Chinese assets: diversification and return

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This report provides five-year forecasts for the Chinese economy and markets and demonstrates the diversification benefits of adding Chinese financial assets to a global portfolio of stocks and bonds.

Key takeaways:

- We expect Chinese stocks and bonds to outperform their developed-market peers in the coming years.
- Capital markets in China continue to evolve, helping offset demographic and trade headwinds.
- For domestic investors, the demand for publicly traded assets should grow significantly as a growing middle class begins to diversify their wealth.
- For global investors, Chinese capital markets offer welcome diversification benefits.

Introduction

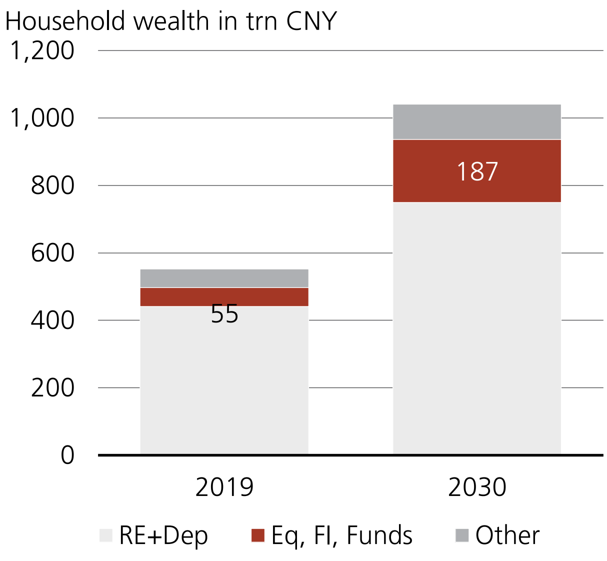
The demand for Chinese financial assets continues to grow at a rapid pace, bolstered by maturing domestic appetite and liberalized foreign access.

Chinese household wealth rose from about RMB140 trillion (about USD 20 trillion) in 2010 to RMB552 trillion in 2019 (USD 75 trillion), almost doubling in size every five years. During this period, the allocation to real estate and bank deposits dropped 10% (from about 90% to 80%) as the share of publicly-traded assets (bonds, equities, funds) increased from about 3% to 10%[1].

If Chinese households' exposures continue to trend towards their developed-market counterparts, we expect publicly-traded securities to gain by 10 to 20 percentage points as a share of wealth over the next generation.

During the next five years, we expect economic growth in China to be lower than the last 20 years, due to aging demographics and downside risks from ongoing tensions with the US on trade and other issues, as well as a natural convergence downwards towards developed markets as the economy matures[2].

Allocation of Chinese household wealth



Source: CICC June 2020, UBS analysis

[1] CICC, "When Chinese families begin to own more financial assets", Thematic Strategy report, June 2020
[2] See Mankiw, N Gregory; Romer, David; and Weil, David, "A Contribution to the Empirics of Economic Growth", Quarterly Journal of Economics, , 407-437, May 1992

However, Chinese activity is still expected to be strong relative to the global average, with abundant and distinct opportunities for investment. Domestic equities have a relatively low correlation with their developed-market peers, and benefit from a vast local customer base as well as a government committed to macroeconomic stabilization.

Financial deepening that brings China's share of capital markets closer to its standing in the global economy should be accompanied by additional inclusions and higher weightings in important market benchmarks, supporting flows from foreign investors as the process of liberalizing market access continues.

We expect Chinese equities will outperform the MSCI World Index over the next five years, with its sovereign debt also poised to post superior returns compared to G10 nations. Therefore, Chinese securities are attractive to global investors looking to maximize returns. In addition, history shows that these assets provide diversification benefits to an already well-balanced portfolio, a dynamic which we expect to continue over the next five years.

UBS-AM 5-year projections

We forecast Chinese macroeconomic variables and financial market expectations from 2021 through 2025 to avoid short term, pandemic-induced distortions. Five-year expected returns are derived from market pricing as well as our assessment of projected economic factors in conjunction with our valuation models.

Our current projections call for 4.8% real GDP growth in China over the next five years, and some of this growth may be front-loaded due to the rebound from the pandemic. We expect consumer based-inflation to be 2.5% annually over the next five years with strong short-term disinflationary pressures initially. These combine to produce a nominal growth rate of 7.4%.

Recent gains in the market over the last few months now have equities closer to fair value, resulting in no multiple expansion in our base case scenario. We expect earnings growth to fall short of nominal growth by about 0.5 percentage points, meaning nominal earnings growth around 6.8%. We expect dividends to stay around their current 2% level.

Expected 5-yr performance of growth and inflation

Annualized Rmb terms
August 2020

Economic Growth	4.8%
Inflation	2.5%
Nominal Growth	7.4%

Expected 5-yr equity return

Annualized Rmb terms
August 2020

Inflation	2.5%
Real earnings growth	4.3%
Dividends	2.0%
Valuation	-0.1%
Total return in Rmb	**8.9%**

UBS-AM 5-year projections

August 2020

	In CNY Terms			In USD Terms		
Asset Class	**Geometric Return**	**Standard Deviation**	**Sharpe Ratio**	**Geometric Return**	**Standard Deviation**	**Sharpe Ratio**
Cash [1]	2.0%	1.3%	0.00	0.3%	1.3%	0.00
China 10-yr Gov	2.9%	5.9%	0.25	1.2%	5.9%	0.18
China Gov Bonds	3.0%	4.6%	0.31	1.2%	4.6%	0.23
China Policy Bank Bonds	3.3%	4.2%	0.41	1.5%	2.7%	0.50
China Corporate Bonds	3.4%	4.7%	0.38	1.7%	4.7%	0.32
China Aggregate Bonds	3.1%	4.6%	0.35	1.4%	4.6%	0.27
Chinese Equities	8.9%	21.5%	0.45	8.9%	22.9%	0.50
Global Equities	7.8%	16.7%	0.42	7.2%	16.0%	0.50
Inflation	2.5%			1.4%		

[1] 1-month Treasury bills. Notes: Fixed income in USD terms are hedged. Chinese equities in USD terms are unhedged. Global equities are unhedged in both CNY and USD terms. Note: These estimates are UBS Asset Management's forward looking estimates of local equity market returns and currency impacts. Proxies for the local markets are can be represented by the MSCI series with China-A shares, S&P 500 for the US, MSCI EMU for the Euro, and MSCI Switzerland for the CHF indices.

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The commitment of the Peoples Bank of China (PBoC) to a relatively stable currency means that there is a bit less uncertainty to the intermediate term movement of the renminbi. When we look at the returns in other currencies, we view the CNY (Chinese Yuan Renminbi) as very near fair value (again short-term views are different), so we see a near direct pass through of the total expected RMB 5-year equity returns of 8.9% into USD terms.

The euro and Swiss franc are undervalued and slightly undervalued respectively, resulting in better returns for unhedged investors from those regions.

5-yr Chinese equity returns and currency perspectives

	Currency Perspectives			
Annualized RMB terms	**CNY**	**USD**	**EUR**	**CHF**
China Equity Local	8.9%	8.9%	8.9%	8.9%
Local Market return	8.9%	5.9%	8.1%	7.2%
Unhedged currency impact		0.0%	-0.7%	0.4%
Total return unhedged		8.9%	8.2%	9.3%
Hedged currency impact		-1.7%	-2.6%	-2.8%
Total return hedged		7.2%	6.3%	6.1%

Note: These estimates are UBS Asset Management's forward looking estimates of local equity market returns and currency impacts. Proxies for the local markets are can be represented by the MSCI series with China-A shares, S&P 500 for the US, MSCI EMU for the Euro, and MSCI Switzerland for the CHF indices.

We expect the current differentials in short rates to continue for the next few years. Thus, hedging costs reduce the attractive 8.9% equity return by 1.7 to 2.8 percentage points. As for fixed income and cash, current yields are always the starting point for expected returns. We expect cash rates in China to be quite low—around 1.5% to 2.0% for the next few years, with more downside risk than upside. These are well above rates in other developed markets.

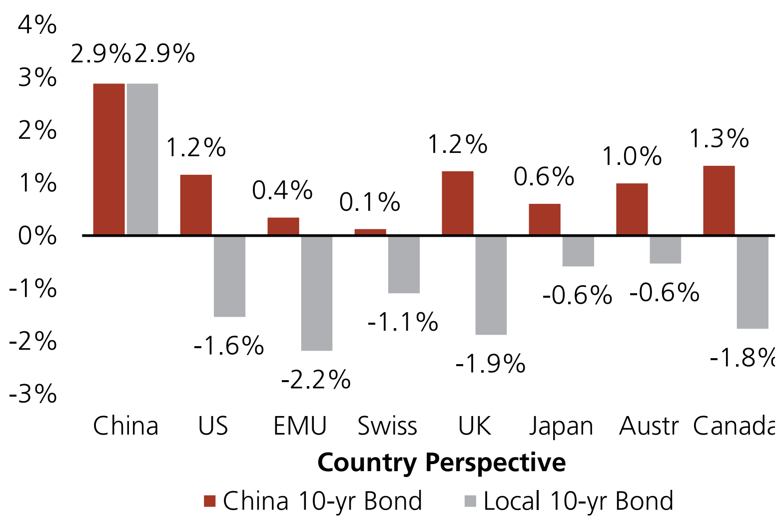
We have a similar expectation for the Chinese10-year bond yield: it should hover around these levels for the next few years, generating a return of 2.9%. The Chinese 10-year bond is expected to post superior performance compared to similar-dated debt in developed markets.

For example, consider the US 10-year bond, which had a starting yield of 0.5% at the end of July. That starting yield coupled with a rising interest rate environment produces an expected return over the next five years of -1.6%, but a hedged Chinese 10-year government bond should earn 1.2% (a 2.8% percentage point differential).

Similarly, for a Eurozone investor investing in the 10-year German bund, this expected premium from investing in Chinese bonds grows larger, estimated at -2.6% over this period.

Expected 5-yr return from hedged 10-yr bonds

August 2020



Source: UBS Asset Management, August 2020

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Volatility, correlations, and liquidity

Equity volatility has declined from elevated levels from 2013 through 2015. Currently, we expect volatility to continue to be in the low 20% area but would not be surprised to see it decline into the high teens.

The stock-bond correlation in China has been unstable over the past decade. In the early part of the 2010s, it was positive, but subsequently declined and has been slightly negative over the last five years (-0.11 for CSI 300 versus ChinaBond Treasuries). We model the stock-bond correlation to be slightly above zero, matching the experience since 2013 (0.09 correlation). Historically, this is a reasonable assumption, though at times we see some negative correlation in times of stress.

Measuring diversification benefits for global investors

Our projections for above-average performance in Chinese equities and fixed income provide a compelling case to add or increase exposure to these securities to increase returns. Importantly, history has shown that even when Chinese financial assets have underperformed, there are diversification benefits from including them in the portfolio as well – a difficult achievement when making additions to an already well-balanced set of holdings.

Chinese equities lagged their developed and emerging market peers over the past five years, but the introduction of Chinese stocks and fixed income to a diversified global portfolio denominated in US dollars tended to produce incremental improvements in the Sharpe ratio during this period.

Applying a similar analysis to our five-year return projections, we find a similar enhancement in diversification and risk reduction on a forward-looking basis for USD investors.

	Initial Allocation	**Move 5% into a 50/50 Chinese portfolio**			
	60/40	**A**	**B**	**C**	**D**
MSCI China NR USD	0.0%	2.5%	0.0%	0.0%	0.0%
MSCI China All Shares NR USD	0.0%	0.0%	2.5%	0.0%	0.0%
MSCI China A NR USD	0.0%	0.0%	0.0%	2.5%	0.0%
MSCI China H NR USD	0.0%	0.0%	0.0%	0.0%	2.5%
S&P 500 TR USD	30.0%	30.0%	30.0%	30.0%	30.0%
BBgBarc US Agg Bond TR USD	40.0%	37.5%	37.5%	37.5%	37.5%
BBgBarc China Aggregate TR Hedged	0.0%	2.5%	2.5%	2.5%	2.5%
FTSE Treasury Bill 1 Mon USD	0.0%	0.0%	0.0%	0.0%	0.0%
MSCI EAFE NR USD	20.0%	18.0%	18.0%	18.0%	18.0%
MSCI EM ex China NR USD	10.0%	9.5%	9.5%	9.5%	9.5%
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Total Equity	60.0%	60.0%	60.0%	60.0%	60.0%
Total FI and Cash	40.0%	40.0%	40.0%	40.0%	40.0%
Total Intl Eq	30.0%	30.0%	30.0%	30.0%	30.0%
Total China Eq	0.0%	2.5%	2.5%	2.5%	2.5%
China FI	0.0%	2.5%	2.5%	2.5%	2.5%
Total China	0.0%	5.0%	5.0%	5.0%	5.0%
5-yr Statistics					
Geometric Return	6.38	6.54	6.45	6.39	6.31
Arithmetic Return	6.59	6.74	6.66	6.61	6.53
Standard Deviation	8.81	8.83	8.83	8.83	8.78
Sharpe Ratio	0.625	0.641	0.632	0.625	0.620
10-yr Statistics					
Geometric Return	7.15	7.20	7.20	7.23	7.08
Arithmetic Return	7.27	7.32	7.31	7.33	7.20
Standard Deviation	8.29	8.30	8.27	8.21	8.29
Sharpe Ratio	0.809	0.815	0.817	0.825	0.800

Diversification benefits from USD perspective

60/40 Portfolio

	Starting portfolio	Add 5% to Chinese assets
Developed Market Equites	55.0%	55.0%
Emerging Markets x China Unh	5.0%	2.5%
China Eq Unh	0.0%	2.5%
Global Aggregate Hedged	40.0%	37.5%
China Aggregate Hedged	0.0%	2.5%
Total	100.0%	100.0%
5-year Expected Return	4.2%	4.3%
Standard Deviation	10.3%	10.2%
Sharpe ratio	0.43	0.44

Conclusion

Our expected returns for the next five years for Chinese equities are generally higher than for other global markets, but along with the higher return comes higher risk. The fixed income markets add another dimension—current yields are meaningfully more attractive than other markets, and the growing corporate bond market in both CNY and USD terms offers another vehicle to increase exposures to the country. We expect demand for Chinese assets to be strong domestically, with an additional steady flow of funds from abroad as new equity and bond markets evolve.

We have always maintained that China is distinct and unique. It is neither a typical emerging market nor one completely in synch with other developed nations. The economy is huge and has tremendous technological and manufacturing expertise. These phenomena help foster a suite of relatively uncorrelated financial assets that will continue to offer diversification benefits to investors.

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