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Markets

FOCUS

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In *Focus* we comment on extraordinary market events and analyse capital market related special topics.

More stability in the portfolio with China

In every crisis, the question arises as to how a portfolio can be made even more diversified and thus more robust – precisely because the correlation of many investments rises sharply when they are sold off. In the COVID-19 crisis, an investment universe that had previously been relatively untapped for this purpose proved to be helpful: Chinese mainland bonds and shares (A-shares). Chinese local-currency bonds (Bloomberg Barclays China Aggregate Index) have almost without exception been in positive performance territory since the beginning of the year, while mainland equities (CSI 300) have seen a much smaller loss in value than other regions. Despite the global importance of the Chinese economy, the mainland capital market is still under-represented in global portfolios, partly because it has not been available to foreign investors for long. The mainland stock market was accessed in 2014 through the "Stock Connect" programme, followed by access to the bond universe in 2017 through "Bond Connect".

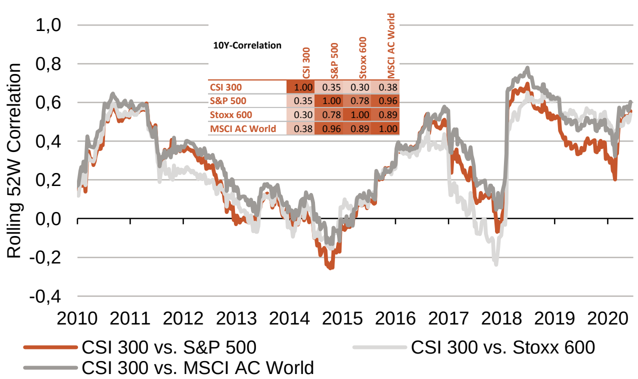
Added value through diversification

Mainland Chinese equities diversify the portfolio

The correlation of A-shares (CSI 300) versus global equities (MSCI ACWI) has been below 0.4 over the past 10 years, while the Stoxx Europe 600 had a correlation of close to 0.9 over the same period (see Figure 1). Although an increased correlation has been observed in recent years due to the trade conflict and the risk of a new "Cold War" between the US and China, it has decreased again over time. The reasons for the less correlated behaviour of the mainland market are the somewhat different economic, political and monetary policy environment, but in particular the dominance of local investors. This has helped limit losses this year. Moreover, because the coronavirus first appeared in China and the first successes in combating it were also seen in China, the Chinese stock market sold off earlier than the rest of the world – as did the recovery. Since the beginning of the year, A-shares have thus also been one of the best equity regions (see Fig. 2). For Chinese A-shares (CSI 300), the maximum drawdown, which represents the loss in value from the high and the subsequent low within a given period, was only around 16% since the beginning of the year, compared with just under 34% for US equities (S&P 500) (see Fig. 3).
Chinese government and corporate bonds performed even better: a mix of both

Fig. 1: Diversify with mainland Chinese equities

Rolling 52W correlation of Chinese A-shares against US equities (S&P 500), European equities (Stoxx 600) and global equities (MSCI World) and the correlation over a 10-year period.

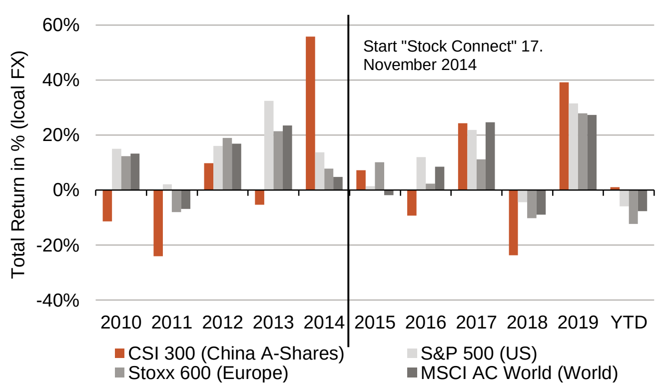


10Y-Correlation	CSI 300	S&P 500	Stoxx 600	MSCI AC World
CSI 300	1.00	0.35	0.30	0.38
S&P 500	0.35	1.00	0.78	0.96
Stoxx 600	0.30	0.78	1.00	0.89
MSCI AC World	0.38	0.96	0.89	1.00

Period under consideration: 01/01/2010-26/06/2020
Source: Bloomberg, own calculations

Fig. 2: A-shares fared best since the beginning of the year

Total return (including dividend): development of the individual indices per calendar year.



Period: 01/01/2010-26/06/2020
Source: Bloomberg, own calculations

bond segments (Bloomberg Barclays China Aggregate Index) has hardly ever left the positive performance range since the beginning of the year in local currency terms and recorded a maximum drawdown of only 2.5% in the same period, while a mix of European government and corporate bonds (Bloomberg Barclays Euro Aggregate Index) recorded a maximum loss of 5.3%.

China is all arround

If you want to invest in megatrends, there is no way avoiding China

The COVID-19 crisis has thus highlighted the added value of diversification with Chinese investments. But there are also other points in favour of Chinese investments in the portfolio. Geopolitically, China is already one of the most important players in the world, but there is also no way avoiding China at the corporate level either. The days of the extended workbench are over, and China is now the technology leader in many areas. In addition, the service sector is becoming increasingly important. The country's dependence on exports has decreased – resulting in a strengthening of the domestic market, which is gradually making China less vulnerable to future trade conflicts. With its "Made in China 2025" initiative, the Chinese government wants to push this development even further. There is no avoiding China if you want to invest in the megatrends of the future. In addition to the well-known names, other high-growth companies from the mainland, which also stand for China's progress, should also benefit.

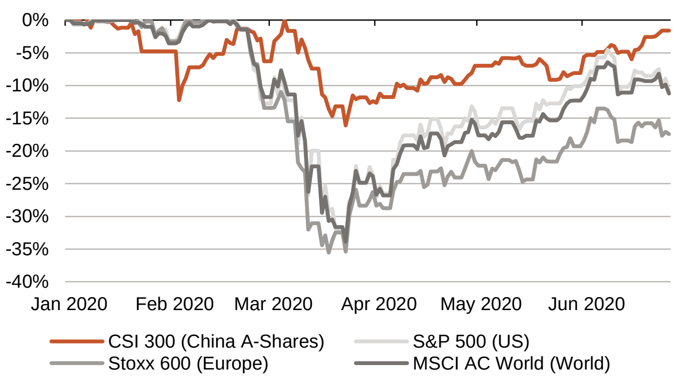
Opening up of the stock market...

Most international investors are still underinvested in China, but this should change over time

Another reason why Chinese assets are likely to perform well in the future is their inclusion in widely-used global indices. Compared to the size and importance of its economy and capital market, China is still significantly underrepresented in most indices and thus in most actively managed and passively managed portfolios. For some time now, index providers have therefore been weighting Chinese positions higher. In addition to the passive providers, who have also significantly increased the number of China ETFs in recent years, active asset managers who use the indices as their benchmark will thus also further increase their exposure to China in the future. MSCI, for example, has started to include Chinese A-shares in the MSCI Emerging Market in 2018. Currently, A-Shares account for only about 5% of the index. If A-Shares are included at 100% of their market capitalisation in the future, their weighting is likely to increase to around 23%.
Other index providers are taking a similar approach. As a result, Chinese shares will

Fig. 3: A-shares saw the lowest drawdown in 2020

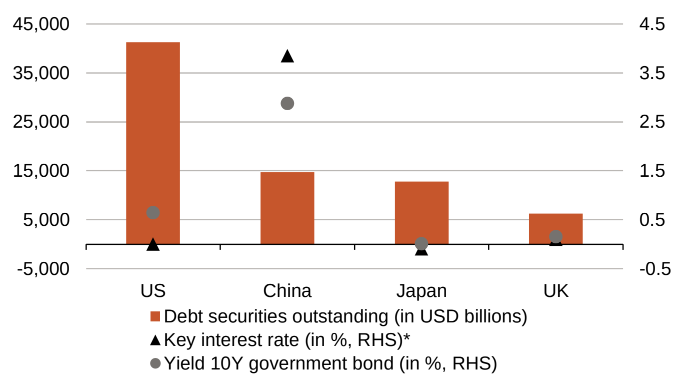
Drawdown refers to the maximum loss of value from the high within a certain time period.



Period: 01/01/2020-26/06/2020
Source: Bloomberg, own calculations

Fig. 4: The second-largest bond market offers attractive yields

The size of bond market in terms of outstanding debt securities the current yields on 10-year government bonds and the key interest rate* (right scale).



Source: BIS (as of 31/12/2019), Bloomberg (as of 26/06/2020)
*China: Interest rate for a one-year loan (1Y Loan Prime Rate)

continue to gain in importance globally in the future and demand will increase considerably.

...and the bond market

Clearly positive yields and the relatively stable currency make China's bond market attractive

The same applies to the Chinese bond market – the world's second-largest. Chinese mainland bonds are also becoming increasingly important. On the one hand, there are only a few bond markets with clearly positive returns. Unlike in the US, Japan or Europe, Chinese interest rates are still far from zero. For example, the interest rate set by the central bank for one-year bank loans (loan prime rate) is 3.85% (see Fig. 4). There is no reference interest rate comparable to the interest rates of Western central banks. The mainland bonds denominated in yuan can be roughly divided into government, local government, development bank and corporate bonds. Chinese local-currency bonds entail not only the default risk, which has historically been low compared to other market, despite the tendency of issuers to operate with high debt levels thanks to government aid, but also the currency risk. While currency risks are often negligible for equities due to the high yield expectations, they play a more important role for bonds. However, this risk is manageable, as China actively limits currency movements. For example, there was no significant depreciation of the yuan even at the height of the trade war. But despite their attractive yield, international investors are still under-invested in these types of bonds considering the importance of the market. However, this should change soon, as these bonds are also gradually being included in global indices. On 1 April 2019, for example, the Bloomberg Barclays Global Aggregate Index started to include government and development bank bonds of mainland China for a period of 20 months – at the end of this period, these bonds will account for approximately 6% of the index. Corporate bonds should follow in the not too distant future.

Added value in the long term

Chinese investments should offer added value in the long term

The inclusion of Chinese investments in major benchmark indices has and will result in large global capital flows in A-shares and Chinese mainland bonds. As a result, the Chinese capital market and hence global importance of the Chinese economy will become more and more reflected in the portfolios of international investors. The Chinese market will continue to be very attractive in the future despite the already strong performance of Chinese A-shares and mainland bonds. This applies both from a return and diversification perspective. Nevertheless, as with any investment, there are risks that should be borne in mind. In addition to currency risk and the ongoing conflict between China and the US, local private investors, who often focus on quick profits, play a role and can contribute to increased volatility. Corporate governance is also not yet as advanced as in the West. There is often a lack of standards, transparency or verifiability. International rating agencies can only enter the market slowly. However, with the further development of the capital market in China and a higher share of professional international investors, the risks are likely to diminish increasingly. Even if the conflict between China and the US is likely to continue for the time being and put some strain on the markets, Chinese investments can offer added value in the long term.

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