Now that you can, should you buy Shanghai?

Thomas Gatley | GaveKal | 18 November 2014

After years of frustration, months of speculation and repeated assertions that "there is no firm timetable," the world's biggest inaccessible stock market is finally opening up to foreign investment. Since Monday, the Shanghai-Hong Kong Stock Connect program will allow international investors to buy and sell around 560 of the largest A-shares listed in Shanghai, directly through their Hong Kong broker, without all the hassle of complying with existing QFII and RQFII institutional quotas. The long term potential of this move is huge for both sides - together, Hong Kong and Shanghai leapfrog the London Stock Exchange, Euronext and Tokyo to take the number three spot in terms of capitalisation.

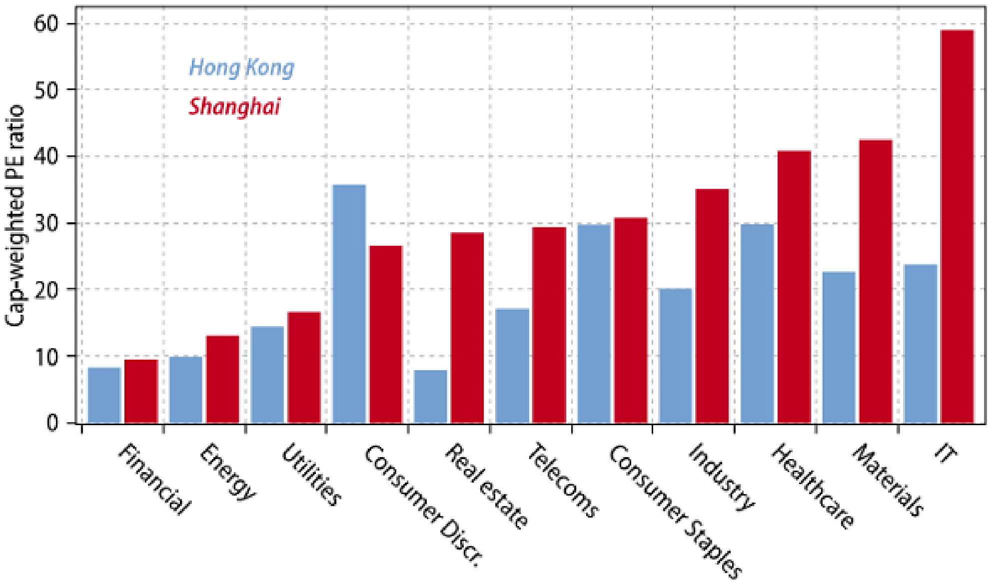
But, for now, the question facing investors is a simple one: Now that I can invest, should I?

In a previous note (Shanghai A-Shares: The Illusion of Value) we looked at valuations in Shanghai, and concluded that the market contains far fewer bargains than its aggregate P/E ratio of 11.5 would suggest. Like many emerging market exchanges (Korea and Brazil for example), Shanghai is dominated by a handful of large firms - most notably, the big four banks, which make up 20% of the market's capitalisation and contribute 40% of its earnings. The rock-bottom valuations of these institutions - which may be fully justified, depending on the true ratio of bad loans on their balance sheets - drag down the aggregate to a huge degree. In fact, the market cap-weighted P/E for stocks in the group of 560 which the Shanghai-Hong Kong Connect scheme will open up is around 20, comparable with Japan.

Yet, for many investors, the question is not whether to allocate to China, but how to do so. Specifically, what are the relative advantages of A-shares over H-shares (mainland companies listed in Hong Kong) now that the former are freely accessible for the first time? The answer depends on the nature of your China play.

If Shanghai's indexes are strongly influenced by the financial sector, Hong Kong's are totally dominated by it. Financial and energy firms make up 80% of H-shares by market capitalisation, with industrials bringing the total up to almost 90%. Consumer, healthcare and IT firms meanwhile make up a tiny 6% of the H-share market. In Shanghai, financials and energy firms constitute a little less than 60% of the market, with consumer, healthcare and IT firms carrying more than twice as much weight as in Hong Kong at 16%. But, while Shanghai offers the opportunity to invest in a wider spectrum of market sectors, what it does not offer is a bargain. Across all sectors except consumer discretionary, A-shares are more expensive on a market-cap weighted basis than the equivalent H-share sector in Hong Kong (Figure 1).

Figure 1: Most sectors are more expensive in Shanghai than Hong Kong
Market-cap weighted PE ratio by sector H-shares vs. Shanghai eligible 560



Sources: Wind, GaveKal Data / Macrobond

So, investors with strong convictions about the rise of the Chinese consumer may well want to take a hard look at Shanghai, both for individual opportunities and for a degree of diversification which simply does not exist in the H-share universe.

However, investors whose views on China fall into a broader "growth will do fine, the banks will sort themselves out with minimal pain, real estate will recover and reforms will proceed nicely" category, will probably want to stick to the deeply discounted bank and developer plays on offer in the H-share market.

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