China equities

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10 questions on strategy

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We sat down with Bin Shi and the China equities team and asked them 10 questions about their strategy and how they see the market currently.

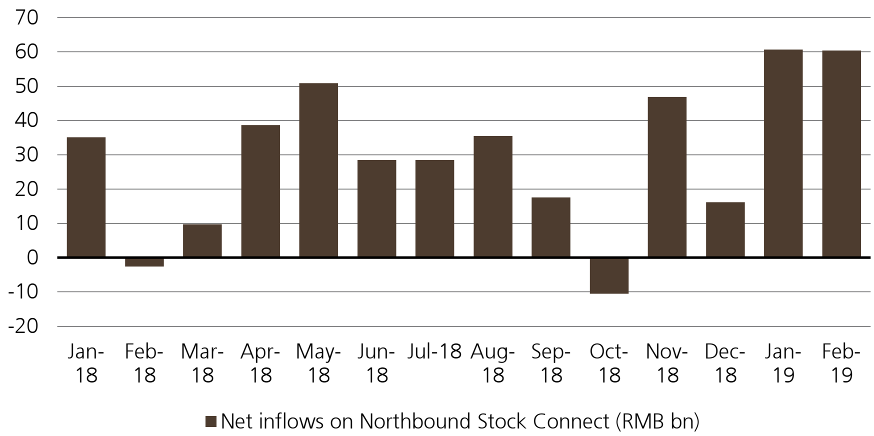
How has the market performed recently?

China equities extended their rally in February, helped by continuous policy support in China and positive expectations on the US-China trade negotiations.

Easing measures began to feed through into the economy and we expect overall credit growth to improve.

Overseas investors have been increasing their China onshore holdings, with the Northbound Stock Connect sucking in record inflows in the first two months of 2019 , continuing a trend that we have seen emerge toward the end of 2018.

Net Northbound Stock Connect flows (RMB billions), Jan 2018-Feb 2019



Source: Hong Kong Exchange, March 2019

Northbound flows on the Stock Connect increased partly because investors expected MSCI to announce an increase in the inclusion factor of China A-shares in its MSCI Emerging Markets index in late February.

Investors' expectations were realized on February 28 when MSCI said it would increase the inclusion factor from 5% to 20% in a three-step process starting in May 2019[1].

When completed, China A-shares will be 3.3% in the MSCI Emerging Markets Index.

1 Source: MSCI, February 2019

What do you mean by policy support from the government? What has the Chinese government actually done?

We have seen strong support for private companies, steps to boost business confidence, and relaxed financial regulations.

Specifically, we have seen corporate and personal tax cuts, as well as specific policies to bring more liquidity to money markets and directives to channel credit to the private sector.

These policy changes are starting to have an effect, but we expect them to really start showing in official figures towards the second half of 2019.

Just how significant is the latest MSCI announcement?

It is significant, firstly, because it will improve China A equities' presence and acceptance on the global stage.

Secondly, it will likely bring further reforms and improvement in corporate governance standards among the A-shares to move closer in line with global standards, which will be a long term positive.

These two factors mean that foreign participation in the A-share market will likely increase - continuing a trend that has picked up in the past few years and seen overseas investors become more influential.

That's a positive development because overseas investors bring different investment strategies, i.e. long-term oriented and fundamentally-driven.

China's A-share market is dominated by retail investors, and an influx of institutional capital may reduce volatility and make the market more fundamentally-driven.

You continue to be positive on China's healthcare sector despite recent regulatory changes, why?

Despite regulatory changes, long-term drivers for China's healthcare sector remain intact.

For starters, healthcare spending per capita in China is still very low by international standards[1], so there's lots of room for it to catch up.

Additionally, China's population is getting older, which means there's a fast-growing market for aged care and health treatments.

Finally, the healthcare industry in China is going through a process of rationalization.

What that means is that a lot of smaller pharmaceutical companies in the sector will slowly exit the sector, which will create opportunities for larger, high-quality names to increase their share of what we see is a fast-growing market which has lots of potential for future growth.

Official data seems to be showing a slowdown in consumer demand in China, aren't you concerned about that and doesn't that threaten your positive view on some of the leading names in China's baijiu sector?

Not really.

Overall retail sales levels are still doing well, with the latest data showing a 8.2% y-o-y increase in Jan/Feb this year, while online retail sales grew 13.6% y-o-y during the same period[2].

It's true that consumer confidence took a hit from trade-tension linked uncertainty, but we're confident that the policy support we have seen so far this year will underpin both the economy and consumer demand through 2019.

As for the baijiu sector, we're still positive – but we are highly selective. Demand for premium goods, like baijiu, still remains strong, and we expect it to continue to do so as incomes rise.

You've said before that investors won't consider a distinction between offshore and onshore China in the future, can you explain why?

The offshore and onshore distinction won't be such a consideration for investors in the future because accessibility has greatly improved as the Stock Connect program has been set up, which opened up onshore China equity markets to offshore investors and vice versa. We have already seen the two merging in the past years.

So in the future, investors should really think about how to best allocate their portfolios to Chinese as a whole market, regardless of whether it is onshore or offshore. And we think that in the future there won't be a distinction as onshore and offshore markets move closer in line.

[1] World Health Organisation, January 2018

[2] China National Bureau of Statistics, March 2019
http://www.stats.gov.cn/english/PressRelease/201903/t20190314_1653831.html

Tencent and Alibaba are two titans of the China tech sector. What makes them different?

Simply put, Alibaba's backbone is e-commerce, while Tencent is more of a social and content company.

There are ways they overlap - like in cashless payments and ad services - but, in the main, that's the distinction between the two.

E-commerce is Alibaba's core business, and it has a very strong advantage in that sector because it has invested heavily in building large-scale, national logistics operations, which differentiates it from other players in the space.

Tencent is a social and content company.

If you look at China's online sector, whether its video, music, games, or social media, Tencent has built an ecosystem with its–platforms in these categories and that's a core reason why it has grown so large.

You are long-term positive on China's education sector. You've talked before about regulatory changes in a past Q&A, but what makes you so positive on the demand outlook?

We're positive on the education sector, and we specifically see opportunities for companies offering after-school tutoring in the K-12 age range.

It's about fundamentals. China's cities have urbanized rapidly and that has created huge competition to get into the best schools and universities, which means there's a huge addressable market in the K-12 age range.

That's because all students must get a high score on the national university entrance exam (gaokao) to get access to a good university. That is a key factor, as well as huge competition for places, that is driving demand for K-12 age range tutoring.

Additionally, in some cases teaching quality in public schools may not be adequate, so parents are keen to spend on additional classes to give their children the best chance of achieving good results in the gaokao exam.

5G is the next big theme in the TMT sector, what's your view on the opportunity in this space?

Right now, 5G is still an early stage concept, not a product or system that is well understood by the market.

It's recently getting a lot of attention because the government is stressing the importance of building 5G networks, so there's lots of optimism about it.
But 5G is going to take a long time to develop and in our view it's still too early to gauge exactly where the opportunities are from 5G development or exactly what key benefit 5G systems will bring to businesses and consumers in China.

What's your outlook for the market in 2019?

We believe that 2019 will be a better year than 2018. We based our view on increased policy support from the Chinese government, and the easing US-China trade tensions.

The market movements have been consistent with what we have been saying. This year, the market rebound has so far been quite sharp and we certainly do not expect the same magnitude of return to repeat every month.

In the near term, the market is likely to be volatile, but our positive view on the China equity market outlook remains unchanged, valuations still look inexpensive and we continue to see opportunities in the market.

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