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UBS Asset Management Flash Commentary

Update on sharp falls in Chinese equity prices

- Chinese equities slump 7%
- Sell-off sparked by weaker-than-expected Chinese manufacturing data
- Growth fears spark broad-based global equity sell off

What Happened?
China A-share market recorded a sharp decline on the first day of trading in 2016. Trading was halted on the CSI 300 in early afternoon local time after the index of largest companies listed in Shanghai and Shenzhen fell 7%. Under new rules designed to reduce volatility, a fall of 7% triggered an end to the day's trading.

Why?
Investors' concerns about the pace of economic slowdown in China came to the fore. While a lack of liquidity in the first trading day of 2016 may have exacerbated these concerns, the sell-off was sparked by the release of weaker-than-expected economic data.

The Caixin Manufacturing Purchasing Managers' Index (PMI) for December came in well below market expectations. December's 48.2 reading represents the tenth consecutive month of industry contraction according to this measure (a score of above 50 indicates growth).

The Caixin PMI only served to fuel investors' already heightened fears about the pace of sustainable growth in China with the survey revealing falling output, weak export orders and a further deterioration in the PMI's employment component.

Other factors contributing to the decline included selling ahead of the imminent end to the ban on major share sales. In July 2015, the China Securities Regulatory Commission responded to heightened equity market volatility by banning company directors and major investors with holdings of more than 5% from selling for six months. Other investors clearly expect pent-up sales to dominate market activity when the ban is lifted on January 8.

Chinese equities listed in Hong Kong, which have not been subject to the same restrictions, fell 3.5%.

Broader Market Reaction
On foreign exchange markets, the Chinese renminbi weakened against major currencies including the US dollar. Ahead of the US business day, equity markets across Asia and Europe took their lead from China and posted falls of between 2% and 4%. Concerns about heightened geopolitical risks are adding to the selling pressure in the wake of the escalating political tensions between Saudi Arabia and Iran.

China's Response
The Chinese authorities have responded swiftly to yesterday's falls. The PBoC injected USD20bn into the money market to calm investors. Elsewhere, the Chinese stock market regulator said it was considering additional measures to improve market stability that include fresh restrictions on stock sales.

Implications for our Multi Asset and equity portfolios

- We remain positive on selected equity markets. We continue to believe that European and Japanese equities in particular remain supported by the scope for earnings growth driven by loose monetary policy.

- Our view on China is that the authorities will use the considerable tools at its disposal to support both markets and economic growth if the slowdown accelerates materially or investor concerns about a hard landing start shifting to panic.

- We have highlighted in previous commentary that China's transition from a manufacturing led economy to one more focused on consumption, is unlikely to be smooth.

- Our major exposure to Chinese equities is therefore a tactical relative value position that seeks to exploit a closing of the gap between China's onshore (A-shares) equity market and its offshore Hong Kong-listed counterpart (H-shares).

- In currencies, we are also short the New Zealand dollar v the US dollar, a trade that seeks in part to benefit from expectations of slowing demand from China for imports of New Zealand milk.

Implications for our Equity portfolios
We believe that the market reaction today had little to do with the fundamental strength of the companies, but more to do with the nature of the China A-share market. The majority of domestic investors are retail investors and they are more influenced by market momentum and newsflow. There are significant uncertainties and speculative activities in the market.

In our portfolios, we focus on good quality blue chip companies and sector leaders. Bottom-up stock selection forms the core of our investment process and we want to invest in fundamentally resilient companies at reasonable valuations. As such, we think our portfolios are in a better position to manage the volatility and to outperform even though the market environment may continue to be challenging.

For more information, please contact your regular UBS Asset Management representative

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