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China

A spotlight on standalone allocation

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In a world where China increasingly propels the global economy, investors could now consider a standalone allocation to Chinese assets, like they do for regions such as the US, Japan, Europe and the UK. This is because:

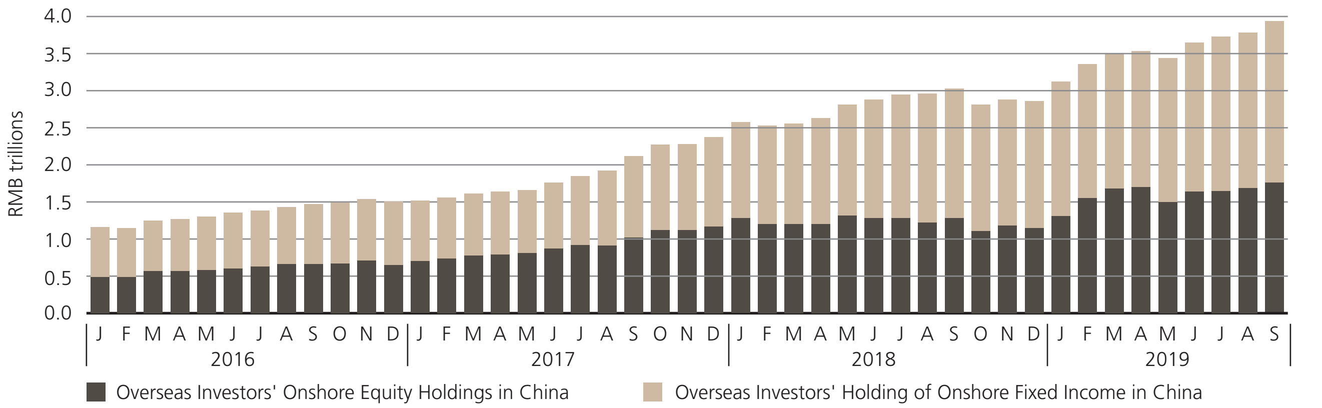
- Adding a forecast 33% of global growth in 2019[1], China is taking the lead in the global economy and its equity and bond markets are some of the largest on earth;
- Restrictions on investor access to China opportunities are becoming a thing of the past after the launch of Stock and Bond Connects;
- China equities and fixed income offer diversification benefits, and market volatility can mean opportunities for active investment strategies to exploit;
- As China leads the world in many areas of new technology and innovation, a standalone allocation offers investors greater potential to participate in China's growth story.

Forward-looking investors are beginning to reflect on whether it is time to take a new approach to markets for Chinese assets. We believe the evidence is growing in favour of making a standalone China allocation.

China has steadily reduced market barriers over the last several years through programs connecting its formerly closed equity and bond markets to global investors, such as Stock Connect and Bond Connect.

The success of this effort was recently underscored when key equity and bond indices increased their weightings of Chinese securities, which in turn will further increase already strong flows of foreign investment into Chinese assets.

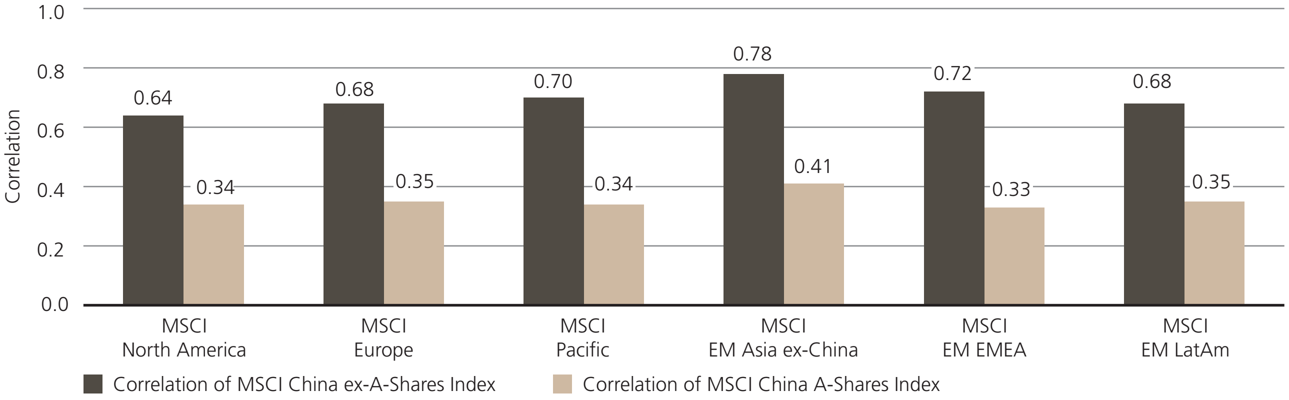
Exhibit 1: Overseas Investors' Onshore Holdings in China, Fixed Income & Equities (RMB Trillions) Jan 2016-Sep 2019



Source: People's Bank of China, October 2019

1 IMF, Visual Capitalist, March 15, 2019. Note: GDP estimates are made on a PPP basis and represent a share of additional global growth in 2019.

Exhibit 6: Correlation of MSCI China ex-A-Shares & MSCI China A-Shares Indices with Global Benchmarks
February 2002-December 2019 (USD)



Source: UBS Asset Management, December 2019

Looking further afield, and over a longer time period, China A shares have low correlation with a much more geographically diverse range of markets, thus offering further support to our belief that China equities offer strong diversification benefits.

Active management can make the difference in China

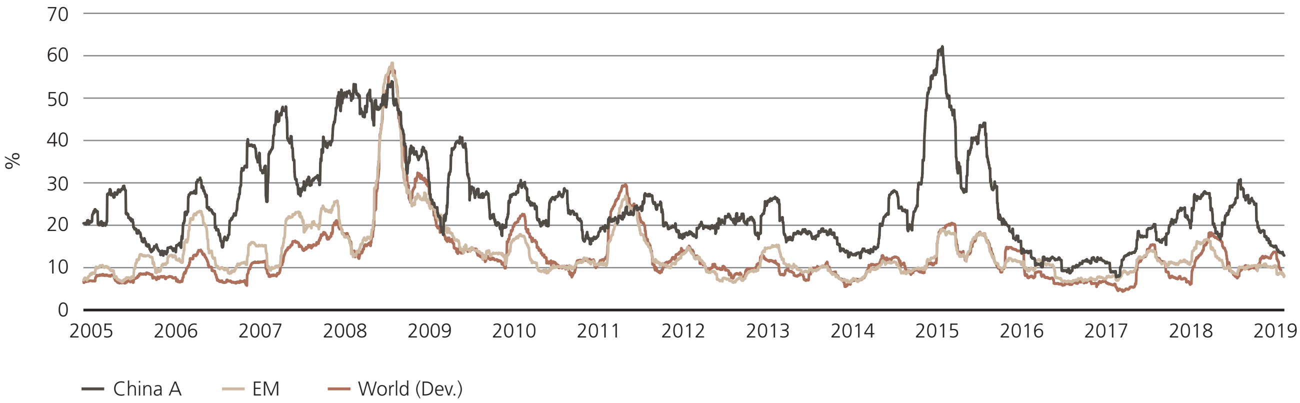
Chinese equities have also seen considerable volatility historically, even compared to emerging market benchmarks – often seen as at the riskier end of the spectrum of public equity markets.

While this can be a mixed blessing for investors, both higher levels of overall and cross sectional volatility can create an attractive playing field for active management. Skilful investors have more scope to position for sharp changes in market thinking and to be rewarded if these positions are proved to be correct.

In a market with a very high proportion of retail ownership by international standards, a focus on fundamental, industry and company research and taking advantage of unconventional sources of information can be rewarded.

Looking to identify industry leaders that will benefit as China transitions towards a consumer based, services led economy can help to uncover investment opportunities.

Exhibit 7: MSCI China A, MSCI EM and MSCI World, 60-day volatility of index returns p.a
February 2005-December 2019



Source: Bloomberg, January 2020

Turning to bonds, China now hosts a rapidly growing fixed income market, which is already the third largest in the world and closing in on Japan in second place. As the market continues to broaden beyond government and policy bank bonds, a number of regulatory changes has made it more attractive to overseas investors.

The move by Bloomberg to include Chinese bonds in its flagship global indices is likely to see further strong inflows from such investors, where holdings of onshore bonds have already tripled in just three years.

Again, Chinese bonds can offer diversification benefits to a global fixed income portfolio, with low correlation to other large markets. With yields on offer on government, high quality credit and high yield markets all having fallen in recent months, yield-hungry investors may also be attracted by more tactical considerations.

Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally despite having delivered strong relative risk-adjusted returns in recent years. Real yields also look attractive, and the cost of hedging Chinese yuan exposure has also tended to fall – providing potential investors with an important risk mitigation tool.

While bond market access and investment has improved dramatically, the market has not been through continuous credit quality scrutiny in the same way that developed market bonds have been. The development of onshore ratings will be of importance to build investor confidence with China's authorities making big steps to bring foreign ratings companies into the market.

As fixed income market participants become more comfortable with investing in China, we believe that bottom-up issue selection will be key, as idiosyncratic risks will be prevalent and that's where investors can benefit from having on-the-ground local presence and knowledge.

Time to consider a standalone approach to capturing China's growth story?

Taking all the discussed factors together, it is clear that the internationalization of China’s capital markets is continuing rapidly.

The key for global investors then is how to most effectively capture China's ongoing growth story, and we believe that a standalone investment allocation can increasingly be an effective option for investors.

In part that's because the size of the opportunity is just too big to ignore – China is the most significant driver of global growth and its onshore markets are rapidly surpassing other major global markets in terms of size.

This pattern of growth is likely to differ from other markets, both in emerging and developed regions, in terms of its key drivers, the role China increasingly plays in key new economy industries and the focus on developing links with other emerging economies.

More than that, China equities and fixed income asset classes offer investors diversification benefits compared to other widely-held portfolio allocations, as well as attractive opportunities for active management to add value.

These factors mean that a standalone allocation to China offers exciting opportunities for investors, both within individual asset classes and from an overall portfolio allocation perspective.

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

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