For marketing purposes
For professional / qualified /
Institutional clients and investors only

China markets

The outlook for China equities and fixed income

Bin Shi, Head of China Equities
Hayden Briscoe, Head of Asia-Pacific Fixed Income
Gian Plebani, Portfolio Manager, Investment Solutions

How will China's stock and fixed income markets & indexes perform in H2 2019 and 2020 as the global economy slows? Our three China experts give their key views to investors and look ahead to investing trends for the next 18 months.

Our views – in 60 seconds

- China's economy is slowing, but we expect growth to stabilize and an 'L-shaped recovery in H2 2019';
- Policy will remain supportive. Further RRR cuts, tax cuts and supply-side reforms likely in H2 2019;
- Positive real yields make China government bonds an attractive safe-haven as global growth slows;
- September/October may be a good entry point to invest in China High Yield strategies;
- Equity valuations remain attractive, and we are still positive on consumer, IT, healthcare and insurance sectors as their fundamental drivers remain intact;
- An All-China approach to equity investing may offer investors the best way to combine the best equity investment opportunities in China's onshore and offshore equity markets

China economy outlook: slower growth – and that's fine

Hayden Briscoe
Head of Asia-Pacific Fixed Income

China's economy is slowing, and so is global growth.
The IMF estimates 6.3% growth for China in 2019, compared with 6.6% in 2018, and 3.3% for the global economy in 2019, versus 3.6% in 2018.

China's economy: will it continue to slow?

We don't think China's economy will see a continued slowdown, and that's for a number of different reasons.

Firstly, the policy support rolled out in Q4 2018 is only just starting to be felt in the real economy.

During the next six months, the policy measures taken, including monetary policy easing, tax cuts, and supply-side reforms will start showing up in the official numbers. As such we, expect China's economy to stabilize in H2 2019.

Keeps your eyes on China's all-important real estate sector

Additionally, we're expecting a boost to the economy from China's real estate market. What's happened in the past couple of months is that sales have grown rapidly, but the actual construction of the buildings has fallen behind1.

When China's developers get around to building the houses they have sold, we'll see the effect of that activity ripple through the economy and that will deliver a further boost to the economy in H2 2019 and add further weight to our expectation of stabilizing growth later in the year.

China policy moves will come into focus in H2 2019/2020

We're also expecting further support for the economy.

Looking at China's monetary policy, we're expecting further rate cuts, most likely in the form of cuts to RRR, to come through in H2 2019, which will likely ease the flow of credit into the economy.

What this means for investors is that they will have to get used to a new reality, which we describe as the '3Ls':

- L-shaped recovery: growth will stabilize rather than rebound. Policymakers are wary of adding huge stimulus and are making targeted moves to keep growth stable;
- Longer business cycles: following on from the above idea, the business cycle will likely be longer and more stable because the authorities are taking a more measured policy approach;
- Longer-term quality growth: deleveraging policies and new regulations imposed in 2017 and 2018 have imposed new discipline and forced poor-quality firms out of the market, and that has improved the longer-term outlook for China.

So with these trends playing out, and the prospect of a L-shaped recovery, we actually think that slower growth is fine for China. We'll now turn to how the above trends open up opportunities in Chinese fixed income.

[1] China National Bureau of Statistics, June 2019

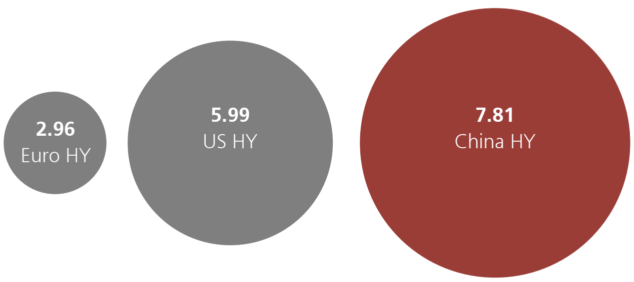
China fixed income: two essential trends and trades

Investors face a difficult problem: where do you hide out as the world economy slows?

Developed markets like Germany, Japan and the United Kingdom are offering little or no protection – real yields are negative there and US treasuries aren't offering that much either.

With markets the way they are, China government bonds stand out as an excellent choice.

High yield benchmarks compared, yield-to-worst (%)



Source: Bloomberg, June 2019

Offering positive real yields and low correlation to developed markets, we believe this asset class has a place in everybody's portfolio and is an emerging safe haven asset of choice for global investors.

And this is an asset class that has performed, racking up a position as one of the top-performing assets globally in 2018, and which we expect will continue to do well.

Moving on, we believe there is an excellent investor case to consider China high yield strategies.

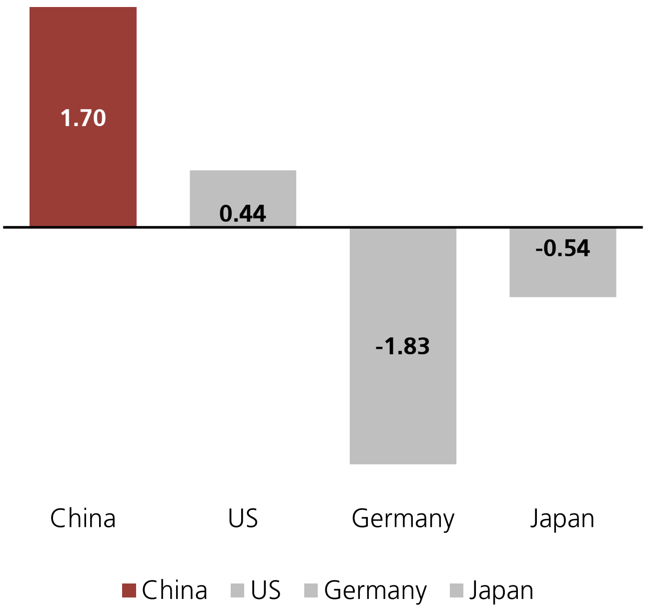
In a world starved of yield, China high yield offers excellent relative value vs. other global high yield markets.

And we see decent fundamentals for the asset class. Real estate companies dominate the issuance universe for China high yield bonds, and we have tracked a pronounced uptick in sales during the past year.

These improved sales trends, coupled with the sustained efforts to deleverage undertaken by some of the larger developers, means we are confident about the asset class and favor the larger players in the space.

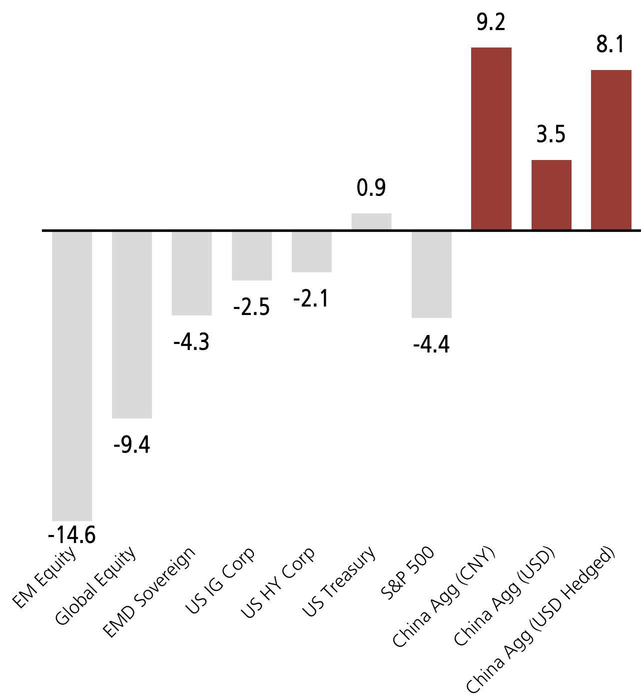
Looking at fundamentals in the economy too, we see an attractive entry point for China High Yield later in Q3 2019. We believe as the economy stabilizes, we'll see an opportunity for capital appreciation too from potential yield tightening.

Real yields on 10-year government bonds (%), June 2019



Source: Bloomberg, June 2019

Returns by asset class benchmark (%), FY 2018



Source: Bloomberg, March 2019

China equities: don't fear volatility, fundamental drivers remain intact

Bin Shi
Head of China Equities

The ongoing trade discussions between China and the US are producing a lot of noise in the media.

This is likely to continue because we don't expect a solution to emerge any time soon. As such, China's stock markets will remain volatile.

China markets come with volatility

But volatility isn't a new thing to China's stock markets. In fact, China's markets have been volatile for some time now and it is certainly not new to us, the trick is to use it to your advantage.

One way to do that is to stay focused on fundamentals.

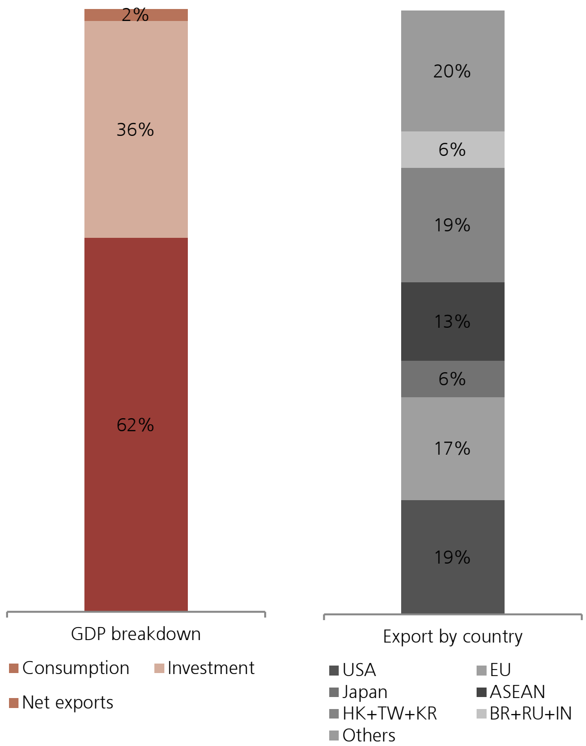
Cut through the noise, focus on fundamentals

Despite all the noise about trade tensions and concerns about slower growth in China, we'd remind investors that China has limited exposure to US trade.

Looking at the companies making up the MSCI China index, only 1.8% of their revenues come from the US[1].

Looking at the macroeconomy, net exports account for only 2% of China's GDP, and US exports account for 19% of total exports[2].

China 2018 GDP breakdown vs. Export by country



Source: UBS AM, Factset, May 2019

[1] UBS Asset Management, Factset, May 2019
[2] UBS Asset Management, Factset, May 2019

With regard to fundamentals, we are focused on domestic demand and the long-term fundamentals underpinning four main domestic demand drivers remain intact.

The four drivers are :

- **Growing consumer demand:** consumption growth in China remains robust, and many of the consumer names we follow have produced better-than-expected results, despite noise in the media about trade tensions.

- **Continuing urbanization:** China continues to rapidly urbanize rapidly and that's creating large, urban consumer markets and supporting demand for services like education.

- **Automation and innovation:** China's industries now have the biggest stock of installed robots in the world and continued strong investment in R&D means sustained innovation by Chinese companies.

- **China's aging population:** 245.9 million people in China will be aged over 65 by 2030, which we believe will create huge demand for services like healthcare and insurance.

We're confident that these fundamentals still have much more room to grow, and that means opportunities on China's equity markets for disciplined investors.

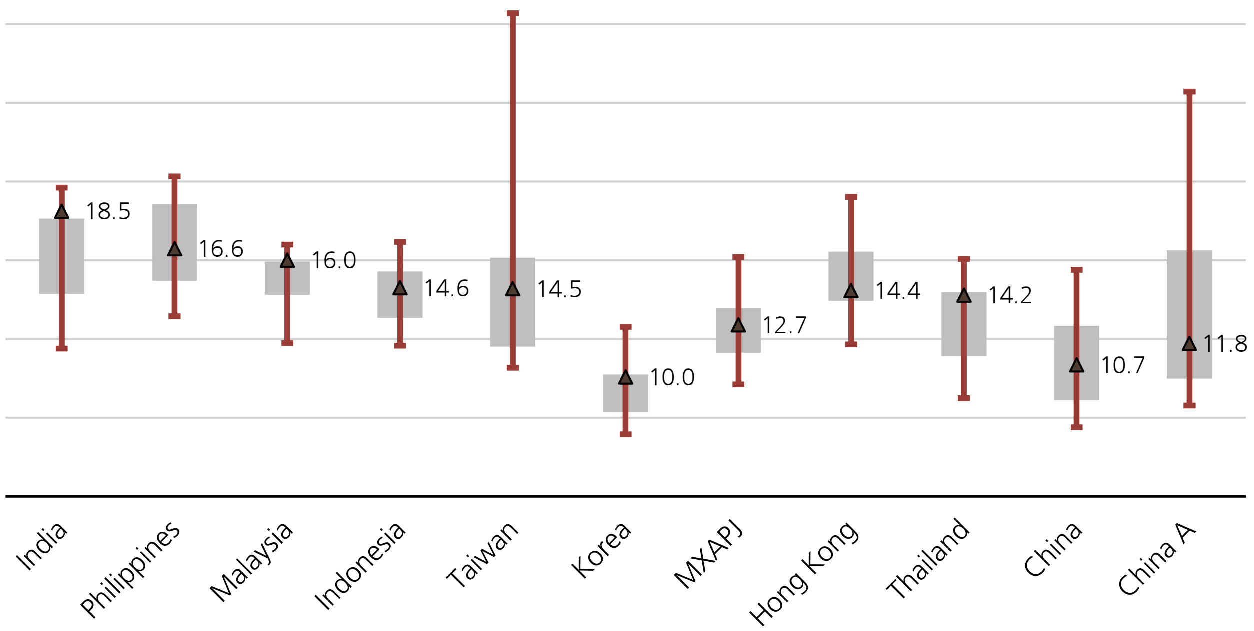
Take advantage of current valuations; think about strategy

And current valuations on China's equity markets remain attractive on both historical measures and compared to other markets in the Asia-Pacific region.

The trick then for investors is how to access the best opportunities.

Now that reforms such as Stock Connect have opened up China's onshore equity markets, an All-China approach that allocates to the best equity opportunities whether in onshore or offshore China markets may offer the best way for investors to capitalize on the many opportunities in the China equity space.

Markets compared: 12M forward price-to-earnings ratio (P/E)



Source: FactSet, MSCI, UBS Asset Management, data as of end May 2019.

China multi-asset investing: getting the right balance

Gian Plebani
Portfolio Manager,
Investment Solutions

When choosing between equity and fixed income assets, we are currently overweight to risk assets, and favor China equities, with particular preference for China A markets.

China policy stimulus: supportive, but this time it is different

At the macro level, we have seen substantial policy stimulus for China's economy, and that's translating into an upturn in leading indicators which we believe will stabilize the economy in H2 2019.

But this recent round of stimulus is different to the huge credit injections seen in 2009.

This time, monetary and fiscal stimulus has targeted capital-efficient private sector corporates rather than highly-indebted property and state-owned enterprise sectors.

We see this as a welcome differentiator and reduces structural capital intensity and the volatility of China's longer-term growth prospects.

China investment strategy: overweight risk; prefer equities over bonds

That's one of the key reasons for our asset allocation strategy.

We favor equities, and particularly China A, because we believe domestic companies in China are better positioned to benefit from the Chinese government's supportive policy measures.

But we still have conviction in China fixed income. We prefer USD denominated HY bonds and we are positive on our exposure to onshore RMB bonds as an efficient diversifier in the portfolio context.

We keep a moderate cash level and have hedged out some of our CNY exposures as the USDCNY rate was hovering around the psychological level of 7 and it could lead to an acceleration of currency depreciation once the level has been passed.

China allocation strategy: capturing growth, controlling risk

We believe this allocation offers the best way forward to benefit from China's growth story - don't forget China's expected to grow at 6.3% - whilst striving to minimize the impact to investors of what we expect will be continued volatility in the markets.

It's this approach to capturing China's growth story but striving to give investors a smoother ride that has served both our multi-asset strategy, China Allocation Opportunity, and our investors well over the years.

And we are confident that our in-depth research, onshore capabilities, and high-conviction views will continue to drive performance.

Putting our views together: our China outlook

- China's economy is slowing, but we expect growth to stabilize and an 'L-shaped recovery' in H2 2019;
- Policy will remain supportive. Further RRR cuts, tax cuts and supply-side reforms likely in H2 2019;
- Positive real yields make China government bonds an attractive safe-haven as global growth slows;
- September/October may be a good entry point to invest in China High Yield strategies;
- Equity valuations remain attractive, and we are still positive on consumer, IT, healthcare and insurance sectors as their fundamental drivers remain intact;
- An All-China approach to equity investing may offer investors the best way to combine the best equity investment opportunities in China's onshore and offshore equity markets

For marketing and information purposes by UBS. For professional clients / qualified / institutional investors only.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

Americas

The views expressed are a general guide to the views of UBS Asset Management as of August 2019. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA

The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document.
Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient. The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG. This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK

Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction.
Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.
You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia

This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

Source for all data and charts (if not indicated otherwise): UBS Asset Management

www.ubs.com/chinaforesight

For professional / qualified / institutional clients and investors only.

Follow UBS Asset Management on LinkedIn

UBS