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September 2020

China: Five year capital market expectations and boots-on-the-ground insights

China's economy is rebounding after the COVID-19 outbreak but what is the long-term outlook for China and where are the opportunities for investors? Our experts came together in an exclusive webinar to answer these questions and help investors navigate China's fast-growing markets.

Key Takeaways

- China is in a strong starting position and will continue to see robust growth to 2025, albeit at a slower pace than in previous years.
- We project annualized returns of 8.9% for Chinese equities and 10-year China government bonds (hedged) over the next five years.
- For global investors with a 60/40 portfolio in equities and bonds, we estimate that adding a 5% allocation to Chinese assets will increase expected 5-year returns and the Sharpe ratio, while slightly decreasing volatility.
- Young generations are becoming mainstream consumers and increasingly do their shopping online, which supports a strong outlook for the e-commerce sector.
- COVID-19 has accelerated long-term behavioral changes in China, and online sectors have been key beneficiaries,

China: Five year capital market expectations

Dr. Louis Finney, PhD, Co-Head of Strategic Asset Allocation Modeling, Investment Solutions
Max Luo, Director, Investment Solutions

China is in a strong starting position. It has got through the pandemic first and its growth rate has picked up before other Western and emerging markets.

China offers higher growth and yields

Although growth will moderate compared to the past twenty years, we still expect future growth to be well above the developed markets and offer opportunities to investors.

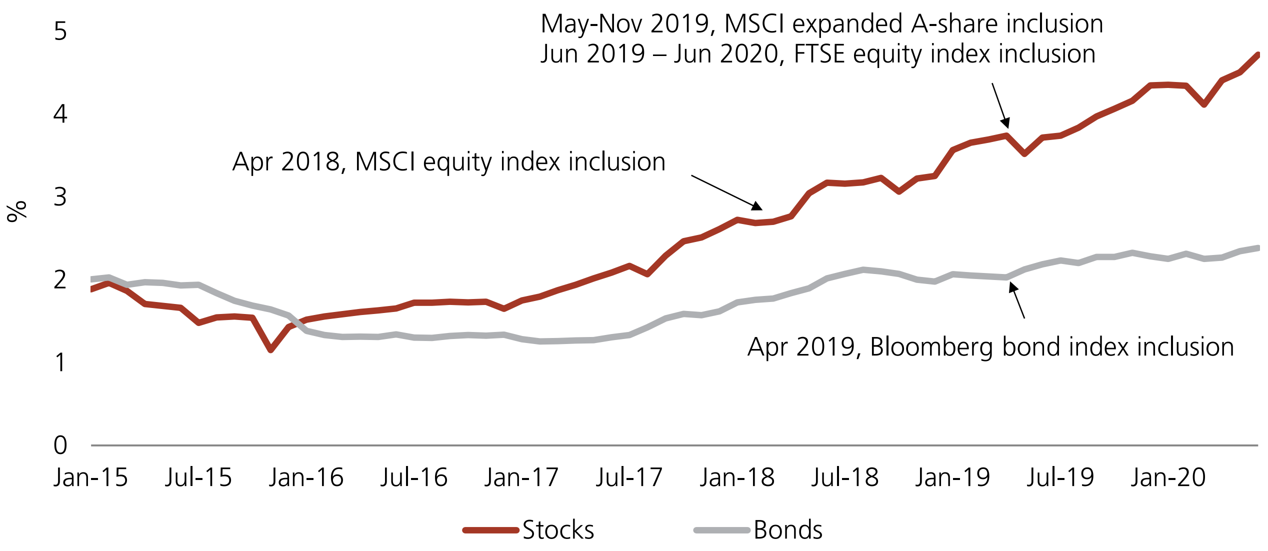
Additionally, China has higher nominal and real interest rates than in developed markets.

	2010-2019	2020	2021-2025
GDP Real Growth			
China	7.7%	2.5%	4.8%
Developed Markets	1.7%	-6.2%	1.8%
Emerging Markets	6.3%	-2.4%	5.0%
Inflation			
China	2.6%	2.5%	2.8%
Developed Markets	1.5%	0.7%	1.5%
Emerging Markets	4.7%	3.9%	3.0%

Source: WEO, UBS Investment Bank, UBS Asset Management

We are seeing continued integration of China within global financial markets. Although tensions between the US and China have provided some hiccups, we are seeing continued opening of China's capital markets to foreign investors, and China's equity and bond markets are steadily being included into the major global indices.

Foreign investors' ownership of onshore China equity and stock markets (%), Jan 2015-Jun 2020



Source: Bloomberg, Wind, UBS estimates; data as of June 2020

Put together, these factors have significant meaning for investors. First, domestic investors are increasingly looking to allocate to financial assets, creating huge demand for investment vehicles and new opportunities. Secondly, we are seeing much stronger demand from foreign investors for Chinese assets.

Driving trends for China's economy

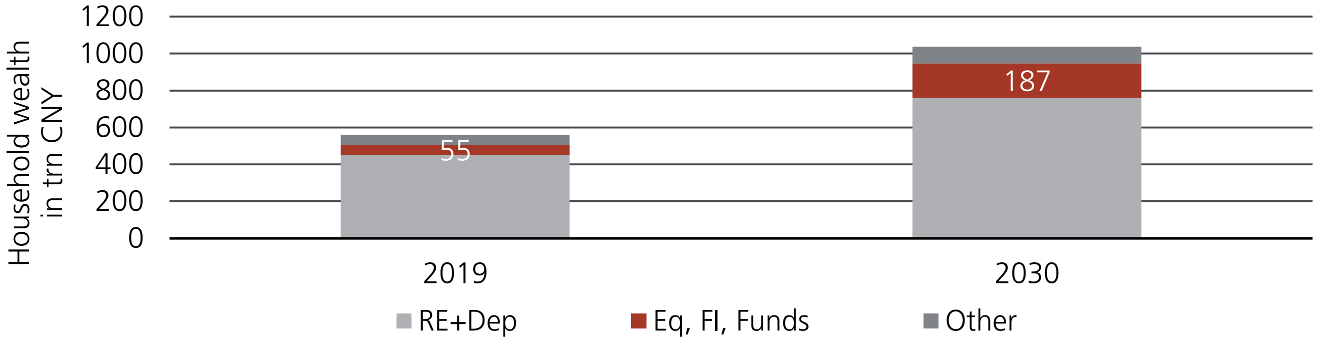
Looking into the next decade we expect that growth will moderate, mainly because of China's aging population and the shrinking labor force.

That said, we do see support for the outlook. Firstly, we see productivity gains from the increasing quality of China's labor force as well as the expansion of technology through both the manufacturing and services sector.

Additionally, we expect the rebalancing of the economy to consumer-driven growth and the growth of the middle class will propel Chinese activity in the future.

We believe the growth of the middle class, plus continued capital reforms, will result in a marked shift in asset allocation away from real estate and deposits and into public equities, bonds, and funds.

Allocation of Chinese household wealth



Source: CICC June 2020, UBS

China: Five year projections

On the cash and fixed income side, we project geometric returns of 2%-3.5% in CNY terms over the next five years.

For Chinese equities, we project annualized returns of 8.9% in CNY terms between August 2020 and August 2025, albeit with higher volatility than for the global equity market.

Capital market assumptions, Aug 2020-Aug 2025

	In CNY Terms			In USD Terms		
Asset Class	**Geometric Return**	**Standard Deviation**	**Sharpe Ratio**	**Geometric Return**	**Standard Deviation**	**Sharpe Ratio**
Cash[1]	2.0%	1.3%	0.00	0.3%	1.3%	0.00
China Government Bonds	3.0%	4.6%	0.31	1.2%	4.6%	0.23
China Policy Bank Bonds	3.3%	4.2%	0.41	1.5%	2.7%	0.50
China Corporate Bonds	3.4%	4.7%	0.38	1.7%	4.7%	0.32
Chinese Equities	8.9%	21.5%	0.45	8.9%	22.9%	0.50
Global Equities	7.8%	16.7%	0.42	7.2%	16.0%	0.50
Inflation	2.5%			1.4%		

[1] 1-month Treasury bills

Notes: Fixed income in USD terms are hedged. Chinese equities in USD terms are unhedged. Global equities are unhedged in both CNY and USD terms.

Source: Bloomberg, Wind, UBS estimates; data as of August 2020

Chinese equity returns and currency perspectives

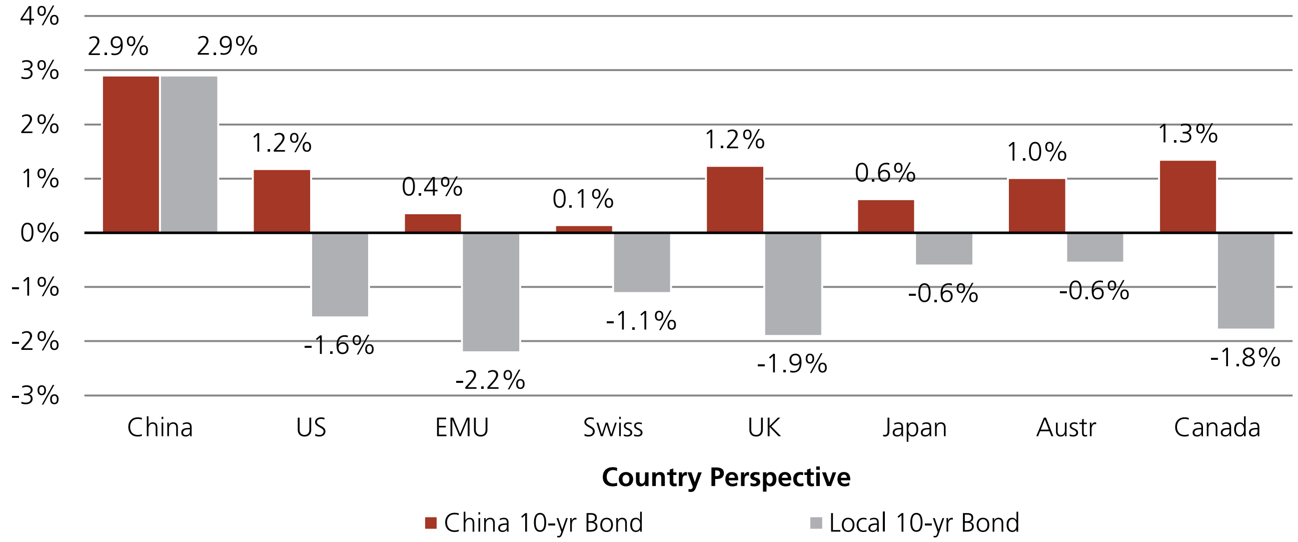
	Currency Perspectives			
Annualized RMB terms	**CNY**	**USD**	**EUR**	**CHF**
China Equity Local	8.9%	8.9%	8.9%	8.9%
Local Market return	8.9%	5.9%	8.1%	7.2%
Unhedged currency impact		0.0%	-0.7%	0.4%
Total return unhedged		8.9%	8.2%	9.3%
Hedged currency impact		-1.7%	-2.6%	-2.8%
Total return hedged		7.2%	6.3%	6.1%

Source: Bloomberg, Wind, UBS estimates; data as of August 2020

Looking at the fixed income side, we expect annualized returns of 2.9% in CNY terms over five years for 10-year Chinese government bonds.

Looking across seven major global markets, our expected annualized returns over five years for hedged 10-year Chinese government bonds are superior to those available for local bonds in all markets considered.

Expected 5-yr returns from hedged 10-yr bonds



Source: Bloomberg, Wind, UBS estimates; data as of August 2020

How do these assumptions affect portfolios?

Looking firstly at correlation, we expect the correlation of Chinese equities with the S&P 500 to stay lower than the correlation we see of US equities with the other developed markets. For fixed income, we are expecting correlation to be even lower than for equities, which is very promising for investors who are building global portfolios.

For global investors with a 60/40 portfolio to equities and bonds, we estimate that adding a 5% allocation to Chinese assets, with 2.5% to equities and 2.5% to bonds on an unhedged basis, will increase expected 5-year returns and the Sharpe ratio, while slightly decreasing volatility.

Diversification benefits from USD perspective 60/40 portfolio

	Starting portfolio	Add 5% to Chinese assets
Developed market equities	55.0%	55.0%
Emerging markets x China Unh	5.0%	2.5%
China Eq Unh	0.0%	2.5%
Global aggregate hedged	40.0%	37.5%
China aggregate hedged	0.0%	2.5%
Total	**100.0%**	**100.0%**
5-year expected return	4.2%	4.3%
Standard deviation	10.3%	10.2%
Sharpe ratio	0.43	0.44

Source: UBS Asset Management, August 2020

In summary, we view China as a very unique economy and it is neither an emerging market nor a developed one. We think that adding Chinese assets should improve the Sharpe ratio on a forward-looking basis and lower volatility, particularly from a fixed income allocation.

China's consumer sector: boots-on-the-ground insights

Denise Cheung, Analyst, Equity Specialist, Global Emerging Markets Equities and Asia Pacific Equities

We are long-term investors and that means we are always looking forward to future opportunities.

Since the consumer sector is one of the primary areas of focus, we pay attention to new groups of consumers and their behaviors. Focusing on these groups gives us a sense of how the consumer sector will evolve and which companies are best placed to cater to them.

Currently, the main group of consumers are those born in the 1970s and 1980s. But the new generation born in the late 1980s and 1990s are becoming the mainstream consumer group in China.

	Age	Population Size, mn	Share of Total Population
Born in 2010-2020	0-9	171	12%
Gen Z: Born in 1996-2010	**10-24**	**254**	**18%**
Millennials : Born in 1981-1995	**25-39**	**327**	**23%**
Born in 1966-1980	40-54	340	24%
Born in or before 1965	55+	349	24%
Total Population		1,439	

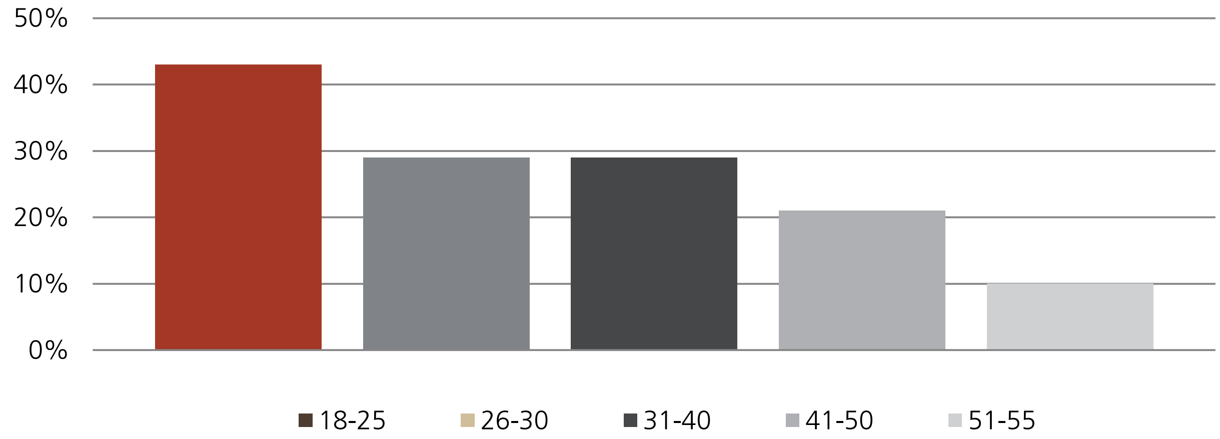
Source: United Nations, 2019

Young generations are becoming mainstream consumers

These 'Generation Z' and Millennial groups made up 40% of the total consumer base in 2019. Importantly, these groups grew up as China's economy surged, living standards improved, and internet access widened.

That's significant for a couple of key reasons. Firstly, these generations are spenders rather than savers, largely because we believe they are more optimistic about the future than elder generations. Secondly, they grew up with the internet, spend a lot of time online reviewing, comparing and purchasing products, and can quickly accept new innovations.

% of online spending accounted for overall surveyed consumers' monthly expenditure (By age group)



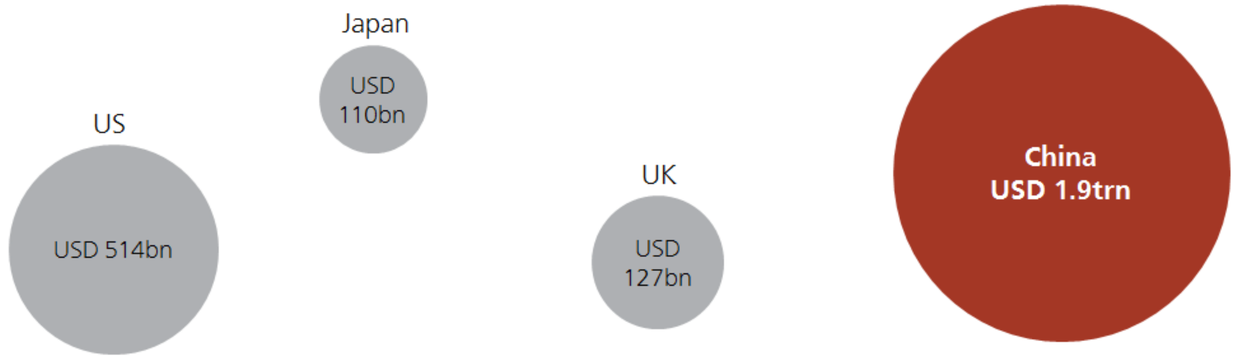
Source: Consumer Survey, Minerva Analysis as of Jun 2020

China's e-commerce market is the largest and still has room to grow

Compared to their parents, these younger generations are more influenced by information in the virtual world and are more inclined to spend online, and we expect they will become the mainstream consumer group over time.

Additionally, most online shoppers in China are located in first-tier cities, like Shanghai and Beijing, meaning that online penetration in lower-tier cities remains low and has space to grow. So as younger consumers become mainstream and online shopping expands into lower-tier cities, we expect that China's e-commerce sector will continue to grow in the future.

World markets: Total E-Commerce Sales, 2019



Source: Source: Emarketer, 2019. Size of the bubble is for illustrative purpose only

Online platforms offer innovative sales channels

Online feedback is one of the key factors when making a consumption decision, others include quality and brand image. In this context, livestreaming is becoming one of the most popular ways to stimulate consumption in China.

Livestreaming combines the experience of shopping, socializing and entertainment into an online show broadcasts directly to viewers.

In the broadcasts, hosts and key opinion leaders give live product reviews, make recommendations, and interact with viewers. Importantly, these shows give viewers confidence in products and help drive sales. For example, iMedia estimates that livestreaming broadcasts generated USD 61bn of sales in 2019, and sales may double in 2020 as livestreaming become even more popular under the pandemic.

COVID-19 has accelerated long-term behavioral changes

COVID-19 has changed many aspects of daily life across the globe, including China. More specifically, it has accelerated behavioral changes in a matter of months that usually takes years.

For example, students are studying online, workers are working from home, and online gaming and shopping has become increasingly common.

For investors, it is now increasingly important to have the foresight to anticipate future behavioral changes to be positioned appropriately to capture these changes. In this context, bottom-up, on-the-ground research in China is more important than ever.

1 Is the Chinese economy now completely back to normal?

Max Luo (ML): When I walk around Shanghai, it feels like things are back to normal. Looking at official data for the whole economy, most indicators are now either back to or higher than their pre-COVID-19 levels.

2 Will the upcoming election cause any meaningful change in US/China relations?

Louis Finney (LF): I would expect that either administration that comes in next January will have some tension with China. In the short run, there will be ups and downs with the relationship, and that's why we have built in political risks into our expectations and why we expect to see some volatility in the outlook for China assets classes.

But when we look to the longer run outlook, we see trade tensions as a temporary issue, and expect there will be gradual integration of China into the global economy, and we believe that's what long-term investors should really be focused on and thinking about.

3 How do you see China dealing with their relationship with the US?

ML: In the near-term, I don't think China is in any mood to escalate matters with the US. I see the Chinese government in 'relationship management' mode with the US and other Western democracies.

For example, despite many Chinese companies being put on the US 'entity list,' China has waited a long time to issue a list of its own and has not specifically issued any names of US companies so far.

Ultimately, we see China responding with further reforms to open the economy. China has recently accelerated the pace of economic reforms and financial market opening, such as allowing foreign companies to take majority stakes in domestic financial services companies.

4 How has the equity team navigated the recent US/China tensions?

Denise Cheung (DC): Our approach is very much driven by bottom-up research, we want to pick the stocks that will do well in the long run no matter the market cycle or geopolitical environment.

In general, our China equity portfolios are focused on companies that are driven by domestic factors. Additionally, we are very selective about the companies we put into the portfolio.

5 What impact will the inclusion of China bonds and equities into global benchmarks have on the markets and what kinds of flows are you expecting?

LF: We expect China's share of the major indices to increase over time, and that may raise the level of correlation with global markets.

However, I don't think this correlation will rise to the level seen between developed markets. China is such a unique economy with its vibrant tech sector, capital markets opening, and huge population that it's going to have its own cycle, which will be distinct compared to the rest of the world.

MC: We expect inflows to climb as the markets go into global indices. That ultimately means retail investors will become less influential in the market and longer-term institutional investors more prominent.

6 How are US measures affecting China's tech sector? (45.39)

DC: With regard to Tencent and Alibaba, their overseas exposures are actually quite small and growth is primarily driven by the domestic market in China.

Looking at the tech hardware space, it is evolving rapidly with innovation cycles having a very short timeframe.

So far this year, the sector has done very well. The reason for that is that investors expected China's government to support tech hardware companies because of geopolitical tension.

Currently, it is hard for us to see a clear leader in the tech hardware space and valuations have rerated significantly after the recent rally so we are taking a prudent approach to investing in this sector.

7 China's equity markets have rallied this year, how are you navigating it?

DC: We believe that the rally is well-founded from a fundamental perspective.

The companies that have performed well in the rally have not been so heavily impacted by the COVID-19 outbreak and are relatively domestically driven and thus largely protected from US/China tensions.
This is a very different situation to the rally in 2015. At that time, we saw a lot of investors putting money into the market without much attention to fundamentals, and the equity market crashed in the second half of the year.

For now, liquidity in the market has played a part in the rally, and we have taken a cautiously optimistic approach. We remain positive on the long-term prospects for investing in China and see many good quality companies in the market.

However, we do see some volatility in the short-term ahead of the US election, so that's why we are keeping some dry powder available to take advantage if market volatility presents buying opportunities.

8 What kind of allocation should investors have in a balanced global portfolio?

LF: For a hypothetical 60 equities/40 bonds global investor, a 5% weight to equities and bonds, close to what the global benchmarks have currently, is a terrific starting point.

With a separate allocation to China, an investor has a great lever from a tactical asset allocation perspective because of the low correlation and growing liquidity within China's markets.

Starting from a 5% level, maybe moving up to 10% at very opportunistic times, and down to 2% when we feel markets are overvalued, is a good starting point for a truly global investor.

9 What is the quality of Chinese companies on ESG and how do we assess it?

DC: ESG has always been a very important factor when we evaluate companies. We are long-term investors so we take a rigorous approach to ESG issues in our bottom-up research and assessments.

We have monitored Chinese companies for years and their standards have definitely improved. This became particularly obvious after the launch of the Stock Connect program in 2014.

Stock Connect put Chinese companies under greater scrutiny from international investors, so they had to bring their standards in line with global levels.

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