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Bin Shi in Shanghai

Bin Shi, Head of China Equities, gave a presentation at a recent UBS event in Shanghai. | August 19, 2021

Bin Shi
Head of China Equities

Here are the key points:

2021 has been more challenging than we expected

In 2020, China's rapid recovery from the COVID-19 pandemic and supportive government policies drove strong performance in the markets.

Looking at stock market performance year-to-date, some companies have performed well, others have not, but overall the A-share market is down year-on-year.

Government policy has been less supportive so far in 2021 and regulatory changes have weighed on the market, particularly recently.

Market volatility has increased significantly

Looking in more detail, volatility has increased significantly in Chinese equity markets. I liken it to fire and ice: some days the market is hot, and some days it is cold.

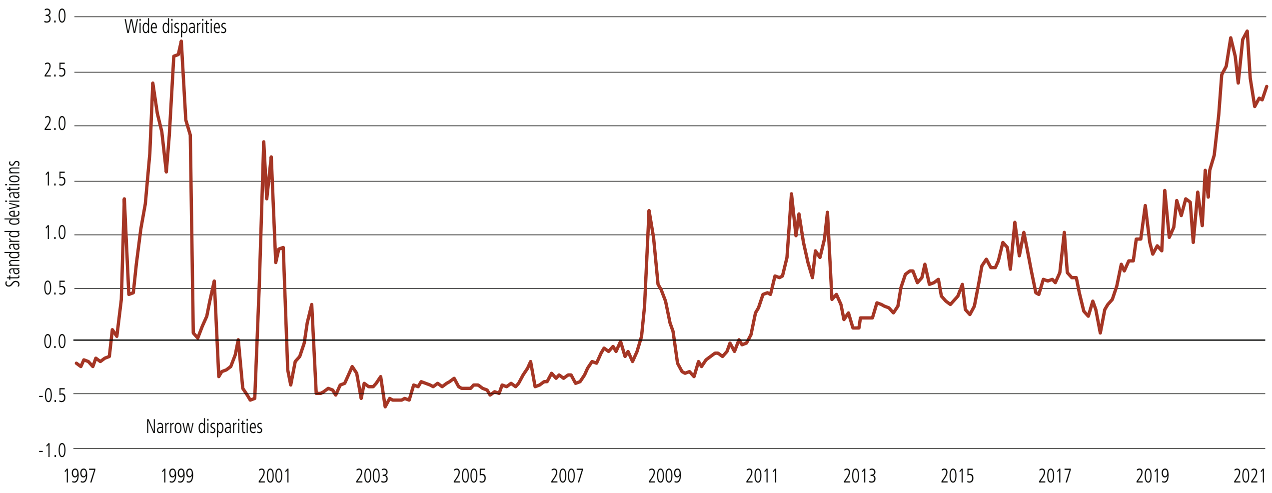
Recent regulatory changes partly explain this. Take the recent regulatory moves in the after-school tutoring, real estate, and IT sectors as an example. The policy changes, plus their rapid release, raised investor fears of a wider regulatory crackdown across sectors and drove market volatility.

While the impact of regulations on market volatility is an important factor, a more significant one is the accelerating and widening spread of information. Mobile technology means the latest news or market rumors flash up rapidly and frequently across a wide range of platforms to many different market participants.

Rumors and short-term thinking are fueling market irrationality

If anything, the speed and scope of information transfer will continue to grow, but at times like now — with elevated valuations (Chart 1, page 2), policy uncertainty, wide participation (particularly by retail investors), and the backdrop in some cases of outstanding stock performance in 2020 - it fuels irrationality and volatility in the market.

Chart 1: China valuation spreads — the top quintile compared to the region, avg Jan 1997 to Jun 2021



Source: Empirical Research Partners Analysis. Data as of June 2021.

There are three reasons why: firstly, because investors feel under pressure to react; secondly, because many investors don't have a rigorous process to digest the latest news and fundamentally assess its significance and thirdly, because a lot of the information is neither accurate nor pertinent — I'd even go so far as to say that only about 5% is of any use.

Long-term view essential to filter market noise and identify opportunities

If you are following the latest news story or rumor, it can be very hard indeed — if not impossible — to make money on a sustained basis, with some stocks rising rapidly and then falling on a day-to-day basis.

This makes having a long-term view, focused on stock and sector fundamentals, and supported by rigorous research, absolutely essential to filter out what news is significant and what is not.

In my view, China still remains a highly-attractive equity market

Despite the recent volatility and weaker market performance vs. 2020, China's equity markets remain highly attractive from a long-term investing perspective. China remains the world's second-largest economy and has a huge consumer market and manufacturing sector.

Chinese companies are increasingly competitive vs. global rivals

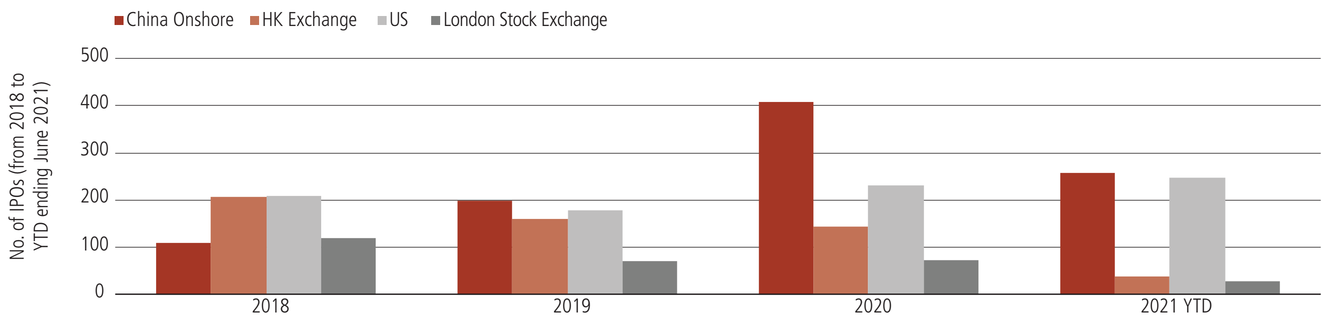
Importantly, Chinese companies continue to innovate and develop business models, products and services that are ahead of the curve compared to overseas competitors.

WeChat is a great example, offering a platform that is more than a messaging service and is in fact a multi-function platform where users can do all manner of things, unlike the more limited overseas platforms like WhatsApp.

In health care, Chinese companies increasingly compete with bigger global names. China has a talented workforce of researchers and scientists comparable to overseas but who are much cheaper in terms of labor costs. That makes China a highly-attractive location for pharmaceutical R&D.

China's cross-border e-commerce companies are also seeing rapid growth. One Chinese e-commerce company focusing on overseas markets and specializing in fast fashion has seen more downloads than Facebook. This company offers a flow of new designs, specializes in small batches, and is well-connected to supply chains in and around Guangdong — China's manufacturing center — allowing it to manufacture and deliver quickly while minimizing losses from over-ordering and excessive inventory.

Chart 2: No. of IPOs (from 2018 to YTD ending June 2021)



Source: WFE, Bloomberg, Goldman Sachs Research. Data as of July 2021.
Note: ^ based on latest available data updated by respective exchanges on WFE database.

China's strong IPO pipeline creates long-term opportunities

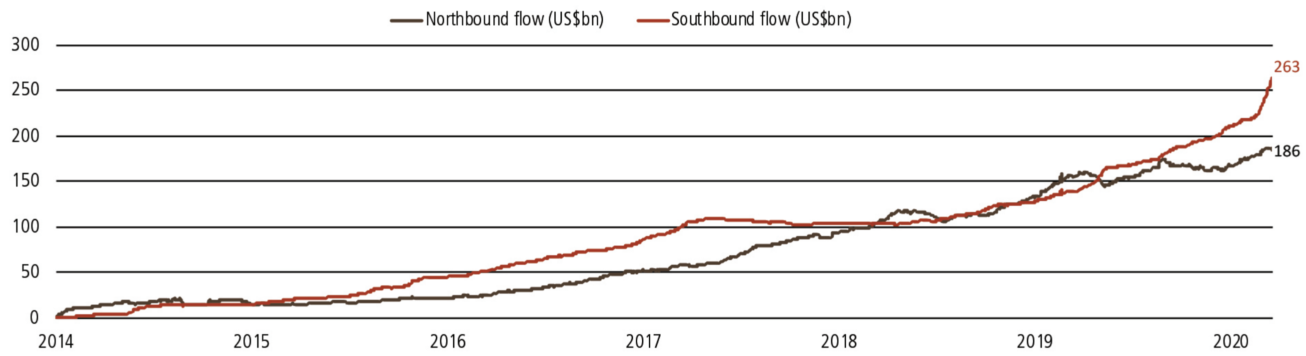
So we are seeing a lot of interesting business models being tested out in China. Given how competitive the local market is, we believe those companies that can do a good job in China can ultimately emerge as global leaders over the longer term.

And this feeds into a strong IPO pipeline, making China the most active IPO market globally, which we believe creates more opportunities for us in the market over the longer term (Chart 2).

Overseas investors recognize this too because, despite recent market instability, their ownership of onshore China stocks is growing.

Net buying on the Northbound Stock Connect has grown steadily over the years (Chart 3), and overseas investors' holdings of onshore stocks was up 53.1% year-on-year at the end of June 2021, according to the People's Bank of China. As the weighting of A-shares in global indices is expected to grow, we can expect this trend to continue.

Chart 3: Cumulative net buying of Southbound/ Northbound Connect since inception (In USD bn)



Source: Wind, Goldman Sachs Global Investment Research, as of January 2021.

Summary: In our view, if you are prepared to tolerate the volatility, China equities are likely to offer attractive long-term opportunities

In summary, volatility in China's equity markets remains high, driven by regulatory uncertainty and short-term speculation.

Now, more than ever, we believe a focus on long-term fundamentals, supported by rigorous research, is essential to cut through market noise and deliver sustainable performance.

We believe valuations have fallen to compelling levels and because we see many opportunities emerging in the market, we consider that the long-term case for investing in Chinese equities remains intact.

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