Investing in China (onshore)

The dragon awakens

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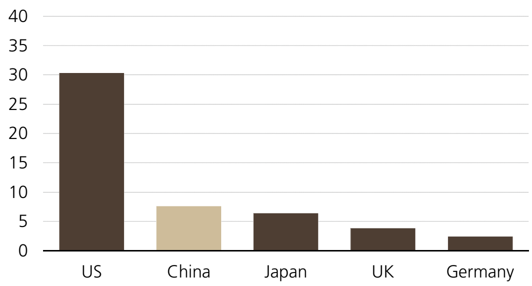
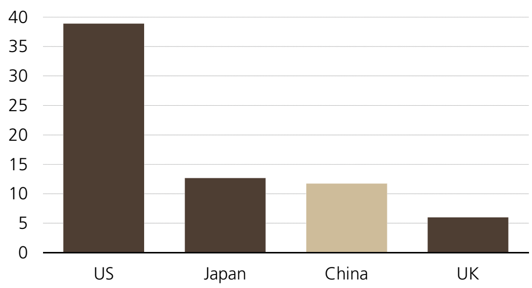
- China's domestic capital markets have grown significantly in recent decades to USD 20trn, but foreign participation is still very low. However, this is expected to change in the coming years due to Beijing's efforts to open up and the rising demand from foreign investors.
- Meanwhile, China is undergoing an economic transition which should result in lower but more sustainable growth. In light of an expanding middle class and further urbanization, we expect the economy to be increasingly driven by household consumption and the service sector.
- Despite the favorable structural outlook and related investment opportunities, investors have to monitor risks closely, especially debt dynamics, as well as potential policy missteps related to capital-account liberalization.

Fig. 1: Equity market too big to ignore...
Domestic equity market capitalization (USD trn)



Source: Bloomberg, UBS, as of May 2018

Fig. 2: ...so is the bond market
Domestic bond market capitalization (USD trn)



Source: BIS, UBS, as of December 2017

Opportunities await in China's USD 20trn onshore market

An unparalleled transition is taking place in China's financial markets and economy as both increase in global relevance. The gradual opening up of the onshore market, which has started to attract global investors, creates unique investment opportunities in equities and bonds alike. Based on our assessment of structural shifts, expected returns should be well above developed markets in the coming years, but related risks are higher too and have to be monitored actively. For investors, diversification across asset classes is essential to investing successfully in China's onshore market. So, in this report, we focus on longer-term trends, identifying key milestones of the transition, investment opportunities in the onshore market as well as risks for financial assets related to structural economic shifts.

Unlocking the onshore market

The rising relevance of the onshore market

China's capital markets have grown sharply over the past few decades. At USD 8trn, China's equity market has become the world's second largest, and at USD 12trn, the bond market is the third biggest globally.

Despite the size, foreign participation in Chinese equity and bond markets remains very small, at only around 2%. This does not reflect the size and importance of the Chinese economy and its financial markets. We believe this will change significantly, thanks to China's efforts to open up and the rising interest from foreign investors.

China has been gradually opening up its capital markets in recent years. Although there was a pause due to huge currency depreciation pressure after a move to a market-determined exchange rate in August 2015, this process has re-accelerated since last year when capital outflow stabilized (see Table 1). The motivation is clear: China wants foreign capital to help deepen its capital markets and increase efficiency in capital allocation. In addition, the resulting capital inflows should help create a two-way currency market and ultimately support the internationalization of its currency, the yuan or renminbi (RMB).

Recent efforts, including the launch of stock and bond connect programs and the lifting of restrictions regarding foreign ownership in the financial sector, demonstrate China's desire to open up its capital markets.

Global investors are also increasingly recognizing the importance of Chinese assets in their portfolios. MSCI included A-shares into its benchmark indices in June 2018, and Bloomberg announced in March the likely inclusion of China onshore bonds in April 2019. Although initial inclusion factors are small, these changes represent a material shift by major indices to boost exposure to Chinese onshore financial assets, and we expect more to follow. Putting aside the long-term macro and earnings thesis described later in this piece, MSCI China A appears well positioned to achieve outperformance compared to global equity markets based purely on investor positioning.

Table 1: China's gradual opening up of capital markets

November 2014	China launched Shanghai-Hong Kong Stock Connect
October 2016	CNY joined the USD, EUR, JPY and GBP in the IMF's special drawing rights basket
December 2016	China launched Shenzhen-Hong Kong Stock Connect
June 2017	MSCI announced the addition of China A-shares to the MSCI EM index starting June 2018
July 2017	China launched Bond Connect (northbound only)
March 2018	Bloomberg announced the planned addition of China onshore bonds in Bloomberg Barclays Global Aggregate Index starting April 2019
March 2018	China launched an RMB-denominated oil future open to international investors
March 2018	China opened doors for Chinese depository receipts (CDRs) and IPOs for innovative companies in the onshore market
April 2018	China pledged to lift foreign ownership limits for domestic financial institutions
May 2018	China quadrupled the daily quota on the stock connect programs
May 2018	China opened Dalian iron ore futures market to overseas investors
June 2018	China A-shares included in the MSCI EM Index
June 2018	China scrapped repatriation cap and lock-up period for QFII and RQFII programs and allowed FX hedging

Source: Media reports, UBS

Increased overseas inflows to serve as catalyst to onshore equity market

We see the continued institutionalization and internationalization of A-shares as a long-term trend, following the opening up of Chinese capital markets. The impact may be mild on the overall market given the huge market cap of A-shares (about USD 8trn currently), but could be significant for individual stocks as foreign capital will continue to be concentrated in just some stocks, largely in the consumer and healthcare sectors.

The recent quadrupling of the two Stock Connects' daily quota for both north and southbound capital flows improves the accessibility to A-shares, in preparation for expected inflows due to the MSCI A-share inclusion. Although the market has barely utilized the current daily quotas (10-20% for the Shanghai-Hong Kong Connect and even less for the Shenzhen-Hong Kong Connect), northbound trading will likely increase sharply as a result of the MSCI inclusion in June 2018, in our view. We are forecasting an additional USD 60bn of inflows into A-shares following the first step of the inclusion in June; the inclusion factor of 5% by September 2018. In 3-5 years, we expect over USD 350bn of inflows on full inclusion, and foreign capital to reach 6-7% of A-shares' market cap versus less than 2% currently.

Northbound inflows have been picking up since 2017 and have reached around USD 70bn year-to-date. Foreign investors are much more overweight on the consumer and healthcare sectors than Chinese investors are in the A-share market. The top 20 most-held northbound stocks accounted for 57% of total northbound inflows in 2017. And data shows that 15 stocks have accounted for 49% of northbound net buying since March 2018, most of which are in the consumer and healthcare sectors. In terms of investment styles, foreign investors are more risk averse than their Chinese counterparts and prefer EPS certainty to high beta.

Access to unique investment opportunities

The rising interest in Chinese assets is understandable: the market is simply too big to ignore and the country's economic growth is more than double the rate of the US. Some global investors already have allocations in Chinese financial assets via offshore listed stocks and bonds. However, the onshore market is much larger and offers some unique opportunities not available in the offshore market.

Equity market

Clearly, there is no simple correlation between higher GDP growth and superior stock market performance as the latter also depends on superior ROE and EPS growth over the cycle. But the growth transition envisaged in the next section of this report does imply that the Chinese equity market, onshore in particular, will continue to undergo a dynamic process of new company listings likely to build out innovative players in value added sectors with pricing power. For example, many of the leading consumer brands are only listed onshore, so investors who wish to capitalize on the rising consumption theme need to access the A-share market. The onshore equity market also has higher exposure to healthcare names which are likely to benefit from the aging population. In addition, sectors benefiting from the industrial upgrade plan, such as electronic components and aerospace & defense, are mostly listed onshore. In the coming years, we expect double-digit equity market returns due to China's superior economic growth compared to global GDP growth and on the back of margin expansion as companies move up the value chain and gain more pricing power.

When forecasting the total return for equities, we derive estimated earnings reflecting a moderation in economic growth and a real revenue growth rate. This assumes a gradual increase in margins due to sector consolidation and improvement in the return on equity (ROE). To forecast the expected change in valuation, we use macroeconomic factors to estimate the long-term fair value for China onshore equities given their relatively short trading history. We then forecast future dividends by using the historical level as a starting point and assume the current dividend yield will converge to the fair value over the business cycle as Chinese listed companies' dividend policy becomes more mature. We then forecast real returns based on estimates of these factors, and add an inflation expectation to reach the nominal return forecast per annum. Based on this framework, we expect low double-digit total returns in the onshore equity market – slightly higher than our expectation in the offshore market. At the same time, small caps are set to outperform large caps.

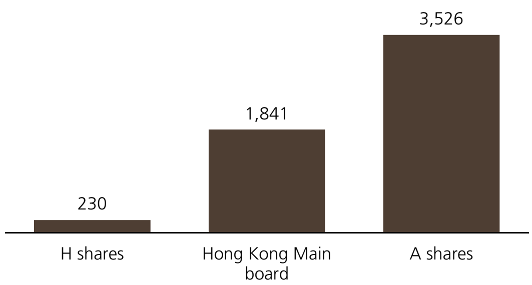
Several of the domestically-listed companies operate in a relatively protected environment with entry barriers for international competitors. While this creates attractive investment opportunities, volatility is also higher than in developed market equities, and related market risks and inefficiencies require active monitoring.

Bond market

China's onshore bond market is also undergoing structural shifts. Recent efforts to deleverage and remove implicit guarantees are a long-term positive for the domestic bond market. For investors, this has two important implications.

Fig. 3: A deeper opportunity set in A-shares

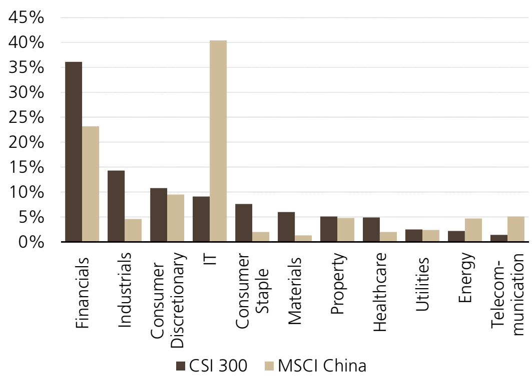
Number of listed companies



Source: Hong Kong Stock Exchange, UBS, as of 15 June 2018

Fig. 4: More exposure to financial, industrial and consumer sectors in the onshore market

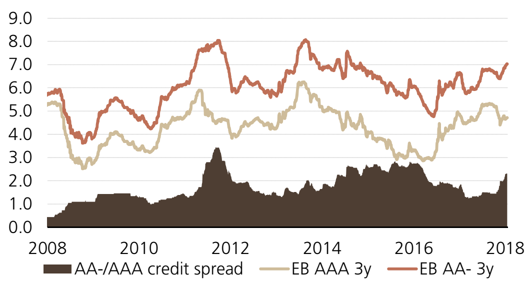
Sector weights



Source: CSI, Bloomberg, as of December 2017

Fig. 5: Rising credit differentiation

Yield of enterprise bonds (EB) rated AAA and AA-, including spread



Source: WIND, UBS, as of June 2018

First, we expect Chinese treasury rates to come down as a result of the deleveraging efforts and gradual growth slowdown, which should propel returns and the yield curve to show a bull steepening. This means attractive return prospects for onshore government bonds, given the likely capital gains on top of already attractive yields relative to their global peers. Given current yields of 3% and 3.5% for one- and ten-year government bonds, respectively, and expected lower average yields over the next few years, we expect total returns above 3% p.a. for shorter dated government bonds and 4% p.a. for longer dated ones.

Second, we expect increased credit differentiation among corporate bonds. This means investors who do their homework on credit analysis will now be fairly compensated with higher yields. Investors who used to chase yields irrespective of credit quality due to implicit government guarantees in the past will now have to face growing pains, as wider credit spreads and higher default rates for risky issuers are likely in the near term. After considering the trend of credit spreads, corporate defaults and recovery rates, we expect around 5% p.a. gains for corporate credits over the next few years, but credit selection will become increasingly important.

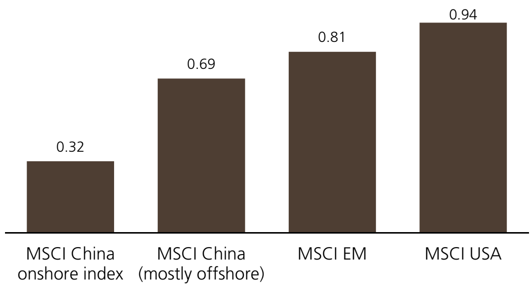
Market characteristics
Market inefficiency still exists in the onshore market, especially in the equity market given the retail dominance. Analyst coverage of onshore stocks and credits is also still expanding from low levels. As a result, we think active management can add value to investment returns, and hedge funds operating in Chinese onshore capital markets should be an integral part of investors' portfolios. Our estimates suggest onshore-focused hedge funds should be able to achieve higher returns than their global competitors as they can benefit from more market inefficiencies and low stock correlation and dispersion. In addition, hedge funds also provide diversification benefits given their low correlations to bonds and equities throughout the business cycle.

From a portfolio perspective, Chinese onshore assets also provide a meaningful diversification benefit for global investors, given their relatively low correlation to global assets. For example, the MSCI China onshore index has a correlation of 0.32 with the MSCI ACWI World Index, relative to 0.69 for MSCI China offshore index and 0.94 for the US. This year, despite the 50bps rise in the 10-year US Treasury yield, the 10-year Chinese government bond yield has dropped by around 30bps (as of 19 June 2018), as the Chinese economy is largely driven by domestic factors. In addition, given the still low foreign participation, asset prices are less sensitive to international capital flows, though we expect this to rise gradually going forward.

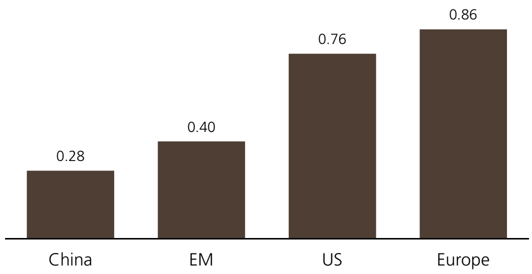
Outlook
We think Chinese assets will continue to increase in size and importance in a globally diversified portfolio. Recent efforts to open up the capital market have significantly broadened the access, and we expect more to come over the coming years. In addition to China's significant size, the country is undergoing important structural shifts which should offer tremendous investment opportunities. Investors with better understanding of the onshore market will be better positioned to capitalize on this.

Fig. 6: Onshore Chinese assets provide a meaningful diversification benefit

Correlation with MSCI ACWI World

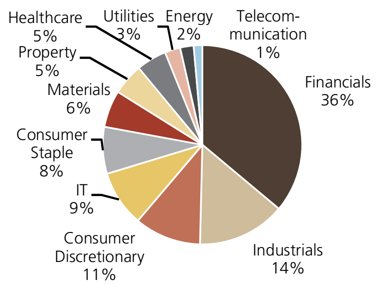
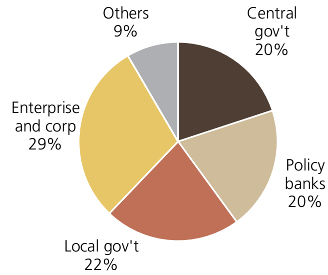


Correlation with Bloomberg Barclays Global Aggregate



Source: Bloomberg, UBS, correlation based on 5y weekly data, as of June 2018

Table 1: Onshore markets at a glance

	Equity	Bond
Market size	USD 8trn	USD 12trn
Investor mix	Retail investors dominate (85% of turnover)	Domestic institutional investors dominate: banks hold 56% and funds 23%
Foreign ownership	2%	2%
Average daily trading volume	USD 75bn	USD 63bn for cash bonds USD 548bn for repo transactions
Global index inclusion and fund flows	MSCI is adding China A-shares this year with a 5% inclusion factor, and we expect USD 60bn of initial inflows. In 3-5 years, we expect over USD 350bn of inflows on full inclusion, and foreign ownership to reach 6-7% of A-shares' market cap.	Bloomberg will include onshore bonds in Bloomberg Barclays Global Aggregate Index starting from April 2019 over a 20-month period; we expect USD 140bn of inflows as a result. Going forward, we expect Chinese bonds to be also included in the JPM GBI-EM Index and the Citi World Government Bond Index, with additional inflows of around USD 100-150bn, bringing foreign ownership to 5% of onshore bond market in the medium term.
Investment style	Domestic retail investors favor high growth and small-cap stocks, while institutional and foreign investors favor large-cap and new economy stocks.	Government and policy bank bonds are the most actively traded by both domestic and foreign investors and the most liquid tenor is 10 years.
Composition		

Source: Index providers, UBS

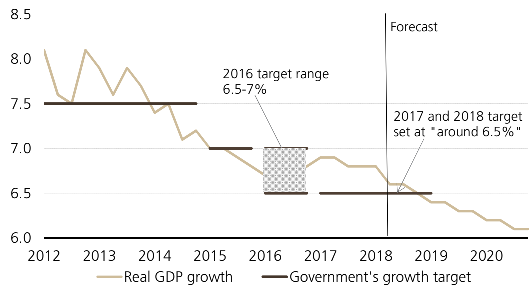
Benefitting from structural shift in the economy

Economic rebalancing offers investment opportunities
The investment opportunities highlighted above are largely a reflection of major structural changes taking place in China. We believe China will be able to generate a new pattern of growth which combines increasing investment and labor plus productivity more efficiently. To be clear, China is being forced to make these major structural shifts as the previous growth model had major limits. In the past two decades, China's high growth model primarily relied on the mass-mobilization of inefficiently used resources. However, in the aftermath of the global financial crisis, China has become victim of its own success in pursuing such an approach, having remained indifferent to the structural shift in global and domestic demand. As a result, a rapid buildup of excess capacity in key sectors due to over-investment ensued, and policymakers were forced to roll out supply-side reforms mainly consistent with capacity reduction targets and financial support to facilitate this adjustment. These government policies have helped to re-direct resources to more productive sectors, but it takes time to reach fruition. Part of the delay is due to the distortive impact of the huge stimulus program after the global financial crisis. Since excess capacity in heavy industries and high property inventory could not be reduced quickly, the economy went through an extended period of lower returns to investment and reduced productivity. However, recent profit and real investment trends indicate that China has passed the worst of this period.

Rebalancing toward a consumption- and service-based economy
Certain long-term trends have yet to run their full course and are deeply interconnected. Service industry growth, urbanization and higher municipal land values all tend to go hand in hand. The trade-driven industrialization since the 1990s has drawn millions of workers out of rural areas into towns and manufacturing hubs. The supply of services like health, education, finance and logistics mushrooms to meet demand. Land and property values rise to reflect this change in demand and the greater use of credit and mortgages to price it.

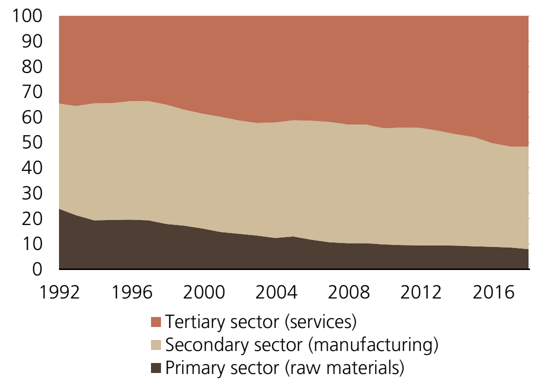
China's domestic growth will be increasingly driven by household consumption and the service sector, as the economy rebalances away from debt-fueled investment. The price, in the near term, is a slowdown in the absolute growth rate as resources are reallocated. Uncertainty around Beijing's trade relationships with select partners could also add to near-term headwinds. But the long-term benefits weigh more because the switch in growth drivers makes the economy more healthy and sustainable. In terms of industry, growth in the service sector has continued to outpace that in the manufacturing sector, and we have seen its share of GDP expanding in recent years.

Fig. 7: China is seeking high-quality growth amid structural slowdown
China's real GDP growth vs. government target (in % y/y)



Source: NBS, CEIC, UBS, as of May 2018

Fig. 8: Tertiary sector's share of GDP has been expanding
Structure of China's economy (% of total GDP)



Source: CEIC, UBS, as of May 2018

Consumer upgrade serves as a key driver for growth

This has already started to happen. In 2017, consumption accounted for 59% of China's real GDP growth, thanks to the expanding middle class and continued urbanization. We believe the potential on the consumption side is huge. Between 2015 and 2020, close to 100 million new migrants will have moved to cities in China, according to UN forecasts. By 2030, this figure will potentially double. Upper middle and high income consumers, defined as those with annual incomes over USD 9,600, are estimated to reach 480 million, 35% of China's population by 2030. This has been evidenced in recent years by the fact that disposable income growth has started to outpace GDP growth. A key reason for this is that the saving rate has started to decline modestly owing to improved social safety net provisions and better credit access for households.

Consumer upgrade

Along with the high growth in consumption, we see continued consumer upgrades taking place in two ways. First, the majority of people are paying more attention to quality of life. People are willing to pay more for well-known brands, which is also helping the recovery in the luxury market and industry consolidation in the consumer sector. Second, the Chinese are shifting their pattern of spending and moving more towards discretionary items. They are spending less on housing and food, but more on upgrading their lifestyles, like healthcare, education, travel and entertainment, as well as on high-tech products. Engel's coefficient, which measures the proportion of income spent on food, dropped to 29% in 2017 from above 35% before 2016, but remains quite high when compared to developed countries (12-13% for middle-income households and single digits for the high-income group). A continued decline in the spending on food will support the robust consumption in quality, high-end and luxury spending.

Infrastructure still important

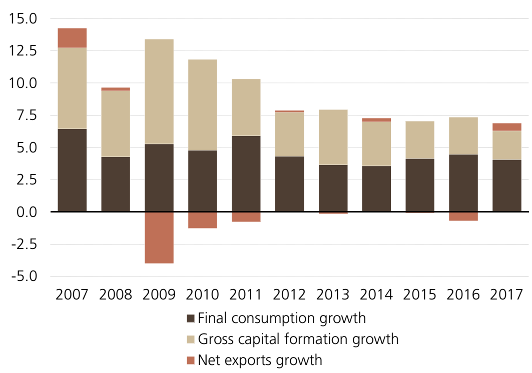
There is still incremental demand for infrastructure construction domestically as China is still perhaps ten years or more away from the 70%+ urbanization ratios of Japan, Taiwan and Korea in the 1980s. Certain factors like better transport links allow the big central provinces like Hubei, Hunan and Henan (each with 50-100m populations) to follow the domestic demand story.

Shifts in the industrial level

At the industrial level, there is a natural shift from the manufacturing sector to the more "knowledge intensive" services sector as income levels rise. And within manufacturing, the key changes are the shift up the value-added ladder and a move away from manufacturing assembly towards keeping more production at home (similar to Korea). For example, China's recent industrial upgrade plan aims to increase the domestic content of core materials to 40% by 2020 and to 70% by 2025. Higher wages and China's rapid advancement in various technologies make this shift inevitable irrespective of the current Sino-US tensions. However, the initiative has increased China's sense of urgency to innovate and reduce foreign dependence. This shift in comparative advantage also brings China into more direct competition with its North Asian neighbors in certain product categories.

Fig. 9: Overall growth increasingly dependent on consumption in recent years

Contribution to real GDP growth (in percentage points to overall growth in % y/y)



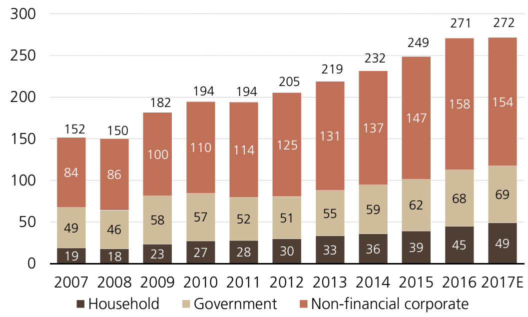
Source: CEIC, UBS, as of May 2018

A balancing act to manage risks

In this section, we review the key challenges that China faces in achieving the previously described economic shifts. While we believe China's policymakers will be able to prevent the economy from hitting one of the roadblocks described below, navigating around them involves some major challenges. And there is a significant risk that some of these key challenges will temporarily flare up and result in periodical stress in the domestic capital markets. Temporary noise from external risks, like the recent escalation of Sino-US trade tensions, could hurt sentiment during certain periods as well. Thus, we believe the volatility in the onshore Chinese financial market, in particular in equities, will be significantly higher than in more traditional markets in the years ahead. Therefore, as China offers superior investment return opportunities, we have to monitor these risks. We address below some of the major concerns that investors regularly highlight.

Concern #1: Debt and overcapacity. *Debt-to-GDP ratio rose to 272% in 2017 from 152% in 2007. Some investors are concerned that China might face a looming financial crisis and crumble under the massive debt buildup. Meanwhile, oversupply in 2015 depressed steel prices so much that the profit from producing one ton of steel could not even pay for an ice cream cone, according to the China Iron and Steel Association.*

Fig. 10: Rising debt levels
China's debt-to-GDP ratio (%)



Source: CEIC, UBS, as of 2017

Given China's current account surplus, USD 3trn FX reserve and 46% savings rate, a debt crisis appears unlikely. It is important to note that 97% of Chinese debt is domestic and funded by savings, a rather stable funding source. In addition, much of the debt buildup was used to fund investment rather than consumption, which makes additional restructuring options such as debt-to-equity swaps possible.

Still, the rapid rise in debt-to-GDP ratio reflects that China has borrowed a lot from the future. Much of the debt has gone into unproductive industries, so the leverage problem is also linked to the overcapacity issue. Ultimately, China needs to improve the efficiency of capital allocation.

The good news is policymakers have implemented a series of reforms to tackle both issues. The supply-side reform started in 2016 combines de-capacity and deleveraging in one package: the former sets production cut targets, and the latter cuts off funding for the unproductive "zombie" enterprises. As a result, industrial capacity utilization rose to a five-year high of 77% in 2017, and non-financial corporate debt/GDP fell for the first time in 10 years.

Another issue in China's credit market is the lack of credit differentiation and prevalent implicit guarantees in investment products. Put simply, if all investment products pay in the end, investors would rather go for the higher yielding ones. This has artificially pushed down rates for risky borrowers while pushing up rates for safer borrowers. Recent regulations, such as the new asset management product rules, aim to break the implicit guarantees, which should increase credit differentiations between good and bad borrowers and ultimately improve the efficiency of capital allocation.

To be clear, we are not saying the deleveraging process will be a smooth ride. Defaults will likely rise as funding becomes tight for high yield issuers, but at a moderate pace from very low levels. Growth will likely slow, but new growth drivers are emerging. We remain optimistic that China can manage the deleveraging process without a credit crisis or a hard landing. At the same time, it will be necessary for investors to actively manage the credit portfolio.

Concern #2: The impossible trinity. *Economic theory suggests that a central bank cannot have a fixed exchange rate, an open capital account and an independent monetary policy at the same time.*

As China gradually has been relaxing its capital controls in recent years, it has become increasingly difficult to manage an independent monetary policy while maintaining the dollar-yuan peg. In August 2015, China decided to forgo the dollar peg and move to a more flexible exchange rate regime. Although the move was theoretically the right thing to do, the timing was not ideal. Amid a slowing domestic economy, the yuan depreciated 3% in three days against the dollar and wreaked havoc across global markets for fear of a currency war. The mounting capital outflow pressure as a result forced the policymakers to backtrack on China's capital market opening and to rush to defend the currency.

After the 2015 FX reform, policymakers have learned their lesson. They still want to keep monetary policy independence, as China's large domestic economy has different business and debt cycles versus the US. However, abrupt exchange rate movements are also unacceptable, given domestic capital outflows, the international suspicion of a currency war, and more importantly a significant setback for RMB internationalization. Eventually, Beijing decided to ease off on the capital markets opening process.

As highlighted in the financial markets section, the opening of capital markets is now reaccelerating. Timing is on China's side this time, thanks to the stronger domestic economy and a weaker US dollar over the past two years. Although China burned through USD 1trn of FX reserves during the 2015-16, it still has a sizable cushion of USD 3trn. Moreover, the RMB's emergence as an international reserve asset should reduce the need for large FX reserves over time. The push for RMB internationalization is crucial in this regard, and we view the increased opening of China's domestic capital markets as positive for solving the trilemma over the long run. In the process, however, exchange rate volatility will likely increase amid a gradual depreciation trend in the long term. The latter could result from a diminishing current account surplus and the interplay of capital outflows and inflows as the exchange rate regime moves closer to a free float.

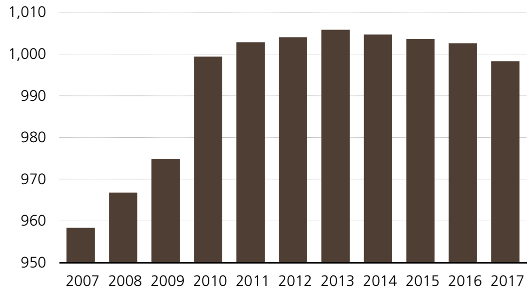
Concern #3: Demographics. *Some market observers highlight China's unfavorable demographics as a headwind. While it's true that its population is aging, we think the economic impact should be manageable as growth driver shifts to services.*

According to the United Nation's forecast, China's population will peak in 2024 at 1.44 billion and remain stable till the 2030s, after which it may start declining. But the shrinking number of working-age population (age 15-64), which fell to its lowest level since 2009 last year and below 1 billion for the first time in seven years, is an even more ominous sign to China's long-term potential growth rate. Meanwhile, the number of people over 60 is set to rise. This means there will be far more elderly residents in retirement, with fewer working-age citizens to support them. That said, China's spending on services, especially healthcare, insurance, elderly-care and recreation should thrive in the coming years with an aging population that is increasingly affluent. In addition, relaxation on the one-child policy should also soften the negative impact.

Compared with Korea and Japan, which are at more advanced stages of aging, China is facing this issue at a lower income level, which makes pension reform more pressing. For households, this phenomenon may also encourage a higher rate of saving at an earlier point in life and generate higher-than-expected demand for financial saving products and for properties, which are held as assets.

Fig. 11: Working-age population fell below 1 billion for first time since 2010

China's working-age population (number of people aged 15-64, in million)



Source: CEIC, UBS, as of 2017

Appendix

Emerging Market Investments
Investors should be aware that Emerging Market assets are subject to, amongst others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and socio-political risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. CIO GWM generally recommends only those securities it believes have been registered under Federal U.S. registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as "Blue Sky" laws). Prospective investors should be aware that to the extent permitted under US law, CIO GWM may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.
For more background on emerging markets generally, see the CIO GWM Education Notes, *Emerging Market Bonds: Understanding Emerging Market Bonds*, 12 August 2009 and *Emerging Markets Bonds: Understanding Sovereign Risk*, 17 December 2009.
Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher yielding bonds for shorter periods only.