China Region Stabilizes, CEF JFC Reaps The Rewards

24 June 2016

By **Thomas Hughes**

Senior Editor of Global Investor Spotlight

JP Morgan China Region Fund managers have long said a stabilization of the market is all the fund needed to show positive results, and they were right.

China Region Stabilizes, Risks Remain But So Does Opportunity

It has been a few months since China has made any market shaking actions. In fact, there have been very few major market moving headlines out of the country since the "circuit breaker" fiasco and ousting of financial market regulator Xiao Gang for his mishandling of the market. In that time the Chinese markets and the funds built on them have had a chance to stabilize. Nowhere is that more evident than with the JP Morgan China Region Fund which has risen more than 25% since hitting its low in early February. The mainland Chinese Shang Hai index rose only 11.7% in that time, the Hong Kong Heng Seng index 13.7%.

Risk To China Growth Remain

However, despite the seeming calm in the market there is still quite a bit of risk present, as evidenced by the recent MSCI decision to keep China out of the emerging market index. Their decision was based on limited accessibility to mainland markets and the need for an "observation" period to make sure reforms would hold, and perhaps to see if the country's regulators would make further missteps. Mainland shares, traded on the Shang Hai and Shenzen stock exchanges and referred to as "A" shares, are stock in Chinese based companies priced in Renminbi and typically only purchased or own-able by Chinese nationals.

Chin Ping Chia of MSCI had this to say about the China A market . . . "China A-Shares are too big to be ignored but remain difficult for many institutional investors to access. How can global investors avoid a stock market that is now the world's third-largest, with a total market value of nearly USD 4 trillion, putting it just behind the United States and Japan?"

The MSCI is not the only global oriented organization to feel this way. The IMF has also recently upped its near term forecast for the country, describing it as "more buoyant", but hedged that statement by saying mid-term risk remain. Risks associated with rising credit levels, excess capacity and financial sector risk. The IMF sees the growing level of corporate debt a "key fault line... that must be addressed immediately with a commitment to reforms". The IMF spokesperson went on to say that China's economy faces growing vulnerabilities, and that there is less capacity to deal with them. Treasury Secretary Jack Lew says overcapacity is "corrosive" for Chinese growth.

These sentiments were echoed by Sheng Laiyun of China's National Bureau of Statistics who said in response to slowing fixed asset investment "overcapacity and difficulty finding credit financing is keeping private companies from investing... economic growth momentum needs to be strengthened". The latest data shows that FAI grew only 7.4% in the YTD period, versus 10+% in the same period last year.

Looking to the data signs of slowing persist despite the PBOC's reiteration of the 6.8% GDP growth target for this year. On the inflation front consumer level inflation slipped to 2% annually in May while exports and imports both fell. Exports declined by -4.1%, imports by -0.4%, leading the PBOC to predict the 2nd year of declining exports. The services sector, long hailed as the key growth driver in China's changing economy, is also in trouble. The Services PMI, while still above the expansionary 50 level, fell to a three month low of 51.2. Manufacturing PMI fell as well, dropping to 50.1, showing the bare minimum of expansion.

"The one ray of hope through all of this is a report last month that China's government was seeking help from Great Britain in efforts to create a "super" regulator"

The one ray of hope through all of this is a report last month that China's government was seeking help from Great Britain in efforts to create a "super" regulator. The Reuters report cites several sources with inside knowledge saying Beijing had sent delegations to London to observe and study the system there.

JP Morgan's China Region Fund In A Time Of Uncertainty

The JP Morgan China Region Fund has been making changes to accommodate for the ever changing investment scene in China. Over the past few months there have been some notable alterations in the portfolio make-up such as a reduction in exposure to financials (-4.7% in May), an increase in exposure to consumer discretionary (+5.3% in May) with industrials and most others holding fairly steady. In addition, fund managers have been raising capital at the same time, up 6.4% from the previous month, in effort to be ready for new investments as the opportunity arises. Likewise, there has been some changes in where the money is deployed. May saw a 5.3% increase in China/Hong Kong "P" chips and a -7.0% reduction in Taiwan holdings, and -4.6% reduction in China/Hong Kong "H" shares.

I've already mentioned that the fund saw a +25% increase in value over the past 5 months, since China markets hit bottom in February. This is roughly double the performance of the mainland and Hong Kong markets and example of management's expertise in the region. In past updates managers had commented numerous times on the possibilities of further stimulus, the effects of intervention and the need not so much for increased expansion but simply a stabilization of markets for the fund to do well. They were right. Forward outlook remains the same, diminishing stimulus with policy supporting a shit to a consumer driven economy.

"As hopes of a rapid, stimulus fueled macro-economic recovery have diminished, the opportunity in Greater China should remain in policy or consumer-driven growth markets. A rapid recovery, while positive for cyclical equities in the short-term, would likely be premised on a continued build-up of debt to unsustainable levels. Moderation should continue economically, while equities should be supported by a still buoyant liquidity situation and the possibility of greater foreign participation via either index inclusion or the start of Shenzhen-Hong Kong Connect."

NAV, Discounts And Opportunity For The Future

Net asset value, and the discount to NAV, have been a bit volatile over the past 12 months due to market volatility in the underlying region. At the height of the China scare NAV had declined nearly 50%, not surprising give the +40% drop in the value of Chinese equities, and produced a discount to NAV of nearly -20%, an historic low. This discount proved to be a prime entry for shareholders as it has been reduced by half in the recent months. As of last check the discount was closer to -10% and in line with historical averages but this does not mean opportunity does not still exist, in fact, based on some recent developments, the opportunity for shareholders may be better than ever.

The board of directors is pursuing a program to further reduce the funds discount to NAV. The proposals, which may result in an increase to the funds size, repurchasing shares at or close to NAV and other means of returning shareholder value. The proposals are due in part to advice from the funds investment adviser, JF International Management, INC. who believes them to be in the best interest of shareholders. The plan is not yet implemented though, subject to shareholder approval at the twice postponed annual meeting. The meeting was postponed due to lack of quorum.

Disclaimer: The opinions in this article are for informational purposes only and should not be construed as a recommendation to buy or sell the stocks mentioned. Please do your own due diligence before making any investment decision.