SHENZHEN-HONG KONG STOCK CONNECT APPROVAL

On August 16, financial regulators in China and Hong Kong approved the Shenzhen-Hong Kong Stock Connect scheme, a move markets had long anticipated. The scheme is expected to be launched by end-2016, two years after the pilot Shanghai-Hong Kong Stock Connect started. ChiNext, China's version of Nasdaq, which lists high-growth start-ups in Shenzhen, will also be opened up, though only to institutional professional investors.

Immediate Implications

Compared to the Shanghai stock exchange, the Shenzhen bourse lists companies in China's higher-growth, "new economy" sectors such as information technology, consumer discretionary and health care, and also commands a smaller share of state-owned enterprises. The Shenzhen Stock Exchange is the largest in China by trading volume, with an average daily turnover of about USD50 billion in 2016.

The linkage will grant Hong Kong investors access to c.880 Shenzhen-listed stocks that represent more than USD1 trillion in market capitalisation, and mainland investors to c.417 Hong Kong-listed stocks[1]. More importantly, the aggregate trading quota has been lifted for both Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connects, as regulators on both sides seek to boost flows.

The timing of the announcement is widely viewed as somewhat of a response to the MSCI's decision not to include A-shares in its benchmarks during its recent June review—the third consecutive year of rejection. The index provider had cited market accessibility as an ongoing hurdle. In truth, the Shenzhen-Hong Kong Stock Connect was expected to debut last year, but was delayed following Chinese stock markets' correction in mid-last year and at the start of 2016. Also, China has yet to address regulations around its Qualified Foreign Institutional Investor scheme—which permits selected investors to invest in its capital market—one of the MSCI's bugbears in A-share inclusion in its indices.

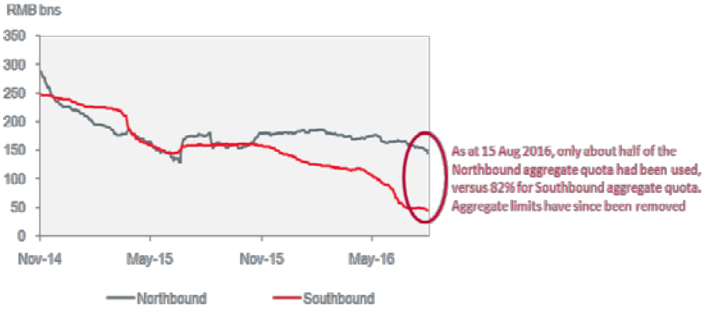
Fig 1: At a Glance: Shanghai & Shenzhen Stock Connects

	Shenzhen-Hong Kong Stock Connect		Shanghai-Hong Kong Stock Connect	
	Northbound	Southbound	Northbound	Southbound
Launch date	End-2016		Nov 2014	
Eligible stock universe	-Shenzhen Composite Index & Shenzhen Small/Mid-Cap Innovation Index with at least RMB6 billion in market cap	- Hang Seng Composite Large-Cap Index	- Shanghai Stock Exchange (SSE) 180 Index	- Hang Seng Composite Large-Cap Index
	- Shenzhen Stock Exchange (A-shares) & Hong Kong Stock Exchange (H-shares) dual-listed stocks	- Hang Seng Composite Mid-Cap Index	- SSE 380 Index	- Hang Seng Composite Mid-Cap Index
	- ChiNext (only available to institutional professional investors)	- Hang Seng Composite Small-Cap Index constituents with at least HKD5 billion in market cap	- SSE-HKEx dual-listed A-shares	- SSE-HKEx dual-listed H-shares
No. of eligible stocks	~880 (270 in Main board, 410 in SME Board, 200 in ChiNext)	~417	567	318
Aggregate quota	Removed from Aug 2016			
Daily quota	RMB13 bn	RMB10.5 bn	RMB13 bn	RMB10.5 bn

Source: Goldman Sachs, Hong Kong Exchanges and Clearing, Eastspring Investments, 17 August 2016.

If the Shanghai-Hong Kong Stock Connect serves as any indication, Southbound flows through the Shenzhen-Hong Kong scheme will likely be more robust than Northbound flows; domestic liquidity in the mainland sloshes around in search of investable assets. This is especially so, given that no Qualified Domestic Institutional Investor quota—which allows Chinese firms to invest overseas—has been approved since April 2015[2]. In addition, downward pressure on the Renminbi may encourage mainland investors to seek overseas assets. On the other hand, Hong Kong investors may be deterred by Shenzhen stocks' richer valuations.

Fig 2: Shanghai-Hong Kong Stock Connect Aggregate Quota Balance



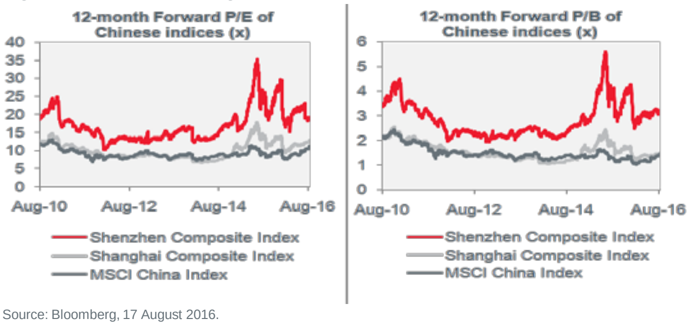
Source: Bloomberg, 17 August 2016.

Broader Opportunities, but Less Compelling Valuations

We are positive on the move as it is a step in the right direction for China's ongoing capital market liberalisation. It also unveils a broader range of stock universe.

However, from a stock-picking perspective, we are less sanguine on the investment opportunities from Shenzhen equities, which currently trade at higher valuations to the MSCI China Index, as well as the Shanghai equity market. On a price-to-earnings (P/E) basis, the Shenzhen Composite Index commands a valuation premium of 42.0% against the MSCI China Index and 33.9% against the Shanghai Composite Index. The valuation gap is even larger on a price-to-book (P/B) basis.

Fig 3: Valuations of Shanghai, Shenzhen and MSCI China Indices



Source: Bloomberg, 17 August 2016.

In addition, the Shenzhen bourse offers fewer large-cap stocks than its Shanghai counterpart. The Shenzhen index has only 26 stocks with a market capitalisation of more than USD10 billion, compared to 65 stocks in the Shanghai index.

Also, A-shares are dominated by retail investors, who tend to be short-term, momentum-driven and prefer growth and small-cap stocks. This may consequently drive gyrations in the stock market. Individual investors account for about 85% of A-share trading volumes, compared to just 35% of H-share volumes[3].

As bottom-up value investors, we will continue to search for valuation outliers and invest when such opportunities arise.

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Source: Eastspring Investments (Singapore) Limited.
[1]Hong Kong Exchanges and Clearing, 16 August 2016.
[2]UBS Securities, 17 August 2016.
[3]CEIC, UBS Securities, 18 August 2016.

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