One-on-one interview

Chinese equities: ‘A’ is for another leap forward

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Starting in May 2019, domestic Chinese stocks will be better represented in some key benchmark indices and consequently, in a large number of global portfolios. MSCI announced earlier this year that it was increasing the weight of onshore China A-shares in its emerging market and global benchmarks through a three-step process in May, August and November. In this interview, HSBC Global Asset Management’s head of Chinese and Hong Kong equities, Mandy Chan, explains the diversification benefits of including onshore Chinese equities in a global portfolio and discusses the catalysts that are seen driving the rally in China’s equity markets.

Key messages -

- China’s A-shares have a low correlation with global equity markets, providing diversification benefits for overseas investors, in addition to allowing them broader access to one of the world’s largest and fastest growing economies and consumer markets
- We believe increased foreign participation in the domestic market could eventually translate into more market transparency and better corporate governance on the whole, with Chinese companies adopting higher accounting standards and disclosure policies
- Corporate earnings growth should slowly pick up in the second half of the year, as the impact of the government’s stimulus measures starts to improve corporate bottomlines
- Investors should be mindful about a pullback in the market if the trade talks between US and China break up without arriving at an acceptable resolution

HSBC
Global Asset
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Q: With MSCI increasing the weight of China A-shares in key indices, what's key message for global investors?

Mandy: MSCI's decision to quadruple the weighting of China's domestically traded A-shares in its emerging markets index is another noteworthy recognition of Beijing's efforts to woo foreign investors and become more integrated with global financial system. Besides the weight increase, we think the addition of mid-cap stocks is another significant development, as it enables a broader and better representation of the market which is made up of 3000+ securities. In our opinion, a more diversified benchmark could help attract more fund flows and capture the growth potential of both bellwether stocks and fast-growing new economy companies, through different economic and business cycles.

In the short term, the weight increase could lead to upwards of USD70 billion in equity inflows into the A-share market in 2019, adding more fuel to the red hot rally in the domestic China market. But many foreign investors are not waiting for the MSCI-initiated change to kick in, they have been pouring into the A-share market since the beginning of the year, to get ahead of the curve. Northbound fund flows (from HK into China's equity markets) has been robust this year, amounting to USD19 billion in net inflows in the first quarter of the year, the largest quarterly inflow since 2014. Over the medium to long term, better representation in global indices could have a more profound impact on the development of the Chinese capital markets.

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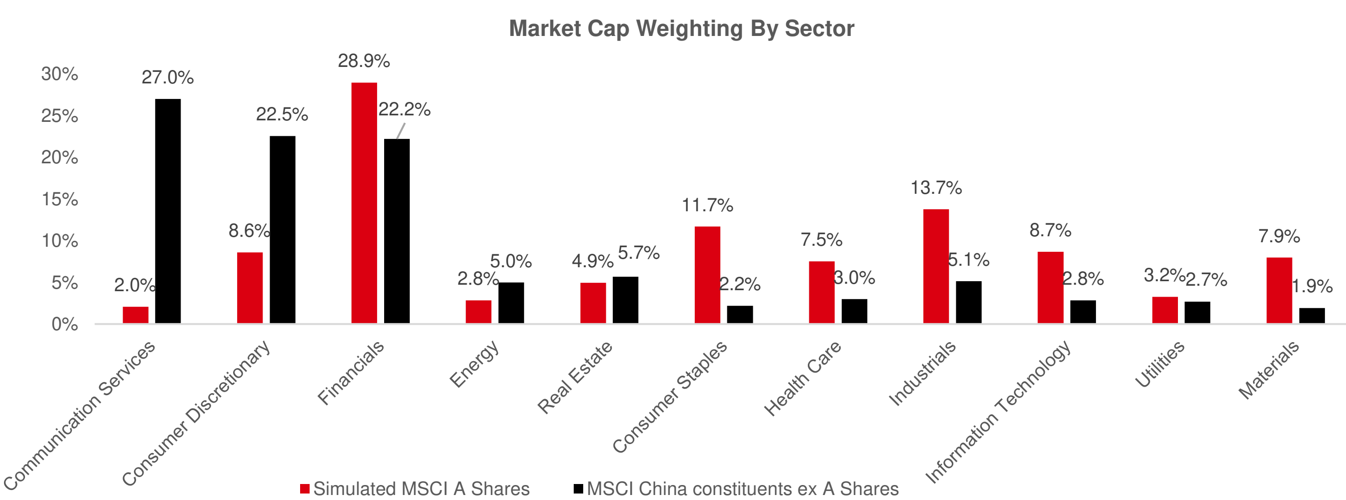
On the whole, we believe A-shares merit a long-term allocation in a global equity portfolio, as they offer diversification benefits and access to investment opportunities that were not freely available to foreign investors previously. Some of China's most unique and fastest growing companies can currently only be accessed through the local markets. Companies that fall within the so-called new-economy sectors, such as healthcare and various consumer-focused industries, are typically listed on the Shenzhen or Shanghai exchanges. For instance, the biggest manufacturer of China's famed liquor *baiju*, which is also the world's most profitable distiller, and the country's largest movie producer are only listed in the A-shares market. At the same time, representation within the mostly offshore MSCI China Index is further distorted by its 28% weight to two Chinese technology firms. At present, A-shares offer better diversification potential than H-shares as the onshore markets have been relatively isolated in the past, due to limited accessibility, and thus more insulated from global market events and fund flows. Currently foreign investors own only about 2% of the A-shares market, compared with 30% for Japan and 20% for the US.

Table 1: Low correlation provides diversification

	MSCI China	MSCI Emerging Markets	MSCI Asia Pacific ex-Japan	MSCI World	MSCI US	MSCI Europe
Shenzhen Composite Index	0.64	0.54	0.58	**0.24**	**0.11**	**0.27**
Shanghai Composite Index	0.66	0.59	0.63	**0.26**	**0.12**	**0.29**
MSCI China A Onshore Index	0.68	0.58	0.63	**0.27**	**0.14**	**0.29**

Source: Bloomberg, HSBC Global Asset Management
Daily correlation calculated in local currency from 31 March 2017 to 31 March 2019.
Investment involves risk. Past performance is not indicative of future performance

Fig 1: Analysis of the onshore and offshore markets



Source: MSCI, HSBC Global Asset Management data as of 21 March 2019; The simulated list is available on https://www.msci.com/index-consultations
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Q: What are the likely catalysts for the Chinese stock markets?

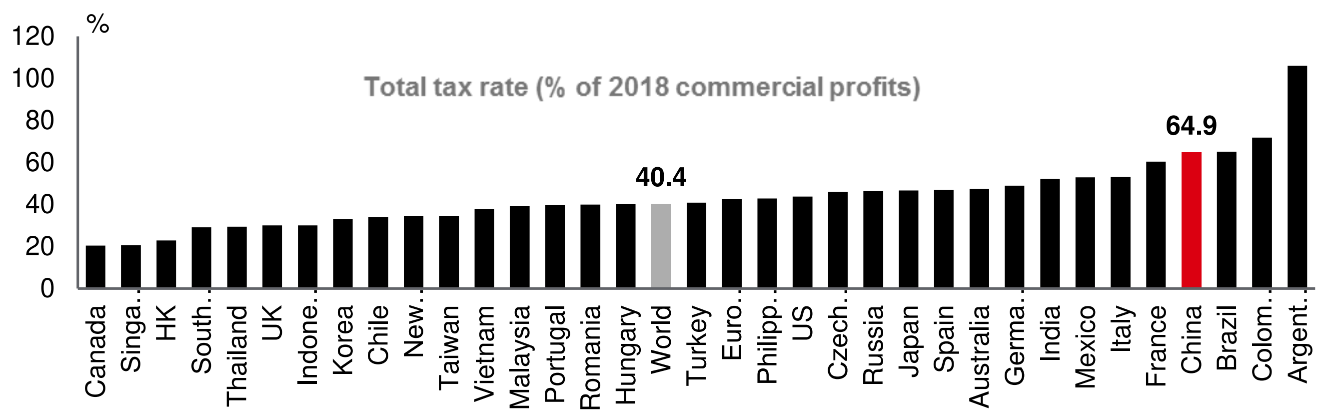
Mandy: The MSCI announcement helped move the spotlight from China's growth concerns and prolonged trade tensions with the US, which dominated headlines in 2018, and steered the narrative in a more constructive direction. But it's hardly the only catalyst driving the rally in China's equity markets.

Since late 2018, cooling economic data has spurred Beijing into action, with the government rolling out a slew of intensifying and broadening monetary and fiscal policy measures, amidst a shift in focus from the de-leveraging agenda that dominated previous years. With a subdued growth outlook for the rest of the year, investors, including us, expect further easing measures in the near term. In our opinion, Chinese authorities can continue to lower its tax rates and boost credit growth to buffer the slowdown in its economy. And the surge in the total social financial (TSF), a broad measure of credit and liquidity in the economy, has allayed some of the anxiety around the refinancing pressure on property developers and local governments. The monthly expansion in TSF rose to RMB2.86 trillion in March, from RMB703 billion in February. This significantly overshot the market consensus forecast of RMB1.85 trillion.

Additionally, China and the US are now in the final stretch of talks to resolve their trade dispute, with signs pointing to a potential agreement by May. The outcome of these trade talks will have a material impact on investor sentiment after the prolonged period of uncertainty. While the outcome of the trade talks are hard to predict, we believe, incremental measures to open up China's capital markets and economy will continue to provide fresh impetus to the current rally. Besides MSCI, other index providers such as FTSE Russell and S&P Dow Jones will also begin to include A-shares in their global benchmarks this year, attracting more flows from passive funds and other benchmark-tracking portfolios. According to CSRC's estimates in January, foreign capital inflows this year could potentially double to ~RMB600 billion.

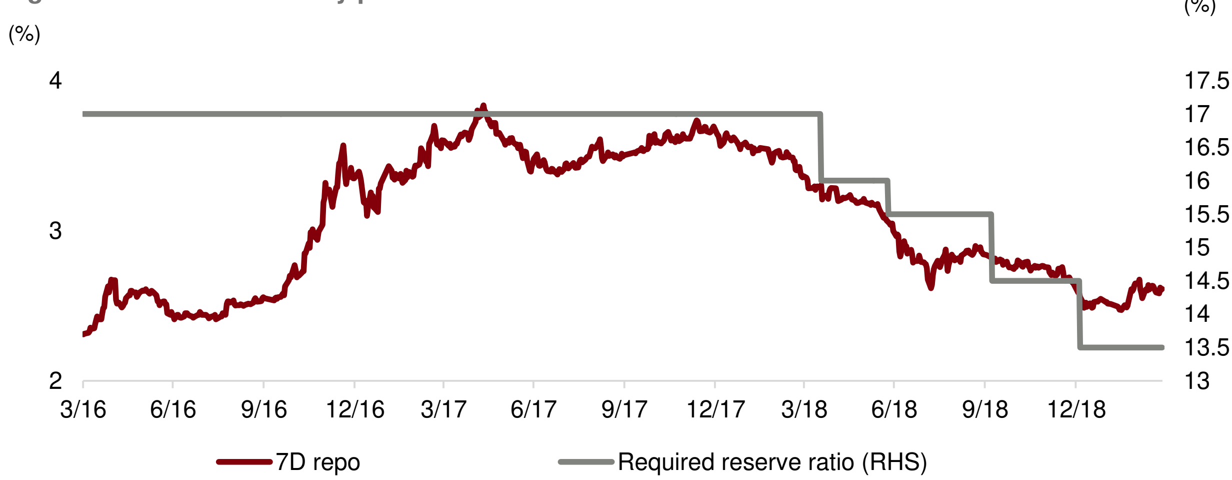
Finally, in our view, earnings of Chinese companies should slowly pick up in the second half of the year, as the impact of the government's stimulus measures starts to improve corporate bottomlines. So, all in all, Chinese stocks provide attractive upside potential for investors, offering higher earnings and GDP growth potential than its regional and developed markets peers at relatively undemanding valuations.

Fig 2: China has more room to cut taxes



Source: World Bank, HSBC Global Asset Management, as of December 2018

Fig 3: China eases monetary policies to buffer slowdown



Source: PBOC, HSBC Global Asset Management as of March 2019

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Q: What is your portfolio strategy amidst recent developments?

Mandy: Even before the MSCI announcement, we have been constructive on the onshore stock market, adding exposure to a range of industries including banking, insurance and infrastructure-related companies such as airport operators. We expect to increase our A-share holdings throughout this year. Our investment mandate allows us to invest up to 70% of the net asset value (NAV) of our core Chinese equity portfolio in A-shares.

The valuations of A-shares are still supportive despite the sharp rally in the first quarter of 2019. Price-book ratio of CSI 300 stocks is still trading below its 10-year average, while its price-earnings ratio also remains undemanding, trading at around 11.9x forward earnings, again below its 10-year average.

Having said that, our strategy will continue to focus on capturing the anomalies and price discrepancies between the domestically-listed A-shares and Hong Kong-listed H-shares. Onshore shares typically trade at a premium to H-shares of the same company, reflecting the restrictions on free capital flows in the onshore market. Moreover, the domestic market is still largely driven by local retail investors, who account for over 80% of the daily turnover and tend to have shorter investment horizons than institutional investors.

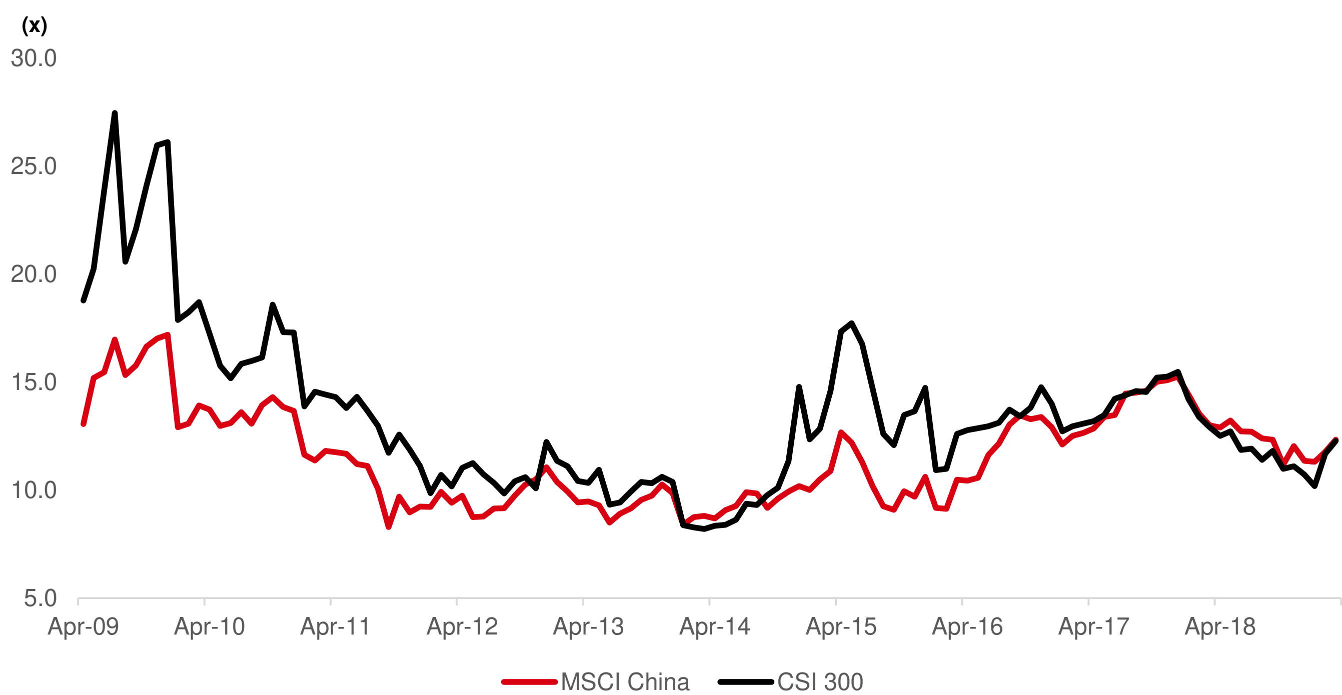
In the overall Chinese equity market (including offshore-listed stocks), we like select companies in the consumer discretionary and consumer staples sectors, amidst anticipation of further policy support. Companies which produce essential household products ranging from air conditioners to vitamins are direct beneficiaries of the government's cuts to value added taxes and fees.

We also like some homegrown healthcare and pharmaceutical companies that have their own innovative R&D capabilities, as the demand for both private and public medical services will continue to grow due to the country's rapidly aging population.

In addition to "new economy" sectors, we are also overweight Chinese banks as loan growth may pick up following Beijing's call to ramp up lending and lower interest rates. Data released in April provided further support to the notion of stablisation, although we think more decisive policy measures are needed to further revive consumer sentiment and address structural issues. Over the long-term, the asset quality in the banking sector will continue to be closely scrutinised by investors, since the government has instructed the banks to boost their lending to the small-and-medium private sector companies.

In addition to banks, we also like insurers as their income from investments are likely to benefit from the ongoing market rally. Within the property sector, strong underlying demand for housing and the relaxation of home purchase restrictions in some cities underpin our preference for market leading companies as they are best positioned to benefit from a more accommodative refinancing environment and a potential industry consolidation.

Fig 4: 12-month forward PE for MSCI China and CSI300, past 10 years



Source: Bloomberg, HSBC Global Asset Management, data as of March 2019

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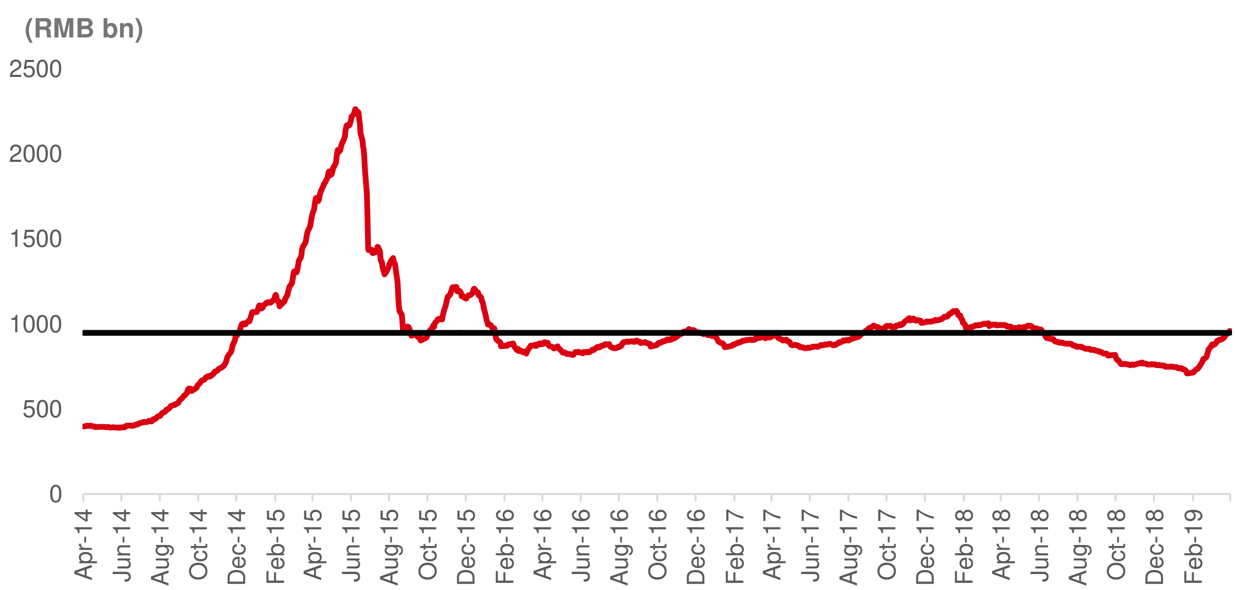
Q: What's the biggest uncertainty in the A-shares market?

Mandy: Despite the positive developments and potential breakthroughs we've witnessed since the beginning of the year, we believe the China-US trade conflict still poses risks from a policy and political uncertainty point of view. As the market continues to rally on trade talks-led optimism, investors should be mindful about a pullback if the talks break up without arriving at an acceptable resolution.

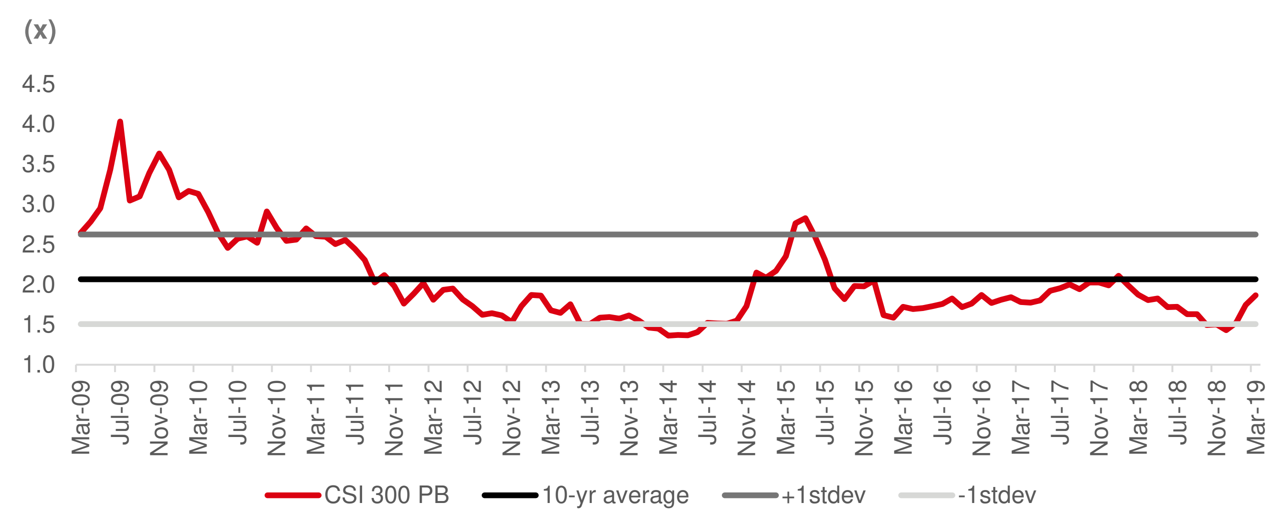
While valuations of onshore stocks remain inexpensive despite the rally, in recent weeks, we have noted an uptick in margin financing, which is a gauge of retail sentiment. Margin financing has picked up from RMB710 billion in early February to about RMB900 billion in late March, according to China Securities Finance Corp, a data provider controlled by the State Council (see Fig 6). At the same time, fundamental factors such as earnings quality seem to be less of a concern for the retail punters who bet on momentum and concept stocks. For instance, the best performing 30 stocks in the onshore market have collectively surged 172% in the first quarter of 2019 , even though half of them are expected to report a contraction in earnings growth in 2019 (only eight of these companies are expected to post earnings growth and seven have no analysts' forecasts). China's securities regulators have been closely monitoring the use of leverage among retail investors, and we believe regulators may step in to curb further speculation once margin financing crosses a certain threshold.

Fig 5: Margin trading has risen since Feb



Source: Bloomberg, HSBC Global Asset Management, as of 31 March 2019

Fig 6: PB ratio of CSI 300 trading below 10-yr average



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