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FOCUS

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

China enriches the portfolio

Chinese capital market with many investable opportunities

China has ambitious goals, both economically and geopolitically. China's importance in the capital markets is also increasing. A broadly diversified portfolio can therefore hardly afford to ignore Chinese capital markets any longer, especially since they offer many advantages – such as attractive *growth investments*, high *alpha opportunities*, *diversification*, and advancing *professionalisation* – and are both globally *underinvested* and *fairly valued*. However, the turbulence of 2021 in the Chinese equity markets caused by a rebalancing of the economy, regulatory measures and a real estate crisis, put investors to the test. As a result, scepticism prevails among many investors and they wonder whether China is still investable. We believe that China continues to offer many opportunities if one focuses on the right market. The focus should be on mainland (onshore) assets, which, unlike many non-mainland (offshore) assets that are struggling heavily with regulatory and delisting concerns, also had a positive year in 2021 – especially for euro investors (Fig. 1).

Investing in China with mainland assets

Attractive: stabilisation and recovery on the doorstep

After two strong years, there was a correction in China's (offshore) stock markets in 2021, with the introduction of the fourteenth Five-Year Plan and the corresponding sometimes painful reforms. The plan focuses on innovation, sustainability and strengthening the domestic market. Viewed at some distance, a strategy can be seen behind the regulatory interventions, with the aim of ensuring healthy growth in the long term, reducing debt levels and combating income inequality in order to strengthen the domestic market.

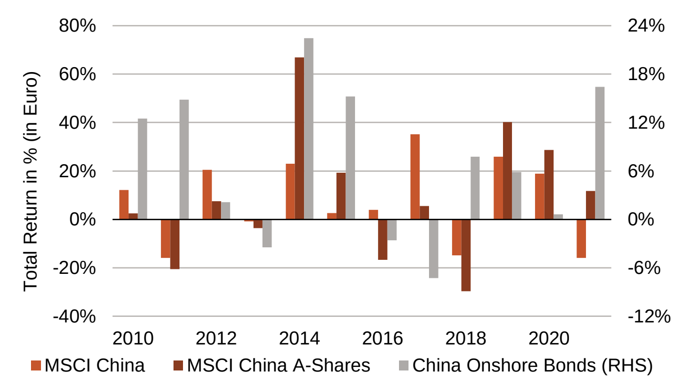
Reforms should pay off in the long run

The historical approach of growth financed by debt has led to much unproductive investment, so a shift away from this and towards the consumer and innovative enterprise seems sensible. Qualitative growth has thus become a central point in Chinese policy. And just how strong China already is in many technologies – also thanks to incomparable data availability – becomes clear when one looks at megatrends such as 5G, digitalisation, automation, electrification, urbanisation and wellbeing.

China is at the forefront of megatrends

Fig. 1: Mainland investments could gain in 2021 in euros

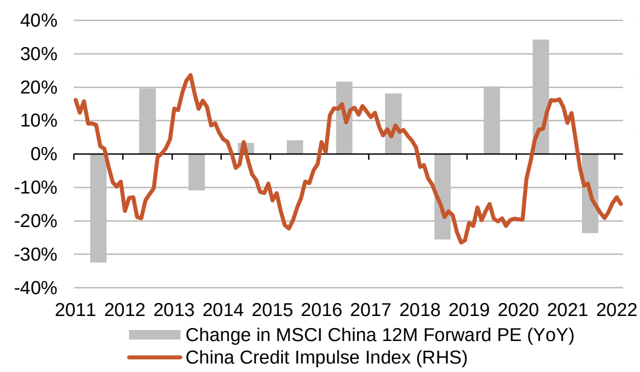
Performance of MSCI China, MSCI China A-Shares (Mainland Equities) and ICE China Broad Market Index in Euro per calendar year



Time period: 31.12.2009-31.12.2021
Source: Bloomberg, own calculations

Fig. 2: Good starting position for a valuation expansion as in 2019

Annual change in price-earnings ratio of MSCI China versus financing conditions in China



Time period: 31.12.2010-28.02.2022
Source: Bloomberg, own calculations

Investors in mainland assets should also benefit from this, as the mainland stocks we prefer offer clear exposure to such structural growth trends.

Expansionary measures should support economy and capital market

In addition to the long-term attractiveness of Chinese investments, there is also much to be said for investment opportunities during the year. Chinese politics can be roughly divided into three regimes: *growth*, *reform* and *stability*. Following a year of restrictive fiscal and monetary policy, China has recently started to adopt more expansionary measures again. After a year of reform and once the COVID situation improves, there should be a phase of fiscal stability and economic recovery ahead – especially with the upcoming re-election of Xi Jinping in autumn. The expansionary measures necessary for this should boost economic growth and provide a tailwind for the stock market. This is also illustrated by the historical correlation of improving or stable financing conditions and positive equity developments through valuation expansion, as the year 2019 impressively illustrates (Fig. 2).

Interest rate advantage over other regions

Investment opportunities are available in both the equity and bond markets. Unlike in the west, bonds in China generate positive real returns. With significantly positive yields, Chinese mainland bonds are therefore an attractive portfolio component. And unlike in the west, 2022 is a year of monetary easing in China. In China, 10-year government bond yields have therefore been falling for some time, while they are rising significantly in all western countries, especially the US (Fig. 3).

Underinvested: China is too significant to be ignored

China's capital market remains significantly underrepresented in global indices and underinvested by global investors

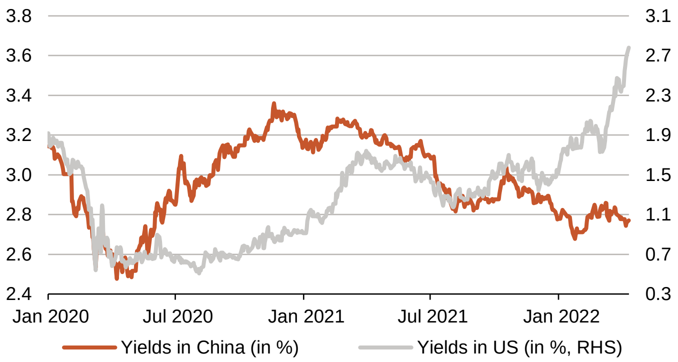
Access to the capital markets of China, the world's second largest equity and bond market, has become easier in recent years thanks to ongoing capital market reforms. Nevertheless, Chinese mainland equities (A-shares) and mainland bonds (local currency) are particularly underrepresented in global indices, and global investors are only marginally invested (Fig. 4). The A-shares market alone has a market capitalisation of more than USD14trn, representing more than 11% of global market capitalisation. The Chinese bond market even accounts for 14% of the global bond market. The Chinese capital market is thus too large and attractive to be ignored by global investors.

Investment rate of global investors should continue to rise

The importance of Chinese mainland assets has not gone undetected. Index providers have started to successively weight Chinese positions higher for some time now, and this is likely to continue. In addition to passive providers, which also significantly

Fig. 3: Interest rate environment in China currently better than in the US

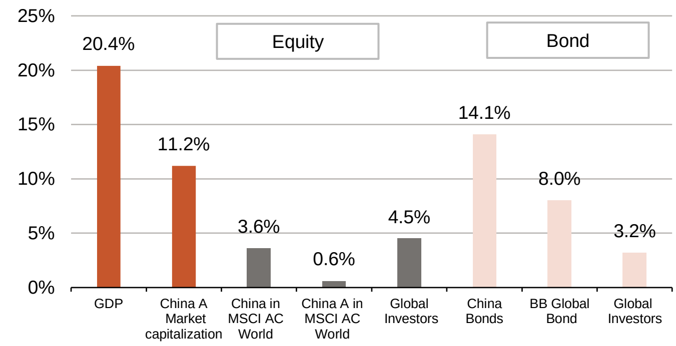
China and US 10-year government bond yields



Time period: 01.01.2020-11.04.2022
Source: Bloomberg

Fig. 4: Economic importance not reflected in the capital market

Share of China's GDP in global GDP, share of China A-shares and bonds in global markets, share of stocks in various indices, share of global investors in asset class



As of: 31.12.2021
Source: Goldman Sachs

expanded the number of China ETFs, active asset managers that use the indices as benchmarks will also further increase their China exposure in the future. MSCI has already started to include Chinese A-shares in the MSCI Emerging Market in 2018. Currently, A-shares are only included at around 20% of their market capitalisation, which means an index weight of less than 5%. If A-shares are fully included in the future, the index weight should increase to around 21% (Fig. 5). Other index providers follow a similar path. Thus, Chinese mainland stocks will continue to gain importance globally and demand will increase accordingly.

The importance of the Chinese bond market is increasing

The same applies to the bond market. Chinese mainland bonds are also gaining in importance. As with equities, international investors are still underinvested compared with the importance of the market (Fig. 4). However, this is likely to change increasingly as inclusion in global indices progresses here as well. The Bloomberg Barclays Global Aggregate Index began to gradually include Chinese mainland bonds in 2019, followed by the J.P. Morgan Government Bond Index in 2020 and the FTSE World Government Bond Index in 2021.

Capital market reforms enable professionalisation and improved market structure of the Chinese capital market

The professionalisation of the Chinese capital markets is also progressing. In addition to several capital market reforms to make the market more professional and accessible, new stock exchanges such as the Beijing Stock Exchange have been established. And market structure has also improved. Compared with the past, there have been significantly fewer trading interruptions for individual stocks in recent years, reflecting the increased market stability. These changes are also appreciated by international investors who are beginning to discover the market for themselves. International inflows into the market, which remained positive in 2021 despite high market volatility, are therefore likely to continue in future, in our opinion (Fig. 6).

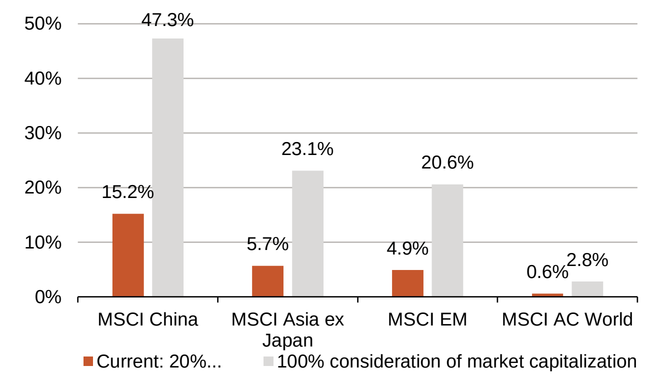
Valuation: growth at a fair price

Chinese equities are favourably valued, by historical standards

After the correction in 2021, Chinese shares are no longer expensive. If valuation ratios such as the price-earnings ratio are viewed from a historical perspective, they even look cheap again. If we put this ratio in relation to growth, a picture emerges in which China offers growth at a fair price – especially compared with other markets such as the more expensive US, or the slower-growing Europe (Fig. 7).

Fig. 5: Mainland shares with increasing importance in indices

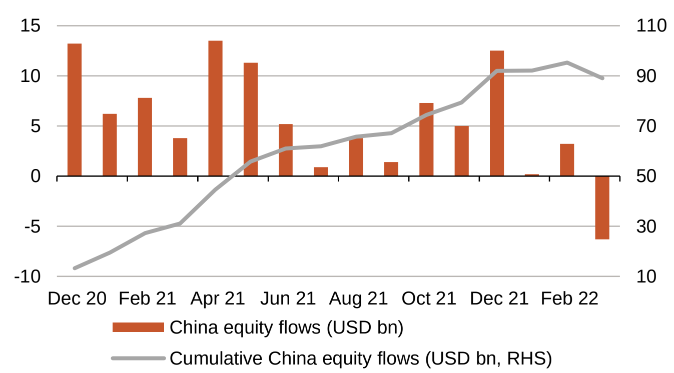
Estimated weight of Chinese mainland stocks in MSCI indices when fully considered by market capitalisation



As of: 31.12.2021
Source: Goldman Sachs

Fig. 6: Inflows from global investors clearly positive in 2021

Inflows and outflows in Chinese equities in billions of US dollars.



Time period: 01.01.2021-31.03.2022
Source: IIF

However, valuation and growth are only one side of the coin. In China, in addition to earnings performance, the sentiment of the dominant private investors is particularly crucial. And sentiment is at a low, which led to the valuation adjustment, but is now a good starting point should sentiment brighten. That it can be worthwhile to invest precisely when sentiment is at a low is also shown by similar sentiment moments in the past, such as during the anti-corruption campaign of 2014, the trade suspension scandal of 2015-2016 and the trade war between China and the US in 2019 (Fig. 1). The sentiment picture is likely to improve once the housing crisis is under control, the government's zeal for reform weakens, and the restrictions imposed by anti-pandemic measures diminish. Initial developments in this direction can already be observed in some cases.

Diversification: opportunity to make the portfolio even more robust

Mainland investments often only slightly correlated with other asset classes

In many cases, Chinese mainland investments have a low correlation with other asset classes (Fig. 8). The reason for this, besides the dominance of local private investors, is the economic and (monetary) political environment, which is often decoupled from the western world. This is also evident at present. Following the tighter monetary policy and the desire for reform from the end of 2020, the economy had cooled down considerably. However, monetary policy has now already returned to an easing path, while the credit impulse has visibly found a bottom and is picking up again–- exactly the opposite of the development in the US.

Chinese currency also offers diversification

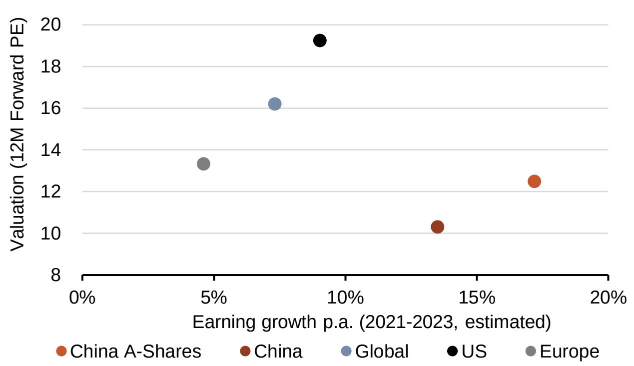
The Chinese renminbi also offers diversification. It is one of the few currencies worldwide that has appreciated against the US dollar in recent decades, and the long-term outlook also remains positive with good economic data and low inflation, even if it is likely to become more difficult in the short term as the interest rate differential with other regions declines.

High alpha opportunities for professional investors

The dominance of private investors in daily trading also offers advantages. For active investors in particular, this creates interesting opportunities, as Chinese retail investors account for more than 70% of daily trading volume, but their quest for quick profits often leads to irrational actions. Moreover, the market is barely covered by analysts. Thus, the market offers high alpha opportunities for long-term professional investors.

Fig. 7: China offers growth at fair prices

P/E valuation of equity regions (MSCI indices) versus earnings growth outlook based on consensus estimates



As of: 11.04.2022
Source: Factset, own calculations

Fig. 8: Mainland assets only slightly correlated with the west

Performance correlation of various assets on a weekly basis over the last 10 years (local currency)

10Y-Correlation	CNY-Bonds	EUR-Bonds	USD-Bonds	MSCI China A	MSCI China	MSCI USA	MSCI Europa	MSCI AC World
CNY-Bonds	1.00	0.09	-0.23	0.29	0.14	-0.01	0.06	0.04
EUR-Bonds	0.09	1.00	0.08	0.15	0.12	0.18	0.17	0.22
USD-Bonds	-0.23	0.08	1.00	0.04	0.23	0.32	0.07	0.28
MSCI China A	0.29	0.15	0.04	1.00	0.75	0.38	0.36	0.45
MSCI China	0.14	0.12	0.23	0.75	1.00	0.53	0.52	0.64
MSCI USA	-0.01	0.18	0.32	0.38	0.53	1.00	0.75	0.96
MSCI Europa	0.06	0.17	0.07	0.36	0.52	0.75	1.00	0.87
MSCI AC World	0.04	0.22	0.28	0.45	0.64	0.96	0.87	1.00

Time period: 31.03.2012-31.03.2022
Source: Bloomberg, own calculations

Will to change: sustainability plays an increasing role

Sustainability increasingly plays a role

The issue of sustainability is not bypassing China. After years of high air pollution, China has virtually turned the corner on sustainability. The manufacturing sector is being decarbonised. Environmentally friendly reforms, subsidies for green technologies and even closures of companies responsible for high air pollution are already part of everyday life. After all, China wants to achieve CO_2 neutrality by 2060. This development can also be observed in corporate reporting, where the topic of ESG is increasingly frequent. "Green bonds" are also increasingly in demand. But it is not only on the climate side that China has big goals. On the social side, the country is also striving for more social justice through its latest five-year plan – at least in terms of income.

Risk: volatility is part of China

Government works to tackle corporate debt and growth on credit

A perfect storm of regulatory, geopolitical and fundamental economic factors has recently been weighing on China, but this is likely to subside. China has its problem areas, as the real estate crisis shows. For several years, the government has been working to bring corporate debt and growth in credit under control, and thus avoid excesses. Like other disruptive reforms, the measures taken continue to lead to increased volatility, of which investors should be aware. However, the importance of reforming unstable economic structures in a timely manner was demonstrated during the financial market crisis of 2008.

Geopolitics harbours risks

Geopolitical tensions are likely to continue in the future. China's claim to global leadership puts it on a direct collision course with the US, as reflected in the recent trade dispute. But the Taiwan conflict also harbours risks and could trigger international sanctions. However, China's rather restrained stance in the Ukraine-Russia war so far makes us confident that China is not interested in a geopolitical escalation with sanctions consequences – at least for the foreseeable future.

COVID-19 temporary load factor

Another, but more temporary, problem area is the zero-COVID strategy still being pursued, which leads to economically damaging lockdowns. These dampen economic growth and thus investor sentiment. However, an end to this strategy could become a positive market catalyst. The weaker developed health system, for example the comparably low number of intensive care beds per 100,000 inhabitants, will probably not allow an opening policy comparable to that of western countries for the time being.

Conclusion: only with China is a portfolio truly global

We prefer mainland equities and bonds

Chinese investments offer a number of opportunities overall: attractive growth investments, diversification, alpha potential and low positioning of global investors. Moreover, China is the second largest economy in the world after the US. A global portfolio should reflect this. But not all China is equal. We prefer mainland equities and bonds because most of the benefits filter through there, and they are often less vulnerable to government reforms. However, the risks of investing in China cannot be dismissed, which is why one should keep one's nerve even in more difficult times. Because these times offer opportunities, as we can also observe at present.

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IMPORTANT NOTICES

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