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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;

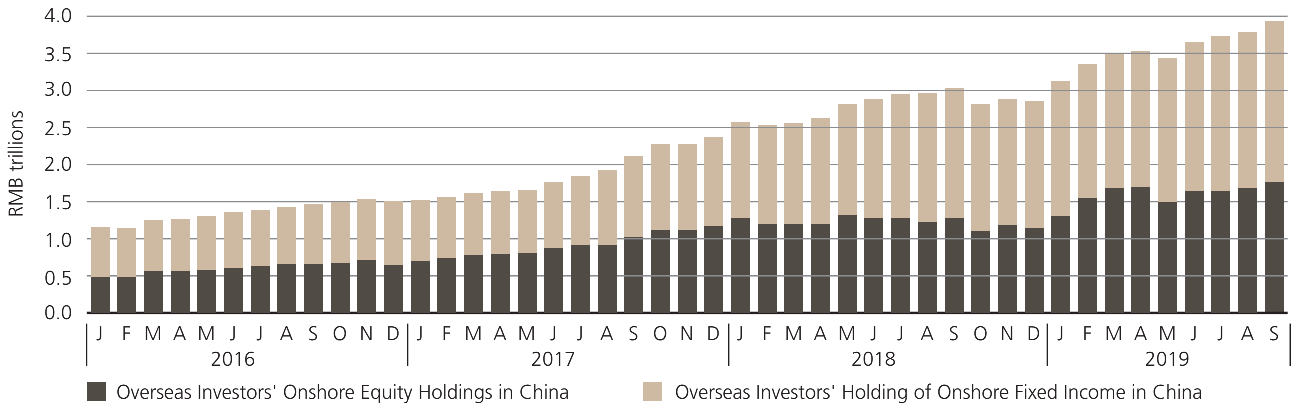
- As China leads the world in many areas of new technology and innovation, a standalone allocation offers investors greater potential to participate in China's growth story.

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.

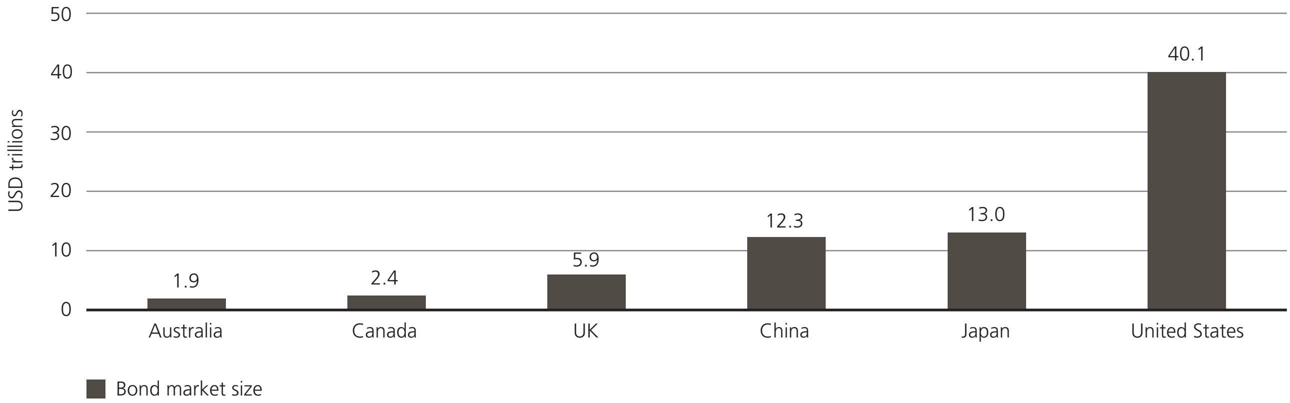
On 28th February 2019, the equity index provider MSCI announced it would quadruple the weighting of onshore Chinese companies in its flagship emerging markets index by November 2019, bringing the weight of onshore and offshore Chinese stocks to almost a third of the total emerging market exposure.

The widely followed Bloomberg Barclays Global Aggregate index began a gradual process of adding China onshore bonds from April 1st 2019, – a change which we believe will be followed by other index providers in due course, further propelling the China onshore market past Japan as the second largest bond market in the world.

To some extent these changes are merely indices playing 'catch up' with a clear theme we at UBS Asset Management have been exploring with our clients for a number of years.

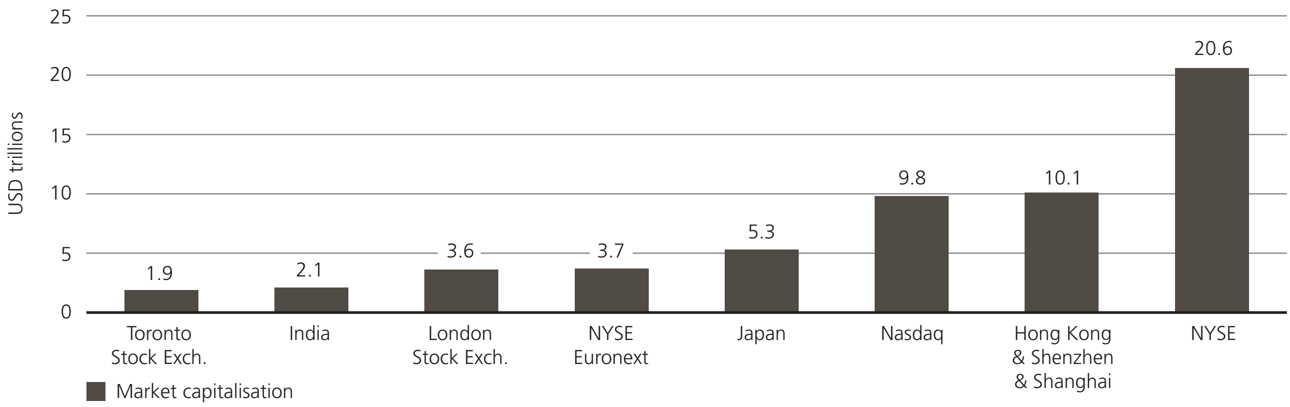
That is, the scale and variety of the opportunities offered by Chinese investments is compelling to investors looking for both market and active returns across asset types.

Exhibit 2: Bond markets by size (USD Trillions)
November 2018



Source, Bank for International Settlements, November 2018

Exhibit 3: Stock markets by size (USD Trillions)
December 2018



Source: Securities and Futures Commission, Hong Kong, January 2019

As China takes the lead…

The breadth of these opportunities is perhaps less surprising when we consider the scale of the role played by China today, both across the global economy as well as within sectors which are likely to be at the centre of future economic efforts.

While China is expected to drive 33% of global growth in 2019, and overtake the US as the largest global economy by 2030[2], this rise to economic leadership has a range of different dimensions for investors. The direct impact of developments in the ongoing trade negotiations between the country and the US on investor sentiment can itself be taken as emblematic of the key role of China as a trading nation.

Such investments are often looking to capitalise on China's leadership position in new economy areas such as cashless payments, smartphone usage and online data utilisation. When these developments are twinned with the rebalancing of domestic growth towards consumer demand and away from exports and fixed asset investment, it creates exciting possibilities for a wide range of product and service providers.

Looking further afield, China is increasingly seeking to improve infrastructure with other emerging markets in particular, both in terms of physical links and through trade agreements.

While the widely publicised Belt and Road initiative has grabbed most attention, China had concluded 17 global free trade agreements by Q2 2019, negotiated another 14 and targeted nine further deals.

Investments have tended to focus on areas expected to experience high population and income growth, with corporate flows concentrated on areas where the middle class is expected to expand by almost 3 billion people by 2030[3].

A standalone approach becomes a matter of course

Many of the factors identified above are not unique to China, of course. However, we increasingly see an argument for starting to consider investments in China on a standalone basis, rather than as part of a wider emerging markets allocation, when setting asset allocation at an overall portfolio level.

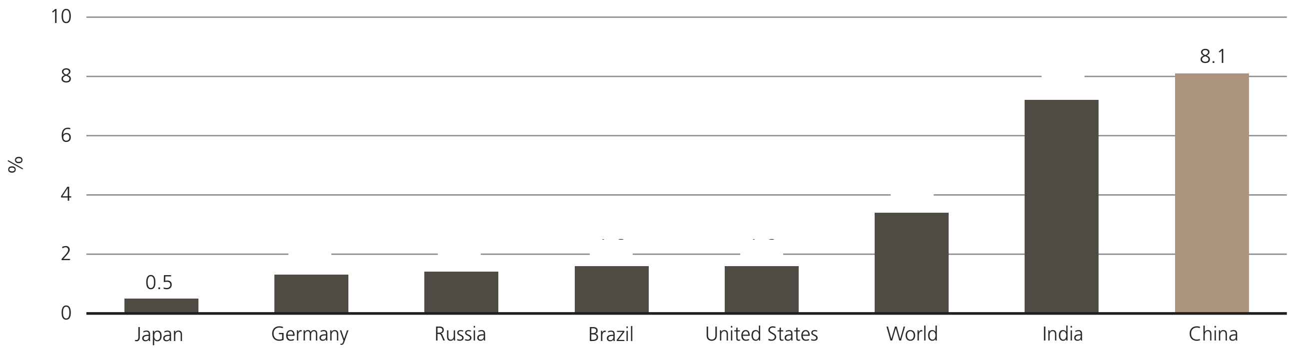
The characteristics of the Chinese economy can be seen as different in a number of key ways to other countries classified as emerging markets, both in Asia and beyond:

- China's scale as the most populous country in the world[4], the second largest destination for foreign direct investment[5] and the world's largest trading nation[3];
- The pace of historic and prospective economic growth and the range of policies enacted to refocus the economy with a target of 6.0-6.5% p.a. for domestic growth restated at the National People's Congress in March 2019;
- A leadership position in new industries such as robotics, electric cars, drones and photovoltaic technology, which is increasingly reflected in the make-up of the Chinese stock market.

Because China's growth is hard to ignore

The chart below shows the changing pace of growth in a number of global economies. In the most recent period, since the global financial crisis, such growth has become more differentiated in terms of both the overall level and rate of change.

Exhibit 4: Average GDP Growth by Country (YoY-%)
2010-2018



Source: IMF, April 2019

2 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.
3 UBS Asset Management, January 2019
4 World Bank Open Data, April 2019
5 UNCTAD, January 2019

Parallels can start to be seen with the differentiated growth rates and drivers of large regional economies in the developed world. Investors often focus on different regional blocs e.g. North America, Europe, UK, Japan, Asia Pacific and so forth when investing in developed markets, particularly in traditional assets such as equities and bonds.

As these same investors start to increasingly differentiate between major emerging markets, it is likely that a similar approach will emerge.

Returning to the forecasts of global growth for 2019 quoted earlier, it might seem a little strange to treat China and India as part of a homogenous block spanning the entire globe, while regarding the US, which is expected to contribute a similar amount to India and half as much to China to this growth, as a completely standalone allocation!

And the opportunities are too great

In addition, the full range of investment opportunities in China are becoming available to a wider range of investors through changes such as further global index inclusion, expansion of the Stock Connect daily quota and reduction in the number of industries closed to foreign investment.

As Chinese securities increasingly form part of widely-followed indices and hence investor portfolios, there is likely to be greater investor awareness of and comfort with holding such securities, and a move beyond broad exposures to something more targeted. Again, this would be following a pathway which is well-trodden for many developed markets.

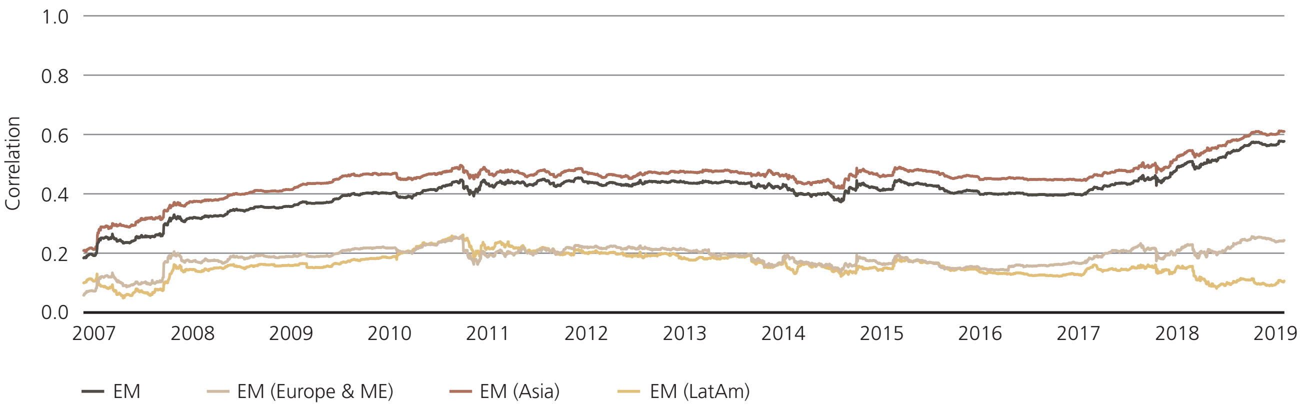
Chinese assets: a good diversifier

For investors looking to better understand the role Chinese assets can play in their wider portfolios, there has been strong diversification benefits from such holdings historically.

This topic is discussed in more detail in the October 2018 issue of Investment Insights published by UBS Asset Management, but below we show the rolling three-year correlation of daily returns for the MSCI China A share index in local currency with the equivalent indices for the MSCI Emerging Markets index, as well as regional variants.

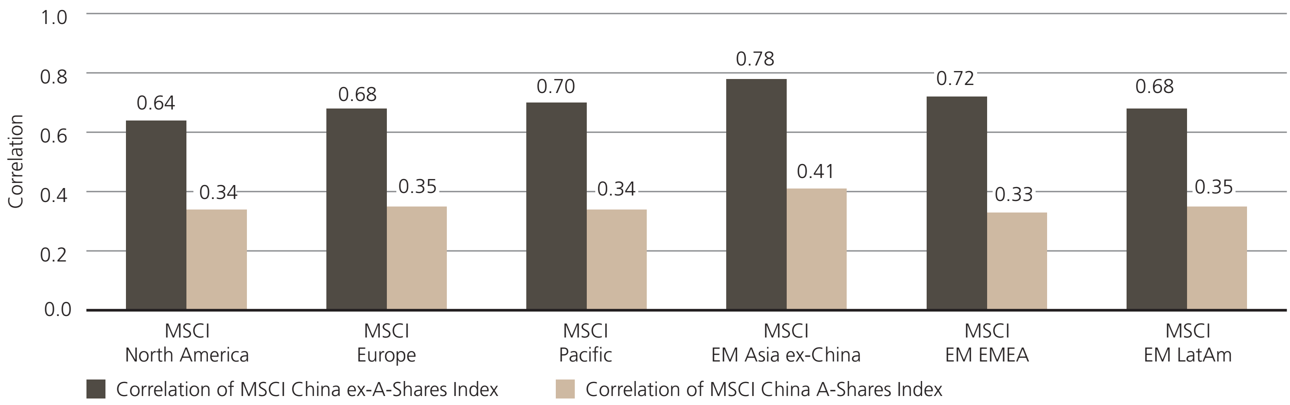
Even when considering the correlation of the A share market with the EM Asia index, correlations have been around 0.5 for much of the period, suggesting some differences in drivers of volatility seen historically. Correlations with other emerging markets regions have been much lower, again offering support for a more granular approach to these exposures

Exhibit 5: MSCI China A, Three Year Correlation of Returns with Regional MSCI Benchmarks
Dec 2007-Dec 2019



Source: Bloomberg, January 2020

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

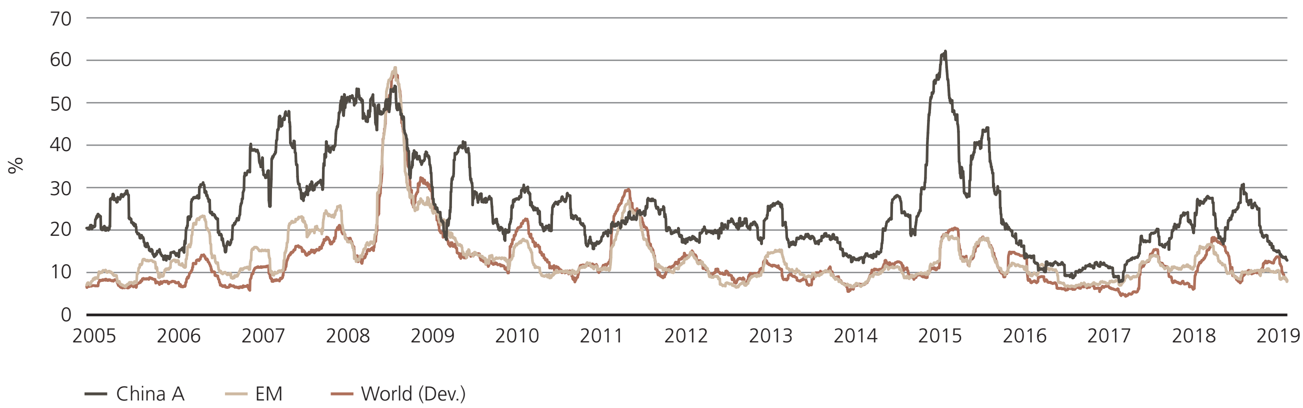
Chinese equities have also seen considerable volatility historically, even compared to emerging market benchmarks – often seen as at the riskier end of the spectrum of public equity markets.

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.

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