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MSCI TO TRIPLE CHINESE WEIGHTING IN ITS EMERGING MARKET INDEX

In response to decision to integrate China's domestic markets into the global financial system, Michelle Qi, Chief Investment Officer, China - Equities, shares why the Chinese domestic markets are attractive and answers five key questions on the US-China trade talks.

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Eastspring Investments welcomes the decision by MSCI to raise the inclusion factor of China A-shares from the current 5% to 20% in three steps. The decision is largely in line with MSCI's detailed plan but slightly ahead of market expectations: 1) ChiNext Large Caps will also be included with a 10% inclusion factor in May 2019; 2) Mid Cap Stocks will be included in Nov 2019 instead of May 2020 as previously proposed.

This implies that demand for China A shares from global asset managers will increase over the next few years. Following the three-step inclusion plan, the pro-forma weight of China A-shares in MSCI Emerging Market index will be increased to 3.3% versus 0.7% previously, leading to an estimated inflow of US$70-80bn this year, and an even larger inflow next year.

The presence of foreign institutional investors in the A-share market will be further strengthened. According to statistics from the People's Bank of China, foreign investors' equity holdings stood at RMB1.15trn or 6.7% of A-share free-float cap as at end 2018. This is already close to the equity AUM of domestic mutual funds, the current mainstream local player in the A-share market.

Accordingly, we will see stronger pricing power of foreign investors in the onshore market. The strong northbound inflows (RMB130 bn, 40% of total inflows in 2018) have been a key driver to the A-shares' bull run year-to-date. Foreign investors' investment thesis, research framework and stock picking preferences have had a growing impact on the A-share market and is likely to continue going forward.

Why do Chinese domestic markets provide an attractive investment proposition?

Compared to H-shares or American Depository Receipts, A-shares offer a more comprehensive sector and company coverage, such as the consumer and health care sectors which can benefit from China's long-term demographic shifts and structural changes. A-shares also have lower correlations with offshore markets than other emerging markets, thus providing a better risk diversification profile.

In the short term, we expect economic and corporate earnings growth to bottom in the first quarter of 2019 and recover in the second half of the year. This, along with the MSCI inclusion factor in the middle of the year, points to some fairly attractive investment opportunities. We look to industry leaders across sectors with solid fundamentals, convincing growth and reasonable valuations to deliver better performances.

FIVE KEY QUESTIONS ABOUT THE US-CHINA TRADE TALKS

1. WHAT IMPACT HAS THE US-CHINA TRADE WAR HAD ON CHINESE MARKETS TO DATE?

The positive trade talks is one of the drivers that have contributed to the market re-rating year to date. The potential tariff hike which may even evolve into a full-out trade war had been worrying A-share investors and weighing on market valuations throughout the past year. With the trade talks close to reaching a deal, the major external downside risks seem largely removed, leading to a recovery in market sentiment.

2. HOW HAS PRESIDENT TRUMP'S ANNOUNCEMENT OF A POSTPONEMENT IN THE PLANNED TARIFF INCREASE AFFECTED THE MARKETS? IS IT THE MAIN REASON BEHIND THE MARKET'S STRONG RALLY ON 25TH FEBRUARY?

The announcement was one of the drivers behind the market's rally, with the financials and technology sectors registering the largest gains. While the rally in the technology sector was largely helped by the tariff announcement, the catalyst behind the rally in the financials sector was the speech delivered by President Xi at the Politburo meeting on 22 February, which highlighted the significance of financial services to the economy.

3. WHICH SECTORS DO YOU BELIEVE WILL BENEFIT MOST FROM AN IMPROVEMENT IN THE US - CHINA TRADE RELATIONSHIP? WHY?

We see the potential trade war having an impact on the Chinese economy mainly via two channels: 1) In the short-term, a sharp drop in export growth may slightly weigh on Chinese GDP growth, 2) Over the longer term, rising uncertainties due to US-China tension could result in slower global growth, which may further contain China's corporate earnings and wage growth. The latter would have a more profound impact on the China economy than the former.

Concerns over the trade war weighed on market sentiment and led to visible de-rating throughout 2018, as long-term uncertainties for businesses and the Chinese economy rose. Hence, we expect the A-share market to enjoy a broad based uplift should the US-China relationship improve.

4. FOR INVESTORS LOOKING TO AVOID THE VOLATILITY OF THESE TRADE NEGOTIATIONS, WHICH SECTORS OF THE CHINESE ECONOMY ARE LIKELY TO BE LEAST AFFECTED AND WHY?

Intuitively, sectors with smaller export exposures especially to the US (in other words, a higher reliance on domestic demand) could be less vulnerable. These sectors include the healthcare, F&B, consumer services (media/tourism), and real estate sectors etc.

However, as elaborated earlier, if trade tensions intensify, it is likely to hurt market sentiment and weigh on valuations across the board. Sector performances will then be determined by the details of supportive domestic monetary and fiscal policies.

5. WHICH OTHER COUNTRIES MAY BENEFIT OR LOSE OUT FROM AN IMPROVEMENT IN US-CHINA RELATIONS?

Should US-China relations deteriorate, other manufacturing bases that export similar products such as Mexico, Thailand, Germany, Canada, Japan and Taiwan, will likely benefit from winning US market share, and vice versa.

Sources: [1]JPM JACI Non Investment Grade Index from Thomson Reuters Datastream as at 15 November 2018.