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China equities market update & outlook

China equities – what is the market outlook for A-shares and H-shares in 2021? Markus Egloff, Head of Wholesale Asia, sat down with Bin Shi, Head of China Equities, for an hour-long chat to find out. Read more below.

China equities update and market outlook 2021 – 10 key points

1. China's economy will grow 8.4% y-o-y in 2021, and 5.6% y-o-y in 2022, according to April 2021 estimates by the International Monetary Fund.
2. China's government is targeting stable growth, so future changes to monetary policy won't be that drastic.
3. Bin Shi feels that the Chinese government has done more to control risks than other more developed nations, which will make the Chinese economy healthier in the long run and create good prospects for China equities.
4. China's A-share markets have seen a correction, but Bin Shi sees more opportunities to buy into high quality companies and is comfortable to add to current holdings.
5. New regulations on the after-school tutoring market will likely benefit leading companies because lower quality players will exit the market.
6. Bin Shi believes that, despite hope and expectation around electric vehicles, the industry structure in China remains unstable and he is not willing to buy at high valuations at this point.
7. Bin Shi remains positive on consumer, health care and financial services sectors.
8. US embargoes have given China's domestic semiconductor industry a huge boost and Bin Shi believes they are creating a huge competitor to the US semiconductor sector.
9. Bin Shi believes it is likely we have seen the worst in terms of anti-trust penalties on Chinese tech companies.
10. Chinese pharmaceutical companies' strong R&D skills mean they can compete with leading international competitors and Bin Shi remains positive on their long-term outlook.

Markus Egloff, Head of Wholesale Client Coverage Asia Pacific

Before we look forward, let's start by looking back.

Almost a year to the day, we held a webinar asking if China really was 'out of lockdown and into recovery?

In the months that followed, the answer was clear.

Absolutely.

Despite the difficulties experienced across the world, China's economy roared out of its Q1 2020 COVID-slump and

rebounded in the second half of 2020.
Now, the IMF estimates that China's economy will grow 8.4[1] % this year – far faster than other major global economies.

But what explains this rebound?

A few factors are key, including rigorous controls to limit the spread of COVID-19 within China; innovative tech innovations to help with contact tracing, and strong government policy support.

From a market perspective, these factors helped drive China's equity markets, making them top performers in 2020. But that momentum has slowed recently. Indeed, China's onshore markets have weakened slightly YTD. Naturally, after such a strong year in 2020, investors have a lot of questions:

- Has China's post-COVID-19 equity rally now come to a halt?
- What next for government policy?
- Where are the opportunities now?
- How to position for the next five years?

Against this backdrop, we now turn to Bin Shi for an expert view on China's markets.

Bin Shi, Head of China Equities

Markus Egloff (ME): Can you summarize briefly some of the key observations since we last spoke a year ago, and were you surprised by China's rebound?

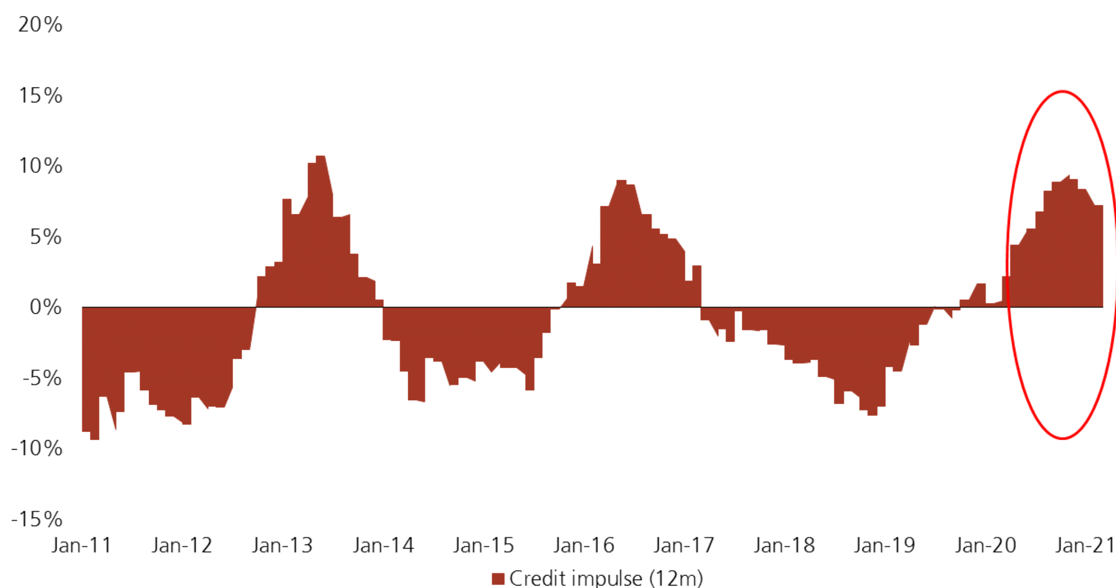
Bin Shi (BS): COVID-19 was definitely something new that the whole world needed to deal with, and it was hard to predict the duration and severity of the pandemic.

China has done a very good job in controlling the virus, but at a certain cost – people cannot travel outside China, and foreigners cannot travel in to the country without strict quarantine procedures. During the past year, China's economy and companies proved their resilience and competitiveness.

ME: Looking at the policy side, we have seen we have seen China's top banking regulator saying he is concerned about the risks emerging from the financial markets. We have also seen the People's Bank of China recently withdrawing some liquidity from the market. The big question remains - is China about to introduce policy tightening, like we saw in 2017/2018 with the deleveraging campaign?

BS: I think the overall policy was extremely stimulative last year to really battle the COVID-19 outbreak, so since things are back to normal there is no need to stimulate the economy that significantly.

China credit impulse (YoY Growth/%), Jan 2011 – Jan 2021



Source: Bloomberg, WIND, As of end Feb 2021

1 Source: International Monetary Fund (IMF), Apr 2021

The Chinese government is targeting stable growth, so the withdrawal of liquidity probably won't be that drastic.

As for the comments from Governor Guo Shuqing, it's his job to warn of potential risks within the financial system and within the property sector. If risks in these areas are left unchecked, it could lead to a potential crisis.

But compared to a lot of major economies, China has done a good job in terms of controlling risks within the financial and property sectors, and we feel pretty comfortable with the overall situation.

We feel that the Chinese government has done more to control risks and been more disciplined in terms of the size of stimulus measures, and we think that will make the Chinese economy healthier in the long run, and that is good for prospects for Chinese equities.

ME: Turning to markets in particular, volatility has risen and the A-share market has pulled back – do you expect the recent current market correction to continue?

BS: So far this year, the rapid rise and subsequent decline in the A-share market has been pretty dramatic. We think that some of the rise wasn't really supported by fundamentals, and was rather supported by liquidity and higher subscription to mutual funds, which then had to deploy quite quickly.

Following the decline, I think expectations are much more realistic now and the mood is probably more rational. After the correction, we actually see more and more opportunities to buy into high quality companies and we feel more comfortable to add to our holdings at this point.

ME: It has been a strong year for IPOs, especially in Hong Kong – what are the driving forces for this?

BS: Usually, a strong market will lead to more IPOs.

But when we look at the IPO market, we need to focus on two things. One is quality and the other is valuation. Usually, in the early stage of a bull market, quality is good and valuations are sensible.

In later stages, the quality is usually less good and valuations higher because people have unrealistic expectations.

So I think at the later stage we need to be more careful and disciplined and look at all companies on a case-by-case basis.

Overall, we have participated in fewer names, but if the right company comes out at the right valuation, we will be more than happy to participate.

ME: Given recent market trends, how have you managed risk since 2020 and how have your strategies evolved since then?

BS: For us, we focus on the long term, and also on the quality of companies. We feel that's the best way to manage risk in the long run, no matter if it a strong market or a weak market.

You always want to buy high-quality companies. Even though you might not buy them at the perfect time, in the long run we believe that positions in those companies will work out. In contrast, we believe that if you buy into lesser quality companies, the longer you hold them the more money you lose.

Obviously you need to make some changes from time to time - in bull markets even high-quality companies can get overpriced - but we try to be consistent with our focus.

For example, there have recently been a lot of IPOs, but in many cases even though we recognized some high-quality companies, we felt the expectations and valuations were unrealistic and quite detached from reality, so we took some profit on those names.

We have also kept some cash until we can identify reasonably priced high-quality companies. Our cash levels may have hurt us last year, but this year they have helped us, to some extent.

ME: What is your thinking around cash now? We note that your China onshore strategy is under 5% but the China offshore portfolio is over 10% cash. What does that tell us about how you're viewing both markets?

BS: Our cash levels are not really a market timing tool, they are really a result of investing with discipline. Lower cash levels in the onshore strategy mean we feel more comfortable at this point to either add to our recent holdings or buy some of the high-quality names.

As for our offshore strategy, if ADRs correct, most likely our cash levels will go down. A key determining factor is: if we buy these companies today, can we expect a reasonable return over two-to-three years? If we feel we can, then we should buy them because trying to predict the next upturn is very hard to do.

ME: How are your portfolios positioned right now, and what are some of the notable changes you've made recently?

BS: We have always positioned ourselves for long-term capital appreciation but obviously macro dynamics are different under different circumstances. So we made some adjustments, but we haven't really deviated much from our core approach.

In terms of changes we have made, probably at times of uncertainty and market weakness I think it is more important to focus on quality, valuation, and discipline.

So, in terms of changes made, we have taken profits in some of the IPOs and stocks that have done extremely well, but we think that fundamentals need some time to catch up. We have also invested more in quality names in some less glamorous sectors, such as the more innovative banks in the financial services space.

ME: You mention that 'boots-on-the-ground' research is a key part of your process, have COVID-19 controls and travel limits affected this? If so, how have you responded?

BS: Travelling is more difficult, which makes our due diligence work more difficult, but we have followed many of the sectors we focus on for a very long time and established a lot of industry contacts, who help us to track trends in China.

We also have people based in Shanghai, and our analysts in Hong Kong have travelled to mainland China and gone through quarantine processes in order to do necessary due diligence work. In all, we have to get the job done and we have to have strong convictions in companies before we deploy our investments.
So while COVID-19 has had some impact, overall it has been quite minor on our research approach.

ME: Can you talk about ESG as part of your investment process?

BS: Actually, ESG has been a very important part of our investment process for a very long time. We are long-term investors, so we tend to focus on the factors that decide the long-term success of a company.

Our focus on quality has an ESG element to it, such as corporate disclosure, quality of governance, and whether the company is environmentally friendly, and these have been elements of our process - well before ESG has become everybody's buzzword.

The attention on ESG has been helpful for our work too. In the past there were few resources available, such as external databases.

Now there are a lot more resources available that actually make our assessments easier than before. At UBS Asset Management we also have a separate ESG team that look at all the holdings we have to assess if they meet our standards or not.

One thing to emphasize though is that business practice in China is quite different to other more developed markets, so sometimes you have to take into account some of the local factors in order to come to the right

conclusion on the ESG front.

ME: The Chinese government appears to be taking a tough stance on anti-trust regulations – what impact do you see for large players like Alibaba and Tencent?

BS: To put it precisely, anti-trust law has existed in China for quite a long time and it has only been strongly enforced recently.

I think it is a fact that a lot of the platform companies have become so big that they have a huge influence on their industry, the economy and their competitors.

So there is a need for standard procedures to deal with anti-competitive behavior from the platform companies, and that's what this is all about.

When the Chinese government handed out the Alibaba penalty, they actually emphasized the benefit of platform companies and their positive impact.

So I think the government's objective is not to kill the platform companies but to deal with some of the negative impacts from them becoming so large.

ME: You have mentioned the growing presence of longer-term institutional investors in the A-share markets – does this mean reduced potential to generate alpha in the future, and where do you look to find the new rising stars?

BS: Institutional investors' participation in the China A-share market has definitely been going up, from both foreign and domestic sources. We do expect the China A-share market will become more efficient, as we expect participating investors will be more sophisticated.
But that doesn't mean alpha opportunities will disappear. If we keep improving our investment capability, we can continue to deliver alpha. If you look at our offshore products, based in markets with higher institutional presence than in the China A-share space, we have delivered strong alpha over the years as well.

Audience Q&A

1. Education companies have been a major holding for you, but we have also seen an increasing amount of regulations hitting that space, particularly the after-school tutoring space. What is your outlook on both the sector and the major holdings?

Under China's current education system, the college entrance exam is extremely important. In the US and UK, college entrance is multi-dimensional, so applicants get assessed on factors like athletic ability, as well as academic performance. In China, academic achievement is the most important factor.

For students to get ahead, they need to do well on the college entrance exam. So after-school tutoring support can give them an extra advantage when applying to a good college.

The regulations from the government, though harsh, are really to iron out some of the negative elements within the after-school tutoring sector, such as some of the smaller, unsustainable players who go out of business without repaying tuition fees, and those without properly qualified teachers.

The regulations in this sense are trying to make the entire after-school tutoring segment better, and we think the leading companies will actually benefit because some of the lower quality players will exit the market.

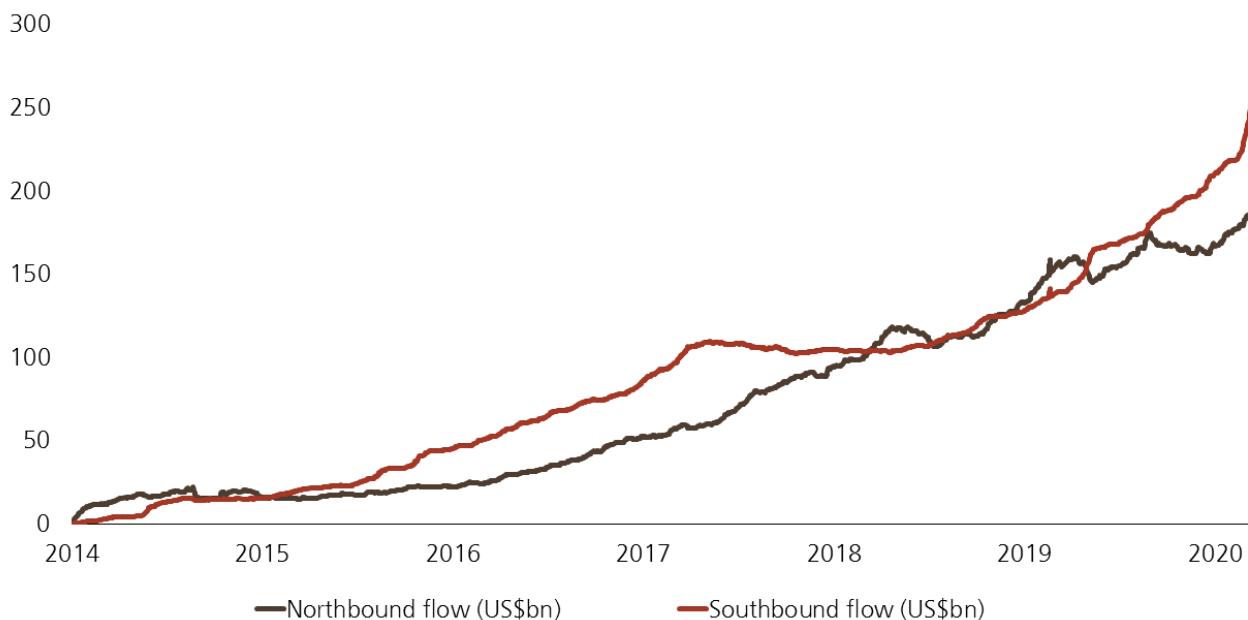
2. We have seen a lot of Southbound capital flow into Hong Kong. Can you explain why and tell us whether you expect it to continue?

This again shows that domestic investors are still not very long-term and that they tend to chase after performance.

The valuation discount between A-shares and H-shares has existed for some time. Last year, we saw a significant inflow into Southbound channels, reaching a peak in January 2021. However, since then it has slowed, mainly due to a market correction.

I think this demonstrates something unique about both the China A-share market and domestic investors.

Cumulative net buying of Southbound/ Northbound Connect since inception (USD bn)



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

Basically, strong performance tends to lead to strong inflows, and once the market starts to correct the inflows will disappear, and it will take time for the market to consolidate. Additionally, performance can pick up in a very short time frame. Even though we hope that performance can sustain in a more balanced way, it actually comes in spurts.

This again shows that we have to focus on the long-term, instead of being distracted by some hard-to-predict flows.

We think over the long-term flows will continue since the allocation of total savings in China to equity markets remain low. If you look at equity market valuations and investment prospects for other assets, say fixed income, we think the equity market continues to be quite attractive from a long-term perspective.

3. Which sector in the A-share market do you think is most attractive right now, and what's your view on the electric vehicle (EV) sector?

We continue to be very positive on the consumer, healthcare and - to some extent - financial services sectors. In those sectors, we continue to see a lot of changes and believe that industry structures are more stable. That means the leaders we identify are so far ahead of their competitors and will most likely continue to do well, so we can invest in them for the long term.

For the EV space, at this moment we don't have any exposure.

It's not because we don't believe in EV in the future, we do believe they will eventually replace gas engine vehicles down the road.

However, the industry structure at this point is very unstable, with a lot of existing, young, and brand-new players in the market.

So at this point we think that while there is a lot of hope and expectation around EVs, the industry structure remains unstable and we think it will take some time for the dust to settle.

As such, we are not will to pay the high valuations at this point.

If we can see a company stand out significantly from their competitors, we'll pay attention to them. At this point there are a lot of Chinese EV players, but in terms of technology and product sophistication Tesla is probably still leading the pack at this point.

4. China's birth rate has really slowed, how does this impact your view on the consumer sector?

That's an excellent question. If consumer sector companies focus on quantity, they will have a tough time because population growth has slowed down significantly.

However, most of the companies we invest in really only focus on quality, such as growing demand for premium goods.

Despite COVID-19, those kinds of companies have seen demand continue to pick up. Take premium liquor companies for example, the top ones are actually seeing a shortage of supply, since demand continues to grow for their premium products.

Ten years ago, investors were probably focused on whether companies can get the largest market share. Nowadays, its all about quality and which segment companies are in, and you don't just bet on companies that are focused on the size of the industry anymore, because the growth rate of the industry will probably slow down because of population issues.

5. Turning to tensions between US and China, is the global semiconductor shortage an opportunity for China?

The shortage has happened for a few reasons, not just the conflict between US and China.

Firstly, the growth of 5G, particularly 5G handset networks, means the demand for semiconductor components is growing.

Secondly, because of the economic uncertainty caused by COVID-19, many companies were not sure about how far the economy would slow, and so held back on capex investments.

The subsequent recovery has been stronger than many people expected, so that's why all-of-a-sudden we are facing industry shortages that we have never seen before – even during the boom years. The shortages we are seeing will probably last for another year.

Turning to the Chinese semiconductor industry, it has actually benefited tremendously from tensions between the US and China.

In the past, a lot of leading Chinese tech companies relied on US-made semiconductor components. Embargoes enforced by the US have pushed these companies to find alternative semiconductor sources, and that's given the domestic semiconductor industry a huge boost.

Now we are seeing many domestic semiconductor companies reporting triple-digit growth, and that would have been impossible without the conflict.

So, in the short term, the US embargo created some pain for Chinese companies but, I believe that in the long-term, it will be extremely detrimental to the semiconductor industry in the US because it is creating a huge competitor.

6. Have anti-trust risks for China's tech sector been appropriately priced in, and do you expect this theme to be an evolving story over the next 12-18 months?

I think we have seen the worst in terms of anti-trust penalties.

Alibaba was the first to be identified, and they actually had some anti-competitive behavior in written format, so that's perhaps why they received the stiffest penalty. Other companies may have some anti-competitive behaviour in their practices, but most likely not to the same degree as Alibaba.

7. Is China reversing its steps to open up to foreign investors?

I don't think China is reversing its policies, if anything the government has opened up the door a lot more, such as allowing foreign companies 100% ownership within industries like insurance and asset management.

I think the Chinese government realizes that foreign expertise actually benefits the long-run growth of the economy, so I don't think they are about to reverse their open-door policy.

8. How do you pricing in political risk, if at all?

It's hard to do, actually, and political risk is part of life when investing in China. The best thing for us to do is to invest in a diversified way and in quality companies.

9. China has always been in the front with new business models, have you found any new and exciting trends with the companies you have been looking at?

When we talk to both public and private companies we actually get quite excited because we feel that many are doing new and interesting things that will enable them to do very well down the road, not only in China but also internationally too.

Take Chinese pharmaceutical companies for example.

In the past, most of them licensed products from leading companies in the US or Europe to sell in China. Now, we are seeing more and more Chinese pharmaceutical companies license out their products because they can do their R&D faster, cheaper, and more efficiently than international competitors. As Chinese companies become more innovative and competitive, we might see more cases like that down the road.

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