INVESTMENT

Chinese equities: Reasons to be cheerful

In these extraordinary times, with an unprecedented pandemic holding the world to ransom, we believe the investment potential in Chinese equities remains nevertheless… extraordinary

That might sound debatable not too long after reading headlines about China's Q1 2020 GDP growth slowing down sharply due to the outbreak. But in our view, the long-term growth prospects of the country's vast, diverse equity markets make a very attractive proposition for active investors seeking to enhance the risk-return profile of their global portfolios.

For Chinese equities, we see seven strategic reasons to be cheerful.

1. Untapped opportunity in China's long-term (quality) growth path

Once the pandemic has passed, we see powerful domestic tailwinds such as urbanisation and a growing middle class continuing to drive China's GDP growth and productivity. Underpinning this, the government has firmly refocused its economic growth strategy away from sheer volume and speed and towards stable, high quality, higher value development.

In addition, despite China's economy accounting for 19% of global GDP, 12.4% of global trade and 11% of global consumption, Chinese equities remain significantly under-represented in global indices, and foreign ownership of A-shares – so far – remains small.

2. Chinese equities: A vast, accessible market

The total market capitalisation of Greater China onshore (Shanghai and Shenzhen stock exchanges) and offshore equity markets (Hong Kong stock exchange) is some USD 12 trillion. China A-shares account for about USD 8.5 trillion of listed market capitalisation, across some 3,800 stocks, making the onshore market one of the world's largest after the New York Stock Exchange and Nasdaq.

Unlike China offshore equity market, China A-share market still presents a relatively high number of momentum-driven retail investors. Yet in recent years, the retail/institutional balance is changing. The increasing participation of foreign capital will create a more balanced investor structure in the market. A higher institutional presence will help to improve corporate governance at China A-shares companies, which should benefit shareholders over the long term.

3. A-shares and H-shares: Complementary markets bringing diverse opportunities

China's onshore and offshore equity markets are complementary, with China A-shares providing more diversified access to structural growth opportunities. There is a significant difference in sector weights between the different types of shares.

While Hong Kong-listed companies have tended to be dominated by large, state-owned financial and energy firms, China A-shares provide more exposure to privately-owned companies in consumption-driven industries. Unlike H-shares, A-shares offer unique access to growth opportunities such as Chinese pharmaceutical companies providing diabetes treatments for the ageing population.

So, by investing in both China's A- and H-shares, investors can benefit from risk management via sector diversification and a broader opportunity set for alpha generation.

4. Under-explored market offers mispricing opportunities

Importantly, there is a lack of coverage of Chinese stocks by sell-side analysts. The quality of domestic broker coverage in A-shares also tends to be weak. Only 7% of onshore stocks are audited by the 'Big 4' global auditing firms.

A focus on environmental, social and governance (ESG) criteria is critical when investing. This is especially true in China, and for A-shares, where ESG analyses are still complicated by low levels of data availability. Despite some risk factors related to investing in Chinese companies (e.g. corporate governance and stock suspensions), Chinese policymakers are now making efforts to address these concerns, as they seek to attract more foreign investor participation.

Active managers, equipped with the resources to undertake their own on-the-ground research in China and who have a long-term investment horizon to benefit from the low market efficiency, should be well-placed to take advantage of the investment opportunity in both China offshore and China onshore.

5. A-shares: Different can mean good

After being long-closed to global investors, China A-shares have some features that set them apart from typical China exposure in a global portfolio. Typically, more than 90% of China A-share companies' revenue is domestically driven, and thus less sensitive to global macroeconomic trends – and global shocks. A-shares also have a low correlation to other global equities and this, plus ample liquidity, means they can provide an effective means for foreign investors to diversify their portfolios.

While exposure to Chinese equities can appear challenging from a risk-return perspective, the diversification in the portfolio mitigates this to some extent, such that risk-adjusted returns may actually improve. As a result, adding China A-shares can potentially enhance the risk-return profile for an emerging market (EM) portfolio as well as a China offshore equity portfolio.

6. Further inclusion in indices

The decision of the key global index providers (MSCI, FTSE, S&P) to include more China onshore companies in their indices was a significant milestone in the mainstream acceptance of Chinese equities in international investors' portfolios.

In our view, this inclusion helps support the renminbi and improve the China A-shares market's investor structure from being retail-focused to a more balanced mix of institutional and retail investors. We believe that the inclusion will likely improve China's capital market liberalisation and regulations.

7. Attractively valued

China A- and H-shares markets are reasonably priced relative both to those of developed equity markets and to their historical average. The MSCI China (offshore) and CSI 300 (onshore) indices are attractively valued at around 12.2x P/E and 11.0x for the 12-month forward P/E, respectively (as of 1 April 2020) which represents a discount compared with MSCI US, MSCI Europe and MSCI World indices.

Three structural trends for long-term sustainable opportunities

Technology innovation: China has shifted from cheap labour-based manufacturing towards medium to high-end manufacturing. This is further supported by the size of the domestic market, higher R&D spending and a vast talent pool. Examples include not only information technology (hardware, software), but also sectors related to capital goods, industrial automation, new industrials (e.g. electric vehicles, high-speed train).

Consumption upgrading: We see significant long-term growth opportunities for leading companies, not only in goods but also in services. A number of these domestic winners are already emerging as multinational corporates, supported by rising household incomes, low household debt and more diversified consumer profiles. The current COVID-19 crisis notwithstanding, we believe this will likely only accelerate in the next five to 10 years. Examples include premium consumer brands, healthcare, education, insurance and travel.

Industry consolidation in China in recent years is being driven by regulatory tightening on new capacities, environmental cost pressures, higher financing costs and structural and consumption upgrading. We believe this trend has longer to run in a slowing macroeconomic environment, and the emergence of leading companies in various sub-sectors should provide attractive investment opportunities. Faster acceleration in industry consolidation should play favourably for industry leaders over the long term. Examples include: cement, property, machinery, mining and chemicals.

Globally-backed local expertise

BNPP AM believes there is a significant investment opportunity in Chinese markets, driven by the growing acceptance of Chinese equities in institutional investors' portfolios, and the changing nature of China's economy, prompting the emergence of globally recognised Chinese companies. We also believe it requires local expertise to navigate the Chinese markets successfully. Our Greater China Equities team, based 'on-the-ground' in Shanghai and Hong Kong, manages or advises on assets totalling more than USD 1.3 billion (as of 30 April 2020) for local and international investors. In addition, three of the 25-strong BNPP AM Sustainability Centre are based in Hong Kong to support ESG integration and engagement. ■