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Six questions on China

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Michelle Qi, Head of Equity at Eastspring Shanghai explains why active managers are beating the China A benchmark, what will underpin the market over the medium term and whether equity investors should be worried about rising bond yields.

1. AN ABOVE AVERAGE NUMBER OF PORTFOLIO MANAGERS APPEAR TO BE BEATING THE CHINA A-SHARE BENCHMARK. IS THIS DUE TO THE MARKET'S INEFFICIENCY?

The China A-share market is inefficient to some extent. This partly arises from the short-term horizons of many domestic retail investors. Given the large retail participation in the market, this trait creates alpha-generating opportunities that can be rewarding for strategic and long-term investors.

At the same time, the outperformance of active managers can be attributed to the composition of the China A-share indexes. Growth stocks have consistently outperformed value stocks in the past two years but Financials, a value sector which accounts for over 20% of both the MSCI China A and CSI 300 Indexes had weighed on the indexes with its laggard performance.

2. WHY SHOULD INVESTORS CONSIDER INVESTING IN CHINA A EQUITIES?

Onshore China stocks offer investors a more comprehensive exposure to China's new economy sectors as well as exclusive exposure to certain sectors (e.g. Chinese Spirits) that not available in the offshore market. By investing onshore, investors can also benefit from the Chinese Renminbi's strength. We expect the onshore market to continue to enjoy inflows from foreign institutional investors as China A shares rise in prominence within global equity benchmarks. The Stock Connect Scheme also helps facilitate easier access to the Chinese equity market for foreign investors.

3. THE CHINA A-SHARE MARKET WAS ONE OF THE TOP PERFORMING STOCK MARKETS IN 2020. CAN THE RALLY CONTINUE?

China was the only economy that delivered positive GDP growth in 2020 and we believe that China's ongoing structural reforms and large consumer market will continue to generate attractive investment opportunities for global investors. Over the longer term, we expect to see more foreign capital inflows to the China A-share market as its

weighting in the MSCI Emerging Markets Index is still small relative to the size of the Chinese economy. A positive outlook for the Chinese Renminbi would also make Chinese assets attractive.

On the domestic front, a 2019 central bank survey on Chinese urban household assets revealed that physical assets (e.g. property) make up about 80% of urban household assets. As China's capital markets continue to develop, we can expect Chinese households to increase their allocation to Chinese equities as per capita income rises, expectations of property prices are tempered, and risk-free rates stay relatively low. This will help to underpin the China A-share market over the medium to long term.

However, the China A-share market's strong performance in 2020 has caused the market to trade at one standard deviation above its long-term average . As such, in the near term, market gains are more likely to come from improvements in fundamentals such as earnings growth, rather than further valuation expansion.

4. SHOULD EQUITY INVESTORS BE WORRIED ABOUT THE RECENT RISE IN BOND YIELDS?

As vaccination programmes pick up pace and the COVID-19 pandemic comes under control, 2021 will be a year of global economic recovery. The International Monetary Fund forecasts that global GDP growth will rebound from -3.5% in 2020 to 5.5%[1] in 2021. With the recovery, the extremely loose monetary conditions would also eventually normalise.

The level and the change in risk-free interest rates will affect equity market valuations, particularly so since valuations have climbed over the last 12 months.

That said, while the rise in US bond yields reflect investors' expectations of a stronger recovery and higher inflation, the Federal Reserve (Fed) is unlikely for now to desire an overly aggressive rise that derails the recovery in interest rate sensitive sectors. Nor one that creates extreme volatility in the financial markets and hurt consumer confidence. As such, we are likely to see the Fed try to temper the rise in bond yields through its communication and forward guidance.

In addition, the data vacuum in the first few months of the year in China may have also made it challenging for investors to assess the true state of the Chinese economy and generated additional market volatility. Traditional macro data for January and February tend to be consolidated and published after February. We believe that as more data becomes available in the coming months, the improving fundamentals will create opportunities for investors. With mobility restrictions limiting a typically busy travel period during the Lunar New Year, we expect the lift in domestic output to boost the Chinese economy and corporate profits. As vaccinations pick up globally, the overall recovery in external demand should also be positive for Chinese corporate earnings.

5. WHERE ARE YOU CURRENTLY FINDING OPPORTUNITIES IN THE CHINA A-SHARE MARKET AND WHAT ARE THE KEY RISKS?

We are focusing on structural themes such as creative innovation, ageing demographics and consumption upgrade which we believe presents attractive long-term investment opportunities. We are also looking at sectors that have either low sensitivity to interest rate changes or can benefit from rising interest rates and the economic reflation.

Source: [1]12-month forward price to earnings ratio.

We believe that policy fine-tuning would be one of the key challenges for the market. Premature policy tightening may create downside risks for the economy but keeping policy accommodative for too long could cause the economy and market to overheat. It will also be tricky trying to strike a balance between stabilising short-term growth and promoting structural reforms. If growth slows too rapidly, it could also slow the progress of reforms. Other external challenges arise from China's relationship with the US, and the potential impact on tariffs as well as technology.

6. WHAT DOES THE TERM "DUAL CIRCULATION" MEAN AND WHAT ARE THE INVESTMENT IMPLICATIONS?

The "dual circulation" model was first introduced in China's Politburo meeting in May 2020. At that time, China has experienced two-years of escalating US-China trade tensions which saw a double-digit decline in the exports to the US. As a result of the CVOID-19 pandemic outbreak, the Chinese economy had also contracted 6.8% yoy in the first quarter of 2020, its first and largest decline in about 20 years. Against such a backdrop, the "dual circulation" model has strategic significance. It aims to reduce China's reliance on overseas markets as well as technology by boosting domestic demand and promoting supply-chain resilience.

Within this framework, domestic circulation serves as a core pillar, together with the external circulation, to push forward the structural shift in the Chinese economy. Specifically, China intends to promote domestic households' consumption power through demand-side reforms which was mentioned in the 14th Five-Year Plan. This would allow it to leverage on its huge consumer market, in turn helping to foster domestic industry upgrade and technology independence.

As such, we expect to see more Chinese companies in the advanced manufacturing, technology, New Energy Vehicles, new infrastructure and consumer sectors grow to become globally competitive leaders over the next decade.

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