The Perfect Storm

China's Domestic Stocks are on the Move

China A-Shares Report | Q2 2015

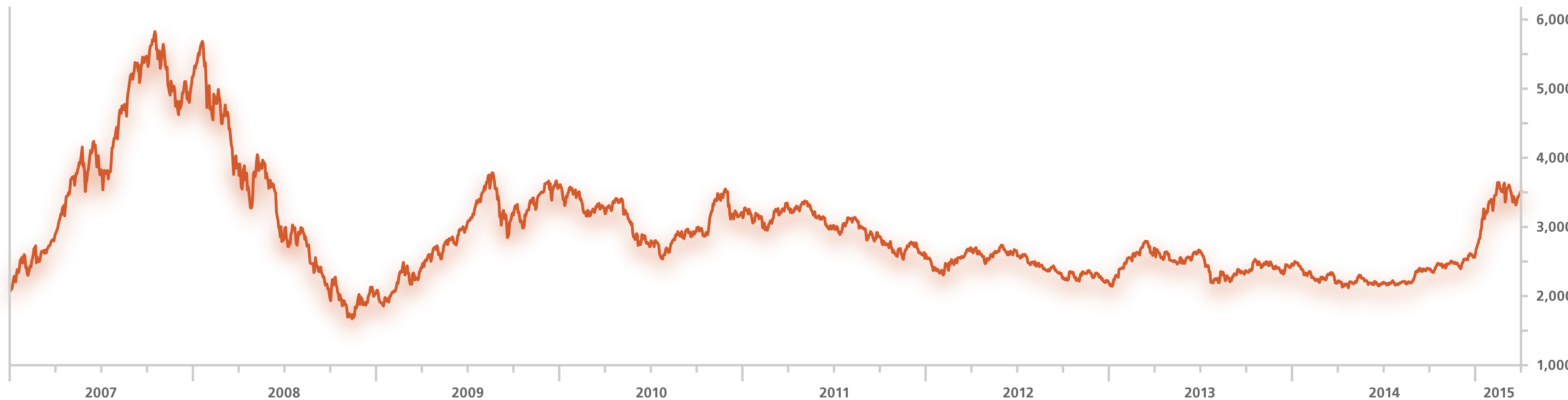
When we released...

...our China-A shares research report in December of 2012, the CSI 300 was trading at roughly 2200 and we gave varying reasons for why we thought A-shares were not only cheap, but had significant upside potential.

Since then the market has rallied over 1200 points or 54% and is today at around 3400. The same reasons we believed China A-shares were worth buying in 2012 - we believe are true today.

"FMG China Fund is one of the few and exclusive funds already invested in domestic A-shares."

CSI 300 Index



Source: Bloomberg

EXPANSIONIST MONETARY AND FISCAL POLICIES

China's economic fundamentals remain positive. Even with the latest drop in interest rates, the first in two years, rates are at 5.6% – high when compared to the zero rate policy of the Federal Reserve, Bank of Japan and the European Central Bank. Since the People's Bank of China cut rates on November 21st, the CSI 300 has rallied 36.8% up till Dec 31st 2014. While the US, Japan and EU have completed or embarked on aggressive quantitative easing programs, China still has significant monetary policy tools at its disposal. Although the developed world's central banks have little room to maneuver, we believe China will lower interest rates further – adding additional fuel to the recent market rally.

Also just last quarter, in the hope of encouraging banks to lend more, the central bank injected more than US$ 126 bn into Chinese banks. ▶

Unlike Americans, the Chinese are voracious savers. In 1990 their savings rate was at about 16% of disposable income, but today has nearly doubled to over 30%, one of the world's highest. This has created a staggering US$ 6.5 tn in domestic savings (compared to US$ 643 bn in the US), an indispensable source of domestic capital, which has the potential to either drive markets higher or finance internal consumption and investment. To stimulate the economy further the government has recently increased public spending on railway and airport projects valued at US$ 138 bn. The government has expressed a will to stimulate the economy, and has ample means to do so, which we believe should buoy stock prices further.

THE CHINESE CONSUMER

The Chinese consumer and the growing middle class we believe will drive the economy going forward. According to The Economist, China will soon overtake Japan to become the world's second-biggest consumer economy with about US$ 3.3 tn in private consumption, about 8% of the world total. China Mobile is the world's second largest mobile provider in terms of subscribers.

The Chinese car market has overtaken the US as the world's largest. There are just about as many KFCs in China as there are in the US not to mention the Chinese are the world's largest drinkers of Bordeaux wine and brandy. Also, Shanghai, today, has a sky line rivaling any US city. China is clearly transitioning from an export-led economy to one that is becoming consumption driven.

> "China is on track to overtake the US as the **world's largest** consumer market in just four years"
> – Accenture

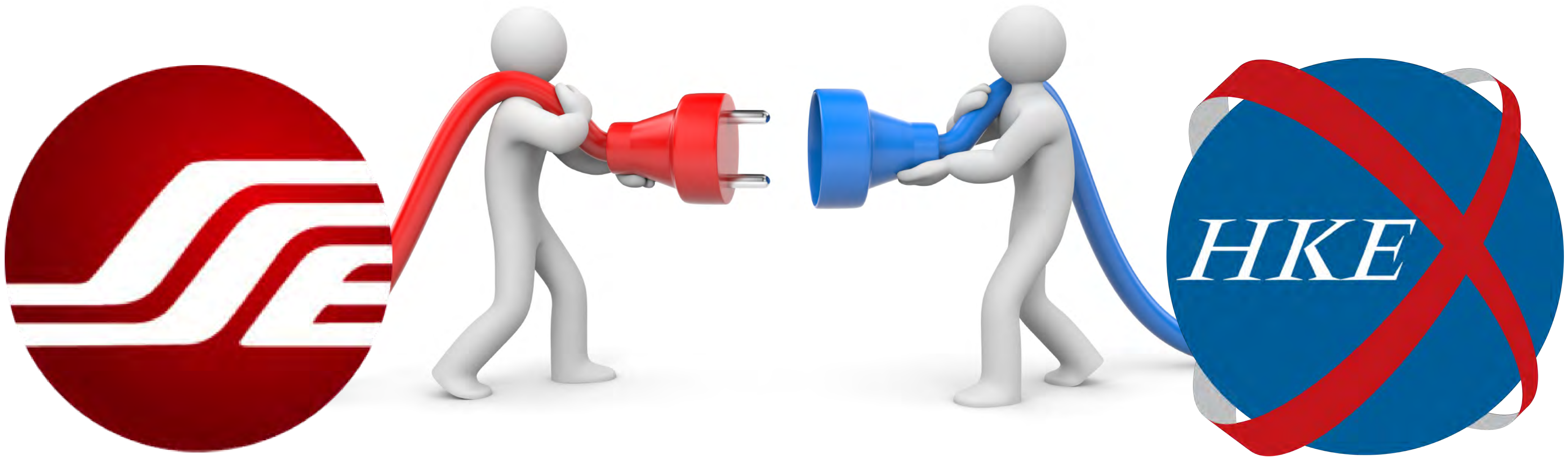
President Xi Jinping

"China became the world's 2nd largest economy in 2010 and the OECD forecasts that they will soon be the world's largest economy."

GROWTH AND REFORM

The OECD and IMF forecast China's 2015 GDP growth rate will be 7.1%, not bad considering the World Bank expects the global economy to grow at 3% in 2015. China has also taken steps to further open its capital markets to foreign investors and has allowed its currency to trade outside of the country. There has also been concrete action on allowing Chinese companies to access overseas borrowings and to move cash more efficiently move cash in and out of the country. The Chinese have also taken a hard line approach toward battling corruption. Since the start of 2013 the government reported that over 200,000 officials were punished in one way or another. Dozens of ministers, municipal leaders and business executives have been investigated, shamed or imprisoned.

"China is still a developing country and still has a long way to go before achieving modernization"
– Premier Li Keqiang

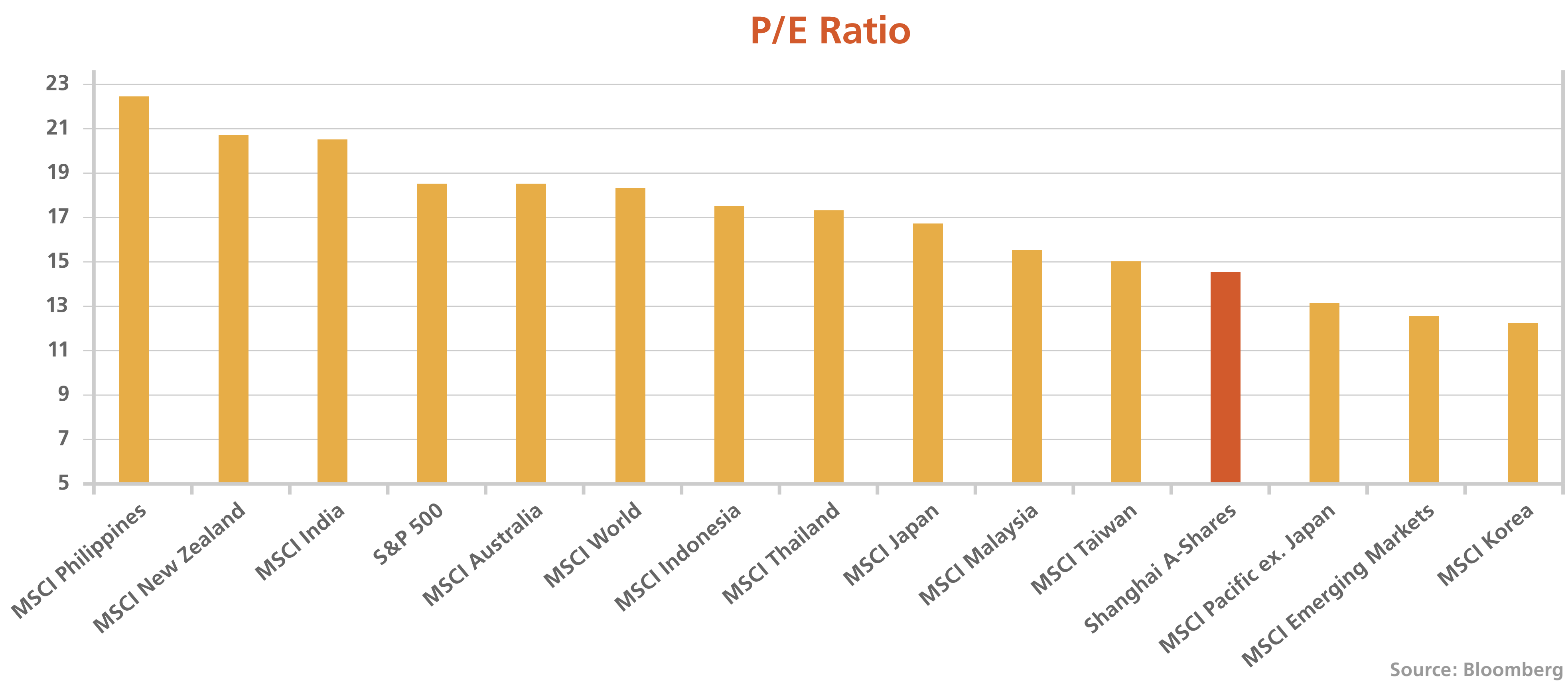


SHANGHAI – HONG KONG STOCK CONNECT

The recent surge in shares prices has been a function of both foreign and local Chinese investors' interest, driving the market to roughly US$ 4 tn in market capitalization. Much of the rally has come in the wake of the November 17th implementation of the Stock Connect, linking the Shanghai and Hong Kong stock exchanges. Previously licensed fund managers were able to invest in local markets through the US$ 105 bn QFII quota system.

However, the Stock Connect program will allow foreign individual and institutional investors the ability to invest up to US$ 50 bn on the Shanghai stock exchange. This has afforded global investors access to a broad range of companies that were once out of reach. Today foreigners can select from up to 568 Shanghai A-shares with Hong Kong based brokers giving foreign investors increased access to stocks trading in the world's second largest economy.

We believe it's only a matter of time till the program is expanded to include the Shenzhen Stock Exchange, which when combined with the Shanghai Exchange will form the world's second largest stock market. Local investors have also taken a renewed interest in the CSI 300 being there were a number of high profile real estate and wealth management blow ups last year, and investors have found few investment options other than local shares.



CONCLUSION

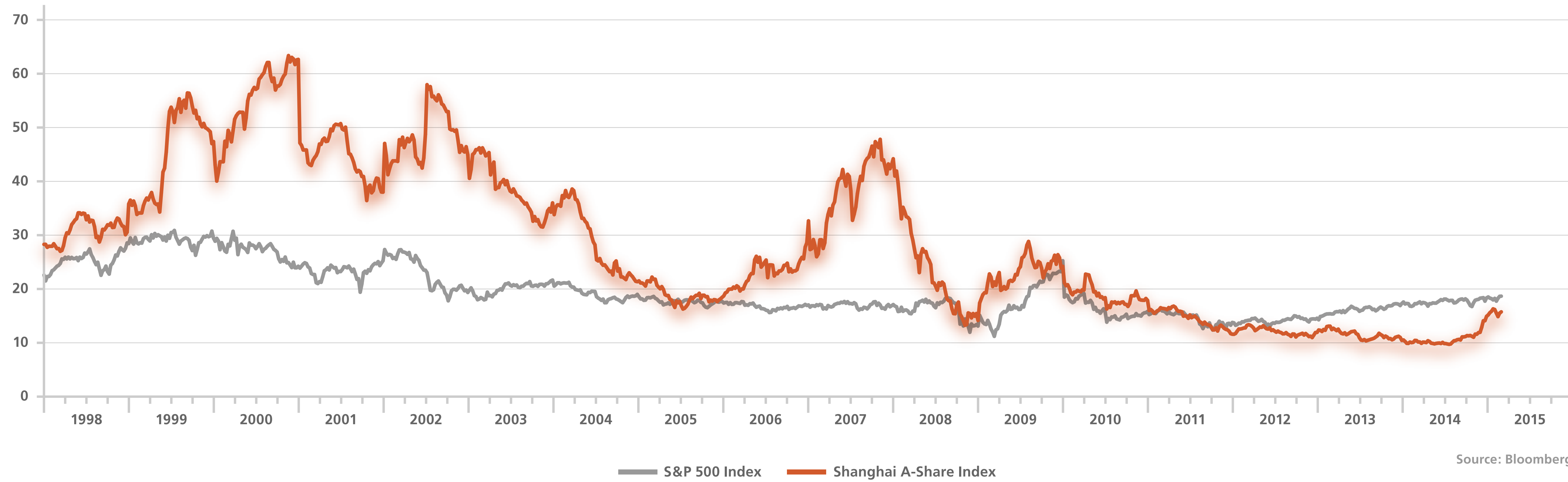
Not only is China's economy growing at over double the world's GDP growth rate, with a P/E ratio of 14.5, it is well below the S&P 500's 18.5 P/E. True, China is cheap when compared to the developed world, but it also trades at a discount when compared to other emerging markets.

Even with last year's CSI 300 rally, the index is still about 50% below its October 2007 all-time high. We continue to expect cyclical names within construction, materials and infrastructure will perform well. We are overweight the cyclical sectors, expecting a bull cycle in infrastructure investment to last for several years.

We also believe increased tendencies towards nationalism, consumption and a more entrenched middle class will drive shoppers increasingly towards local brands catering to consumer needs.

"China is **in the beginning**, not at the end, of a major secular long term up trend."

P/E Ratios: Shanghai A-Share Index vs. S&P 500 Index



Source: Bloomberg

We continue to believe China's growth prospects are exceptional and both expansionary fiscal and monetary policies will act as a tail wind for the economy and stock prices. Low equity valuations, particularly when compared to the developed world, makes the Chinese A-shares market a compelling buy and long term hold. The FMG China Fund has traditionally had high exposure (>90%) to domestic China Mainland A-Shares. We highly recommend exposure and believe our Fund is an effective vehicle to obtain exposure to these markets.

"Urbanization is creating a new **consumer market**"

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