past 10 years). Moreover, China is still currently cheaper than both Europe (12x P/E and 1.5x P/B)[3] and US (13.6x P/E and 2.1x P/B)[3].

6. In which sectors do you see the most value and potential in China and India today?

As bottom-up stock pickers for both China and India, we see value and potential on attractive stocks where we think there is a margin of safety priced in at current prices.

Around this time last year, the market had been very concerned on a potential consumer slowdown in China and therefore we saw consumer stocks underperforming.

Consumer discretionary and selected staples stock valuations had de-rated and expectations had come down. We saw opportunities that we think can deliver good returns in the future. As a result we had taken the opportunity to add new positions and to increase exposure to existing stocks within the consumer sectors such as supermarkets, shoe retailers, auto companies and advertising firms.

SOURCES

[1] Consensus Economics, Jan 2013

[2] MSCI India and MSCI China from Thomson Datastream Jan 2013

[3] PE and PB is based on IBES MSCI India, IBES MSCI China, IBES MSCI Europe and IBES MSCI US from Thomson Datastream, Jan 2013

[4] IBES MSCI China Bank Sector PE and PB from Thomson Datastream, Jan 2013

[5] IBES MSCI China from Thomson Datastream, Jan 2013

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